Program at a Glance

THURSDAY 4th AUGUST

6.00pm - 8.00pm	**Welcome Reception –** Poolside Lawns, Sheraton Mirage Resort	

FRIDAY 5th AUGUST

8.00am	**Registration desk / Secretariat opens**	
8.45am	Ballroom 1 & 2	Conference Opening John Evans, Partner, Henry Davis York, Brisbane & President of the BFSLA
9.00am - 10.30am	Ballroom 1 & 2	**Opening Plenary** The importance of equity in financial risk allocation
	Chair:	Ian Davidson SC, Selborne Chambers, Sydney
	Speakers:	**Hon. Justice Patrick A Keane**, Chief Justice, Federal Court of Australia, Brisbane *'Equitable doctrines and financiers' liabilities'* **Dr. Sheelagh McCracken**, Professor of Finance Law, The University of Sydney, Sydney *"Equity's role in allocating risk: satisfying or defying commercial expectations?"*
10.30am	Morning break	
11.00am - 12.30am	Ballroom 1	**Who couldn't see the wood for the trees?** (Panel session)
	Chair:	Cameron Belyea, Partner, Clayton Utz, Perth
	Panelists:	Tim Williams, Head of Strategic Business Services, National Australia Bank Limited, Melbourne Julian Dayman, Director - Agriculture, Azure Capital Pty Ltd, Perth James Thackray, Partner, McGrathNicol, Perth
11.00am - 12.30am	Ballroom 2	**The Bartle Effect – the not so sophisticated borrower dealing with the sophisticated lender?**
	Chair:	John Powell, Partner, Partner, Russell McVeagh, Auckland
	Speakers:	**Tim Pritchard**, Associate General Counsel, National Bank New Zealand, Auckland **Michael Robinson**, Partner, Simpson Grierson, Auckland
12.30pm	Lunch break	
1.30pm - 3.00pm	Ballroom 1 & 2	**Regulators:** accountable to stakeholders or a law unto themselves?
	Chair:	Paul Rogerson, Head of Legal, NRMA, Sydney
	Speakers:	Sean Hughes, Chief Executive, Financial Markets Authority, Wellington **A/Prof. Joanna Bird**, Sydney Law School, The University of Sydney, Sydney **Richard Gilbert**, Chief Executive, Rule of Law Institute of Australia, Sydney
3.00pm	Afternoon break	
3.30pm - 5.00pm	Ballroom 1	**Frank'n Dodd let loose.** Its effects on market participants in Australia
	Chair:	James Connell, Legal Counsel, Australian Executor Trustees Ltd. Sydney
	Speakers:	Kevin Nixon, Executive Director, Head of Regulatory Reform, Westpac Banking Corporation, Sydney **Mark Grolman**, General Counsel, Deutsche Bank AG, Sydney
3.30pm 5.00pm	Ballroom 2	**The NZ Statutory Management Regime: What is it and what does it mean for my client?**
	Chair:	Michael Robinson, Partner, Simpson Grierson, Auckland
	Speakers:	**Andrew Butler**, Partner, Russell McVeagh, Wellington Dermot Ross, Partner, Chapman Tripp, Auckland Chris Darlow, Consultant, Grove Darlow & Partners, Auckland
5.15pm	Lagoon Room 1	AGM of the Banking & Financial Services Law Association
7.00pm	Ballroom Gallery	Pre-Dinner drinks
7.30pm	Ballroom 1 & 2	Conference dinner

SATURDAY 6th AUGUST

8.00am	Lagoon Room 1	**Opinions Committee Breakfast**
9.00am - 10.30am	Ballroom 1 & 2	**Australian / New Zealand case law update**
	Chair:	Dermot Ross, Partner, Chapman Tripp, Auckland
	Speakers:	**Hon. Justice Mark O'Regan**, Court of Appeal, Wellington **Hon. Justice Robert McDougall**, Supreme Court of New South Wales, Sydney
10.00am	Morning break	
11.00am - 12.30pm	Ballroom 1	**Forum shopping and choice of law issues – my law is better than your law**
	Chair:	John Sheahan SC, 5 Wentworth Chambers, Sydney
	Speakers:	**Andrew Bell SC**, Eleven Wentworth Chambers, Sydney **Emeritus Prof. Mary Hiscock**, Faculty of Law, Bond University, Gold Coast **Brendan Cash**, Senior Associate, Bell Gully, Wellington
11.00am - 12.30pm	Ballroom 2	**The PPSA: shaken but not stirred?**
	Chair:	David Turner, Barrister, Victorian Bar, Melbourne
	Speakers:	**Prof. Rod Wood**, Faculty of Law, University of Alberta, Canada **Alan Maclean**, Partner, HWL Ebsworth, Melbourne **Helena Busljeta**, Special Counsel, Mallesons Stephen Jaques, Sydney
12.30pm	Lunch break	

TRANSNATIONAL COMMERCE, CERTAINTY AND THE CONFLICT OF LAWS

Paper delivered to the Banking and Financial Services Law Association by
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Introduction

1. Australia's economic future will be closely tied to Australian companies' ability to do business globally. Australian companies and, therefore, Australian commercial lawyers are increasingly involved in transnational commercial transactions.

2. As with any commercial transaction, a transnational transaction carries with it risk for the parties involved. That risk may or may not be insured against, and careful drafting of the commercial terms will be designed to minimise risk or at least uncertainty in the event of disputes arising. At one level, there will be greater scope for disputes to arise in a *transnational* contractual setting because often at least one party will be doing business in a country with which it may not be familiar including in terms of its legal and regulatory frameworks as well as in terms of its business culture and ethos.

3. Two of the particular and most fundamental risks which may arise in the context of a transnational commercial transaction are the risks of exposure to:
   i. an unfamiliar body of law; and or
   ii. an unfamiliar legal system or, alternatively, a legal system in which an Australian company may lack confidence because of real or perceived corruption, bias, inexperience, incompetence or dilatoriness.

4. In this paper, I focus upon the ways in which these two particular risks can be minimised through the careful drafting of choice of law and dispute resolution clauses (by which I include both jurisdiction or choice of court clauses, and arbitration clauses). The inclusion of such clauses in a transnational commercial contract or transnational financing documents is designed to inject certainty on the twin questions as to where, and by reference to what law, any disputes will be resolved. The degree of certainty injected, however, will be a function of the care taken in the drafting of such clauses.

5. In what follows, I highlight, by reference to a number of recent Australian decisions, some of the issues can arise where such clauses are not well drafted, and also some of the issues which, in my opinion, can be regarded as unsettled. I begin with choice of law clauses.

Choice of law clauses

6. Assume that a contract contains a choice of law clause in the following terms:

> *"This contract shall be interpreted [and/or construed] in accordance with German law."*

Such a clause, on its face, is confined to the *interpretation* and *construction* of the contract. It is far from self-evident that a clause drafted in this way will be effective to require that the contract in question be *governed by* German law. For example, the question of whether or not a party is entitled to terminate the contract is not typically regarded as a question of interpretation or construction. A party to a contract containing such a clause could be met with an argument to the effect that, whilst German law may govern the interpretation of the contract, another body or system of law has a claim to govern substantive contractual questions arising in a contractual dispute. Ultimately, this will turn on a question of the proper interpretation of the choice of law clause, but if the competing governing law may yield a different substantive answer to that which German law would provide, a "wildcard" is introduced into the dispute resolution process which may be wielded to provide leverage where the other contracting party may have thought that the matter was clear.

7. It should be noted, parenthetically, that where there are multiple language versions of a particular contract, a word such as "*interpreted*" or "*construed*" may, upon translation, have or be given a different meaning, e.g. "*governed by*". Where multiple language versions of the contract are in existence, it is important for there to be a clause identifying which language version of the contract is authoritative or to prevail in the case of the inconsistency.

8. A superior form of drafting of the first example would be to provide that:

> *"This contract shall be governed by German law."*

This form of drafting eliminates the potential argument arising in relation to the first example, namely that the reference to German law and its applicability was intended to be limited to questions of interpretation and construction, and that some other body of law had a role to play in the resolution of the parties' dispute.

9. On the other hand, a clause which simply provides that "*This contract shall be governed by German law*" leaves an uncertain question as to whether or not the reference to German law is a reference to *German domestic law* or to German law including its own principles of private international law. Depending on the content of those principles, if the choice of German law was interpreted to include a reference to the entire body of German law including its principles of private international law, the operation of German law may require reference to another system of law to be applied to resolve the dispute, e.g. if the contract was being performed in a third country, the law of that country may be referred. This is the problem of *renvoi* which has long been the bane of academics and law students and has

tended to be treated as theoretical conundrum unlikely to be encountered in practice.

10. The issue has, however, been the subject of a relatively recent decision of the High Court in *Neilson v Overseas Development Corporation* (2005) 223 CLR 331 where it was held that, in a case being litigated in the Supreme Court of Western Australia, although the law governing what was in that case a tort, was the law of the place of the tort, namely China, Chinese law referred the matter, in a case (as *Neilson* was) involving nationals from the one (foreign) country, to the law of *that country* to resolve any disputes. On the facts of *Neilson*, this was not simply academic point-taking but was crucially important to the outcome of the case. Mrs Neilson was living in China with her husband who had been posted there by his Australian employer, the Defendant. The Defendant had provided the Neilsons with a form of housing for the period of Mr Neilson's employment in China. Mrs Neilson suffered serious injuries when a balustrade in the house in which they were living gave way. The tort undoubtedly occurred in China but, if Chinese domestic law were to apply, Mrs Neilson's claim was out of time under the Chinese limitation law. If, however, Australian law was to apply by reason of the fact that Chinese law "referred" the matter on to Australian law, the matter was not out of time because of the difference in the limitation periods under Chinese law and Australian law.

11. Returning to the question of drafting, the potential scope for *renvoi* can be eliminated by drafting a clause along the following lines:

> *"This contract shall be governed by German law excluding the principles of German private international law".*

I describe such clauses as an "anti-renvoi" clause. It is obvious that such a clause minimises the risk for debate as to the applicable law and adds certainty to dispute resolution. You may consider that this represents an excessive caution but, where the stakes are sufficiently high, any competent transnational litigator should be alive to this argument and will explore the question to ascertain whether or not (i) the nominated law may or would, in the circumstances, refer the matter to another legal system, and (ii) if it did, whether such a reference would provide his or her client with some strategic benefit because of, for example, a difference in the substantive law of the legal system to which the dispute were referred.

12. But even a clause of the kind I have referred to in the previous paragraph does not, at least on its face, cover a situation whereby disputes arise between parties to a contract governed by, say, German law but where those disputes are not or may not be characterized as contractual in nature even though they may arise in the context of and/or in relation to the contract. The most obvious example is a claim in tort. Conceivably, one party may have a claim in contract to be governed by German law and a claim in tort which may fall to be governed by some other country's law, depending on the choice of law rules of the forum in which the dispute is litigated, regardless of the fact that there may be a very close overlap indeed between any contract claim and any tort claim. For example, assume a joint venture between an Australian and a German company to perform work in Indonesia with a German governing law clause. If the relevant tort occurred in Indonesia, Australian law would dictate that Indonesian law governed this claim, but the identical facts may give rise to a contractual claim which would fall to be determined by German law.

13. There is obvious merit from the perspective of certainty and indeed consistency in a single system of law being applied to govern all aspects of commercial disputes, in whatever form the various causes of action are dressed or may be characterized. The question is: can this be achieved by contractual drafting?

14. An example of a clause seeking to achieve this outcome was contained in the contract between Oil & Natural Gas Corporation of India ("**ONGC**") and Clough Engineering Ltd which was the subject of litigation ultimately concluded in the Full Court of the Federal Court: *Clough Engineering Limited v Oil and Natural Gas Corporation Limited* (2008) 249 ALR 458.

15. The relevant clause provided:

> *All questions, disputes or differences* *arising under, out of or in connection with* *this Contract shall be settled in accordance with laws of India (both procedural and substantive) from time to time in force and to the exclusive jurisdiction of the Courts in India, subject to the provisions of clause 1.3.2.* (emphasis added)

The draftsman could have added after the word Contract, to be abundantly cautious, words such as (whether contractual, tortious, restitutionary or statutory).

16. But even a clause such as this may not be fully effective to identify an exclusive body of law to govern the outcome of a dispute, as the facts of the litigation between Clough and ONGC serves to demonstrate. Australian Banks had furnished to ONGC performance bonds on the application of, and to guarantee the performance of Clough in the performance of large scale off shore construction work in India. The circumstances in which ONGC was entitled to call on the bonds were governed by the construction contract containing the choice of law clause as set out above. ONGC sought to call on the bonds but, prior to this call being honoured, Clough got wind of the call and moved *ex parte* in the Federal Court seeking to restrain the call on the bonds on the basis that to do so was unconscionable in contravention of s.51AA of the *Trade Practices Act*: see *Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd* (2007) 29 ATPR 42-166.

17. The case involved many issues and was ultimately resolved, in the context of a successful challenge to the jurisdiction by reference to the absence of a prima facie case, based upon the proper construction of the construction contract and an analysis of whether or not the contract required there to be an actual breach of contract as opposed to bona fide claimed breach in order to call on the bond. One argument which the Court did not need to resolve, however, was whether or not the Trade Practices Act in fact applied, given the widely drawn choice of law clause and whether or the choice of law

clause as set out above in fact meant that, by virtue of their agreement, the parties could not invoke a law other than a law of India to resolve any dispute between them.

18. Another case involving a clash between a contractually chosen governing law (and jurisdiction) clause, on the one hand, and an arguably mandatory law of the forum (mandatory in the sense of being a law which, on its proper construction, is intended to apply irrespective of the operation of common law choice of law principles) was the recently settled litigation between Qantas Airways Ltd and Rolls-Royce plc in relation to the A380 engine incident over Indonesia. Qantas commenced its proceedings in the Federal Court of Australia, raising claims for misleading and deceptive conduct under the Trade Practices Act and secured an ex parte anti-anti-suit injunction restraining Rolls-Royce from commencing proceedings in England seeking to enforce its express English choice of law and exclusive jurisdiction clauses on the footing that to do so would be to oust or run the risk of ousting or excluding a hearing of the Trade Practices Act claim on its merits (for the reason that the English choice of law rules would not "pick up" the Trade Practices Act cf. *Reinsurance Australia Corp Ltd v HIH Casualty and General Insurance Ltd (in liq)* (2003) 254 ALR 29.)

19. There are obviously competing policy considerations in play. On the one hand, practitioners will be familiar with statements in the cases to the effect that parties cannot "contract out of" the Trade Practices Act (albeit that these statements are usually found in the context of exclusion clauses although note *Green v Australian Industrial Investment Ltd* (1989) 25 FCR 532 and *Pty Limited v Kiukiang Maritime Carriers* (1998) 90 FCR 1). That legislation, and cognate provisions in the *ASIC Act* and Fair Trading Acts, is undoubtedly underpinned by normative policy considerations in relation to commercial dealing.

20. On the other hand, at least in the context of a transnational contract which is to be performed outside of Australia (as was the case in *Clough* but not

Qantas), the question may be posed as to why it would be contrary to policy to permit sophisticated commercial parties to agree on one governing law, even if not Australian and even though the effect of that choice may be that the operation of the Trade Practices Act is excluded. After all, as Kirby J. observed in *Pan Foods Company Importers and Distributors Pty Ltd v Australia and New Zealand Banking Group Limited* (2000) 170 ALR 579; (2000) 74 ALJR 791 at [24]:

> Business is entitled to look to the law to keep people to their commercial promises. In a world of global finances and transborder capital markets, those jurisdictions flourish which do so. Those jurisdictions which do not soon become known. They pay a price in terms of the availability and costs of capital necessary as a consequence of the uncertainties of the enforcement of agreements in their courts.

21. In a related context, in *Comandate Marine v Pan Australia Shipping Pty Limited* (2006) 157 FCR 45, Finn J. observed:

> I would merely add that, whatever advantage or disadvantage accrued to Pan from having both the relevant legal effects of its pre-contractual conduct and its Trade Practices Act claims determined in London according to English law (including relevant principles of conflict of laws), this is what has been agreed to by the parties as international commercial contractors. There is no legal principle of, nor is there any policy immanent in, Australian law that denies them what they have agreed.

22. As a matter of principle, there would seem to be a great deal to be said for permitting parties to make provision for the law which will govern any non-contractual as well as contractual claims arising *inter se*. Such an approach has two principal virtues. It ensures consistency in the sense that it eliminates the prospect of a claim in tort being governed by the law of country "X" whilst the claim in contract is governed by the law of country "Y", being the parties' agreed governing law, the example given in paragraph 12 above. The second virtue is that it could eliminate the notoriously difficult question which arises from time to time in transnational cases, namely identifying the place or "locus" of the tort. This is particularly important since *John Pfeiffer Pty Ltd v Rogerson* (2000) 2003 CLR 503 and *Renault v Zhang* (2002) 2010 CLR 491 which cases established, on a domestic and international level respectively, that the

Australian choice of law rule for torts is the *lex loci delecti* or law of the place of the tort.

23. Parenthetically, it may be noted that the simplicity of that formula masks the very real difficulty that can sometimes arise where it becomes necessary to identify the place where the tort occurred. That difficulty is at its most acute in cases which can be characterised as ones involving a negligent omission. Where does the negligent omission occur in a transnational context? Equally complex may be tortious claims involving conspiracy (where conspirators may be located in more than one jurisdiction) or claims involving the use communications via the internet. The issue of "locating" the tort was of importance in the High Court's decision in *Voth v Manildra Flour Mills Pty Limited* (1991) 171 CLR 538.

24. It is somewhat surprising that the prospect of a tort claim being the subject of a "choice of law agreement" does not appear to have attracted much if any attention in the academic writing. The principal exception to this is the outstanding monograph by Professor Briggs in the OUP Private International Law series entitled *Agreements on Jurisdiction and Choice of Law*.

25. If liability in tort can be excluded by virtue of a sufficiently clearly expressed contractual exclusion clause, it is difficult to understand why, as a matter of principle, parties should not be able to identify, *ex ante*, the law that is to govern any tortious (or statutory or otherwise non-contractual) claims arising as between the parties in a choice of law clause. And although the argument is probably more delicately balanced in the context of statutory causes of action, there is much to be said for an approach which encourages parties to choose in advance the legal system (and ideally one legal system) which is to govern their claims. (Of course, in *true* cases of consumer contracts, the Courts may be more reluctant to permit this, and the problem in Australia is that the *Australian Competition and Consumer Act* (formerly the *Trade Practices Act*) and cognate provisions in the ASIC and

Fair Trading Acts are, of course, not for the most part, so confined, and statutory unconscionability has been left somewhat and regrettably in limbo by reason of the High Court's decision in *ACCC v CG Berbatis Holdings Pty Ltd* (2003) 214 CLR 51.)

26. One final point to be made in the context of express choice of law clauses is that one must be careful in selecting any particular forum's law as the governing law as the Commonwealth Bank probably discovered in the context of its margin lending arrangements with former clients of Storm Financial. Even though the vast majority of individuals affected and who entered into borrowing facilities with the Commonwealth Bank were residents of Queensland, the standard form loan documentation contained an express choice of law clause nominating New South Wales law as the governing law. This had the fortunate consequence for the Queensland-based clients that the provisions of the New South Wales *Contracts Review Act 1980* (and the liberal jurisprudence relating to lending contracts that has developed around the interpretation of that Act) was arguably engaged, thus greatly improving their leverage in commercial negotiations. No similar legislative regime exists under the law of Queensland.

Jurisdiction clauses

27. Turning to the drafting of choice of court or jurisdiction agreements, it is extraordinary how often sloppy or shorthand drafting has led to expensive and extensive litigation in relation to the construction of such clauses. Sometimes such disputes are described by judges as "arid" and it is no doubt correct to say that semantic submissions in relation to the difference between, for example, the expression "arising under" and the expression "arising out of" are aptly so described. On the other hand, such disputes do not occur without good reason. There will invariably be perceived, a major tactical, strategic or substantive advantage in winning such a dispute. In that sense, such disputes are far from "arid".

28. On the question of the scope of jurisdiction (or arbitration) agreements, that is to say, questions as to the width or ambit of such clauses, recent decisions of the Full Court of the Federal Court of Australia (*Comandate Marine Corp. v Pan Australia Shipping* (2006) 157 FCR 45), the House of Lords (*Premium Nafta Products Limited v. Fili Shipping Company Limited* [2008] 1 Lloyd's Rep 254 (in which the Full Court's decision was cited) and the NSW Court of Appeal (*Global Partners Fund Ltd v Babcock & Brown Ltd (in liq)* (2010) 79 ACSR 383) have done much to eliminate the scope for such disputes.

29. In the Australian context, an earlier Full Court decision, that of *Hi-Fert Pty Limited v Kiukiang Maritime Carriers* (1998) 90 FCR 1 had appeared to endorse a somewhat semantic approach to the construction of such clauses. Thus, in that case, an arbitration clause provided that:

> *Any dispute arising from this charter or any Bill of Lading issued hereunder shall be settled in accordance with the provisions of the Arbitration Act, 1950, and any subsequent Acts, in London, each party appointing an Arbitrator, and the two Arbitrators in the event of disagreement appointing an Umpire whose decision shall be final and binding upon both parties hereto.*
>
> *This Charter Party shall be governed by and construed in accordance with English Law.*

This clause was construed by the Full Court as excluding a claim brought under the *Trade Practices Act*. That decision went very much against the thrust of an earlier decision by the New South Wales Court of Appeal in *Francis Travel Marketing Pty Limited v Virgin Atlantic Airways* (1996) 39 NSWLR 60 in which Gleeson CJ had endorsed what in England had been described as a presumption of "one stop" adjudication, namely an approach to the interpretation of the scope of jurisdiction and arbitration clauses which attributed to commercial parties an intention that there be only one forum, or jurisdiction or mode of dispute resolution for all of the parties' disputes, whether tortious, contractual or statutory.

30. The decision in *Hi-Fert* was expressly disapproved in *Comandate Marine Corp. v Pan Australia Shipping* (2006) 157 FCR 45. In that case, *Pan* had commenced proceedings in Australia seeking to rely on the *Trade Practices Act* in order to extricate itself from a charterparty. The charterparty provided for arbitration in London, with English law to apply. *Pan* perceived that, one way or another, English maritime arbitrators were unlikely to apply the *Trade Practices Act* or, even if purporting to do so, would be unlikely to do so in a manner which correctly and fully gave effect to that Act's remedial operation.

31. Plainly enough, the earlier decision in *Hi-Fert* gave some encouragement to Pan in this forensic endeavour. At first instance, *Pan* succeeded in resisting a stay of the *Trade Practices Act* claim. On appeal, however, the Full Court said that the *Trade Practices Act* claim plainly fell within the scope of the arbitration clause which was to be broadly construed. The leading judgment was delivered by Allsop J. (as he then was). Important passages from his Honour's reasons included the following:

> This liberal approach is underpinned by the sensible commercial presumption that the parties did not intend the inconvenience of having possible disputes from their transaction being heard in two places. This may be seen to be especially so in circumstances where disputes can be given different labels, or placed into different juridical categories, possibly by reference to the approaches of different legal systems. The benevolent and encouraging approach to consensual alternative non-curial dispute resolution assists in the conclusion that words capable of broad and flexible meaning will be given liberal construction and content. This approach conforms with a common-sense approach to commercial agreements, in particular when the parties are operating in a truly international market and come from different countries and legal systems and it provides appropriate respect for party autonomy.

His Honour went on (at [175]) to observe, after an extensive reference to authority, that

> If, subject of course to the context and circumstances of any particular contract, the meaning of the phrase "arising out of a contract" can be equated with "arising in connection with" (as Hirst J and Gleeson CJ say) it seems to me clear that the words "arise out of the contract" are apt, or at least sufficiently flexible, to encompass a sufficiently close connection with the making, the terms, and the performance of the contract as permit the words "arise out of" aptly or appropriately to describe the connection

> with the contract. These words encompass more than merely arising as a contractually classified complaint from one party's rights or another party's obligations under, or in, a bilateral juridical relationship. The width of the phrase "arising out of" in this context and its synonymity with the expression "in connection with" reflect the practical, rather than theoretical, meaning to be given to the word "contract" out of which the disputes may arise. The notion of a contract can involve practical commercial considerations of formation, extent and scope, and performance of the juridical bonds between the parties, out of which disputes may arise.

32. As noted above, the Full Court's decision was cited with approval by the House of Lords in *Fiona Trust Holdings sub nom: Premium Nafta Products Limited v. Fili Shipping Company Limited* [2008] 1 Lloyd's Rep 254. In that case, Lord Hoffmann observed:

> Arbitration is consensual. It depends upon the intention of the parties as expressed in their agreement. Only the agreement can tell you what kind of disputes they intended to submit to arbitration. But the meaning which parties intended to express by the words which they used will be affected by the commercial background and the reader's understanding of the purpose for which the agreement was made. Businessmen in particular are assumed to have entered into agreements to achieve some rational commercial purpose and an understanding of this purpose will influence the way in which one interprets their language.
>
> In approaching the question of construction, it is therefore necessary to inquire into the purpose of the arbitration clause. As to this, I think there can be no doubt. The parties have entered into a relationship, an agreement or what is alleged to be an agreement or what appears on its face to be an agreement, which may give rise to disputes. They want those disputes decided by a tribunal which they have chosen, commonly on the grounds of such matters as its neutrality, expertise and privacy, the availability of legal services at the seat of the arbitration and the unobtrusive efficiency of its supervisory law. Particularly in the case of international contracts, they want a quick and efficient adjudication and do not want to take the risks of delay and, in too many cases, partiality, in proceedings before a national jurisdiction.
>
> If one accepts that this is the purpose of an arbitration clause, its construction must be influenced by whether the parties, as rational businessmen, were likely to have intended that only some of the questions arising out of their relationship were to be submitted to arbitration and others were to be decided by national courts. Could they have intended that the question of whether the contract was repudiated should be decided by arbitration but the question of whether it was induced by misrepresentation should be decided by a court? If, as appears to be generally accepted, there is no rational basis upon which businessmen would be likely to wish to have questions of the validity or enforceability of the contract decided by one tribunal and questions about its

> performance decided by another, one would need to find very clear language before deciding that they must have had such an intention.
>
> A proper approach to construction therefore requires the court to give effect, so far as the language used by the parties will permit, to the commercial purpose of the arbitration clause. But the same policy of giving effect to the commercial purpose also drives the approach of the courts (and the legislature) to the second question raised in this appeal, namely, whether there is any conceptual reason why parties who have agreed to submit the question of the validity of the contract to arbitration should not be allowed to do so.

33. Whereas the decisions in *Comandate Marine* and *Fiona Trust* have signalled a clear approach towards the construction of the *scope* of jurisdiction agreements, no similar, broadbrush approach has been articulated in cases where the issue concerns *not the scope* of such clauses *but their nature*, i.e. whether the jurisdiction clause is exclusive or non-exclusive. This is a potentially vital distinction. Where a jurisdiction agreement is exclusive, a stay of proceedings commenced in the face of such a clause is far more likely to be granted as the strong presumption is that parties should be held to their bargain. Similarly, proceedings commenced in a foreign jurisdiction in breach of an exclusive jurisdiction clause may be restrained by the grant of an anti-suit injunction: see, for example, *CSR Limited v Cigna Insurance Australia Limited* (1997) 189 CLR 345; *The Angelic Grace* [1995] 1 Lloyds Rep. 87.

34. The context of this aspect of the discussion may be set by identifying some typical and potentially ambiguous forms of jurisdiction clause:

- Jurisdiction: England.
- This contract is subject to the jurisdiction of Australian courts.
- The parties submit to the jurisdiction of the courts of New Zealand.

Each of these clauses could be construed as exclusive or non-exclusive jurisdiction clauses. They might be contrasted with the following examples:

- (From *Safe Effect Technologies Limited (ACN 099 107 623) v Hood Group Holdings Ltd (ACN 097 778 375)* [2006] FCA 758):

  (a) This agreement is governed by the laws of New South Wales.

> *(b) Each of the parties irrevocably submits to the exclusive jurisdiction of the Courts of New South Wales.*

- (From *Slater & Gordon v Porteous* [2005] VSC 398):

  > *This deed will be governed by and construed in accordance with the laws in force in the State of Victoria and each party submits to the exclusive jurisdiction of the courts of that State.*

- (From *Wholesome Bake Pty Ltd v Sweetoz Pty Ltd* [2001] NSWSC 248):

  > *"This Agreement is governed by the laws of the State of Victoria, the Courts at which State shall have exclusive jurisdiction."*

35. A useful summary of the principles applicable to the construction of such clauses was provided by Giles J. (as he then was) in *FAI Insurance Limited v Ocean Mutual Marine Insurance* (1997) 41 NSWLR 117:

> (a) Whether a jurisdiction clause is an exclusive jurisdiction clause is a question of construction of the particular contract, with such regard to the circumstances surrounding the entry into the contract as is permissible.
>
> (b) The word “exclusive” is not determinative, and a clause may be held to be an exclusive jurisdiction clause notwithstanding the absence of that or a similar word or phrase: as was said in *Continental Bank NA v Aeakos Compania Naviera SA* (at 594), it would be a surrender to formalism to require a jurisdiction clause to provide in express terms that the chosen court is to be the exclusive forum.
>
> (c) Although mutuality, in the sense that both parties agree to the relevant jurisdiction, has been thought to point to exclusive jurisdiction, I have some difficulty seeing why that should be so. Lack of mutuality is likely to tell against exclusive jurisdiction (*Continental Bank NA v Aeakos Compania Naviera SA*), but mutuality is consistent with no more than submission to the jurisdiction. However, when taken with other matters mutuality may assist in finding a contractual intention that disputes shall be submitted only to the courts of the relevant jurisdiction: *British Aerospace Plc v Dee Howard Co*; *Austrian Lloyd Steamship Co v Gresham Life Assurance Society Ltd*.
>
> (d) Other language in the clause or the nature of the contract may point towards that contractual intention, for example “under the jurisdiction of the English courts” and the assumed desire for certainty in *Sohio Supply Co v Gatoil (USA) Inc*; or the use of transitive language as in *Austrian Lloyd Steamship Co v Gresham Life Assurance Society, Ltd*, *British Aerospace Plc v Dee Howard Co* and *Continental Bank NA v Aeakos Compania Naviera SA*.

(e) If the courts of the relevant jurisdiction would have jurisdiction in the absence of the clause, that may indicate that the clause was intended to confer exclusive jurisdiction: *Sohio Supply Co v Gatoil (USA) Inc*; *Gem Plastics Pty Ltd v Satrex Maritime (Pty) Ltd*. It will not always be so, as the clause may have been intended only to put beyond doubt the existing jurisdiction (*S & W Berisford Plc v New Hampshire Insurance Co*), or be an unthinking inclusion.

36. Drafters of choice of court clauses sometimes fail to appreciate the technical distinction between a submission to suit and a jurisdiction clause. In *Autotrop SDN BHD v Powercrank Batteries Pty Limited* [2006] VSC 401, the clause relevantly provided:

> *This agreement shall be governed by and construed in accordance with the laws that are applicable in Sarawak, Malaysia.*
>
> *In relation to any legal action or proceedings arising out of or in connection with this agreement ('proceedings'), the Manufacturer and the Purchaser hereby irrevocably submit to the jurisdiction of the High Court in Sabah and Sarawak (in particular at Kuching) and waives any objection to proceedings in any such courts within the jurisdiction of the High Court in Sabah and Sarawak on the grounds of venue or on the grounds that the proceedings have been brought in an inconvenient forum or any similar grounds and the Purchaser agrees that any writ, summons, order, Judgment or other document shall be deemed duly and sufficiently served if addressed to the Purchaser and left at or sent by post to the address of the Purchaser last known to the Manufacturer.*

Whelan J of the Supreme Court of Victoria held that "*It seems to me that the clause here is an irrevocable submission to the jurisdiction of the courts of Malaysia. The words used do not relevantly go beyond that. It is not an exclusive jurisdiction clause*"

37. The decision of Jacobson J. of the Federal Court in *Armacel Pty Limited v Smurfit Stone Corporation* (2008) 248 ALR 573 provides an instructive illustration of the pitfalls that can follow poor drafting. In that case, the contract contained the following clauses:

21.3.1 This Agreement must be read and construed according to the laws of the State of New South Wales, Australia and the parties submit to the jurisdiction of that State. If any dispute arises between the Licensor and the Licensee in connection with this

> *Agreement or the Technology, the parties will attempt to mediate the dispute in Sydney, Australia.*
>
> *21.3.2 In the event that there is a conflict between the laws of the State of New South Wales, Australia and the jurisdiction in which the Equipment is located, then the parties agree that the laws of the State of New South Wales shall prevail.*
>
> *21.3.3 If the licensee is in breach of this Agreement, the Licensee must pay to the Licensor on demand the amount of any legal costs and expenses incurred by the Licensor for the enforcement of its rights under this Agreement and this provision shall prevail despite any order for costs made by any Court.*

38. A dispute arose between the parties. Armacel contended that Smurfit had acted in breach of contract. Smurfit denied this and commenced proceedings in the United States seeking a declaration that it was not liable to Armacel. Armacel countered by commencing its own proceedings in the Federal Court of Australia some three weeks later. It did not, however, immediately seek an anti-suit injunction to restrain Smurfit from continuing with its proceedings in the United States. This was a mistake. Rather, Armacel sought a stay of the American proceedings on the basis, inter alia, of the jurisdiction clause contained in the contract. Smurfit sought a stay of the Federal Court proceedings in Australia on the basis that they were duplicative, commenced second in time and that the centre of gravity of the dispute was the United States.

39. Armacel's stay application came on for resolution first. In accordance with the American practice, that motion was decided on the basis of written arguments without oral hearing. The United States court interpreted clause 21.3.1 as simply a submission and not an exclusive jurisdiction clause, and applied United States law to reach this conclusion notwithstanding the parties' choice of New South Wales law. Accordingly, when Jacobson J. came to consider Smurfit's stay application, he was confronted with a decision of the United States' court which had already construed the jurisdiction clause.

40. Unlike the United States' court, Jacobson J. inclined to the view that the clause was intended to confer exclusive jurisdiction on Australian courts, as a matter of construction.

41. Notwithstanding this view, he considered, consistent with the authority of the House of Lords in *The Sennar (No 2)* [1985] 1 WLR 490 that the decision of the United States' court on the question of the construction of the jurisdiction clause, notwithstanding its interlocutory nature and that it had not applied principles of Australian law to govern this question, nevertheless gave rise to an issue estoppel such that he was bound to proceed on the footing that the clause was, in fact, non-exclusive in nature. In these circumstances, the basis for declining to stay the Australian proceedings became far less compelling. His Honour's reasoning on this issue is worth setting out because it is the first time that I am aware of that this matter – which once again highlights the importance of the race even to interlocutory judgments - has been decided in Australia:

> 66 Having approached the present matter with what, I hope, is the requisite degree of caution, I have come to the view that the present case is indistinguishable from *The Sennar* and that, accordingly, Armacel is barred by an issue estoppel from contending that cl 21.3.1 is an exclusive jurisdiction clause. In coming to this view, I have considered the decisions of the House of Lords, and the Court of Appeal in that case. The Court of Appeal decision is cited as *"The Sennar" (No 2)* [1984] 2 Lloyd's Rep 142.
>
> 67 It seems to me that the reasons for judgment of Kerr LJ and Sir Denys Buckley (Cumming-Bruce LJ concurring) make it clear that it is not possible to avoid the consequence of issue estoppel by simply re-characterising the issue as one which is sought to be litigated in accordance with the law of a different jurisdiction.
>
> 68 As Kerr LJ said at 149, it was not open to the plaintiffs to say, simply:
>
> *What we seek to litigate here are issues under English law, and it does not matter that we litigated precisely the same issues under other systems of law in Holland.*
>
> 69 The facts of *The Sennar* are of some importance. The plaintiffs, who were the holders of a bill of lading, invoked the jurisdiction of a Dutch Court by arresting a sister ship of *The Sennar* in Rotterdam. They brought an action for damages in the Dutch Court which held that their only cause of action lay in contract and that the Dutch court was bound to decline jurisdiction because the contract contained a clause under which the parties submitted to the exclusive jurisdiction of the Court of Sudan.

70 The plaintiffs then began an action in the Admiralty Court of England. However, although they succeeded on the jurisdictional question at first instance, the Court of Appeal held that they were barred from suing in the English Court by reason of an issue estoppel arising from the determination of the Dutch Court as to the construction and effect of the exclusive jurisdiction clause.

71 Kerr LJ observed at 148 that the classification of the plaintiffs' claim, as a matter of private international law, fell to be decided by Sudanese law as the proper law of the bill of lading. He said at 149 that by applying Sudanese law, the Dutch Court of Appeal had adopted the correct approach under the English rules of private international law.

72 However, as I have said, Kerr LJ at 149 also rejected the proposition that it was open to the plaintiffs to seek to re-litigate under English law the same issue that had been litigated under other systems of law in Holland.

73 His Lordship observed at 150 that to accept this proposition would altogether remove the possibility of an issue estoppel arising "from any decision by any Court" on the jurisdiction clause. It would permit uncontrolled forum shopping and run directly counter to the policy behind the doctrine of issue estoppel.

74 Sir Denys Buckley's analysis was to the same effect. He said at 159 that the Dutch Court answered the question by reference to Dutch law, except insofar as it paid attention to Sudanese law; an English court must answer the question by reference to English law except insofar as Sudanese law would be applied. He continued:

This does not, however, mean that the question for decision is not the same in each jurisdiction.

42. A further example worthy of note is the decision of Einstein J. in *HIH Casualty & General Insurance Limited (in liq.) v R J Wallace* (2006) 68 NSWLR 603. This was a case where, for reasons that were wholly unclear, the parties not only included an exclusive jurisdiction clause but also provided for arbitration, thereby generating uncertainty as to how the two clauses related to each other and interacted. The relevant provisions were as follows:

"ARTICLE XVIII SERVICE OF SUIT

The Reinsurer hereon agrees that:

1. In the event of a dispute arising under this Agreement, the Reinsurers at the request of the Company will submit to the jurisdiction of any competent Court in the Commonwealth of Australia. Such dispute shall be determined in accordance with the law and practice applicable in such Court.

2. *Any summons notices or process to be served upon the Reinsurer may be served upon*
MESSRS. FREEHILL, HOLLINGDALE & PAGE
M.L.C. CENTRE,
MARTIN PLACE, SYDNEY,
N.S.W. 2000 AUSTRALIA
who has authority to accept service and to enter an appearance on the Reinsurer's behalf, and who is directed, at the request of the Company to give a written undertaking to the Company that he will enter an appearance on the Reinsurer's behalf.

3. *If a suit is instituted against any one of the Reinsurers all Reinsurers hereon will abide by the final decision of such Court or any competent Appellate Court.*

ARTICLE XIX ARBITRATION:

Disputes arising out of this Agreement or concerning its validity shall be submitted to the decision of a Court of Arbitration, consisting of three members, which shall meet in Australia.

The members of the Court of Arbitration shall be active or retired executives of Insurance or Reinsurance Companies.

Each party shall nominate one arbitrator. In the event of one party failing to appoint its arbitrator within four weeks after having been required by the other party to do so, the second arbitrator shall be appointed by the President of the Chamber of Commerce in Australia. Before entering upon the reference, the arbitrators shall nominate an umpire. If the arbitrators fail to agree upon an umpire within four weeks of their own appointment, the umpire shall be nominated by the President of the Chamber of Commerce in Australia.

The Arbitrators shall reach their decision primarily in accordance with the usages and customs of Reinsurance practice and shall be relieved of all legal formalities. They shall reach their decision within four months of the appointment of the umpire.

The decision of the Court of Arbitration shall not be subject to appeal.
The costs of Arbitration shall be paid as the Court of Arbitration directs.
Actions for the payment of confirmed balances shall come under the jurisdiction of the ordinary Courts."

43. One issue in the case was whether proceedings should have been stayed in favour of arbitration. In the result, Einstein J refused to do so on the basis that, on the proper construction of the relevant clauses, the reinsured (HIH) was given the option either to choose judicial determination in an Australian court or arbitration. This decision had important ramifications for the

manner in which, and the law or principles by reference to which, the ultimate dispute would be resolved.

44. Article XVIII(i) of the reinsurance policy in the *HIH* case was interpreted as permitting proceedings to be commenced "*in a competent court in the Commonwealth of Australia*". It then provided that "*such disputes should be determined in accordance with the law and practice applicable in such court*". In other words, in this case, the parties agreed to what was in effect a "floating" choice of law clause. The law to be applied to the resolution of the parties' dispute would depend upon the choice of forum made by the reinsured. In this context, it should be noted that the law, at least as contained in statutes, differs between the Australian states such that depending on the nature of the case, the choice may be strategically significant.

45. One critical point to note in relation to the *HIH* case was the interaction between the mode of dispute resolution and the governing law. As already noted, were proceedings to be instituted in the particular Australian State, the law of that State would apply. On the facts of that case, it was in HIH's interest to commence proceedings in New South Wales in order to take advantage of certain provisions of the New South Wales *Insurance Act*.

46. Furthermore, and perhaps more critically, had HIH not commenced proceedings but, rather, elected to arbitrate, as it was entitled to do under the reinsurance policy, the arbitrators were directed, by clause XIX to "*reach their decision primarily in accordance with the usages and customs of reinsurance practice and shall be relieved of all legal formalities*". The application of this standard may well have led to a different result on the particular question under consideration in that case, namely the construction of the "*paid to be paid*" clause in the policy, than a decision reached by a New South Wales court applying New South Wales law.

47. HIH not only wanted the benefits of the *Insurance Act*, as noted above, but also wished what was a very important but strictly legal question to be decided by a court of law applying a well recognised body of principles relating to contractual interpretation, and with a right of appeal from the decision in the first instance, to a decision loosely based on custom and practice with the minimum of legal formalities.

48. It might also be noted, in this context, that what HIH saw as an advantage to it in litigating rather than arbitrating was seen as a corresponding disadvantage by the defendant who sought to stay the proceedings in favour of arbitration. Whether or not this was because the defendant thought that the application of the "custom and usage" standard would advantage it is not known although it is highly likely, certainly the application of that standard would have injected a degree of uncertainty (and therefore would have created an appetite for settlement) which may not have existed in that event or simply to be resolved as a question of legal construction.

49. An even more recent case, *Global Partners Fund Ltd v Babcock & Brown Ltd (in liq)* (2010) 79 ACSR 383, represents what is arguably a very significant development in the law where a number of closely related parties are involved in a transaction (and then a dispute) but not all parties are bound contractually to each other. In that case, Global Partners Fund Pty Ltd ("**GPF**") commenced proceedings in the Supreme Court of New South Wales against four Babcock entities, BBL, BBI, BBUS and BBMGP. Only BBMGP was party to a Limited Partnership Agreement ("**LPA**") with GPF with the agreement expressly providing for English law accompanied by a widely drawn exclusive jurisdiction clause for England. GPF sought to justify its commencement of proceedings in NSW on the basis that, whilst BBMGP had the benefit of these two clauses, as a matter of contract, BBL, BBI and BBUS did not, and taking the matter "in the round", as it were, it was more convenient for the matter to be tried in New South Wales rather than England. The Court of Appeal would have none of this with Spigelman CJ saying:

[71] With respect to the proposition that cl 18.11 [the exclusive English jurisdiction clause] does not respond to claims made against non parties to the agreement, there are judgments which have interpreted an exclusive jurisdiction clause to bind a party with respect to proceedings against a non party. (See *Donohue v Armco Inc* [2002] 1 Lloyd's Rep 425 ; [2001] UKHL 64 at [60]–[61] (*Donohue*) per Lord Scott of Foscote (although the issue was not argued in the House of Lords. See [14] per Lord Bingham).) Lord Scott's approach was applied to the clause construed in *Winnetka Trading Corp v Julius Baer International Ltd* [2009] 2 All ER (Comm) 735 ; [2008] EWHC 3146 (Ch) at [28]–[29]. On the other hand, other exclusive jurisdiction clauses have been interpreted as applying only to proceedings between the parties. (See, for example, *Credit Suisse First Boston (Europe) Ltd v MLC (Bermuda) Ltd* [1999] 1 Lloyd's Rep 767 at 777–8; *Morgan Stanley & Co International plc v China Haisheng Juice Holdings Co Ltd* [2010] 1 Lloyd's L Rep 265 at [21]–[30] noting the observations with respect to Lord Scott's judgment in *Donohue* above at [30].)

[72] Each contract must be interpreted in its context. Similar, even identical, words do not necessarily have the same meaning in different contexts.

[73] In the present case, it hardly needs saying that BBL, BBI and BBUS do not have contractual rights with respect to the exclusive jurisdiction clause, because they are not parties to the LPA. BBMGP does have such rights which, in my opinion, it is entitled to assert both with respect to the claims against itself, and with respect to the closely related, indeed, relevantly identical, claims against BBL, BBI and BBUS. The focus of such an assertion is the fact that GPF, which is a party to the contract, has agreed to conduct litigation "arising out of or in connection with" the LPA in England. However, BBL, BBI and BBUS are also entitled to approach the court, in their own right, to request that the court exercise its discretion to grant a stay. This is so because of their involvement in the affairs of the partnership, as envisaged by the LPA itself, and the rights conferred upon them as indemnified persons under the LPA.

[74] GPF sought to categorise the first three respondents as "non parties". However, there are non parties and non parties. These respondents are not strangers to the LPA.

[75] I have set out at [29]–[32] above the provisions of the LPA that directly refer to the involvement of the members of the BB Group in the decision making processes of the partnership. These proceedings concern the internal decision making processes of the BB Group that determined how the funds of the partnership were to be invested, particularly the decision-making process that led to the Coinmach transaction being completed. The obligation imposed upon GPF by cl 18.11 should be interpreted to extend, at least, to the participants in the decision making processes envisaged by the LPA.

[76] The proceedings in this court arise, and arise only, from the internal decision making processes for which the LPA provides, namely the making of investments. By reason of the structure of the BB Group, the functions of BBMGP, as the managing general partner under the LPA, were subject to the assistance and direction of other members of the group in the manner alleged in the commercial list statement. Indeed, that participation is the very foundation of the causes of action which GPF seeks to agitate in this court.

[77] An important clue to resolving this issue is found in the indemnity provisions in the LPA which I have set out at [32] above. Each of the respondents is entitled to the benefit of those provisions. Dr A Bell SC, who appeared for BBI, BBUS and BBMGP, informed the court that his clients intended to rely on these provisions as a contractual defence to the applicant's claims. GPF did not suggest that such issues do not legitimately arise.

[78] Notwithstanding the fact that BBL, BBI and BBUS are not parties to the LPA, they cannot be categorised as members of an undifferentiated group of "non parties". It may well be that cl 18.11 will not apply to other non parties. However, the respondents in the present case are in a quite distinct category.

[79] In a context where the very contract confers rights on identified non parties, the choice of law and exclusive jurisdiction clauses should be construed as binding the parties with respect to proceedings in which such an indemnity may arise. Furthermore, the principles underlying the conclusion that such a clause should not be narrowly construed set out at [61]–[69] above, apply, at least, to include claims against non parties who are so closely connected with the implementation of the contract as are BBL, BBI and BBUS.

[80] In my opinion the GPF's contention that, as a matter of construction, cl 18.11 does not apply to proceedings against BBL, BBI and BBUS

50. What is most interesting about this passage is that it, on one view, creates an exception to the orthodox doctrine of privity of contract cf. *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107. Spigelman CJ's reasoning went some way beyond the argument presented which was one by BBMGP to the effect that the claims against BBL, BBI and BBUS were claims "in relation to" or "arising out of" the LPA (even though those entities were not party to it) and GPF had promised it, BBMGP, that it would not bring such claims otherwise than in England. The argument was that this promise was one made to BBMGP and was one that is could enforce including and even in respect of claims not brought against BBMGP itself.

Conclusion

51. The apparently simple topic of choice of law clauses and choice of court clauses, so often considered by commercial lawyers as "boilerplate" provisions to be copied from a precedents database, can raise some difficult and complex questions of private international law, including renvoi, the

interaction of tort and contract, and public policy questions relating to parties' ability to stipulate and override statutory provisions of a legal system other than that chosen or preferred by the parties.

52. An understanding of these issues, and the potential for complexity, is essential for a commercial lawyer anxious to minimize the scope for adjectival litigation in relation to venue and applicable law. Poor drafting may lead to one party leveraging the uncertainty, and potentially different substantive outcomes that may arise through either the application of different laws to the parties' dispute, or the resolution of that dispute in different forums, or a combination of both.

SATURDAY 6th AUGUST continues

1.30pm - 3.00pm	Ballroom 1	**Funding the Golden Fleece: an A to Z of commodity financing** (Panel session)
	Chair:	Tessa Hoser, General Counsel, Export Finance & Insurance Corporation, Sydney
	Panellists:	**Gillad Dalal**, Partner, Norton Rose, Melbourne
		Colin George, Director – SME Origination, Export Finance & Insurance Corporation, Sydney
		Phil Cubbin, Segment Head, Trade & Supply Chain, Institutional, Australian & New Zealand Banking Group, Sydney
		Bruce Whittaker, Partner, Blake Dawson, Melbourne
1.30pm - 3.00pm	Ballroom 2	**The changed role of the agent in syndicated financings – sheepdog, bulldog, poodle, or lead husky?** (Panel session)
	Chair:	Nuncio D'Angelo, Partner, Mallesons Stephen Jaques, Sydney
	Speaker:	**Diccon Loxton**, Partner, Allens Arthur Robinson, Sydney
3.00pm	Afternoon break	
3.30pm - 5.00pm	Ballroom 1 & 2	**The Intrusion of the 'Nanny state' into commercial law in Australia and New Zealand**
	Chair:	Diccon Loxton, Partner, Allens Arthur Robinson, Sydney
	Speakers:	**Prof. John Stumbles**, Faculty of Law, University of Technology, Sydney
		Victoria Heine, Partner, Chapman Tripp, Wellington
5.00pm	Closing Comments	

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EQUITABLE DOCTRINES AND FINANCIERS' LIABILITIES [*]

by

P A Keane [†]

In the late-1990s, I spent several months in court arguing about whether the private company which operated Bond University was entitled, as against the Long Term Credit Bank of Japan, to the land and buildings of the Bond Campus free of the registered mortgage in favour of the Bank which had funded the acquisition of the freehold of the land and buildings by Bond Corporation.

The claim had its origin in assurances given by Alan Bond on behalf of Bond Corporation to representatives of the nascent Bond University that Bond Corporation would provide the infrastructure to the University on a long term lease. The negotiations in relation to the terms of the lease were not concluded before the financial collapse of Bond Corporation. Drafts of the proposed lease were exchanged and discussed: some of these drafts which were put into evidence showed that the parties were talking about a lease of 99 years for a rent of $10 million per annum payable to Bond Corporation. The University never agreed to pay this rent – or any rent.

The University's case invoked a number of equitable doctrines, principally equitable estoppel, in an endeavour to trump the Bank's registered mortgage.

Witness after witness came forward on behalf of the University to give evidence that he or she took part in the establishment of the University only because of Bond's assurances that the campus and buildings would be made available to the University.

What, you might ask, did any of this have to do with the Bank's registered mortgage? The trial judge and the Court of Appeal concluded that the University had no good answer to this question. And no one ever explained how they expected a public company with obligations to shareholders and creditors could have understood to be promising to just give away many tens of millions of dollars. I can't claim to be an unbiased observer, but there seemed to be something undignified about the evidence of the University's witnesses. One can sympathise with the desperation of their position, but legal doctrines which encourage the abandonment of dignity are not attractive.

Just as General Pickett's failed charge at the Battle of Gettysburg has been described as the high tide of the Confederacy, so this case might be described as the high tide of the doctrine of equitable estoppel. Unlike Pickett's charge, however, the Bond University

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* A paper delivered to the 28th Annual Conference of the Banking & Financial Services Law Association on 5 August 2011, Gold Coast, Queensland.

† Chief Justice of the Federal Court of Australia.

case rapidly faded from public memory: it was not even regarded as of sufficient importance to be reported in the Queensland Reports.

I remember the case principally because, as Counsel for the Bank, I spent months of my life, and the parties spent vast sums of money, in an attempt to expand the scope of equitable doctrines, such as equitable estoppel and unconscionability, into the stream of commerce in a way which would have been distinctly adverse to the interests of those who finance commercial transactions.

In the Bond University case, there were a number of what can now be seen to be insuperable difficulties for the plaintiff: the assurances that Bond gave to the University were not clearly categorical – they always seemed to have been given in a context where they could only be seen to be conditional on the University being ready, willing, and able to pay a substantial commercial rent, and at no time was it ready, willing, and able to do so; no agreement as to the quantum of rent or the period of the lease was ever agreed; there was no evidence that the Bank took its mortgage with notice of expectations on the part of the University that it would receive a lease, even if it did not agree to pay rent, and that the lease would subsist even if it could not pay the rent; and there was no evidence that the Bank itself encouraged anyone on the University side to act upon Bond's assurances. No dishonest or dishonourable conduct could be sheeted home to the Bank.

In retrospect, we can see that it was a hopeless case for the University. That observation could not, however, be made at the time. So fluid was the then current understanding of equitable doctrines such as equitable estoppel, unconscionability, fiduciary obligation, and other doctrines such as unjust enrichment, that the University's case was respectably arguable; and it was argued by some of Australia's most respected lawyers.

How much the pendulum has swung back over the last fifteen years.

In August 2009, in an address to the Supreme Court of New South Wales Conference organised by the Judicial Commission of New South Wales, Lord Neuberger of Abbotsbury MR discussed the then very recent decision of the House of Lords in *Cobbe v YRML*.[1] His Lordship was able to say of equitable estoppel:

> "…[I]t is not enough for the plaintiff to show that the defendant has behaved badly, or even to say that, to the defendant's knowledge, the plaintiff acted in the expectation that the defendant would behave in a certain way. In equity, as in common law, a defendant is entitled to say that the plaintiff took the risk that the defendant would not act honourably. It is like a subject to contract agreement: by using the words 'subject to contract', the parties are saying to each other that, however unattractive it might subsequently appear to be, each is entitled to renege. Equity, like the common law, will not permit a cause of action to be founded on such an agreement, save perhaps in thoroughly exceptional circumstances … The message from the House of Lords in *Cobbe v YRML* is that it is

1 *Cobbe v Yeoman's Row Management Ltd* [2008] 1 WLR 1752.

> simply not for the courts to go galumphing in, wielding some Denningesque sword of justice to rescue a miscalculating, improvident or optimistic property developer from the commercially unattractive, or even ruthless, actions of a property owner, which are lawful in common law".[2]

His Lordship was surely right to emphasise that cases between commercial parties involve a range of policy concerns which are not at play in, for example, a dispute between a mother-in-law and a husband over her rights to a granny flat that she paid for but which is physically attached to his home.

Lord Neuberger went on to say, after reviewing further English and Australian authorities:[3]

> "If the result of this is that proprietary estoppel will not often assist a plaintiff in a commercial context, that is probably all to the good: in the business world, certainty and clarity are particularly important, and judges should be slow to encourage the introduction of uncertainties based on their views of the ethical acceptability of the behaviour of one of the parties."

It is not only in relation to equitable estoppel that the tide of liability for honest financiers has receded. The same can be said of liabilities sourced in equitable doctrines relating to fiduciary relations, unjust enrichment and unconscionability.

I propose to discuss some of these developments, beginning with the observable tightening of the conceptual language in which these doctrines are framed. I will conclude with some speculations as to the dynamics which have driven this tightening after the years in which the expansionary trend predominated.

I emphasise that my concern is not with liabilities to consumers.

FIDUCIARY OBLIGATIONS

In his classic judgment in *Tailby v Official Receiver*,[4] Lord Macnaghten said of a dispute about a fine point of equitable doctrine: "It may be said that this is a question of words. To a great extent it is so; most questions are."[5]

Lord Macnaghten's quip is a pithy reminder of the truism that precision in the language in which we frame our legal concepts is essential if we are not to descend into what Scrutton LJ in another context called "well-meaning sloppiness of thought."[6]

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2 Rt Hon. the Lord Neuberger of Abbotsbury MR, "Thoughts on the law of equitable estoppel" (2010) 84(4) *Australian Law Journal* 225 at 229-230.

3 Rt Hon. the Lord Neuberger of Abbotsbury MR, "Thoughts on the law of equitable estoppel" (2010) 84(4) *Australian Law Journal* 225 at 231.

4 (1888) 13 App Cas 523.

5 *Tailby v Official Receiver* (1888) 13 App Cas 523 at 549 per Lord Macnaghten.

6 *Holt v Markham* [1923] 1 KB 504 at 513.

Over two decades, well-meaning judges, especially in Canada, stretched the language of fiduciary obligations into areas previously the domain of contract or tort in what came to be recognised as an excess of the unifying tendency to which lawyers are disposed.

As Anthony Duggan has said, the line of Canadian Supreme Court decisions after *LAC Minerals Ltd v International Corona Resources Ltd*[7] (harking back to *Guerin v The Queen*,[8] a case concerned with native title) and ending with the string of 1992 cases including *McInerney v MacDonald*,[9] *Norberg v Wynrib*[10] and *M(K) v M(H)*,[11] "substantially reshaped the law of fiduciary obligations and, in doing so … moved Canadian law away from both its historical origins and the law as it is applied in other parts of the Commonwealth."[12]

The Canadian enthusiasm for using the concept of fiduciary obligation as an incantation to solve a range of problems led to the observation attributed to Sir Anthony Mason that in Canada there are three kinds of persons: those who have been held to be fiduciaries, those who are about to be held to be fiduciaries, and judges.

In the 2008 WA Lee Lecture, entitled "Australia's Equity Isolationism",[13] Justice Michael Kirby delivered a trenchant criticism of equity jurisprudence in Australia for its failure to follow the lead of the Canadian Supreme Court in unifying the doctrines of equity and the rules of the common law, particularly in relation to fiduciary obligations as a source of rights and remedies.

In the 2009 WA Lee Lecture,[14] I ventured to respond to Justice Kirby's criticism with the suggestion that there were good reasons, derived from the fundamental values of equity, to resist the unifying tendencies evident in the Canadian jurisprudence.

In that lecture,[15] I sought to make the point that equity was originally, and remains, essentially concerned to restrain, rather than to expand, the exercise of common law rights. That being so, it would be a little surprising if it should have become the driver of an expansionist view of those rights.[16]

The recent decision of the Canadian Supreme Court in *Galambos v Perez*[17] suggests that the expansionary unifying enthusiasm has now run out of steam. Even in Canada it is now recognised that the spillover of fiduciary obligations into other legal categories was

[7] [1989] 2 SCR 574.
[8] [1984] 2 SCR 335.
[9] [1992] 2 SCR 138.
[10] [1992] 2 SCR 226.
[11] [1992] 3 SCR 6.
[12] Anthony Duggan,"Fiduciary Obligations in the Supreme Court of Canada: A Retrospective".
[13] (2008) 8 *Queensland University of Technology Law Journal* 444.
[14] P A Keane,"The Conscience of Equity" (2010) 84 *Australian Law Journal* 92.
[15] (2010) 84 *Australian Law Journal* 92 at 93-94.
[16] (2010) 84 *Australian Law Journal* 92 at 100-101.
[17] [2009] 3 SCR 247

not a sound development of equitable principle and threatened the coherence of the law. I will discuss the Canadian developments which culminated in the recent decision of the Canadian Supreme Court.

There have always been reasons for the boundaries between doctrines of equity and the rules of the common law. For a time, it seemed that they receded from view.

Equity operates as an exception to the legal order. Chancery never set out to provide general regulation of dealings in the market place, being, at the outset and for a very long time thereafter, more concerned with real property.

The common law regards the aggressive pursuit by a trader of his or her commercial interests as legitimate so long as it is conducted honestly and with reasonable care for those at risk of harm if reasonable care is not shown. In a market economy "rivalry between participants is an essential and defining feature: rivalry in which each participant seeks to maximise its profit and market share at the expense of all other participants in that market."[18]

Chancery did not set out to correct the clear eyed view of the common law that loss suffered in trade or commerce "is often no more than one of the ordinary consequences of participation in a market economy".[19]

In the market, your loss may be my profit. In our law of contract, the right of self-interested action at the expense of others is a given from which all else proceeds. It is embodied in the traditional common law approach conveyed by the maxim *caveat emptor*.[20]

In trade or commerce a relationship in which one is obliged to disregard one's own material interests for the benefit of another person is obviously exceptional. This is the standard of self-abnegation which equity requires of a fiduciary. And until the Canadian expansion, equity had no occasion to insist on adherence to that standard save where there was voluntarily assumption of the responsibility for the interests of another which brought with it the extraordinary obligation of selflessness.

There are real differences in the interests which inform the standard of absolute loyalty required of a fiduciary and those which inform the standard of reasonable care in negligence and reasonableness in the law of contract.[21] These differences are readily recognisable. They provide a warning to resist the urge to see an underlying unity of concepts. To elide these differences in pursuit of a common standard of fair and reasonable behaviour is to fail to recognise that the rules of equity and the common law

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18 *Perre v Apand Pty Ltd* (1999) 198 CLR 180 at 299.

19 *Perre v Apand Pty Ltd* (1999) 198 CLR 180 at 299.

20 *Gatsios Holdings Pty Ltd v Nick Kritharas Holdings Pty Ltd (In liq)* [2002] ATPR 41-864; 44-800.

21 *Brogden v Metropolitan Railway Co* (1877) 2 App Cas 666; *Mackay v Dick* (1881) 6 App Cas 251 at 263; *Secured Income Real Estate (Australia) Ltd v St Martin's Investments Pty Ltd* (1979) 144 CLR 596 at 607.

reflect radically different views of the legitimacy of human selfishness and of occasions for its control.

In some respects the duty owed by a fiduciary to the beneficiary of that duty is more onerous than the common law duty to take reasonable care, and in some respects it is less rigorous. In one respect, the strictness of the fiduciary obligation surpasses that involved in the concept of reasonable care. The great cases of *Keech v Sandford,*[22] *Regal (Hastings) Ltd v Gulliver,*[23] and *Boardman v Phipps,*[24] establish that a fiduciary must disgorge a profit made from the sale of property acquired by reason of an opportunity which arose in the course of the fiduciary relationship even though the beneficiary could not or would not have taken up the opportunity. In none of these cases could it sensibly be said that the fiduciary had failed to exercise reasonable care to avoid causing harm to the beneficiary.

A person who owes a duty of care in negligence is obliged to do only what is reasonable not to harm the other, and he or she is entitled to give effect to his or her own selfish interests in that regard; indeed, the determination of what is reasonable in the context of tort law can only be made by taking into account the cost to the person of the steps necessary to ameliorate the risk of harm to the other, and deciding whether the risk is such that the incurring of the expense is reasonably warranted.

A classic example of a fiduciary relationship is that between employer and employee. It is the employee who owes the fiduciary obligation to the employer. That is because it is the employee who deals with third parties and with the employer's assets on behalf of the employer. The employee voluntarily agrees to subordinate his or her interests to those of his or her employer in representing the employer to third parties. But it has never been thought that the fiduciary obligation is owed both ways. The duty which the employer owes the employee is one to take reasonable care to avoid causing the employee harm. It is imposed on the employer as part of the social cost of doing business. As Lord Atkin said in *Donoghue v Stevenson:* "liability for negligence … is … based upon a general public sentiment of moral wrongdoing for which the offender must pay."[25]

The employer's obligation extends only so far as the foreseeable risk of harm extends. Altruism has very little to do with the duty to take reasonable care imposed by the law of tort. In sharp contrast, the fiduciary obligation leaves no room for any sort of self-interested calculation so far as the subject matter of the obligation is concerned: the fiduciary is absolutely required to deny his or her own interests in favour of the person for whose benefit he or she must act. And in equity, it is the insistence upon mutuality of conscientious behaviour by claimants, rather than the common law notion of foreseeability, which serves as the principal brake upon what would otherwise be an ever expanding proliferation of liabilities.

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22 (1726) Cas temp King 61; (1726) 25 ER 223.
23 [1967] 2 AC 134.
24 [1967] 2 AC 46.
25 [1932] AC 562 at 580.

Thus the fiduciary obligation is absolute, subject to the knowing consent of the beneficiary, because nothing less is regarded as a sufficient protection for the interests of the beneficiary against the powerful temptations of self-interest.

Another way of putting it is to say that it would be a violation of mutuality in a relationship, and contrary to the conscience of equity, for the soi-disant beneficiary of a fiduciary duty to assert an entitlement to the benefit of an obligation of self-abnegation against a person who has not willingly accepted the corresponding burden.

The conscience of equity is not concerned solely with the state of mind of the defendant against whom rights are asserted, but rather is concerned, as Pomeroy says, to "test the conduct and rights of suitors" as well.[26] One of the principal problems of the unifying tendency is that it seems to work only one way, i.e. to expand liabilities of defendants, not to restrain overweening demands by plaintiffs.

The burdens of the obligation of self-abnegation upon a trustee are heavy. Why would it be thought to accord with conscience to impose those burdens upon a person who had not freely and deliberately accepted them?

In terms of its foundations and historic mission, the Court of Chancery was not concerned to regulate trade or commerce, save insofar as the financial embroilments of owners of real property may have threatened the aristocratic hold on land. The foundations of equity were ecclesiastical within a tradition articulated most authoritatively by Thomas Aquinas. Aquinas himself looked to Aristotle, referring to him with reverence as "the Philosopher". Aristotle was more concerned with virtue than with rights. He regarded an even-handed willingness to restrain one's self from insisting upon the full measure of one's legal rights as a great social virtue. He called this virtue "epieikeia", which became "aequitas" in Latin and "equity" in English. Not surprisingly then, a principal aspect of equity's role was restraining the exercise of rights rather than broadening the occasions for their exercise.

What this meant for our purposes is that the mindset of Chancery has been that when equity intervenes to prevent unconscientious conduct, it is not concerned solely with the conduct of the defendant and with what is necessary to bring that conduct into conformity with conscience; it is concerned to insist that the plaintiff also act in accordance with conscience.

Moreover, the plaintiff has to be able to stake a claim on the conscience of equity. Merely having one's legal rights infringed would not do.

A strong illustration of this point is provided by the cases which made it clear that equity would not allow a borrower of moneys to take advantage of money lending statutes

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26 John Norton Pomeroy and Spencer W. Symons (eds), *A Treatise on Equity Jurisprudence,* Vol 1 (5th Ed, 1941), p. 94 [57].

which made certain loans illegal for the protection of the borrower, unless the borrower was willing to "submit to the repayment of the moneys borrowed remaining unpaid."[27]

Even where the money lending legislation rendered the loan agreement and securities void, equity would not grant relief to a borrower – not even a declaration of invalidity – unless the borrower was willing to act in good conscience by offering to repay the moneys borrowed. The borrower might have a legal right under the statute to be relieved of the loan but the assistance of a court of equity would only be available if the borrower was prepared to make restitution of the loan moneys.

In *Langman v Handover*,[28] Dixon and Rich JJ identified this insistence on mutuality and fair dealing as expressed in the maxim that a person who seeks equity must do equity. Their Honours said:

> "In the important judgment which *Wigram* VC gave upon the maxim that he who seeks equity must do equity, in *Hanson v Keating* [(1844) 4 Ha 1; 67 ER 537], after instancing the necessity imposed upon a plaintiff in a bill for an account, of submitting himself to account in the same matter, and in a bill for specific performance, of submitting to perform the contract, he proceeds [(1844) 4 Ha, at pp 5, 6; 67 ER 537]:– 'In this, as in the former case, the Court will execute the matter which is the subject of the suit wholly, and not partially. So, if a bill be filed by the obligor in an usurious bond, to be relieved against it, the Court, in a proper case, will cancel the bond, but only upon terms of the obligor refunding to the obligee the money actually advanced. The reasoning is analogous to that in the previous cases. The equity of the obligor is to have the entire transaction rescinded. The Court will do this, so as to remit both parties to their original positions: it will not relieve the obligor from his liability, leaving him in the possession of the fruits of the illegal transaction he complains of.' In such cases the equity is founded, not upon the necessity of protecting the party's legal rights, but upon his willingness to resign them in order that he may be restored to the position he occupied before he embarked upon the transaction which turns out to be unlawful." [29]

That this position in relation to money-lending transactions was ultimately altered by statute does not detract from the force of the point about the even-handed attitude of equitable principle.

As Sir Owen Dixon explained in *Mayfair Trading Co Pty Ltd v Dreyer*,[30] the ability and willingness of a plaintiff to restore the defendant as a pre-condition of equitable relief to

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27 *Mayfair Trading Co Pty Ltd v Dreyer* (1958) 101 CLR 428 at 452. See also *Hanson v Keating* (1844) 4 Hare 1; 67 ER 537; *Jervis v Berridge* (1873) LR 8 Ch App 351 at 358; *Lodge v National Union Investment Co Ltd* [1907] 1 Ch 300; *Langman v Handover* (1929) 43 CLR 334 at 345, 356.

28 (1929) 43 CLR 334 at 353 – 354.

29 (1929) 43 CLR 334 at 353 – 354 (citations footnoted in original).

30 (1958) 101 CLR 428 at 452 – 456.

give effect to a legal right was one of the "basal considerations determining in a court of equity the plaintiff's equitable title to relief."[31] The plaintiff's rights, and the public policy reflected in the legislation which conferred those rights, simply were not sufficient to engage the conscience of equity.[32] It was only when the legislation made it abundantly clear that the borrower should be entitled to relief without doing equity that equity's insistence on conscientious behaviour by the borrower was overcome.

Another illustration of this point is afforded by equity's long-standing reluctance to grant specific performance of a contract of personal service. At the practical level, this reluctance was explained to be based on perceived difficulties in supervision of the court's orders. At the deeper level of principle, it was grounded in a concern about the unfairness, in terms of mutuality, of compelling an employer to continue the employment of a person in whom the employer had lost confidence.[33] Justice would best be served in such a case by leaving the parties to their remedies of damages at law.

And in the area of estoppel, in *The Commonwealth v Verwayen*,[34] Deane J recognised that an attempt by a plaintiff to set up an estoppel by conduct might itself be "unconscientious" because that remedy would be disproportionate to any detriment which the plaintiff might suffer if the estoppel were rejected. Such a result could, his Honour said, be defeated by attention to the plaintiff's position. Deane J supposed:

> "a case in which the party claiming the benefit of an estoppel precluding [the defendant's] denial of [the plaintiff's] ownership of a million dollar block of land owned by [the defendant] would sustain no detriment beyond the loss of one hundred dollars spent on the erection of a shed if a departure from the assumed state of affairs were allowed (cf, eg, *Ramsden v Dyson* [(1866) LR 1 HL 129 at 140 – 141]; *Sheridan v Barrett* [(1879) 4 LR Ir 223 at 229 – 230]."[35]

Deane J suggested that in this hypothetical case, "the payment of, or a binding undertaking to pay, adequate compensation would preclude a finding of estoppel by conduct."[36]

The root of the problem of the unprincipled expansion of the fiduciary obligation, I suggest, can be found in the decision of the Supreme Court of Canada in *LAC Minerals Ltd v International Corona Resources Ltd*.[37] There it was said:

31 *Mayfair Trading Co Pty Ltd v Dreyer* (1958) 101 CLR 428 at 454.
32 Cf *Bridgewater v Leahy* (1998) 194 CLR 457 at 494 [125].
33 *Visscher v Giudice* (2009) 239 CLR 361 at [54].
34 (1990) 170 CLR 394.
35 *The Commonwealth v Verwayen* (1990) 170 CLR 394 at 441.
36 I am indebted to the discussion of this problem by Mr J D McKenna SC of the Queensland Bar: John McKenna SC, "Remedies in Estoppel" in Aladin Rahemtula (ed), *Justice According to Law: A Festchrift for the Honourable Mr Justice BH McPherson CBE* (2006: Supreme Court of Queensland Library), p. 167 esp at 195 – 201.
37 [1989] 2 SCR 574.

> "There are few legal concepts more frequently invoked but less conceptually certain than that of the fiduciary relationship. In specific circumstances and in specific relationships, courts have no difficulty in imposing fiduciary obligations, but at a more fundamental level, the principle on which that obligation is based is unclear. Indeed, the term 'fiduciary' has been described as 'one of the most ill-defined, if not altogether misleading terms in our law'." [38]

The first step in this process of reasoning was to postulate the conceptual uncertainty of the fiduciary relationship. To take that step was to announce a self-fulfilling prophecy. As the late Professor Birks cautioned, "ambiguity rots the foundations of rationality."[39] If the concept is clearly understood then it ceases to be a house with many mansions. And there is no conceptual uncertainty as to what is meant by a fiduciary relationship in the orthodox proposition that a fiduciary obligation is an incident of a voluntary undertaking to act in given circumstances exclusively on behalf of another and not an obligation called into existence by a court whenever it is thought to be fair or reasonable in the circumstances.[40]

To regard a fiduciary obligation as something to be imposed ad hoc, whenever it is thought fair and reasonable to do so, rather than a consequence of facts found to establish a voluntary self-abnegation in respect of a particular subject matter, was not to develop equitable principle but to break radically with it.

In the two decades after *LAC Minerals*, when Canadian (or American) lawyers discussed issues such as, for example, the obligation of good faith as between parties to a contract, they tended to use the terminology of fiduciary obligation. This loose terminology facilitated the grant of equitable remedies, such as the constructive trust, for breach of contract. Thus a court might prefer one creditor over others in defiance of the intention of statutory regimes of personal and corporate insolvency.

In *Breen v Williams*,[41] the High Court declined to follow the "expansive manner" in which the Canadian Courts had extended the limits of fiduciary law. In that case, Gaudron and McHugh JJ observed:

> "… Australian courts only recognise proscriptive fiduciary duties. This is not the place to explore the differences between the law of Canada and the law of Australia on this topic. With great respect to the Canadian courts, however, many cases in that jurisdiction pay insufficient regard to the effect that the imposition of fiduciary duties on particular relationships has on the law of negligence, contract, agency, trusts and companies in

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38 *LAC Minerals Ltd v International Corona Resources Ltd* [1989] 2 SCR 574 at [24].

39 P. Birks, "A Letter to America: The New Restatement of Restitution" (2003) 3 *Global Jurist Frontiers* at 4, cited in Gummow, "Moses v Macferlan: 250 years on" (2010) 84 *Australian Law Journal* 756 at 758.

40 *Soulos v Korkontzilas* [1997] 25 SCR 217 at [35].

41 (1996) 186 CLR 71.

> their application to those relationships. Further, many of the Canadian cases pay insufficient, if any, regard to the fact that the imposition of fiduciary duties often gives rise to proprietary remedies that affect the distribution of assets in bankruptcies and insolvencies.
>
> In this country, fiduciary obligations arise because a person has come under an obligation to act in another's interests. As a result, equity imposes on the fiduciary proscriptive obligations — not to obtain any unauthorised benefit from the relationship and not to be in a position of conflict. If these obligations are breached, the fiduciary must account for any profits and make good any losses arising from the breach. But the law of this country does not otherwise impose positive legal duties on the fiduciary to act in the interests of the person to whom the duty is owed. If there was a general fiduciary duty to act in the best interests of the patient, it would necessarily follow that a doctor has a duty to inform the patient that he or she has breached their contract or has been guilty of negligence in dealings with the patient. That is not the law of this country."[42]
> [Footnotes omitted].

To similar effect, Dawson and McHugh JJ observed:

> "It is, perhaps, reflective of a tendency, not found in this country, but to be seen in the United States and to a lesser extent Canada, to view a fiduciary relationship as imposing obligations which go beyond the exaction of loyalty and as displacing the role hitherto played by the law of contract and tort by becoming an independent source of positive obligations and creating new forms of civil wrong. But, with respect, that is achieved by assertion rather than analysis and, whilst it may effectuate a preference for a particular result, it does not involve the development or elucidation of any accepted doctrine."[43]
> [Footnotes omitted].

Specifically, in *Breen v Williams*, the High Court declined to follow the decision of the Supreme Court of Canada in *McInerney v MacDonald*[44] that a patient is entitled to reasonable access to examine and copy the doctor's records.

There was at work in the Canadian jurisprudence a unifying tendency to treat the conscience of equity as equivalent to common law conceptions of what is fair or reasonable in a particular case. This unifying tendency operated by putting to one side considerations of mutuality. These considerations require a fiduciary to sacrifice his or her own interests only insofar as he or she has voluntarily assumed that burden. The demand might be reasonable, but that does not make it equitable for the plaintiff to make it.

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42 (1996) 186 CLR 71 at 113.
43 (1996) 186 CLR 71 at 95.
44 [1992] 2 SCR 138.

Equity is concerned with mutual relations of good conscience, not with a one sided demand that the other side be reasonable.

To say this is not to indulge in the narrow fussiness which animates caricatures of equity lawyers. To illustrate this point, may I give an example from the classics. In Xenophon's *Chyropoedia* (*The Education of Cyrus*), Xenophon relates that Cyrus' teacher left him in charge of the class for a morning. It was a cold day, and while the teacher was away, Cyrus took from a small boy a large cloak and gave it to a bigger boy whose teeth were chattering because his own cloak was too small. In turn, Cyrus gave the big boy's smaller cloak to the little boy. The smaller cloak was perfectly adequate to keep him warm. When the teacher returned to the class room and saw what had happened, he gave Cyrus a sound thrashing. Xenophon, who you will all recall was, along with Plato, a pupil of Socrates, says that the teacher was in the right because while what Cyrus did was perfectly fair and reasonable, it was not justice according to law.

The 2009 case of *Galambos v Perez*[45] demonstrates the unifying tendency to treat the conscience of equity as equivalent to the Court's view of "legitimate expectations" and of what is fair and reasonable in a particular case. Cromwell J, writing on behalf of a unanimous Supreme Court in *Galambos v Perez,* discarded the tests of "reasonable expectations" and "vulnerability", in favour of emphasising the centrality of undertaking to the existence of a fiduciary relationship.

Ms Perez was a bookkeeper at a law firm who had made sizeable voluntary and unsolicited cash advances to the firm to resolve a cash flow problem. The firm was placed in receivership and its founder, Mr Galambos, made bankrupt.

The Court of Appeal found that Mr Galambos and his firm owed Ms Perez fiduciary duties in relation to the cash advances on the basis of Ms Perez' reasonable expectations that the relationship was characterised as one of "power-dependency".

On appeal to the Supreme Court, Cromwell J pointed out that the Court of Appeal's analysis erred when it found a fiduciary duty without finding an undertaking, express or implied, on the part of Mr Galambos, that he would act in relation to the cash advances only in Ms Perez' interests. Ms Perez had not alleged any explicit undertaking to that effect, and in circumstances where the trial judge found that Mr Galambos had not requested the advances and Ms Perez was the party with more knowledge of the firm's finances, no undertaking could be implied: "any reasonable person would have understood that he or she assumed the position of a precarious unsecured creditor, not that of a protected beneficiary."[46]

Cromwell J held that a fiduciary duty could not arise simply on the basis of one party's reasonable expectations in the absence of any mutual understanding that one party has undertaken to act in the interests of the other. His Honour summarised his view:

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45 [2009] 3 SCR 247.

46 [2009] 3 SCR 247 at [81].

> "In my view, while a mutual understanding may not always be necessary (a point we need not decide here), it is fundamental to *ad hoc* fiduciary duties that there be an undertaking by the fiduciary, which may be either express or implied, that the fiduciary will act in the best interests of the other party. In other words, while it may not be necessary for the beneficiary in all cases to consent to this undertaking, it is clearly settled that the undertaking itself is fundamental to the existence of an *ad hoc* fiduciary relationship."[47]

His Honour's reasons begin with "some basic principles of fiduciary law": that fiduciary law focuses on relationships and, in particular on "the position of the parties that *results from* the relationship" and on the undertaking of loyalty which is a "critical aspect" of that relationship. Much of his Honour's reasoning is devoted to citations of dicta from the earlier Canadian cases which support his thesis so as to minimise the appearance of a disapproval of the earlier decisions. What this does emphasise, however, is the looseness of the language in the earlier cases. Cromwell J said:

> "An important focus of fiduciary law is the protection of one party against abuse of power by another in certain types of relationships or in particular circumstances. However, to assert that the protection of the vulnerable is the role of fiduciary law puts the matter too broadly. The law seeks to protect the vulnerable in many contexts and through many different doctrines. As La Forest J. noted in *Hodgkinson*, at p. 406: '[W]hereas undue influence focuses on the sufficiency of consent and unconscionability looks at the reasonableness of a given transaction, <u>the fiduciary principle monitors the abuse of a loyalty reposed</u>' (emphasis added). This brief sentence makes two important points which help sharpen the focus on the role of fiduciary law.
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> The first is that fiduciary law is more concerned with the position of the parties that *results from* the relationship which gives rise to the fiduciary duty than with the respective positions of the parties *before* they enter into the relationship. La Forest J. in *Hodgkinson*, at p. 406, made this clear by approving these words of Professor Ernest J. Weinrib: 'It cannot be the *sine qua non* of a fiduciary obligation that the parties have disparate bargaining strength … In contrast to notions of conscionability, the fiduciary relation looks to the relative position of the parties that results from the agreement rather than the relative position that precedes the agreement' ("The Fiduciary Obligation" (1975), 25 *U.T.L.J.* 1, at p. 6). Thus, while vulnerability in the broad sense resulting from factors external to the relationship is a relevant consideration, a more important one is the extent to which vulnerability arises from the relationship: *Hodgkinson*, at p. 406.

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47 [2009] 3 SCR 247 at [66].

> The second is that a critical aspect of a fiduciary relationship is an undertaking of loyalty: the fiduciary undertakes to act in the interests of the other party. This was put succinctly by McLachlin J. in *Norberg*, at p. 273, when she said that 'fiduciary relationships ... are always dependent on the fiduciary's undertaking to act in the beneficiary's interests'. See also *Hodgkinson*, per La Forest J., at pp. 404-7.
>
> Underpinning all of this is the focus of fiduciary law on relationships. As Dickson J. (as he then was) put it in *Guerin v. The Queen*, [1984] 2 S.C.R. 335, at p. 384: 'It is the nature of the relationship … that gives rise to the fiduciary duty …' The underlying purpose of fiduciary law may be seen as protecting and reinforcing 'the integrity of social institutions and enterprises', recognizing that 'not all relationships are characterized by a dynamic of mutual autonomy, and that the marketplace cannot always set the rules': *Hodgkinson*, at p. 422 (*per* La Forest J.). The particular relationships on which fiduciary law focuses are those in which one party is given a discretionary power to affect the legal or vital practical interests of the other: see, e.g., *Frame v. Smith*, [1987] 2 S.C.R. 99, *per* Wilson J., at pp. 136-37; *Norberg*, *per* McLachlin J., at p. 272; Weinrib, at p. 4, quoted with approval in *Guerin*, at p. 384."[48]

Cromwell J concluded that fiduciary duties will only be imposed on those who have expressly or impliedly undertaken them in the following passage:

> "The appellants fault the Court of Appeal for holding that fiduciary duties may arise only on the basis of the reasonable expectations of one party. The appellants say that there must be a mutual understanding that the fiduciary will act only in the interests of the other party. While I agree with the appellants that the Court of Appeal erred by basing a fiduciary obligation on Ms. Perez's reasonable expectation, it is not necessary in order to resolve this appeal to go so far as to say that a mutual understanding is necessary in all cases. It is sufficient to say here that what is required in all cases is an undertaking by the fiduciary, express or implied, to act in accordance with the duty of loyalty reposed on him or her.
>
> I note that in *Hodgkinson*, this Court considered competing bases for the imposition of *ad hoc* fiduciary duties, opposing to a certain extent mutual understanding and reasonable expectations of the alleged beneficiary. While the seven judges sitting on the case were not fully unanimous in this respect, they all agreed that *ad hoc* fiduciary obligations may be imposed when there is a mutual understanding to this effect, and, following the example of Dickson J. in *Guerin*, at p. 384, left the door open to such an obligation arising from a unilateral undertaking by the fiduciary (see on this point Professor Lionel Smith's insightful comment

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48 [2009] 3 SCR 247 at [67]-[70].

on *Hodgkinson*, 'Fiduciary Relationships — Arising in Commercial Contexts — Investment Advisors: *Hodgkinson* v. *Simms*' (1995), 74 *Can. Bar Rev*. 714). Thus, what is required in all cases of *ad hoc* fiduciary obligations is that there be an undertaking on the part of the fiduciary to exercise a discretionary power in the interests of that other party. To repeat what was said by McLachlin J. in *Norberg*, 'fiduciary relationships … are always dependent on the fiduciary's undertaking to act in the beneficiary's interests' (p. 273). As Dickson J. put it in *Guerin*, fiduciary duties may arise where 'by statute, agreement, or perhaps by unilateral undertaking, one party has an obligation to act for the benefit of another' (p. 384).

The fiduciary's undertaking may be the result of the exercise of statutory powers, the express or implied terms of an agreement or, perhaps, simply an undertaking to act in this way. In cases of *per se* fiduciary relationships, this undertaking will be found in the nature of the category of relationship in issue. The critical point is that in both *per se* and *ad hoc* fiduciary relationships, there will be some undertaking on the part of the fiduciary to act with loyalty.

Commentators support this view. In his seminal work, *Fiduciary Obligations* (1977), Professor P. D. Finn writes at para. 15:

> For a person to be a fiduciary <u>he must first and foremost have bound himself</u> in some way to protect and/or to advance the interests of another. This is perhaps the most obvious of the characteristics of the fiduciary office for Equity will only oblige a person to act in what he believes to be another's interests if he himself has assumed a position which requires him to act for or on behalf of that other in some particular matter. [Emphasis added.]

To the same effect, Professor Smith writes in his comment on *Hodgkinson*, at p. 717 (echoing Dickson J.'s comments in *Guerin*, at p. 384, and Austin W. Scott, "The Fiduciary Principle" (1949), 37 *Cal. L. Rev*. 539, at p. 540):

> The fiduciary must *relinquish* self-interest; that is an act which the fiduciary does, not an act which is done to the fiduciary. This was put slightly differently by Austin Scott, who said that 'a fiduciary is a person who *undertakes* to act in the interest of another person.' [Emphasis in original.]

This does not mean, however, that an express undertaking is required. Rather, the fiduciary's undertaking may be implied in the particular circumstances of the parties' relationship. Relevant to the enquiry of

> whether there is such an implied undertaking are considerations such as professional norms, industry or other common practices and whether the alleged fiduciary induced the other party into relying on the fiduciary's loyalty."[49]

Cromwell J said:

> "As noted, the trial judge held that the evidence did not establish that Ms. Perez relinquished her decision-making power with respect to the loans to Mr. Galambos or that there was any discretion over her interests that he was able to exercise unilaterally or otherwise (para. 46). The Court of Appeal did not disagree with these conclusions and no basis for doing so has been suggested.
>
> In my respectful view, the finding of the trial judge that Mr. Galambos had no discretionary power over Ms. Perez's interests that he was able to exercise unilaterally or otherwise is fatal to her claim that there was an *ad hoc* fiduciary duty on Mr. Galambos's part to act solely in her interests in relation to these cash advances."[50]

The decision in *Galambos v Perez* is to be welcomed. We may, I think, look forward to further important contributions by Cromwell J.

GOOD FAITH AND UNCONSCIONABLE CONDUCT

The label "fiduciary" has no historical or doctrinal relationship to the common law contractual obligation of good faith,[51] but somehow the duty of good faith became involved in the discourse of fiduciary obligation. This was another confusing conceptual slide.

The fiduciary obligation requires self-abnegation. Good faith, whatever it means, is not the same as self-abnegation. People can be honest and selfish at the same time: indeed, most people are.

In Anglo-Australian law it is an implied term of every contract that a party is obliged to do all things reasonably necessary to ensure that the other party obtains the benefit of its bargain. This notion of a duty of good faith is rooted in agreement of parties; it is not a duty of general candour or fairness beyond the structure and terms of the contract; much less is it a duty to sacrifice one's own interests to those of the other party to the bargain.

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49 [2009] 3 SCR 247 at [75]-[79].

50 [2009] 3 SCR 247 at [85]-[86].

51 P Finn, "The Fiduciary Principle" in TG Youdan (ed), *Equity, Fiduciaries and Trusts* (1989: Carswell, Toronto).

In *Market Street Associates Ltd Partnership v Frey,*[52] Posner J described the obligation of good faith in the following terms:

> "This duty is, as it were, halfway between a fiduciary duty … and the duty merely to refrain from active fraud. Despite its moralistic overtones it is no more the injection of moral principles into contract law than the fiduciary concept itself is. It would be quixotic as well as presumptuous for judges to undertake through contract law to raise the ethical standards of the nation's business people. The concept of the duty of good faith like the concept of fiduciary duty is a stab at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute."[53]

While I would, with great respect, not agree with Judge Posner's implication that the duty of good faith is akin to fiduciary duty, I agree with what he went on to say in his characteristically pungent style:

> "… The office of the doctrine of good faith is to forbid the kinds of opportunistic behaviour that a mutually dependent, cooperative relationship might enable in the absence of rule. 'Good faith' is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties. The contractual duty of good faith is thus not some newfangled bit of welfare-state paternalism or the sediment of an altruistic strain in contract law, and we are therefore not surprised to find the essentials of the modern doctrine well established in nineteenth-century cases …"[54] [citations omitted].

The concept of good faith in contract law is accurately explained by Justice Allsop, the President of the New South Wales Court of Appeal, in his 2010 Sir Frank Kitto Lecture. This concept "has inhered in the fabric of commerce for centuries and which our courts have recognised on a piecemeal basis for a long time".[55] It is not an independent duty, standing apart from the contractual obligations, it is a tool to be used in interpreting and enforcing those obligations.

Unlike fiduciary obligation, the concept of good faith is "intrinsically tied to, and constrained by, the contract entered and to the honest and fair performance of what has been agreed, rather than the superimposition of moral values having their source and legitimacy outside the contract, and operating beyond the agreement of the parties."[56] As

52 (1991) 941 F.2d 588 (7th Cir. 1991).

53 (1991) 941 F.2d 588 (7th Cir. 1991) at 595.

54 *Market Street Associates Ltd Partnership v Frey* 941 F.2d. 588 (7th Circ. 1991).

55 Allsop, "Good Faith and Australian Contract Law – A Practical Issue and a Question of Theory and Principle", *2010 Sir Frank Kitto Lecture* at [135].

56 Allsop, "Good Faith and Australian Contract Law – A Practical Issue and a Question of Theory and Principle", *2010 Sir Frank Kitto Lecture* at [39].

the Privy Council said in *Re Goldcorp Exchange Ltd*, the essence of the fiduciary relationship is that "it creates obligations of a different character from those deriving from the contract itself."[57]

Contract law allows parties to promote their respective interests, whereas fiduciary law requires the subordination of the principal's interests to the beneficiary. Fiduciary obligations are radically different from the obligation to further mutually beneficial self interest – the essence of the contract.[58] As Justice Allsop observed:

> "The characteristic aspect of the duty of the fiduciary is, within the terms of the relationship, to subordinate its interests in favour of its beneficiary. This subordination will be derived from the degree of power and control and consequent vulnerability of the respective parties in the relationship.
> …
> The usage of the phrase good faith in this equitable context should not give rise to the notion that in a commercial non-fiduciary context it carries with it the obligation upon a contracting party to subordinate its interests to those of the arms' length contractual counterparty. That is not the case. The possibility of confusion with the incidents of faithfulness of the equitable fiduciary have led some (wisely I think) to prefer other terminology: fidelity to the bargain and fair dealing."[59]

What the duty of good faith is not concerned with is the subordination of one's own legitimate interests. In this regard, Justice Allsop observed that:

> "In any given case, it may or may not be reasonable to expect a party to act, or refrain from acting given the expense or risk of the act, to ensure the benefit to the counterparty. This notion of fidelity to the bargain and cooperation to vindicate, or ensure receipt of, benefits can be seen to be restrained or constrained by a sense of reasonableness or fair dealing arising from the parties' mutual rights.
> …
> This is the proper scope and reach of reasonableness in good faith and fair dealing: the element of commercial reasonableness and fairness in behaving with a faithfulness or fidelity to the bargain.
> …
> [T]hese obligations do not require subordination of a party's own interests to those of the other party. The content and scope of the obligation depends upon the other terms of the contract and the context in which the contract was made. Reasonableness takes its place as an objective element in fair dealing together with honesty and fidelity to the bargain in

57 [1994] 2 All ER 806 at 821.

58 Laura Hoyano, "The Flight to Fiduciary Haven" in Birks (ed), *Privacy and Loyalty* (1997: Oxford University Press, Oxford) at 186.

59 Allsop, "Good Faith and Australian Contract Law – A Practical Issue and a Question of Theory and Principle", *2010 Sir Frank Kitto Lecture* at [35] – [36].

> the furtherance of the contractual objects and purposes of the parties, objectively ascertained."[60]

A further point to be made here is that "good faith" in the contractual sense is not a test of unconscionability standing free of a contract.

In *Commercial Bank of Australia Ltd v Amadio*,[61] migrant parents, who did not speak English and guaranteed a son's debt to a bank, were relieved of their obligations under their guarantee on the basis that they were under a special disadvantage by way of a "disabling condition or circumstance … which seriously affects the ability of the innocent party to make a judgment as to his own best interests, when the other party knows or ought to know of the existence of that condition or circumstance and of its effect on the innocent party."[62] We can now see this decision as a high-water mark rather than a sign-post pointing the way to further expansion of the concept of unconscionability.

A tightening of the language in which the concept of "unconscionability" is framed, is evident in the decision of the High Court in *Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd & Ors.*[63] In that case, the High Court accepted by a 4-1 majority that there is a real difference between opportunistic exploitation of an advantage to drive a hard bargain and behaving unconscionably.

In that case, the respondents, CG Berbatis Holdings Pty Ltd owned, in common with others, a shopping centre in Western Australia. Margaret and James Roberts leased one of the premises where they operated a fish and chip business.

In 1996 the Roberts, along with a number of other tenants, were involved in a dispute with Berbatis over alleged overpayments made to the owners during the course of their lease. The overpayments were estimated at $50,000 by the Roberts but if they had gone ahead with the settlement of proceedings, they would have been entitled to only $2,786.43.

While the litigation remained on foot, the Roberts' lease was due to expire; no right of renewal existed. The Roberts sought to sell their business, in part due to their daughter being seriously ill with encephalitis. The Roberts received an offer from a potential purchaser, subject to a lease of the premises being assigned to the purchaser's satisfaction. Berbatis, the owners, were aware of the Roberts' desire to sell, their need to renew the lease and the illness of their daughter. The owners were prepared to agree to the arrangement on the condition that the deed include a clause obliging the Roberts and the purchaser to discharge the owners from all claims arising from any act or omission by the owners before the proposed assignment date, and whereby the Roberts would dismiss

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60 Allsop, "Good Faith and Australian Contract Law – A Practical Issue and a Question of Theory and Principle", *2010 Sir Frank Kitto Lecture* at [61].

61 (1983) 151 CLR 447.

62 *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447 at 462.

63 (2003) 214 CLR 51.

their current legal proceedings against the owners. The Roberts acceded to the inclusion of this clause in the deed of assignment.

The Australian Competition and Consumer Commission (ACCC) brought proceedings on behalf of the Roberts alleging unconscionable conduct on the part of the owners. The ACCC alleged that the owners' imposition of cl 14 contravened Pt IVA of the *Trade Practices Act 1974* (Cth) (TPA), which at the relevant time comprised ss 51AA-51AB. It has since been amended, in particular, by the insertion of s 51AC of the TPA (unconscionable conduct in business transactions) and more recently under the change of the TPA to the *Competition and Consumer Act 2010* (Cth).[64] At the relevant time s 51AA stated:

> 1. 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.
> 2. This section does not apply to conduct that is prohibited by section 51AB.

The trial Judge, French J, found that s 51AA of the TPA had been contravened because the Roberts suffered from a special disadvantage which the lessor had taken opportunistic advantage.[65] The fact that the Roberts had received competent legal advice was not seen by French J as fatal to their claim. The critical passage in which French J formulated his conclusions was as follows:

> "In my opinion for the owners to insist, as they did through Mr Sullivan in this case, upon the Roberts abandoning their rights to proceed with bona fide litigation in relation to their rights under their existing lease was to engage in unconscionable conduct. The claims that they, in common with other tenants, were raising against the owners were bona fide and serious. They were taken seriously by both the tenants and by the owners."[66]

His Honour added that it was of no consequence that the detriment suffered by the Roberts may have been small in monetary terms as there had been an exploitation of the vulnerability of the Roberts in relation to the sale of their business which was "grossly unfair".

On appeal to the Full Court of the Federal Court, the Full Court unanimously allowed the owners' appeal, taking a qualitatively different view of their conduct from French J. In particular, the Full Court drew a distinction between parties adopting "an opportunistic

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64 Section 51AA of the TPA is now s 20 of *the Competition and Consumer Act 2010* (Cth). I will, however, refer to s 51AA of the TPA for the purposes of this paper.

65 *Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd* [2000] ATPR 41-778.

66 *Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd* [2000] ATPR 41-778 at 41,197.

approach to strike a hard bargain" and those who act unconscionably within the meaning of the section.[67]

The view of the Full Court was upheld on a further appeal to the High Court. Gleeson CJ referred to the notion of situational disadvantage referred to by French J and warned against such descriptions taking on a life of their own. The critical disadvantage of the lessees was that they had no legal entitlement to a renewal of the lease and that their ability to sell their business depended on the owner's granting such renewal. They were able to make a decision between two financial interests: their legal claim and the sale of their business. In the opinion of Gleeson CJ, the circumstance that a person lacks the commercial ability to pursue both interests at the same time was not a special disadvantage for the purpose of rules against unconscionability. And, with respect, surely it is correct to take a restrictive view of the circumstances in which those who engage in commercial dealings can seek to undo them after they turn out badly by asserting their lack of fitness to be at the bargaining table in the first place.

UNJUST ENRICHMENT AND *FARAH CONSTRUCTIONS PTY LTD v SAY-DEE PTY LTD*

The High Court of Australia in *Farah Constructions Pty Ltd v Say-Dee Pty Ltd*[68] addressed, albeit in obiter dicta, the problem which arises when assets have been misdirected by a fiduciary who is unable to make good the loss and the beneficiaries seek to recover from those persons who received the assets. In considering the "fine balance between the interests of people who have entrusted their assets to fiduciaries and the interests of those who deal with fiduciaries in good faith",[69] the High Court adhered to the view expressed in its earlier decision in *Consul Development Pty Ltd v DPC Estates Pty Ltd*[70] that those who deal honestly with fiduciaries will not be liable to the beneficiaries. There has been a deal of criticism of the High Court's position on this issue.[71]

Ironically, in terms of the criticism that Australia is isolated and should follow the Canadian lead to equity's broad sunlit uplands, the Supreme Court of Canada in *Citadel General Assurance Co v Lloyds' Bank Canada*[72] in 1997 took the same line the High Court of Australia took ten years later in *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* in insisting upon an element of dishonesty if a recipient of trust property is to be held liable for that receipt.

I propose to confine my discussion of the decision in *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* to the criticism of the evident reluctance of the High Court to accede to the restitutionary notion, championed by academic writers such as Peter Birks, that

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67 (2001) 185 ALR 555 at [48] per Hill, Tamberlin and Emmett JJ.
68 (2007) 81 ALJR 1107.
69 Rob Chalmers, "Knowing Receipt: Frozen in Australia" 2007 2 *Journal of Equity* 40.
70 (1975) 132 CLR 373.
71 Rob Chalmers, "Knowing Receipt: Frozen in Australia" 2007 2 *Journal of Equity* 40-41.
72 [1997] 3 SCR 805.

liability for the receipt of trust property should be established without the need for knowledge on the part of the recipient of the breach of trust which has led to the receipt. It is the element of knowledge which makes recipient liability fault-based.

One thing about actually deciding cases within the judicial hierarchy is that it is enough for those of us at intermediate levels within the hierarchy to know what the rules are and to apply them without worrying about whether the rules should be changed. That having been said, I would respectfully suggest that there are good reasons in terms of the fundamental values of equity why the liability should be fault-based rather than absolute.

We are concerned here with what is often referred to as the first limb of the famous statement by Lord Selborne LC in *Barnes v Addy*.[73] It is worth setting out what his Lordship said at some length because the passage shows the importance of the voluntary assumption of responsibility by a defendant who is not a trustee to liability as a de facto trustee. His Lordship said:

> "Those who create a trust clothe the trustee with a legal power and control over the trust property, imposing on him a corresponding responsibility. That responsibility may no doubt be extended in equity to others who are not properly trustees, if they are found either making themselves trustees *de son tort*, or actually participating in any fraudulent conduct of the trustee to the injury of the *cestui que trust*. But, on the other hand, strangers are not to be made constructive trustees merely because they act as the agents of trustees in transactions within their legal powers, transactions, perhaps of which a Court of Equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on the part of the trustees."

There are strong advocates for the view that the mere receipt of the assets of another should be sufficient to give rise to liability. Lord Nicholls of Birkenhead, for example, has said that liability based on "the mere fact of receipt" should be accepted because it recognises "the endurance of property rights."[74] But Lord Parker of Waddington, widely acknowledged as one of the great equity judges of the 20th Century, famously explained that equity, starting from the recognition of personal obligations in respect of property, gave remedies which had proprietary consequences. The property rights of a beneficiary of a fiduciary relationship have never been more enduring than the willingness of courts to require the fiduciary to adhere to obligations voluntarily undertaken.

In this way, equity's refusal to interfere with the rights of a purchaser of property in good faith without notice and for good consideration served to mark out the boundary at which a plaintiff asserting an equitable claim could not, in conscience, be allowed to assert it.

73 (1874) LR 9 Ch App 244 at 251 – 252.

74 Lord Nicholls of Birkenhead, "Knowing Receipt: The Need for a New Landmark" in William Cornish, Richard Nolan, Janet O'Sullivan, and Graham Virgo (eds), *Restitution, Past, Present and Future: Essays in Honour of Gareth Jones* (1998: Oxford), p. 238.

This rule embodies the fundamental concern of equity, not only with the conscience of the defendant, but with ensuring conscientious dealing by all parties.

Under the first limb in *Barnes v Addy*, strangers to a trust are not to be made constructive trustees unless they have made themselves trustees - *de son tort*, as it is said. In other words, they must have deliberately intermeddled with property in a way which would be regarded as legitimate only if they had lawfully assumed the responsibilities of trustee. That was the view of Stephen J with whom Barwick CJ agreed in *Consul Development Pty Ltd v DPC Estates Pty Ltd*.[75] That is a view which also has the support of other judges whose views on matters of equitable doctrine are entitled to the highest respect.

In *Westdeutsche Landesbank Girozentrale v Islington London Borough Council*,[76] Lord Browne-Wilkinson rejected the possibility that a recipient of a legal interest in property could be fixed with the obligations of a trustee for the true owner while ignorant of the acts which might offend conscience. Similarly, in the Queensland Court of Appeal in *Port of Brisbane Corporation v ANZ Securities Limited (No 2)*, McPherson JA, with whom the other members of the Court agreed, held that it would be "offensive to notions of equity and common sense to hold [a defendant] liable for a supposed breach of trust as trustee for [the plaintiff] at a time when it had never undertaken and was not aware that any such obligation existed."[77]

Lord Goff of Chieveley, the doyen of restitution lawyers, recognised the strength of the view that the ethical concerns embodied in equitable doctrines should not be shoehorned into the common law categories collected and rationalised under the rubric of the law of restitution. In *Westdeutsche Landisbank Girozentrale v Islington London Borough Council*, Lord Goff said: [78]

> "Ever since the law of restitution began, about the middle of this century, to be studied in depth, the role of equitable proprietary claims in the law of restitution has been found to be a matter of great difficulty. The legitimate ambition of restitution lawyers has been to establish a coherent law of restitution, founded upon the principle of unjust enrichment; and since certain equitable institutions, notably the constructive trust and the resulting trust, have been perceived to have the function of reversing unjust enrichment, they have sought to embrace those institutions within

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75 (1975) 132 CLR 373 at 408.

76 [1996] AC 669 at 705.

77 [2003] 2 Qd R 661 at 679. This view involved a departure from the approach of the New South Wales Court of Appeal in the earlier case of *State Bank of New South Wales Ltd v Swiss Bank Corporation* (1995) 39 NSWLR 350, where it was held that a recipient of property who could reasonably have undertaken enquiries to establish the true beneficial ownership of the property but did not, was held liable to make good the plaintiff's loss. McPherson JA ([2003] 2 Qd R 661 at 674 – 675) relied upon the view expressed by Sir Frederick Jordan CJ in *Oxley v James* (1938) 38 SR(NSW) 362 at 375, that "in commercial transactions … means of knowledge are not actual knowledge." On this view, so long as a recipient acts in good faith and does not wilfully shut his or her eyes to matters which will reveal actual fraud or impropriety, there can be no liability to the beneficial owner in equity or in restitution.

78 [1996] AC 669 at 685.

> the law of restitution, if necessary moulding them to make them fit for that purpose. Equity lawyers, on the other hand, have displayed anxiety that in this process the equitable principles underlying these institutions may become illegitimately distorted; and though equity lawyers in this country are nowadays much more sympathetic than they have been in the past towards the need to develop a coherent law of restitution, and to identify the proper role of the trust within that rubric of the law, they remain concerned that the trust concept should not be distorted, and also that the practical consequences of its imposition should be fully appreciated. There is therefore some tension between the aims and perceptions of these two groups of lawyers, which has manifested itself in relation to the matters under consideration in the present case."

As Lionel Smith said in his article "Unjust Enrichment, Property, and the Structure of Trusts":[79]

> "The strict liability approach would contemplate that a plaintiff need only allege that a bank received trust property, not that the bank knew or should have known of the trust; with no more than that, the bank would be required to prove its good faith as a defence or to account for what it has done with this money. In other words, there is no procedure which a bank, be it ever so honest, can adopt in order to ensure that it is not prima facie liable for the receipt of trust funds. Prima facie liability implies potentially extended periods of expense and uncertainty when litigation is pending; and of course it throws on the defendant the risk that even though the elements of some defence are present, they cannot be proved to the satisfaction of the trier of fact. Although there may be no difference in the classroom between fault-based liability and strict-liability with defences, there is a great difference in the courtroom."

Third parties who deal with fiduciaries deal with persons clothed with the indicia of title to the asset in question, e.g. possession or control or registration. It is for the very reason that the equitable rights of the beneficiary in respect of the property are not apparent to third parties that equity accords protection to the bona fide purchaser for value against the claims of the beneficiary. A watering down of that protection in relation to recipient liability will not come without cost.[80]

In *Manchester Trust v Furness*, Lindley LJ said:[81]

> "… as regards the extension of the equitable doctrines of constructive notice to commercial transactions, the Courts have always set their faces resolutely against it. The equitable doctrines of constructive notice are common enough in dealing with land and estates, with which the Court is

79 (2000) 116 *Law Quarterly Review* 412 at 434.
80 *Barclays Bank plc v Boulter* [1999] 1 WLR 1919 at 1925.
81 [1895] 2 QB 539 at 545.

> familiar; but there have been repeated protests against the introduction into commercial transactions of anything like an extension of those doctrines, and the protest is founded on perfect good sense. In dealing with estates in land title is everything, and it can be leisurely investigated; in commercial transactions possession is everything, and there is no time to investigate title; and if we were to extend the doctrine of constructive notice to commercial transactions we should be doing infinite mischief and paralyzing the trade of the country."

Moreover, to accept that an internal misapplication of company funds by the company's directors could result in a co-ordinate liability in the company's bank, where the bank had no notice at all of the misapplication, would be to delete the internal management rule from our company law.[82]

Of course, if a recipient still retains the funds when it receives notice of the breach of fiduciary duty, it is obliged to disgorge them, but that is because it has become a recipient of trust property with actual notice of the claim of the true owner.

Apart from pragmatic considerations, it is contrary to equity's sense of social responsibility to allow a remedy to a plaintiff who has made the choice to deal with a third party through a fiduciary against the third party where the third party has acted honestly and without notice of the agent's breach of trust. If a third party deals honestly with an errant fiduciary, that third party should not find itself fixed with a liability equal to that of the defaulting fiduciary: the third party has never accepted the fiduciary obligation of self-denial in favour of the beneficiary.

Furthermore, within the category of unjust enrichment, the liability to disgorge the amount received is measured not by the defendant's promise – as is the case with breach of contract; nor by the extent of the plaintiff's injury – as is the case with the common law of tort; but by the extent of the defendant's unjust enrichment at the expense of the plaintiff. It is difficult to see that the pursuit and recovery of any unearned windfall derived from the successful investment of the asset can be squared with the requirements of conscience so far as the plaintiff is concerned.

DISHONESTY

Of course, the central concept "dishonesty" is complex. In a criminal case, *R v Salvo*,[83] McInerney J explained why the concept of "dishonesty" is so complex:

> "The word 'dishonesty' implies reference to a standard of morality underlying the law. The law sets standards of legality and illegality but cannot set and never has purported to set standards of morality. Standards of morality underlie the law: they derive not from the law but from the standard of ethics accepted by the community."

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82 Cf *BCCI (Overseas) Ltd v Akindele* [2001] Ch 437 at 455 – 456.

83 [1980] VR 401 at 407.

This standard is thus to be discovered, rather than prescribed by judges. But whether the exercise is one of discovery or prescription by the Court, there is a degree of uncertainty in the concept.

While generally speaking, uncertainty in the law is a bad thing, and a very bad thing indeed in commercial law, there is a view abroad that certainty as to the precise metes and bounds of the concept of dishonesty is not a bad thing. Professor Janet Austin in her recent article, "When does sharp business practice cross the line to become dishonest conduct", has suggested: [84]

> "Paradoxically the very uncertainty inherent in the concept of dishonesty may be beneficial for the community at large in that it may act to foster ethical behaviour. As such, the use of dishonesty as an element of criminal offences in areas of commerce where the community expects the highest standards of ethical conduct, such as dealings between financial advisers and the public, should probably be encouraged."

CONCLUSION

The ethical values of individual restraint, mutuality and social responsibility at play within the framework developed by Chancery differ from the individualism and the universalism of the common law. To regard equitable doctrines as modular, so that they may be mixed and matched with common law rules so as to expand the scope of the judicial branch of government's regulation of self-interested action, is to fail to appreciate these differences.

It was always a troubling feature of the unifying and expansionary jurisprudence that it seemed to work only one way. There is a marked absence of examples of defendants avoiding liabilities. So far as commercial law is concerned, there has always been some scepticism in that the proper development of the law does not mean an inevitable broadening and intensification of judicial intervention in the commercial life of the community. There was always a question-mark over the idea of an evolution which involves an ineluctable expansion in the liabilities imposed by the courts upon those in business who conduct themselves honestly.

There were a number of questions: is it necessarily a good thing that arm's length transactions in the commercial life of the community be subject to regulation in accordance with standards of behaviour devised for the regulation of relationships of trust and confidence which are distinctly not arm's length relationships? Is such a development a sound expression of the values of modern commercial life, bearing in mind that equity never set out to bring to heel what John Maynard Keynes described as "the uncontrollable and disobedient psychology of the business world"?

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[84] (2010) 29(2) *University of Queensland Law Journal* 263 at 278.

As the cases referred to in Lord Neuberger's speech in 2009, and the cases I have referred to here, suggest, that so far as commercial law is concerned, equitable doctrines are no longer on the march to expand the liabilities of financiers.

It is perhaps too early in terms of legal history to give a confident explanation of the underlying reasons for the swing back. I suspect the reasons may be that, at least so far as commercial cases are concerned, the rapidly accelerating processes of globalisation have brought home to businessmen, lawyers and judges alike, that the exacting demands of international trade and commerce cannot accommodate rules which pursue abstract notions of fairness and more perfect justice at the expense of commercial certainty.

In one of my last cases at the Bar, the Swiss Bankers for whom I was acting, were aghast at the suggestion that the express terms of letters of credit which they had issued could be trumped by estoppels based on imperfect understandings arising in the course of oral discussions. The English language is imprecise enough when used by native English speakers: to insist that non-English speakers' written bargains should be altered by the effect of oral statements is hubris of an order which international commerce will not tolerate.

In my last few years at the Bar, I found that frequently when discussing upcoming hearings with managers of corporate clients, they would express their concern as to how we lawyers could get across to the judge the extent to which their companies' reasonable commercial expectations had been disappointed by the other side's performance. I would say to them: "Well, we will read the terms of the contract to the judge."

To which they would usually reply with something like: "But that won't convey the extent to which we were really relying on them. We had many discussions with them in which we explained our problems to them and they always told us that they understood where we were coming from and that they were confident that they could solve our problems. If we had not been given these assurances, we would have signed up with someone who would have."

They were always quite serious. They seemed to have no appreciation of the significance of the written contract as the final and exclusive charter of the parties' rights and obligations. Once again I emphasise that we are not talking about cases involving widows and orphans.

The uncertainty inherent in the equitable doctrines I have been discussing not only affects the parties to the contract, their assigns and their bankers; it also has an adverse impact on the courts and the public interest. The lengthy forensic investigations directed to reconstructing the contractual negotiation in each case come at a cost in terms of time and money for the courts, and the taxpayers who fund them, and for other litigants who are kept in the holding pattern while we all relive the day by day negotiation of the contract.

To those who think I exaggerate the value of certainty, I say that you have not spent months of your professional life in cases in which one side or the other troops witness after witness through the court to say why some arrangement which never actually found its way into a signed contract was utterly crucial to the contract which was actually signed.

And the actual success rate of estoppel claims suggests that it is a dog that rarely barks. It seems that the concern to make commerce safe for those who are not able or willing to conform with considerations of reasonable prudence is a game which is unlikely to be worth the candle so far as the return to the wider community is concerned.

This disproportionate demand of commercial cases on the community's resources is a problem which, a couple of years ago, led Chief Justice Gleeson, formerly the Chief Justice of Australia, to warn against the excessive demands which the commercial sector is making on the legal system in this country.

There are, I suggest, other concerns at stake here which relate to the values which a legal system which operates as part of a globalising world should uphold. There are values of competence and integrity on the part of those who engage in commerce. There are concerns about commercial morality.

The signing of a written contract is a solemn moment in a negotiation. It brings the negotiation to an end. Until then the parties are free to alter their position or even to withdraw from the negotiation altogether. This has been well-understood since the time of Hammurabi.

Commerce proceeds on the assumption that each party to a commercial negotiation is expected to do his or her honest best to ensure that he or she concludes a bargain on the terms most favourable to that party, and that it is that party's responsibility not to execute the contract until it is an accurate charter of the parties' rights and obligations.

Each side gives and takes until the contract is concluded, and each side understands that the document finally executed will reflect the final balance struck between give and take. The notion that the signing of the contract was but a provisional episode in an ongoing and open-ended negotiation is distinctly unattractive in terms of the values of commercial prudence and competence.

Surely no-one would knowingly invest in a company in which the management do not understand or will not accept the solemn importance of the signing of a contract, preferring to pursue the hope that some form of post-contractual royal commission will "make them whole", as the Americans say.

It is impossible to imagine that a manager of a corporation would admit to his shareholders that he has allowed the corporations business to be conducted so gormlessly. And yet before a court that same manager may cheerfully assert his incompetence as he comes forward to claim the rewards of his victimhood.

It seems to me that what was at stake is the integrity of those who engage in business in the market. The law should not offer encouragement to those willing to say that they thought that their tentative and provisional arrangements would either replace the need for a concluded contract or, alternatively, would survive the execution of a contract which did not embody those arrangements.

Another reason may be that the activity of the legislature in proscribing higher standards for financiers and other corporations in their dealings with consumers has taken the pressure off the courts to pursue an agenda of consumer protection. The Courts are no longer impelled to develop doctrine to provide the same level of protection to consumers as is provided to those in business. The Courts are no longer under the pressure of trying to formulate doctrines which can apply at the same time to commercial cases involving consumers or persons at a disadvantage. It is open to legislatures to frame rules which provide such differential protection: it is more difficult for courts to make overt policy choices.

This point was recently illustrated in the decision of the Full Court of the Federal Court in *Leveraged Equities Limited v Goodridge*[85] in relation to s 12CB of the *Australian Securities and Investments Commission Act 2001* (Cth) ("the ASIC Act") which proscribes unconscionable conduct. The Full Court held that the section applies only to financial services of a kind ordinarily acquired for personal, domestic or household use so that a borrower who acknowledges that the borrowed funds would be applied wholly or predominantly for investment was outside the scope of the section, even if the investment was for the purpose of providing for the borrower's retirement. The Full Court also reiterated the view, expressed in *Bacnet Pty Ltd v Lift Capital Partners Pty Ltd (in liq)*,[86] that there is nothing unconscionable in a lender enforcing its legal rights to protect itself against a fall in the value of its security.

The points I would emphasise for present purposes are that to afford a differential level of protection to borrowers based on the purpose of the borrowing is to make and articulate the limits (which may be arbitrary) of a policy choice. That process of arbitrary (because a line has to be drawn somewhere when, eg, defining "consumers") choice is not open to judges and that the Courts are not disposed to strain to protect a commercial borrower.

In summary, so far as commercial cases are concerned, we can, I think, say that the tightening of the conceptual basis of equitable doctrine broadly reflects the judiciary's acceptance that, in a globalizing world in which free market values predominate, commerce cannot be made safe for everyone. Having accepted that market based reality, the Courts recoiled from a looming situation in which they would need to put up a sign outside our commercial courts advising litigants: "Please leave Your Mobile Phones and Your Dignity at the Door."

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85 [2011] FCAFC 3.

86 [2010] 183 FCR 384 at [118] – [120].

EQUITY'S ROLE IN FINANCIAL RISK ALLOCATION:

Satisfying or defying commercial expectations?*

WORKING PAPER

1. Introduction

It has been common in discussing equity's role in the commercial field to think of that role in terms of a dichotomy; on the one hand, equity imposing liability and, on the other, equity providing relief from liability. Equity might impose liability through, for example, recognising a fiduciary relationship or a constructive trust. It might provide relief by setting aside a contract on account of a counterparty's unconscionable conduct or undue influence or by giving relief against forfeiture or penalties. In such situations, equity has focused on the position between particular parties dealing with each other. Its role may, in commercial terms, be viewed as allocating risk as between the two specific counterparties. Generally, it is the conduct of one party to the commercial transaction which causes equity to intervene in the transaction[1] and often there is some disparity between the parties, in terms for example of knowledge or experience. Emphasis is laid on the concept of 'conscience', which the Chief Justice of the Federal Court has described as being of 'central importance to [equity's] mission'.[2]

This paper[3] contends however that there is a further role which equity appears to play in commercial, and in particular financing, transactions, which is quite distinct from that more commonly acknowledged role. In certain, at times seemingly ill-defined, circumstances, equity may intervene to 'adjust' a person's legal position. It adjusts it in the sense of first recognising the actual legal position - for example, a legal liability of a party to a transaction or, in more general terms, some form of exposure to financial risk - and then reducing the practical impact of that liability or exposure without necessarily altering the original liability or exposure. Perhaps the clearest example is provided by the position of a guarantor (G1) who has paid out under a guarantee. G1 may be able under equitable principles to call on another guarantor of the same debt (G2) to make a payment to G1, thereby reducing G1's overall exposure. Assume that G1 has a legal liability to pay $100. If equity intervenes, G1 may call successfully on G2 for $50. G1's overall exposure is therefore only $50, although G1's admitted legal liability was $100.

It can be argued that there are a number of equitable doctrines capable of being loosely grouped around a concept of 'adjustment' and that, taken together, they offer a useful insight

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[1] Hence Sir Anthony Mason's extra-curial observation that Equity's intervention in commerce has 'subjected the participants in commercial transactions, where appropriate, to the higher standards of conduct for which it is noted and....exposed the participants to the advantages and detriments of relief in rem': Mason, 'The place of equity and equitable remedies in the contemporary common law world' in Lindell (ed) **The Mason Papers** Federation Press Sydney 2007 at p 309. See also (1994) 110 LQR 238.

[2] Keane, 'The 2009 WA Lee Lecture in Equity: The conscience of equity' (2010) 84 ALJ 92 at 94.

[3] This working paper is part of a larger research project into the role of equity in financial risk allocation. It is also informed by courses developed and taught on 'Equity and Financial Risk Allocation' in conjunction with my colleague, Professor John Stumbles, at Sydney Law School in 2010-2011.

from a banking and finance lawyer's perspective into how equity may allocate financial risk. This paper commences by briefly identifying possible doctrines. While the grouping may be academically controversial, the paper assumes its utility in order to focus on a practical issue potentially of interest to an audience of transactional lawyers; namely, the extent to which such doctrines may be said to satisfy commercial expectations. It is not uncommon to find views expressed that some, if not all, of these doctrines, which tend to be rooted in 17th and 18th century English case law, either have no place in the modern Australian commercial legal landscape or at least need to be significantly modified if they are to survive and flourish. In his dissenting judgment in *Burke v LFOT Pty Ltd*[4] in 2002, Kirby J called, for example, for a re-evaluation of contribution and other equitable remedies and advocated their development to meet what he described as 'new and modern needs'. He observed:

> In developing equitable principles to fit the modern world, courts, including this Court, should look beyond the exposition of the principles in old cases or texts that necessarily reflect the often rigid legal environment and judicial disposition of past times. Instead, they should search for the underlying purpose of the old rule: concepts, not detail... Equitable remedies need to be fashioned to meet new and changing circumstances. Contribution is one such remedy. Our admiration of equity's past is best expressed by being alert to assure its present operation and future relevance.

This paper explores what commercial expectations banking and finance lawyers may have in relation to these doctrines and the extent to which those expectations might reasonably be considered satisfied. Given time constraints, it focuses by way of example on simply one of these doctrines - the doctrine of marshalling, which was recently described in a somewhat understated fashion by the English High Court as 'a doctrine with its own peculiar and distinct characteristics'.[5] The doctrine is of particular interest for several reasons and not only because it is often viewed as impenetrable, with many lawyers typically recalling that it has 'something to do with Whiteacre and Blackacre'[6] but struggling nonetheless to articulate what that something might be. Two rather more serious reasons are:

- an increasing likelihood that the issue will be encountered in practice. It has been suggested, for example, that more claims to marshall than would customarily arise may emerge in the near future, given the proliferation of credit in the period immediately prior to the global financial crisis. The hypothesis is that ready availability of credit would have led to property being used to support more than one mortgage, thereby establishing factual circumstances potentially triggering the operation of the doctrine;[7] and

- unresolved issues emerging from relatively recent academic commentary and judicial obiter dicta which potentially push the boundaries of the doctrine further than perhaps generally appreciated in practice.[8]

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[4] (2002) 209 CLR 282 at 326.

[5] *The Serious Organised Crime Agency v Szepietowski* [2010] EWHC 2570 (Ch).

[6] This recollection is seemingly often based on an oft-cited dictum from *Webb v Smith* (1885) 30 Ch D 192 at 200 per Cotton LJ.

[7] Chippindall , 'A blast from the past: marshalling of later mortgagee's securities and apportionment of proceeds of sale of securities in the current economic climate', (2009) 25(3) BLB 53 at 53.

[8] Interestingly, a ''pushing of the boundaries'' is not confined to marshalling. Recent litigation suggests that other doctrines within this grouping are susceptible to having their scope of operation tested. See for example *Burke v LFOT Pty Ltd* (2002) 209 CLRL 282 and *Friend v Brooker* (2009) 239 CLR 129 on the limits of

An additional, and indeed compelling, reason which should cause banking and finance lawyers at the moment to pause and further reflect on the doctrine is the much heralded advent of the *Personal Property Securities Act* 2009 (Cth),[9] which not only expands the notion of what constitutes a security interest in relation to personal property but also significantly changes the traditional common law rules for creating and ranking such interests. Academic debate in other jurisdictions which have introduced equivalent legislation has raised the question whether the doctrine should continue to be available. In 1994, for example, Professor MacDougall analysed Canadian case law and concluded:[10]

> Marshalling is one old piece of the law that deserves a place in modern secured transactions law.

However, some 10 years later Professor Gedye, reviewing the position in New Zealand, described himself as 'ambivalent' on the issue, pointing to a number of local circumstances which he suggested would make the doctrine more frequently applicable than in Canada.[11] He identified as a matter of particular concern the potential number of suppliers holding unperfected purchase money security interests, for whom marshalling might provide the 'only prospect of payment', bearing in mind that unperfected security interests are not invalidated in an insolvency under the New Zealand legislation.[12] Certainly, it would appear that the statutory recognition of such functionally equivalent transactions, not to mention flawed asset arrangements, as 'in substance' security interests[13] and indeed of other arrangements as 'deemed' security interests[14] has the potential to significantly widen the scope for marshalling. Such issues are, however, beyond the scope of this paper.

2. Identifying possible equitable doctrines which allocate risk through 'adjustment'

The doctrines of contribution and marshalling offer a useful starting point for the analysis of risk allocation. Explanations of their operation based on a notion of 'adjustment' can be found in case law dating back to at least the mid-19th century.[15] While contribution is reasonably readily outlined as noted in the Introduction, marshalling affords a rather more complicated illustration. Marshalling may be said to adjust the position of a second ranking secured creditor (the second creditor), the value of whose security over a particular piece of property has been diminished because a prior ranking secured creditor who also has security over other property (the first creditor), decides to enforce its security over the property over which the second creditor is secured. The second creditor may enforce its security over what remains of the property after the first creditor has enforced. To the extent, however, that there

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contribution; *Bofinger v Kingsway Group Ltd* (2009) 239 CLR 269 in relation to the doctrinal basis of subrogation.

[9] Enacted in 2009, the legislation is expected to become operative in October 2011: see www.ag.gov.au.

[10] MacDougall, 'Marshalling and the Personal Property Security Acts: Doing Unto Others...' (1994) 28 UBC Law Review 91 at 122.

[11] Gedye, 'What's Yours is Mine: Attachment of Security Interests to Third Party Assets' (2004) 10 NZBLQ 203 at 217. See generally ibid at 216-220. See also Gedye, Cuming & Wood, *Personal Property Securities in New Zealand*, Thomson Brookers Wellington 2002 p 17.

[12] Gedye, 'What's Yours is Mine: Attachment of Security Interests to Third Party Assets' (2004) 10 NZBLQ 203 at 218. Compare *Personal Property Securities Act* 2009 (Cth) s 267 under which an unperfected security interest may vest in the grantor on the occurrence of a prescribed insolvency event.

[13] See *Personal Property Securities Act* 2009 (Cth) s 12(1), (2).

[14] *Personal Property Securities Act* 2009 (Cth) s 12(3).

[15] See eg *Tombs v Roch* (1846) 2 Coll 490 at 499, 500; 63 ER 828 at 832.

is a shortfall which would not have arisen if the first creditor had enforced over the other property, the second creditor may be able through marshalling to obtain the benefit of that first creditor's security over that other property. The shortfall will be treated as if were secured by the first creditor's security. Hence the extent of the exposure that the second creditor faces at law is reduced.

Interestingly, in the case of the doctrine of contribution and the example given of the guarantor seeking contribution from another guarantor, the adjustment is not as between the parties to the actual transaction – the guarantor and the creditor. Rather, it is between the two guarantors. The first guarantor may not even be aware of the existence of that second guarantor. [16] In the case of the second creditor seeking to marshall, the person against whom the adjustment is made seems to be more controversial. Depending on how the doctrine of marshalling is understood to operate,[17] the adjustment is likely under modern Australian case law to be made not as against the first creditor but rather as against the debtor, albeit by reference to the position of the first creditor. Once again, however, the second creditor seeking the adjustment will not necessarily know of the existence of the first creditor, unless both securities are registrable securities.

Marshalling and contribution are not, however, the only possible examples of an adjustment taking place in equity. In 1983 the High Court of Australia in *Hewett v Court*,[18] drawing on the judgment of Isaacs J in *Davies v Littlejohn*,[19] observed for example in relation to the doctrine of equitable lien:

> Equitable lien does not depend either upon contract or upon possession. It arises by operation of law, under a doctrine of equity 'as part of a scheme of equitable adjustment of mutual rights and obligations'.

Other doctrines also seem capable of potentially being understood in terms of adjustment, although operating somewhat differently to contribution and marshalling. Equitable set-off, for example, which enables debtors to claim that they are not required to pay the full amount of a demand to the extent of money owing to them by their creditor could be described in terms of 'adjustment' – in the sense that there is an adjustment to the amount of the claim initially owing.[20] Subrogation may also fall within the group to the extent that it enables a person to stand in the shoes of another to gain protection in some form against an exposure that arises. A bank faced with a defaulting corporate borrower who turns out to hold all its assets on trust has an exposure for the outstanding contractual amount of the loan, but may be able to recover an equivalent amount through subrogation to the trustee's indemnity, assuming such an indemnity is available on the facts.[21]

[16] *Dering v Earl of Winchelsea* (1787) 1 Cox 318; 29 ER 1184.
[17] See discussion below.
[18] (1983) 149 CLR 639 at 645.
[19] (1923) 34 CLR 174 at 185.
[20] Whether an actual discharge takes place prior to a court order is currently controversial: see *Fearns v Anglo-Dutch Paint & Chemical Co Ltd* [2011] 1 WLR 366.
[21] See *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319 at 335-356; *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 367; *Lerinda Pty Ltd v Laertes Investments Pty Ltd* (2009) 74 ACSR 65 at 67.

What is striking about these doctrines as a group is that they are long established[22] and that their role of adjusting risk has historically been largely uncontroversial, even though the scope and application of the principles may have at times proved contentious.

It is admittedly not common practice for these equitable doctrines to be grouped together (except perhaps rather frivolously – by academics and practitioners alike- on the basis of a common perception that they are somewhat obscure). Textbook writers vary in their treatment. *Meagher, Gummow & Lehane's Equity Doctrines and Remedies* classifies subrogation, contribution and marshalling under 'Assurances and Assignments' and set-off under 'Equitable Defences'.[23] Parkinson, *Principles of Equity* adopts the same classification for subrogation, contribution and marshalling, and places set-off in a part headed 'Defences and Set-Off'.[24] Heydon and Leeming, *Cases and Materials on Equity and Trusts*, groups marshalling, contribution and subrogation under the general heading of 'Grounds for Relief. [25] Young, Croft & Smith, *On Equity*, treats subrogation, contribution and marshalling under 'Miscellaneous Equities'[26] and Evans, *Equity and Trusts* includes subrogation and contribution as separate chapters under the heading of Equity (as distinct from Trusts), but incorporates marshalling within a chapter entitled Minor Doctrines .[27]

Yet it is contended that a loose grouping of these doctrines, particularly when fashioned around a common concept of 'adjustment,'can offer to a transactional banking and finance lawyer a useful insight into how financial risk may be allocated in equity. It is the potential for an adjustment in the wake of the action of a creditor which makes the doctrines relevant to those involved in structuring security arrangements. Anecdotal evidence suggests, however, that little attention is often paid to the doctrines. Documentation in fact tends to be structured on the basis that such doctrines will potentially operate and should be excluded in the particular situation. From a financial institution's perspective as creditor, there is clearly an advantage to restricting claims for contribution as between co-sureties. While guarantors and indemnifiers may be keen to rely on contribution and may draft their documentation accordingly, a financial institution as creditor may fear interference with its ability either to recover repayment of the principal debt or to enforce the guarantee and indemnity. The financial institution will often seek agreement by sureties to suspend their claims for contribution while moneys are outstanding.[28] Whether, however, it is appropriate to exclude marshalling is not so clear, for reasons explored below. Much depends on what commercial expectations actually are.

[22] See eg *Webb v Smith* (1885) 30 Ch D 192 in the case of marshalling securities. Other well-known earlier cases such as *Lanoy v Duke of Atholl* (1742) 2 Atk 44; 26 ER 668 and *Alrich v Cooper* (1803) 8 Ves Jun 381; 32 ER 402 arose in the context of marshalling of assets but share their principles. See *Rawson v Samuel* (1841) Cr & Ph 161; 41 ER 451 in respect of set-off ; *Duncan-Fox & Co v North & South Wales Bank* (1880) 6 App Cas 12 in respect of subrogation.

[23] Meagher, Hedyon & Leeming, *Meagher Gummow & Lehane's Equity Doctrines & Remedies,* LexisNexis Butterworths Austalia (4th ed) 2002. Equitable lien does not appear to have a separate heading and appears primarily in the context of discussion of subrogation to a vendor's lien under the chapter on subrogation (pp 355-356).

[24] Parkinson (ed), *The Principles of Equity*, Law BookCo Sydney (2nd ed) 2003.

[25] Heydon & Leeming, *Cases & Materials on Equity and Trusts,* LexisNexis Australia 2011.

[26] Young, Croft & Smith, *On Equity*, Law Book Co Thomson Reuters, Australia 2009.

[27] Evans, *Equity and Trusts*, LexisNexis Australia (2nd ed) 2008.

[28] See eg *Hong Kong Bank of Australia Ltd v Larobi Pty Ltd* (1991) 23 NSWLR 593 at 596.

3. **Identifying commercial expectations**

The phrase 'commercial expectations' is rather nebulous and may, in one sense, appear meaningless. Short of empirical research, expectations cannot be readily determined. Furthermore, any expectations ascertained are likely to disclose a wide range of opinions, depending on many factors, not least of which is whether the person surveyed is a lawyer or a banker. The phrase is used in this paper simply as a means to reflect on whether banking and finance lawyers might consider a doctrine to operate in a manner that adequately reflects the demands of commercial practice. The discussion takes as a given that there is a role for the operation of equity. Not only, as Lord Millett pointed out, can equity's place in commercial transactions 'no longer be denied',[29] but the case law makes clear that marshalling of securities has long been used in commercial circumstances. Take, for example, one of the 'classic' cases, *Webb v Smith,*[30] which was a decision of the English Court of Appeal in 1882 and from which the description of the doctrine of marshalling is frequently extracted.[31] The issue was whether funds held by an auctioneer of a brewery were subject to marshalling. On the facts, the relevant funds were not available as they were not regarded as being on the same footing. There was no doubt however of the potential availability of a claim where the established criteria could on the facts be satisfied.

Sometimes litigation can offer some clues, if not a comprehensive guide, as to commercial expectations, reflecting commercial understanding of how a particular doctrine is expected to operate. In that regard, it is interesting to note the stark observation by Lord Hoffmann in *Re Bank of Credit and Commerce International SA* (No 8)[32] that he was at a 'loss to understand' how a marshalling claim had been brought by a bank depositor seeking to require the bank to take the deposit prior to demanding repayment of an outstanding loan. He pointed out:[33]

> There is only one debt and this is owed to [the bank] by the principal borrower. [The bank] has security to which it can resort as it chooses.... there is no basis upon which the depositors can assert an equity to require [the bank] to proceed against their deposits before claiming against the principal debtors.

The very bringing of the claim in such circumstances suggested that the legal foundation for the claim of marshalling was not well understood. Rose LJ in the Court of Appeal had actually described the claim as 'completely misconceived'.[34]

There has been relatively little litigation in Australia, with the High Court of Australia having only considered the doctrine twice: in 1912 in *Ramsay v Lowther*[35] and in 1963 in *Miles v Official Receiver in Bankruptcy*.[36] Only the latter case involved marshalling of securities (as distinct from marshalling of assets) and there too the action appeared misconceived. Had the fund holder not taken the particular action in relation to the fund of which the claimant complained on the ground that it precluded marshalling, the holder would have been in

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[29] Millett, 'Equity's place in the law of commerce' (1998) 114 LQR 214 at 214.
[30] (1885) 30 Ch D 192.
[31] '..if two estates, *Whiteacre* and *Blackacre*, are mortgaged to one person, and subsequently one of them, *Blackacre*, is mortgaged to another person, unless *Blackacre* is sufficient to pay both charges, the first mortgagee will be compelled to take satisfaction out of *Whiteacre*, in order to leave to the second mortgagee *Blackacre*, upon which alone he can go': *Webb v Smith* (1885) 30 Ch D 192 at 200 per Cotton LJ.
[32] [1998] AC 214 at 231.
[33] [1998] AC 214 at 231.
[34] [1996] Ch 245 at 271.
[35] (1912) 16 CLR 1.
[36] (1963) 109 CLR 501.

breach of its obligations to the claimant.[37] In applying the fund as it did, it acted 'strictly in accordance with its obligations'.[38] Interestingly, in that case the High Court affirmed general principles laid down by English courts as far back as 1803,[39] indicating that those principles remained equally applicable over 150 years later. Overseas criticism of the operation of marshalling in more modern times has been that it remains too rooted in its original form when commercial practices have changed[40] – criticism not dissimilar of course to that made by Kirby J in his call, noted previously,[41] for a focus on 'concepts; not detail'. An Australian commentator has observed:[42]

> The history of marshalling of securities in the twentieth century is characterised by a mood of consolidation or affirmation, rather than one of innovation.

It is noticeable, nonetheless, that cases in lower courts since the 1970s in Australia have addressed arguments testing the established limits of the doctrine. Courts have been required to consider, for example, whether the doctrine could make the first creditor a trustee of the other property or could confer an equitable interest in the other property in favour of the second creditor;[43] whether the doctrine restricted the first creditor from choosing which fund to go against;[44] whether there are circumstances in which it is not necessary to have a common debtor;[45] and whether the first creditor might in some circumstances have a liability to account.[46] In the most recent reported Australian case,[47] a decision of the New South Wales Supreme Court in 2008, the court was quick to note on the particular facts an absence of complicating factors such as claims that the first creditor had acted deliberately to the prejudice of the other creditor or had inappropriately released security or should account for moneys received through enforcement action. The raising and discussion of these issues in litigation might be interpreted as indicative of increasing expectations on the part of litigants of the doctrine's possible reach.

Some support for such a suggestion might, at least initially, be argued to be found in provisions typically now encountered in Australian security documentation. Anecdotal evidence indicates that first ranking secured parties commonly attempt to exclude the operation of marshalling. This could be interpreted, for example, as suggesting that those creditors perceive the operation of the doctrine as burdensome. Such an interpretation, however, is based on several assumptions – firstly, an assumption that the inclusion of the relevant negative covenant has been a considered action rather than simply reliance on a well used standard precedent; and, secondly, an assumption that the clause achieves what it sets out to do. While negative covenants may take various forms, it is not uncommon to find that the clause has been drafted in a manner that purports to relieve a first ranking secured creditor from being obliged to marshall. Such a clause clearly assumes that that secured party is

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[37] (1963)109 CLR 501 at 509.
[38] (1963) 109 CLR 501 at 510.
[39] (1963) 109 CLR 501 at 510-511, citing in particular *Aldrich v Cooper* (1803) 8 Ves Jun 382, 32 ER 402; *Trimmer v Bayne* (1803) 9 Ves Jun 209; 32 ER 582.
[40] See eg Averch & Prostock, 'The Doctrine of Marshalling: An Anachronistic Concept under the Bankruptcy Code' (1990) UCC LJ 224, cited and discussed by MacDougall, 'Marshalling and the Personal Property Security Acts: Doing Unto Others...' (1994) 28 UBC Law Rev 91 at 97-98.
[41] See above.
[42] Ali, *Marshalling of Securities*, Clarendon Press Oxford 1999 at p 32.
[43] *Commonwealth Trading Bank v Colonial Mutual Life Assurance Society Ltd* (1970) 26 FLR 338.
[44] *Mir Bros Projects Pty Ltd v Lyons* [1977] 2 NSWLR 192.
[45] *Sarge Pty Ltd v Cazihaven Homes Pty Ltd* (1994) 34 NSWLR 658.
[46] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 14 ACSR 586.
[47] *Accross Australia Finance Pty Ltd v Kalls* (2008) 14 BPR 26,265.

actually under any such obligation and that it is therefore important to preclude an obligation from arising. That clause is problematic, for several reasons.

While it is true that some judicial descriptions in cases regarded as 'classic' authorities do indeed refer to a creditor being, in the phrase used by Cotton LJ in *Webb v Smith* 'compelled to take satisfaction' out of the less encumbered property,[48] it is nonetheless clear that the current legal position under Australian common law, in marked contrast to the US position, regards the first creditor as free to choose against which property or fund it will proceed. This was made clear by the New South Wales Supreme Court in *Mir Bros Projects Pty Ltd v Lyons*[49] in 1977 when Wadell J observed:

> It is, in my opinion...well established that the doctrine does not prevent an earlier mortgagee satisfying his charge against whichever fund or security he thinks fit.

The court described[50] the above dictum of Cotton LJ not only as obiter but also 'contrary to the great weight of authority'. While Lord Hoffmann in *Re Bank of Credit and Commerce International SA (No 8)*[51] also appeared to countenance an action against the first creditor when he referred to the second creditor having 'an equity to require that the first creditor satisfy himself' out of the relevant fund, he immediately qualified that phrase by adding parenthetically '(or be treated as having satisfied himself)'.

More fundamentally, the clause seems to reflect a misunderstanding of how marshalling operates. The security documentation in which the clause is typically located is executed as between the debtor and the first creditor. The person who actually makes the claim to marshall is the second creditor and that creditor marshalls not as against the first creditor but as against the debtor. Not only therefore does the first creditor have a choice as to which property or fund it goes against, but if any restriction is to be placed on making a claim to marshall, that restriction must be a restriction on the second creditor. It is of course possible for the first creditor to preclude the operation of marshalling by agreeing with the debtor that the securities are to be enforced in a particular manner. In circumstances where there is no genuine choice as to which fund to go against, marshalling cannot operate. [52] The clause under discussion however does not purport to narrow the choice of funds.

The use of such a clause raises a further broader question as to why the first creditor should be concerned to exclude marshalling, given that the marshalling is against the debtor. It is possible that those drafting the clause have in mind a possible claim by a second creditor for the first creditor to account, an argument that will be examined below. Yet that is not the situation which the current drafting addresses.

These questions that arise from the current use of marshalling clauses in documentation, coupled with the pushing of the boundaries emerging from the admittedly rather scant case law in Australia, indicate some doubt over the operation of the doctrine and suggest that in practice commercial expectations of the doctrine may be at best rather optimistic, and at worst rather confused.

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[48] *Webb v Smith* (1885) 30 Ch D 192 at 200 per Cotton LJ, noted above. See also *Aldrich v Cooper* (1803) 8 Ves Jun 382 at 388-389, 32 ER 402 at 405, cited with approval by the High Court of Australia in *Miles v Official Receiver in Bankruptcy* (1963) 109 CLR 501 at 510.

[49] [1977] 2 NSWLR 192 at 196.

[50] [1977] 2 NSWLR 192 at 196.

[51] [1998] AC 214 at 231. This description in its entirety was recently cited without comment by the English High Court in *The Serious Organised Crime Agency v Szepietowski* [2010] EWHC 2570 (Ch).

[52] *Miles v Official Receiver in Bankruptcy* (1963) 109 CLR 501.

There is another perhaps more academic aspect to this question of commercial expectations. For the purposes of further assessing the utility of the doctrine, it is worth exploring at a more abstract level what commercial expectations might demand of an equitable doctrine and whether those are currently satisfied. From a transactional banking and finance lawyer's perspective, there seem to be at least three fundamental expectations:

- That the rationale for the doctrine is clear, enabling lawyers not only to understand how the doctrine may apply in particular factual circumstances but to anticipate how the doctrine may develop in the future ;

- That the criteria are readily identifiable and capable of application, enabling lawyers to apply the doctrine in the specific circumstances and guarding against accusations of 'palm-tree justice' while still preserving flexibility; and

- That the interests of the parties to a transaction and those of third parties are balanced appropriately and that equity does not impede the prized and oft-cited 'flow of commerce'.

Each merits attention, but given the constraints of time, the first is dealt with at more length as the most fundamental expectation.

4. Assessing commercial expectations

- ***Expectation that the rationale for a doctrine is clear***

So often concerns over the operation of equitable doctrines lie in the fact that the doctrines are expressed to be based on the broad concept of 'justice'. Reference was made previously to the 19th century case of *Tombs v Roch*[53] where the court spoke of a claim affecting properties which was:

> ...enforced in a manner not unjust, as far as the person is concerned by whom it was or may be enforced, but not just as between the...... properties liable....

Yet, although the notion of 'justice' clearly underlies equity's intervention, the driving factor has often been articulated in terms other than conscience. Furthermore, the meaning of 'justice' under such a formulation has actually been quite limited.

In *Miles v Official Receiver in Bankruptcy* the High Court of Australia approved and adopted the view expressed by Lord Eldon in *Aldrich v Cooper*[54]in 1803. Lord Eldon observed:[55]

> The principle in some degree is that it shall not depend upon the will of one creditor to disappoint another.

Interestingly, the qualification of 'some degree' was missing in the formulation adopted by Sir William Grant MR in *Trimmer v Bayne*,[56] a case decided in the same year as *Aldrich v*

[53] (1846) 2 Coll 490 at 499,500; 63 ER 828 at 832. See above.
[54] (1803) 8 Ves Jun 382, 32 ER 402.
[55] (1803) 8 Ves Jun 382 at 388, 32 ER 402 at 405.
[56] (1803) 9 Ves Jun 209 at 211; 32 ER 582 at 583.

Cooper, and explicitly approved by Lindley LJ in *Web v Smith*[57] and, as noted previously, cited by the High Court of Australia in *Miles v Official Receiver in Bankruptcy*:

> ... a person having resort to two funds shall not by his choice disappoint another, having one only.

In these descriptions of marshalling, the notion of disappointment which the courts appeared concerned to remedy flowed from the deliberate action of the first creditor. In *Across Australia Finance Pty Ltd v Kalls*[58] in 2008 the New South Wales Supreme Court had, however, to consider whether the doctrine might still operate where it was not the first creditor who made the choice but a lower ranking secured party. The court opined:[59]

> ...it is not correct in principle to treat the will or election of a prior mortgagee as a significant ground for a claim for marshalling.

The court focused its intention on the impact on the person seeking to marshall. It did not matter who initiated the action if the impact was that the securities were enforced in a manner which reduced the value of the second creditor's security and left the first creditor's other security untouched. The court regarded references by Lord Eldon to caprice and election in *Aldrich v Cooper* as simply illustrating circumstances in which marshalling was available rather than as 'delimit[ing] the availability of marshalling.'

Even with that possible widening of the notion, this focus on the impact on the second creditor is clear. The accidental action of a creditor as a ground for equitable intervention has certainly been emphasised in two recent decisions of the High Court in 2009 in relation to the doctrine of contribution. In *Friend v Brooker*[60] the court described equity as offering protection against the 'accident or chance' of an action of a creditor. [61] In *Bofinger v Kingsway Group Ltd* a unanimous High Court observed:[62]

> ..equity is moved by concern that the common exposure of the contributors to the creditor and the equality of burden not be defeated by the accident or chance that the creditor select for recovery one or some rather than all of the contributors.

However, uncertainty has crept into the operation of marshalling with explicit references to 'conscience'. In *Sarge v Cazihaven Homes Pty Ltd*[63] in 1994 Young J, referring to Waldock's explanation of the motivation for permitting marshalling as:[64]

> a court cannot countenance an election in the first mortgagee to satisfy or disappoint the second by his choice in realising his securities,

observed:[65]

> ...the probabilities are that the doctrine rests on a principle of conscience....

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[57] (1885) 30 ChD 192 at 202.
[58] (2008) 14BPR 26,265.
[59] (2008) 14 BPR 26,265 at [30].
[60] (2009) 239 CLR 129.
[61] *Friend v Brooker* (2009) 239 CLR 129 at 148.
[62] (2009) 239 CLR 269 at 299.
[63] (1994) 34 NSWLR 658.
[64] Waldock, *The Law of Mortgages* 2nd ed (1950) at 299-300. Waldock dismissed two other bases: namely, specific performance and consolidation.
[65] (1994) 34 NSWLR 658 at 665.

Reference to conscience had also appeared in the judgment of the Supreme Court of Tasmania in the 1970 decision of *Commonwealth Trading Bank v Colonial Mutual Life Assurance Society Ltd*[66] where Neasey J cited a passage from the third English edition of *Story on Equity* explaining the basis of the doctrine of marshalling of assets but which was said also to apply in relation to marshalling of mortgages.[67] There *Story* had laid emphasis on an 'unreasonable power' of the first creditor to defeat the claimants and said that the courts of equity would:[68]

> ...treat such an exercise of power as wholly unjust and unconscientious; and therefore will interfere, not, indeed, to modify or absolutely to destroy the power but to prevent it from being made an instrument of caprice, injustice, or imposition.

It should be recalled however (as was subsequently discussed in the Supreme Court of New South Wales)[69] that in the US the first creditor may be restrained from taking action to enforce his security. In jurisdictions where the first creditor cannot be restrained, the impact of the marshalling order is on the debtor. Nonetheless, in *Re Bank of Credit and Commerce International SA (No 8)* Lord Hoffmann had clearly referred to marshalling as:

> ..a principle for doing equity between two or more creditors...[70]

The current state of thinking was described[71] rather robustly by the New South Wales Supreme Court in 2008 in *Across Australia Finance Pty Ltd v Kalls*. In response to the observation by the plaintiff's counsel that the grounds for equity's action were uncertain, the court remarked:

> This is quite correct; courts of equity have marshalled funds and claims, in the absence of an altogether satisfactory exposition of the juridical basis for doing so, for about three centuries at least.

The court identified what it described as 'several strands of grounds upon which equity has traditionally acted'.[72] These were 5 in number:[73]

> The accidental nature of the impact of the actions of the prior creditor, a wish to avoid the defeat of a later claim by the decision or caprice of a prior creditor, a close but not altogether satisfactory analogy with subrogation, the court's concern to deal justly when establishing entitlements to funds under its control, and the maxim that Equity is equality, leading to decisions which gave similar treatments to persons with closely similar interests.

The court concluded however:[74]

> It is enough….that courts of equity have for a very long time applied principles of marshalling, themselves not highly defined, to problems of this kind.

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[66] (1970) 26 FLR 338.
[67] (1970) 26 FLR 338 at 344.
[68] *Story on Equity*, 3rd English edition p 239.
[69] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 14 ACSR 586.
[70] [1998] AC 214 at 230.
[71] (2008) 14 BPR26,265 at [10].
[72] (2008) 14 BPR26,265 at [10].
[73] (2008) 14 BPR26,265 at [10].
[74] (2008) 14 BPR26,265 at [10].

A lack of clarity over the rationale for the doctrine is of concern, particularly when it is noted that broader notions of justice have crept into other equitable doctrines and in particular in recent years into the doctrine of contribution, often (albeit controversially) said to be linked to marshalling. In the classic 19th century case of *Dering v Earl of Winchelsea*[75] contribution was famously described as 'bottomed and fixed on general principles of justice'. That justice was generally understood, however, as based on the notion of equity being equality – the sureties having a common burden and a common interest. Underlying that was arguably the further notion that it was the accidental nature of the creditor selecting one surety that triggered the claim. [76]

The previously noted observations made by the High Court in *Friend v Brooker*[77] and *Bofinger v Kingsway Group Ltd*[78]in support of 'accident' as a basis of intervention were of particular importance, given the earlier decision of a differently constituted High Court in *Burke v LFOT Pty Ltd*[79] in 2002 where several judges introduced the concept of unjust enrichment in their explanation of the operation of contribution. McHugh J had been very clear on the point:

> An order of contribution prevents the injustice that would otherwise flow to the plaintiff by the defendant being enriched at the plaintiff's expense in circumstances where they have a common obligation to meet the liability which the plaintiff has met or will have to meet. [80]

Professor Goode has explained marshalling in terms of the unjust enrichment of the debtor through the increase in the value of the debtor's equity. [81] In the wake of the High Court of Australia's explicit rejection in *Bofinger v Kingsway Group Ltd*[82] of the concept of unjust enrichment as 'a principle supplying a sufficient premise for direct application in a particular case', this line of argument may be unlikely to be further developed in Australia, at least at the moment.

It is submitted that commercial expectations in relation to marshalling may be better met by confining the notion of justice to the narrower view of a random action.

- ***Expectation that the principles (or criteria) are readily identifiable and capable of application***

In discussing the equitable doctrine of set-off, one of the other doctrines capable of inclusion within a general concept of adjustment, the Queensland Court of Appeal made the telling observation:[83]

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[75] (1787) 1 Cox 318 at 321, 29 ER 1184 at 1185.

[76] 'the one who is sued must pay it...but, as between themselves, there shall be a contribution for they are *in equali iure* : *Dering v Earl of Winchelsea* (1787) 1 Cox 318 at 322; 29 ER 1184 at 1186. See also *McLean v Discount and Finance Ltd* (1939) 64 CLR 312; *Mahoney v McManus* (1981) 180 CLR 370.

[77] (2009) 239 CLR 129.

[78] (2009) 239 CLR 269 at 299.

[79] (2002) 209 CLR 282.

[80] (2002) 209 CLR 282 at 299. See also at 300 and per Gaudron A-CJ and Hayne J at 294.

[81] Goode, *Commercial Law*, Penguin Books London (3rd ed) 2004 at p 645.

[82] (2009) 239 CLR 269 at 299.

[83] *Forsyth & Anor (as trustees for the C&S Forsyth Superannuation Fund) v Gibbs* [2008] QCA 103 at [9].

> Consistently with the technique of equity, which does not seek to define what an elephant is but knows one when it sees one, the principles governing the availability of equitable set-off of cross-claims are couched in open-textured terms, such as 'sufficient connection' and 'unfairness'.

The criteria for a marshalling claim, at least one articulated in orthodox terms and based on the narrower concept of justice, seem more readily identifiable and significantly less open-textured than those for equitable set-off. Although the law relating to marshalling has been described as 'not highly defined or clearly stated',[84] it nonetheless appears less open to the rather controversial charge laid by Kirby J in *Burke v LFOT Pty Ltd*[85]in relation to the doctrine of contribution that the relevant principles had become:

> ...needlessly encrusted with artificial rules and restrictions resulting in disputation, confusion and uncertainty....

The principal criteria emerged at an early stage of the doctrine's development. In summary form,[86] there are three principal criteria:[87]

- *Secured creditors and a common debtor*

  Generally, marshalling arises where a debtor owes a debt to each of two creditors who are secured over the debtor's property. The lack of two such debts was one reason for the dismissal of the marshalling claim in *Re Bank of Credit and Commerce International SA (No 8).*[88]

- *Two existing funds of the common debtor on the same footing*

  Generally, it is said that there must be two existing funds which are on the same footing. This is neatly illustrated by the decision of the English Court of Appeal in *Webb v Smith*[89] in 1885. A brewer had instructed an auctioneer to sell a brewery and some furniture. Following the sale, the auctioneer held two funds: one representing sale proceeds of the brewery; the other, sale proceeds of the furniture. The proceeds of the brewery were subject to two securities; a lien in favour of the auctioneers and a charge in favour of another creditor. The chargee attempted to rely on marshalling by arguing that the auctioneers had a separate claim on the fund representing the proceeds of the sale of the furniture. However the Court of Appeal found that the auctioneers had only a set-off and that a claim based on set-off was 'inferior' to that based on lien, meaning that the auctioneers did not have the ability to resort to either of the two funds.

[84] *Accross Australia Finance Pty Ltd v Kalls* (2008) 14 BPR 26,265 at 26,270.
[85] (2002) 209 CLR 282 at 309.
[86] See more generally McDonald, 'Marshalling' in Parkinson (ed), *The Principles of Equity*, Law Book Co Sydney (2nd ed) 2003 pp 569-580.
[87] A further criterion of 'control' by the court has been rather liberally interpreted: see discussion in *Accross Australia Finance Pty Ltd v Kalls* (2008) 14 BPR 26,265 at 26,270-26,271 where reference on this point is made to *Commonwealth Trading Bank v Colonial Mutual Life Assurance Society Ltd* (1970) 26 FLR 338.
[88] See above.
[89] (1995) 30 ChD 192.

- *The first creditor has a genuine choice as to which fund it will enforce*

  If there is any restriction that requires a creditor to go first against one fund before the other, there can be no marshalling. If the rationale is that the doctrine protects against random choice, the existence of the agreement directs the action and thus precludes any need to rely on the doctrine.

In the future, the application of these criteria may prove more controversial, placing commercial expectations under some pressure. Traditionally, the funds available for marshalling appear to have been constituted by a mortgage or a charge or a lien over property.[90] With the imminent introduction of the personal property securities legislation,[91] the range of available funds may expand to include flawed asset arrangements as well as functionally equivalent security transactions in relation to personal property.[92] A further interesting question will be the extent to which marshalling would be available in respect of deemed security interests, such as certain operating leases.[93]

- ***Expectation that interests are balanced appropriately and that equity does not impede the prized, and oft-cited, 'flow of commerce'***

The balancing of interests as between parties to a transaction and third parties has long been a contentious issue in the commercial application of equitable doctrines. Tension between those twin competing goals of flexibility and certainty can be readily found. In *Hewett v Court*[94] the High Court of Australia was divided 3:2 as to whether to recognise an equitable lien to protect a purchaser under a contract for labour and materials. In refusing to recognise the lien, the minority judges were unwilling to extend principles which had led to recognition of an unpaid vendor's lien as well as a purchaser's lien under a contract for sale of land. The effect of recognition would, in their view, have been:[95]

> [to] introduce unnecessary complexity into the ascertainment of the rights of the parties and would be destructive of that certainty which is the basis of sound commercial practice.

Judicial criteria such as 'impeachment of title to the demand' under the doctrine of equitable set-off [96] and a requirement for co-ordinate liabilities under the doctrine of contribution[97] can be regarded as attempts by courts to set limits on the operation of equity. With marshalling, some limits have certainly been imposed through the development of the principle of 'marshalling by apportionment', said to be 'analogous' to marshalling. It arises when the debtor creates a further security over the single encumbered property in favour of a third

[90] Such property might take the form of land, a chose in possession or a chose in action such as an insurance policy or shares.

[91] *Personal Property Securities Act* 2009 (Cth), currently expected to be operative in October 2011. See above.

[92] *Personal Property Securities Act* 2009 (Cth) s 12(1),(2).

[93] See *Personal Property Securities Act* 2009 (Cth) s 12(3).

[94] (1983) 149 CLR 639.

[95] (1983) 149 CLR 639 at 659.

[96] See *Rawson v Samuel* (1841) Cr & Ph 161; 41 ER 451*; Re Just Juice Corporation Pty Ltd (recs & mgrs apptd)* (1992) 8 ACSR 444.

[97] *Albion Insurance Co Ltd v Government Insurance Office (NSW)* (1969) 121 CLR 342; *Friend v Brooker* (2009) 239 CLR 129. See also the very recent decision of the High Court of Australia, delivered on 22 August 2011, in *HIH Claims Support Ltd v Insurance Australia Ltd* [2011] HCA 31.

person. To allow marshalling in those circumstances would be to prejudice that third person. The court will thus deem the first creditor to have been paid rateably from both properties.[98] Such a limitation has been recognised since the 19th century.[99]

In the context of the debate as to whether marshalling should be available under personal property securities legislation, the view has been expressed[100] that marshalling impacts adversely on the unsecured creditors of the debtor by 'diverting to the junior secured creditor assets that would otherwise be shared pari passu'. However, a Canadian commentator takes the contrary view on the basis that the debtor, and hence 'in most cases' the debtor's unsecured creditors, have no legitimate expectation of property which has been given by way of security; they would otherwise receive a windfall. [101] This view is persuasive.

This expectation of an appropriate balancing of interests is certainly likely to be contentious in the future, with academic and judicial discussion of the potential imposition of a liability to account on a first creditor who has satisfied its debt out of the double encumbered property. This is the so called middle ground advanced by Meagher, Gummow & Lehane and referred to with apparent approval in the New South Wales Supreme Court- initially, in *Sarge Pty Ltd v Cazihaven Homes Pty Ltd*[102] in 1994 by Young J and later that same year in *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd*[103] by Cohen J. Accepting that the second creditor has no proprietary interest in the single encumbered property and hence that there is no relationship of trustee/beneficiary, the middle ground proposes rather:[104]

> .....attaching to the double claimant personal liability of a fiduciary character to account to the single claimant for the loss occasioned by release of the first charge or a proprietary interest in moneys received by the double claimant upon exercise of that charge...

In *Chase* Cohen J saw 'attraction' in the suggestion, but considered it could only apply in what he described initially in very broad terms as 'circumstances where it would be regarded as inequitable or unconscionable to release the security' but which he then immediately qualified by saying 'that is, with full knowledge of the right being asserted by the other mortgagee'.[105] However, in subsequently considering the facts,[106] he did appear to regard unconscionable conduct and knowledge as alternatives, again opening up the issue to further discussion.

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[98] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 35 NSWLR 1 at 18. See also *Across Australia Finance Pty Ltd v Kalls* (2008) 14 BPR 26,265.

[99] In *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 35 NSWLR 1 at 18 the court referred to *Barnes v Racster* (1842) 1 Y &C Ch Cas 401; 62 ER 944.

[100] Gedye, 'What's Yours is Mine: Attachment of Security Interests to Third Party Assets' (2004) 10 NZBLQ 203 at 217. He describes it as ''invariably'' harming those unsecured creditors and argues that it may in fact also provide a windfall for the junior creditor: see his argument in note 50 .

[101] McDougall, 'Marshalling and the Personal Property Security Acts: Doing unto Others....' (1994) 28 UBC Law Review 91 at 122.

[102] (1994) 34 NSWLR 658.

[103] (1994) 14 ACSR 586.

[104] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 14 ACSR 586 at 603.

[105] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 14 ACSR 586 at 603.

[106] *Chase Corporation (Australia) Pty Ltd v North Sydney Brick & Tile Co Ltd* (1994) 14 ACSR 586 at 603: '....it does not seem that I could find that Norbrik or its directors acted unconscionably or that they released their security in the knowledge that Chase would, or even was likely to, seek to be subrogated'.

5. Conclusion

Assessing commercial expectations of equity's role in financial risk allocation is not an easy task, not least because of the difficulty which lies in attempting firstly to identify the range of equitable doctrines potentially capable of playing a part in any such risk allocation and secondly to articulate such expectations. As far as the first obstacle is concerned, it is submitted that a general concept of 'adjustment', whether of exposure or liability, may offer a useful basis for exploring the role of doctrines such as marshalling and contribution as well as those of subrogation, equitable set-off and perhaps equitable lien.

Selecting marshalling as one possible example of a doctrine through which equity allocates risk by adjusting financial exposure, this paper has sought to reach a preliminary assessment on the operation of that doctrine in the light of three general expectations which can be argued to reflect typical concerns of banking and finance transactional lawyers – clear rationale ; criteria that are readily identifiable and capable of application; and an appropriate balancing of interests of those impacted by the operation of the doctrine. The first and third of such expectations appear unsatisfied, with the brief overview of modern Australian case law revealing some lack of clarity on the reasons for equity's intervention and indeed some possible tension as between creditors. Whether such problems arise from uncertainty as to the original role of equity in this area or from attempts to shape equitable doctrine in particular directions reflecting policy goals different to those originally encompassed by the doctrine remains to be investigated and debated. By contrast, the second expectation of clear criteria appears initially to be met. Yet there is also some ground for concern under this heading, and not simply because of doubt as to the manner in which these criteria may operate under the new regime of security interests introduced by the *Personal Property Securities Act* 2009 (Cth). The terms in which marshalling is typically excluded in commercial documentation suggest that the principles which the criteria reflect are not necessarily fully appreciated.

Deutsche Bank

THE DODD FRANK ACT: ITS EFFECT ON MARKET PARTICIPANTS IN AUSTRALIA

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A. Introduction

Since the audience today consists largely of lawyers, you will be pleased to know that the Dodd Frank Wall Street Reform and Consumer Protection Act (the "DFA") is a boon for the legal profession. The DFA itself is over 800 pages long and, according to The Economist newspaper, as at 7 May 2011, the regulations that accompany the DFA were already 3 million words long, highly complex and not yet half written! While there is still uncertainty as to the extra-territorial scope of this law, any Australian financial services provider who deals with US clients or deals in derivatives in the US will be potentially affected by it.

In an effort to produce something that might be of some use to you, I have focused my paper on derivatives. It would be unmanageable in the context of this paper to attempt to discuss the DFA as a whole. The DFA makes sweeping changes to the US financial services regulatory framework. It includes new registration requirements for investment advisers, fund managers and private equity funds. It introduces credit-rating agency reform, living wills for banks, new rules on capital and systemic risk, and on investor and consumer protection. However, the DFA provides little detail on many definitions and important provisions, leaving the regulations to flesh out how the principles established by the DFA are to be translated into practical requirements.

B. Overview of the Dodd Frank Act as it relates to Derivatives

The DFA introduces four major changes to the regulation of OTC derivatives:

(1) the regulation of OTC derivatives and the entities involved in the OTC derivatives business;

(2) the regulation of central clearing houses which are to clear most OTC derivatives contracts;

(3) the regulation and new role of trading venues ("swap execution facilities" or "SEFs"), on which many OTC derivatives will be traded; and

(4) the regulation and new role of trade repositories in reporting OTC derivatives data to bring transparency to the OTC derivatives markets.

The Commodities Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission ("SEC" and, together with the CFTC, the "Commissions") are charged with responsibility for promulgating the regulations relating to derivatives. The CFTC will regulate "swaps" (examples of which include interest rate swaps, equity index swaps, credit default swaps, commodities derivatives, various foreign exchange derivatives) and the SEC will regulate "security based swaps" (such as total return swaps on a narrow based security index and on a single security or loan, and credit default swaps on a single entity or a narrow based basket of entities).[1] While some provisions of the DFA will become effective as early as 16 July 2011, the Commissions recently issued orders effectively delaying compliance dates for provisions that rely on the definition of terms and rulemaking that are still to be completed. The new effective dates will generally be 60 days following adoption of final rules.

1. Registration of swaps dealers and major swap participants

"Swap dealers" and "major swap participants" will be required to register with the CFTC and SEC, respectively (or both, if an entity deals in both swaps and security based swaps). Dealers and major swap participants are subject to transaction requirements (e.g. business conduct rules and record-keeping and trading documentation requirements) and entity requirements (e.g. capital, margin reporting, position limits and risk management requirements).

The DFA generally defines a "dealer" as a person who holds itself out as a dealer in swaps, or makes a market in swaps, or regularly enters into swaps with counterparties in the ordinary course of business for its own account, or engages in any activity causing the person to be known in the trade as a dealer or market maker. Essentially, being a "dealer" involves acting as a principal in entering into a relevant trade.

The DFA has also created a special category called "major swap participant" ("MSP") to regulate entities with significant positions in the derivatives markets. The regulations contain specific criteria to determine whether an entity is a MSP. Entities that trade derivatives solely to hedge or mitigate commercial risk are unlikely to be MSPs. The policy rationale for the creation of the MSP category is to ensure regulatory oversight of entities which are systemically important or which could impact the US financial system.

The DFA provides the Commissions with broad authority to further define both a "swap dealer" and a "MSP".

[1] The SEC has historically had jurisdiction over OTC derivatives on single name and narrow based indices of equity securities (e.g. put and call options, forwards, and instruments involving combinations of them). These instruments, which are already treated and regulated as securities, are not subject to the DFA.

2. Swap central clearing

The DFA requires "financial entities" to have their swaps cleared by a central clearing counterparty regulated by CFTC (for swaps) or SEC (for security-based swaps). Financial entities subject to the central clearing requirement include swaps dealers, MSPs, employee benefit plans and persons predominantly engaged in banking business or activities that are financial in nature. Cleared swaps will be subject to margin requirements defined by the Commissions.

Swaps subject to mandatory clearing may still be exempt from clearing if at least one counterparty to the swap is not a "financial entity", is using swaps to hedge or mitigate commercial risk and notifies the CFTC or SEC (as the case may be) as to how it meets its obligations in connection with non-cleared swaps. There is also an exemption from the mandatory clearing requirement if no clearing organisation is willing to clear the swap.

Uncleared swaps will be subject to higher margin and/or capital requirements than cleared swaps.

3. Swap execution

All swaps required to be cleared are also required to be executed on a regulated exchange or SEF.

At this stage many OTC derivatives are not able to be traded on exchanges or SEFs. There is still some uncertainty as to whether dealer models will qualify as SEFs. For less liquid, non-commoditised swaps, there is a concern that mandating the trading of these swaps on exchanges or SEFs will adversely affect pricing and liquidity. As with Australia, global OTC derivatives activity is dominated by interest rate derivatives (see chart below).

Global Derivatives Market by Product		
Interest rate	$364 trillion	78%
FX contracts	$63 trillion	14%
Credit products	$27 trillion	6%
Equity-linked	$7 trillion	2%
Commodities	$3 trillion	1%
Total	**$464 trillion**	Percentages do not total 100 due to rounding.
		Source: Deutsche Bank

As ISDA has noted (see chart below), there are substantial differences between derivatives which are currently traded over-the-counter and derivatives which are currently traded on exchanges.

Characteristic	**OTC Swaps**	**Listed Futures**
Trading Counterparties	<1,000	>>100,000
Retail Participation	None	Significant
Daily Trades	<20,000	>1,000,000
Tradable Instruments	>>100,000	<1,000
Trade Size	Very large	Small

Depending on how far the Commissions go in forcing OTC trades onto exchanges, this could lead to these derivatives taking on the characteristics of existing listed futures, with consequences such as substantial increases in the volume of trades, a decrease in the types of tradable instruments and a decrease in the trade size.

For end-users of derivatives, standardisation of derivatives contracts and a decrease in trade size is likely to make hedging more difficult to execute (for example, trading banks seeking to hedge their interest rate risks through interest rate swaps may have to enter into more trades and more frequently to execute their hedge). Standardisation of derivatives contracts will also often introduce basis risk for the user (i.e. the risk associated with imperfect hedging) leading to greater costs for end-users.

In addition, these effects and the increased transparency of exchange traded products will result in margin compression for banks and financial intermediaries. In the face of these pressures, banks and financial institutions will, in our view, have to radically alter their cost base to maintain anywhere near their current levels of profitability. A critical element in achieving this outcome will be the speed, efficiency, scalability and reliability of information technology systems. However, even with an aggressive reduction in their cost base, banks and financial institutions in these markets are likely to experience lower profitability as a result of the DFA's reforms to OTC derivative markets.

4. Swap reporting

The DFA requires each party that enters into a swap to report details of such swap trade *"as soon as technologically practicable"* to a swap data repository that is registered with the CFTC or the SEC (as applicable) or, if there is no swap data repository that will accept such a swap, to the CFTC or the SEC, as applicable. The reporting requirement applies to all swaps, not just to those which are centrally cleared. Where one party to the swap is a swap dealer or MSP, the reporting obligation rests with the dealer or MSP. The reporting requirements apply to existing swaps, as well as to new swaps entered into after the reporting requirements take effect.

The data repositories are required to aggregate the data received on trading volumes and swap positions and to publish that data (but not the identity of the parties). The swap data repositories are also required to provide details of information held in relation to swap trades to US regulators.

The aggregation and publication of aggregated data is occurring already in relation to some OTC derivative products. Deutsche Bank is submitting trade repository reports on the derivative open positions of its branches across many asset classes to DTCC and TriOptima (soon to be replaced by DTCC) on either a weekly or monthly basis, depending on asset class. Front office feedback is that the process is relatively painless, although the data that is published is not particularly meaningful.

C. Comparison with other jurisdictions

The G20 Leaders in September 2009 made a commitment (the "Pittsburgh Commitments") that, "*all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared though central counterparties by end 2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements*."

Global derivatives reforms since the Global Financial Crisis have been driven by the Pittsburgh Commitments. However, a comparison of the reforms taking shape in the US and Europe illustrates that divergences in approach and differences in timetables are emerging (see chart below). In April 2011 the Financial Stability Board expressed concern that many G20 countries may not meet the end of 2012 deadline.

1. Europe

In Europe, the European Markets Infrastructure Regulation ("EMIR") is being developed to regulate OTC derivatives, central clearing counterparties and trade repositories and will apply to over-the-counter derivatives transactions. The new rules are in the form of an EU Regulation, rather than an EU Directive, because Regulations apply directly to EU member countries without the need for implementing legislation. The European Securities and Markets Authority ("ESMA"), the new European securities and markets supervisor, will be responsible for identifying contracts subject to clearing and will oversee trade repositories, supporting national authorities with central clearing counterparty ("CCP") supervision and will draft technical standards for EMIR. National supervisory authorities will be responsible for CCP authorisation and supervision.

Financial institutions will be required to have centrally cleared all "eligible" OTC trades. Non-financial counterparties will be subject to the central clearing requirement if the OTC derivatives position exceeds the "clearing threshold" as specified by the European Commission. Unlike in the US, pension funds will not be required to centrally clear their OTC trades until at least 2015 (although because of the margin requirements on trades conducted by financial institutions, pension funds will need to post collateral, which will create a drag on their returns).

Similar to the DFA requirements, non-cleared trades in the European Union will carry additional capital charges for financial institutions or be subject to margining requirements.

All derivatives transactions will be required to be reported to a trade repository within one day of execution (as opposed to "as soon as technologically practicable" which I have already mentioned is the US requirement).

Trade repositories will be required to aggregate and publish derivatives trade data. If there is no applicable trade repository, the trade must be reported to the relevant national authority. Trade repositories must be registered and monitored by ESMA and will be subject to requirements regarding operational reliability, safeguarding information and transparency. While European regulators are expected to pursue stronger oversight of derivatives positions, this is likely to be by way of position management rather than by hard position limits (as opposed to the US which is imposing hard limits).

In addition, the European Commission has undertaken a review of MiFID (Markets in Financial Instruments Directive) and in December 2010 published a consultation paper which, inter alia, addressed the trading of OTC derivatives on trading platforms and transparency and position limits in relation to OTC derivatives. The European Commission is expected to propose draft legislation on the MiFID review towards the end of this year, with an implementation date at the end of 2012.

Under the MiFID proposals, which apply to all derivatives, OTC trading will be moved to regulated trading venues as much as possible and derivatives contracts which are eligible to be centrally cleared and are sufficiently liquid may be required to be traded on a regulated market or other regulated trading venue such as a multi-lateral trading facility or an organised trading facility. ESMA will determine which contracts are eligible contracts and sufficiently liquid for this purpose.

The chart below summarises key differences between the European and the US approach.

EU versus US Considerations		
	European Union	**United States of America**
Scope	• EMIR likely will only apply to OTC derivatives • MiFID will apply rules to all derivatives, including exchange-traded derivatives	• DFA covers all types of swaps, both bilateral and cleared
Timing	• Adoption of EMIR expected Q4 2011 • ESMA to write EMIR technical standards by H1 2012, likely with phased-in clearing requirements	• DFA signed into law July 2010 • CFTC/SEC to finalise derivatives rules Q2/Q3 2011, with phasing-in expected
Exemptions	• FX: FX swaps and forwards expected to be exempt from clearing requirements (likely to be determined by ESMA) • Pensions: Bilateral risk mitigation instead of clearing for 3 years (pending review)	• FX: US Treasury has exempt FX swaps and forwards from clearing, exchange trading and margin requirements • Pensions: Will not be eligible for the end-user exemption from clearing requirements
Position Limits	• Regulators expected to pursue position management rather than position limits	• CFTC/SEC final rules on individual instrument and aggregate limits expected US summer 2011
Extra-territoriality	• Consideration of applicability to 3rd country entities will be critical as EMIR and MiFID rules are finalised	• CFTC/SEC have not yet fully addressed the extra-territorial application of their rules; areas of concern include swap dealer rules, deference to home country regulators, 3rd country entities

2. Asia

In Japan, more limited reforms are underway than in the US and the European Union, although these reforms are more comprehensive than most Asian jurisdictions. Key Asian financial centres have not initiated comprehensive reforms analogous to those proposed by the US or the European Union. It appears that Asian jurisdictions will resist pressure to adopt US regulations, although as is clear from the chart below, they are moving to ensure that they are broadly in line with international supervisory standards, particularly in relation to central clearing.

Comparison of Global Derivative Reform Efforts Underway (Includes Plans Through 2012)									
Focus Area	**U.S.**	**Canada**	**Europe**	**Japan**	**Singapore**	**HK**	**South Korea**	**India**	**China**
1. Regulation of Dealers	✓	✓	✓	✓	✓	✓	✓	✓	✓
2. Definition of "Swap"	✓								
3. Regulation of Significant Participants	✓		✓	✓					
4. Central Clearing Requirement	✓		✓	✓	✓(optional)	✓	✓	✓	✓
5. Regulation of Clearing houses	✓		✓	✓		✓	✓	✓	✓
6. Exchange Trading/ SEF's	✓		✓						✓
7. Post-Trade Reporting Requirement	✓		✓	✓		✓	✓	✓	✓

Canada does not yet have "official" Government led reform proposals underway (Canadian Securities Administrators proposal only)

China has a very small, reasonably "closed" and very highly regulated derivatives market; not a good comparable for other major derivative markets

The main changes being implemented in Asia are in relation to central clearing (see the chart below).

Country	Local Clearing House	Date	Update on timing
Japan	Japan Securities Clearing Corporation	• 19 July, 2011 • August 2012 • November 2012	• JSCC expected to begin clearing Credit Default Swaps ("CDS") (potentially postponed) • JSCC expected to begin clearing Interest Rate Swaps • Mandatory central clearing and reporting effective date
Singapore	SGX Derivatives Clearing Limited	• November, 2010 • July/August 2011	• Singapore Stock Exchange becomes operational as CCP • Target date for having non-deliverable FX forwards clearing
Hong Kong	Hong Kong Stock Exchange (announced)	• Q3 2011 • End of 2012	• SFC to consult market on new OTC derivative regulatory regime • Target date for establishment of central clearing & trade reporting facilities and requirements
Korea	Still TBD (2 candidates are Korea Stock Exchange & Korean Securities Depository	• 2H 2012 • Mid-2012	• Possible introduction of derivatives legislation to Korea National Assembly • Target date for establishment of CCP
India	Clearing Corporation of India Limited	• July 2011 • 2012	• Target date for establishment of domestic CDS market • Target date for mandatory central clearing requirement
China	Shanghai Clearing House	• 20 June, 2011 • 2012	• Effective date for January 2011 new derivatives regulations for China bank sector (mixture of new restrictions) • Shanghai Clearing House expected to become operational

Given that London has existing, fully operational large-scale clearing across all major asset classes and the European regulatory regime offers greater flexibility and is less prescriptive than the US regime, we expect that London will be the principal beneficiary of the G2O push towards central clearing. In the longer term, it may be that Singapore and/or Hong Kong will also be beneficiaries. However, because their clearing facilities are not as extensive as those London currently offers, we do not believe this will be the case in the near term.

D. What do the Dodd Frank Act reforms mean for Australia?

1. Extra-territorial effect

The question of extra-territorial application of the DFA remains among the most uncertain and problematic aspects of the reforms for non-US banks that conduct global swap dealing operations. If the DFA and regulations are given broad extra-territorial scope then the global activities of non-US banks, including Australian banks, could potentially be subject to both US and non-US regulation, giving rise to duplicative or potentially inconsistent compliance obligations.

In particular, there are open questions as to:

(a) Whether US regulatory requirements (such as <u>entity level</u> requirements relating to capital and risk management and <u>transaction level</u> requirements relating to clearing, exchange trading, reporting and business conduct rules, for swaps) would apply to swaps entered into by a non-US bank (or a branch thereof) that is registered as a swaps dealer. Foreign banks are advocating for the US <u>transaction requirements</u> to apply only to their swaps with US counterparties and not to swaps with non-US counterparties. (For securities related transactions, under US law it has long been the case that a US registered broker dealer must facilitate securities related transactions with US clients. Therefore, it will be manageable for most offshore banks and dealers to comply with the transaction level requirements in relation to their swaps and securities based swaps with US counterparties, given that there is existing infrastructure in place); and

(b) Whether a branch or separately identifiable department or division of a non-US bank may be treated as a separate entity for the purposes of the DFA and registration as a swap dealer. (There are several precedents in US securities and banking laws for treating branches of non-US banks as separate legal persons from the bank in certain circumstances. Foreign banks are advocating for the Commissions to permit them to register their US or non-US branches as swap dealers without subjecting the entire foreign bank and its offshore operations to US regulation as a swap dealer).

The current lack of clarity from US regulators has made planning difficult, if not impossible, for foreign banks operating in the US or dealing with US clients. A broad application of the US registration requirements will be overly burdensome on foreign banks. While global banks could limit the scope of the DFA by segregating their US swaps activities in a separate US subsidiary, in our view, this will not be a good outcome. Segregation will increase risk and decrease liquidity due to fewer opportunities for netting and margining on a portfolio basis. It will also result in severe capital and tax inefficiencies and will force customers to transact with less creditworthy entities. It will also potentially reduce the visibility that any single supervisor or regulator might have had into a bank's overall portfolio.

The financial industry has made numerous submissions to the Commissions on the extra-territorial aspects of the DFA but to date there has been no clarification from the Commissions on this issue. The optimal outcome for foreign banks is for the US regulators to oversee only those aspects of the foreign bank's swaps business that directly affect US counterparties and markets. In particular, US regulators should limit the application to non-US banks and swap dealers of US business conduct and other transaction specific requirements to their swap transactions with US counterparties. US regulators should defer to home country regulators of non-US banks and swaps dealers for capital, risk management and other entity-level requirements.

For US regulators to insist on a broad extra-territorial application of the DFA would be contrary to the reciprocal recognition approach contemplated in the European Commission's MiFID consultation and would significantly diminish the likelihood of US institutions obtaining EU passports in the context of MiFID reform. This is because it would give US institutions a competitive advantage by permitting them to access the European markets on better terms than European institutions could access the US market.

2. US banks operating in Australia

US banks have been lobbying to have their non-US branches excluded from most of the DFA regulations on the grounds that it could place them at a competitive disadvantage with non-US banks. Currently the new US regulatory regime will apply to foreign branches of US banks (presumably for the policy reason that the activities of foreign branches could have an impact on the overall financial position of the US bank). This approach will likely disadvantage US banks in foreign swaps business if non-US regulators do not adopt comparable regulation. For example, there is no exemption from the DFA margin requirements for swaps or securities based swaps entered into by an Australian branch of a US entity that are not centrally cleared by a US regulated clearing house. Given it is unlikely that many OTC derivatives which reference Australian underlyings will be centrally cleared by a US clearing house[2], Australian branches of US banks will be at a competitive disadvantage if they are subject to more onerous margin requirements and capital charges than their Australian bank competitors. At this stage, it appears unlikely that many overseas jurisdictions will adopt regulations as comprehensive and prescriptive as in the US, so this remains a major issue for foreign branches of US financial institutions. Of course, to the extent that Australian branches of European banks are subject to more onerous regulation by their home regulator than are their Australian bank competitors, European banks will also be at a relative competitive disadvantage.

3. Central clearing

The G20 push towards standardising derivatives contracts and central clearing will also likely impact Australian market participants. Foreign bank participants in the derivative markets in Australia will be required by their home regulators in the US or European Union to centrally clear at least some of their OTC derivatives.

For a combination of reasons, including operational and balance sheet efficiency, it is likely that a small number of offshore central clearing houses will clear most derivatives trades. From the perspective of a global investment bank, it is operationally more efficient to have a limited number of central clearing counterparties, as this will cut down on the number of operations staff, the number of payments to be made and the number of clearing house exposures for risk management staff to monitor. From the perspective of a client who is active in derivatives markets around the world, it is operationally more efficient to have only one or two margin or payment obligations each day rather than potentially having to make multiple payments to multiple clearing houses across multiple time zones. A concentration of positions at a small number of clearing houses is also likely to result in greater margin offsets and therefore, less capital utilisation.

From the perspective of an international bank, the move towards central clearing of derivatives such as rates, credit default swaps and certain foreign exchange contracts is not as dramatic as it might seem. This is because, for operational reasons and (in many cases) client preference, international banks currently book many of these derivatives trades to offshore branches (in Deutsche Bank's case,

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[2] This is because of, (i) the likely lack of demand in the US making it uneconomic for US clearing houses to clear OTC derivatives with Australian underlyings, (ii) the fact that the underlyings are Australian based and denominated in Australian dollars, and (iii) the time zone difficulties.

mostly London or Frankfurt) and therefore, the central clearing of these trades should, subject to the comments below, have minimal impact on local operations.

4. Council of Financial Regulators discussion paper on central clearing of OTC derivatives

On 17 June 2011, the Reserve Bank on behalf of the Council of Financial Regulators (comprising the the Reserve Bank itself, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Commonwealth Treasury) issued a discussion paper on central clearing of OTC derivatives in Australia as part of its response to the Pittsburgh Commitments. In summary, the Council agencies are considering the case for a requirement that activity in Australian dollar denominated interest rate derivatives be centrally cleared and whether this should take place domestically. The proposal is that the mandatory clearing requirement would apply to financial institutions acting in the domestic market, subject to exemptions for certain participants depending on their size or class.

Given that interest rate swaps comprise by far the bulk of the OTC derivatives market globally and in Australia (although FX derivatives are also a significant component of the OTC derivatives markets in Australia), it is commendable that the Council has focussed on those derivatives that pose the greatest risk.

As the Council notes in the paper, there is currently no central clearing of OTC derivatives in Australia. While offshore clearing exists and is gearing up for a greater role once central clearing is mandated in offshore jurisdictions, the Council has expressed a concern that, where offshore CCPs are clearing domestic markets that are of systemic importance, this may introduce risks to the Australian financial system that do not currently exist.

What central clearing does exist currently in Australia is fragmented. ASX Clear, the CCP for Australian equities, is not open to bank participants but only broker dealer subsidiaries. This means that the current participant criteria for ASX Clear are not conducive to ensuring that the best quality credits are underwriting clearing house risk. This factor has probably impeded the growth of a viable third party clearing market in Australian equities. ASX Clear (Futures) is the CCP for futures and options in interest rates, equity, energy and commodity products which are traded on ASX 24 (formerly the Sydney Futures Exchange). Given that ASX Clear (Futures) is open to bank participants, this may be the more logical local CCP for clearing of Australian dollar denominated interest rate derivatives. However, as the technology required to value and margin long-dated derivatives is different to that required for a generic exchange traded product, ASX Clear (Futures) would need to invest in new technology and infrastructure if it were to broaden its clearing mandate.

It is important that any regulatory initiatives by the Australian Government in relation to CCPs do not restrict competition in central clearing services or create a monopoly in central clearing services for Australian dollar denominated interest rate derivatives. Those outcomes would adversely affect efficiency for many offshore participants and also likely result in higher costs for participants (which will ultimately be passed on to Australian borrowers in the form of higher interest rates).

Given that foreign investors comprise a significant proportion of the Australian interest rate derivatives market (see chart below), it is questionable whether there will be much demand for a local clearing house.

Largest OTC Derivatives Dealers Active in Australia[a]

Dealer	HQ	FX derivatives (b)	Interest rate derivatives (c)	Equity derivatives	Credit derivatives
ANZ Banking Group	Australia	X	X		X
Bank of America ML	US			X	
Bank of Scotland plc	UK		X		
Bank of Tokyo-Mistubishi UFJ	Japan	X			
Barclays Capital	UK	X			
BNP Paribas	France	X	X		X
Citi	US	X	X	X	X
Commonwealth Bank	Australia	X	X		X
Deutsche Bank AG	Germany	X	X	X	X
Goldman Sachs	US			X	
HSBC Bank Australia	UK	X	X		
J.P. Morgan Chase	US	X	X	X	X
Macquarie Group	Australia	X	X	X	X
National Australia Bank	Australia	X	X	X	X
RBS Group (Australia)	UK		X		
Royal Bank of Canada	Canada	X			
State Street	US	X			
UBS AG	Switzerland	X	X		X
Westpac Banking Corp	Australia	X	X	X	X

(a) FX derivatives dealers are top 15 by turnover from RBA 2010 FX survey, equity derivatives dealers are 2009 AFMA market report survey respondents, dealers for other categories are 2010 AFMA market report survey respondents. Not all dealers are active in all products within a category.
(b) Includes FX swaps, forwards and options.
(c) Includes single and cross-currency rate swaps, forward rate agreements, overnight indexed swaps, and interest rate options.
Sources: AFMA; RBA

The merits of Australian based central clearing of OTC derivatives are complex. Some examples of the challenges:

(a) As noted previously, for operational and efficiency reasons, many foreign banks book their interest rate derivatives to a central offshore branch (in Deutsche Bank's case, it is the Frankfurt branch). To centrally clear these trades in Australia, it is likely that local infrastructure would be needed. This will increase costs for the foreign banks and reduce efficiencies to the detriment of the counterparties who deal with them.

(b) Our Sydney Rates desk is currently centrally clearing interest rate swaps with LCH Clearnet in London. Under the LCH Rules (Regulation 25), clearing participants may be compelled to bid on a basket of foreign currency denominated swaps if there is a default by a clearing member. Many local Australian banks may not want to be subject to this requirement because foreign currency denominated swaps may be outside their core competency or create operational risks given the time zone differential. Therefore, the services offered by LCH may not suit all Australian financial institutions.

(c) As I have also already said, unless the CFTC softens its approach on extra-territoriality, US banks dealing in Australian dollar denominated swaps will be required to clear those swaps with a US regulated clearing house or face higher capital charges and/or margin requirements.

Should the Australian Government choose to mandate local central clearing of Australian denominated interest rate swaps there is a real risk that this will fragment the interest rate swaps market in Australia into a domestic market and an offshore market to everyone's detriment, including the Australian economy and financial system.

5. Concluding comments

While the US is much more advanced than the other G20 members in meeting the Pittsburgh Commitments, there is still much uncertainty around the practical application of the Dodd Frank Act reforms – including the extra-territorial application and scope.

It seems highly questionable whether the other G20 members will be able to finalise and implement new derivatives regulations by the end of 2012 as planned when one considers that new market infrastructure will be required and new regulations must be drafted, finalised and then implemented with sufficient lead time for market participants to formulate policies, procedures and systems and to re-document their clients.

Regulatory arbitrage looks like being a major issue for the G20 OTC derivatives reforms given that it is unlikely that European regulations will be as prescriptive and all encompassing as the US regulations. Asia, with its growing importance in world financial markets, also appears to be taking a more moderate approach to OTC derivatives regulatory reform.

The DFA reforms, and similar European reforms, will likely result in higher costs and liquidity demands for end-users. Together with the impact of the Basel III capital requirements, the likely outcome of the reforms is an increase in pricing spreads in the global derivatives market. In effect, this is a large-scale regulation-driven re-pricing of risk. Whether this will ultimately be a good thing for the economies of the jurisdictions adopting these reforms, remains to be seen.

Certainly it is overly optimistic to expect that the current regulatory reforms will eliminate the risk of a future financial crisis. As Warren Buffett once said, “The managers at fault periodically report on the lesson they have learned from the latest disappointment. Then they usually seek out future lessons.”

7 July 2011

Simpson Grierson

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The Legal Effects of Incompetent Independent Advice

Michael Robinson, Partner, Simpson Grierson

Incompetent Independent Legal Advice

- Oxymoron or different issues?

- Key difference between judgments

- Correct result?

Mathias

- Recommended by Blue Chip
- 75% of clients Blue Chip investors
- Never advised against Blue Chip
- Not familiar with documents
- Never advised of legal or commercial risks
- (Inadequately insured)

GE

- Never knew any of this
- Instructed its own solicitors throughout
- Mathias attended to execution/registration

High Court

- [304] ...“*Any vulnerability they may have had by virtue of their unfamiliarity with transactions of this kind and any inequality of bargaining power was (or ought to have been) redressed by the availability to them of independent legal advice.* ***The fact that this advice was flawed cannot be relied upon by the Bartles in relation to the issue of unconscionability. GE was entitled to assume that Mr Mathias would provide proper independent legal advice*** *to them since neither AMS nor GE had any reason to suspect that the Bartles were not receiving proper advice.*”

Court of Appeal

- Hammond J

  "*The High Court Judge found as a fact that Mr Mathias was not independent, and there was no cross-appeal against that finding.*" (para 94)

- Arnold J

  "*In short, had Mr Mathias acted as a truly independent adviser it may be that no question of oppression could arise.*"

  "*If the legal adviser does not fulfil role adequately, the oppression remains*".

Supreme Court

- Advice was independent, notwithstanding incompetence
- GE entitled to assume competence
- No need for further enquiries
- If borrower has independent legal advice, credit contract not oppressive

E W Thomas' Critique

- Supreme Court's confusion "starkly apparent"
- Independence a matter of fact and degree
- If inadequate, not independent. Oppression remains
- Fact of legal advice relevant to remedy

Thomas' Critique

- How does lender prevent oppression?
- Remedies?
  - Letting solicitor off lightly?
  - Insurance relevant?
- A just solution?

Other Points

- Oppressive contracts – strict liability?
- Lenders' duty of care?
- Role of mortgage brokers
- Reform?

POSITIVE DUTIES AND DOUBLE NEGATIVES:
WILL *GE CUSTODIANS v BARTLE* PUSH NEW ZEALAND TOWARDS A MANDATORY "RESPONSIBLE LENDING" REGIME?

(OR WHY GE'S VICTORY IN THE SUPREME COURT MAY NOT BE SUCH A GOOD THING FOR THE NEW ZEALAND LENDING SECTOR)

Tim Pritchard[1]
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Introduction

The Supreme Court's decision in *GE Custodians v Bartle*[2] appears to have been met with a wide range of views, from the approving to the scathing.

At one end of the spectrum are those who consider the decision to be correct[3], some of whom no doubt see it as giving the no-doc/lo-doc (and typically mortgage broker-originated and securitised) end of the home loan market a clean bill of health[4] as far as the New Zealand "oppressive contracts" regime is concerned.

At the other end of the spectrum are those who see the decision as riding roughshod over the true intent of the oppressive contract provisions contained in Part 5 of the Credit

[1] The author is indebted to a number of colleagues who have assisted in the preparation of this paper, including Paul Farrugia and James Wilkinson of Buddle Findlay's Auckland office, Hugo Thistlewood of DLA Piper's Sydney office, and Stef Jones of the Wellington Bar. However, the views expressed in this paper are those of the author alone. Those views do not necessarily represent the views of ANZ National Bank Limited or its affiliates.

[2] *GE Custodians v Bartle* [2010] NZSC 146, [2011] 2 NZLR 31.

[3] See, for example, B O'Callahan *Lenders' Duties* [2011] NZLJ 17.

[4] But not a totally free hand. Even proponents of this view would have to acknowledge that a different outcome could have eventuated from different facts/evidence.

Contracts and Consumer Finance Act 2003 (CCCFA)[5] - and, in the process, meting out rough justice to Mr and Mrs Bartle and hundreds of others like them. To those in this latter category, what others see as a clean bill of health will likely seem more of a get-out-of-jail-free card[6].

This paper considers certain key aspects of the Supreme Court's decision and assesses whether the decision is likely to hasten the introduction of mandatory responsible lending practices in New Zealand, thereby overtaking some modest moves towards self-regulation by certain parts of the industry.

Summary of the case

For the purposes of this paper, the salient aspects of the case can be summarised as follows:

(a) The Bartles are a retired couple, who in 2006 were in their mid-sixties. They had a very modest combined pension income of $21,736 per annum. Their assets were more significant: their unencumbered home in Whangarei, worth around $400,000, bank deposits of $48,000, a car, a campervan and some personal effects.

(b) Like many other retired people in their position (ie asset rich, cash poor), the Bartles were keen to find a low-risk way to augment their income using the equity in their home. They considered the option of a reverse equity mortgage but had reservations about that. They then saw an advertisement issued by Blue Chip New Zealand Limited, a company in the sprawling Blue Chip group of companies of which Mark Bryers was the majority shareholder.

(c) The advertisement promoted a scheme under which homeowners could use the equity in their unencumbered homes to assist with the purchase of a residential apartment and secure an income stream from the apartment for a period of four years, at the end of which the apartment would be sold and the investors would receive a small share of any capital gain.

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[5] See, in particular, EW Thomas *A Critique of the Reasoning of the Supreme Court in GE Custodians v Bartle* (2011) 17 NZBLQ 97.

[6] The effect of the Supreme Court's decision appears to be that, if a lender structures its mortgage origination and processing arrangements in such a way that the lender avoids acquiring knowledge of the borrower's situation and circumstances, then its lending contracts are unlikely to be found to be oppressive by reason of matters relating to the borrower's situation and circumstances. However, those contracts may, of course, be found to be oppressive on other grounds, eg excessive interest rates etc.

(d) Over a period of some weeks the Bartles discussed the scheme with a Blue Chip sales agent, Michael Davis, who painted a very positive and glowing picture of the scheme and of Blue Chip generally. During this period they also met with a solicitor recommended to them by Davis, an Auckland-based lawyer called Jonathan Mathias, who effectively endorsed the integrity and viability of the scheme and pointed out no risks associated with it. Despite some reservations along the way, and despite Mr Bartle in particular having some concerns about some of the numbers not seeming to add up, the Bartles reached a position in September 2006 where they were ready to proceed.

(e) At this point in time, their understanding of the arrangement, based on what Davis had told them (which Mathias had neither contradicted nor qualified in any respect), was as follows:

- They would form a company, Bartle Properties Limited, to buy an apartment in an apartment block in Auckland that was being refurbished. The purchase price of the apartment would be $552,000.

- The apartment would be held by Bartle Properties Limited as bare trustee for an unincorporated joint venture between the Bartles and a Blue Chip company. The apartment would be leased to a second Blue Chip company, with a rental of $640 per week payable once the refurbishment was complete. A third Blue Chip company would act as property manager and would, amongst other things, find tenants for the apartment (for a 10% fee).

- A total of nearly $630,000 would be borrowed in connection with the purchase, of which the Bartles would be expected to borrow around $140,000 in their own names against their home. The balance would be arranged by Blue Chip. The difference between the amount borrowed and the purchase priced of the apartment (some $78,000) would be used partly to provide "working capital" for the joint venture and partly to pay a raft of Blue Chip (and other) fees.

- The Bartles' contribution of $140,000 would be used to pay the 10% deposit on the purchase, to provide the "working capital" and to pay the Blue Chip (and other) fees. This would be borrowed at the outset with the balance of the total borrowings of $630,000 being injected upon settlement.

- Blue Chip would be responsible for all payments due under the loans.

- The Bartles would receive a fortnightly income of $451 (before tax) from the commencement of the arrangement.

- The apartment would be sold after four years, with the Bartles receiving a 10% share of any capital gain.

(f) Unfortunately, this was neither an accurate nor a complete picture. What the Bartles did not know (or at least understand) was as follows:

- The apartment had been purchased by the developer only a short time previously, and Blue Chip had received a 15% commission on the sale. The $552,000 purchase price also included a significant sum for furniture. In the circumstances, the apartment, which had not been independently valued, was almost certainly worth significantly less than $552,000.

- They would, directly or indirectly, end up being personally responsible to the lender for the entire $630,000 of the total borrowings.

- Their co-venturer was a $100 Blue Chip company that was not guaranteed by any other member of the Blue Chip group.

- The "working capital" would in fact be used by Blue Chip to make the $451 fortnightly payments to them and to service the initial loan in their names, at least until rental payments started to flow from the apartment.[7]

- Even when the rental payments started to flow, there would be a massive shortfall between those payments and the cost of servicing the loans, even on an interest-only basis.

- The success of the arrangement, and of the scheme as a whole, depended entirely on the financial health of the Blue Chip group, which in turn depended on property values continuing to rise and on Blue Chip continuing to attract new investors into the scheme. Without capital gains on the sale of properties already in the scheme, and without new "working capital" from new investors, the Blue Chip coffers would quickly run dry.

(g) On 29 September 2006 the Bartles signed an agreement for the sale and purchase of the apartment at the agreed price of $552,000. No finance had been confirmed at this stage, nor had any joint venture agreement been produced, but the agreement was unconditional. As with everything else, Blue Chip took care of the

[7] It seems highly probable also that the "working capital" provided by any given investor was used by Blue Chip to fund payments to other investors and payments on other investors' loans. It has been observed that, in this respect, the Blue Chip scheme had the air of a Ponzi scheme about it – see, for example, D Jessep *Blue Chip: A Ponzi scheme in disguise* at http://duncanjessep.blogspot.com/2010/09/blue-chip-ponzi-scheme-in-disguise.html.

financing arrangements, via a mortgage broker with ties to the Blue Chip group, Tasman Mortgages Limited ("TML").

(h) TML originated loans for a number of lenders, including GE. GE had a no-doc loan product called "Fastdoc 70" that was designed to allow people with unverifiable income (especially self-employed people) to obtain residential mortgage loans without providing evidence of income subject to a maximum 70% loan-to-equity value ratio and subject to the completion of a declaration of ability to pay. TML originated a significant number of loans using this GE product, including for Blue Chip investors. GE would typically on-sell its Fastdoc 70 loans into a securitisation programme.

(i) Guided by TML, the Bartles applied for a Fastdoc 70 loan for approximately $137,000, in the process signing a declaration that they could afford to service the loan (which was, of course, not true). On the application their occupation was shown as "self-employed", a description apparently selected by TML to ensure the criteria for the product were met. The loan was approved by GE and advanced to the Bartles personally on 8 November 2006 against the security of their home. The loan was for 25 years, on an interest-only basis for the first five years, and at an interest rate higher than would be payable on a prime mortgage. By this stage a (heavily deficient) joint venture agreement had been prepared and signed.

(j) The fortnightly payments of $451 duly commenced (paid out of the moneys borrowed by the Bartles) and everything proceeded satisfactorily for 10 months or so. However, when the time came for settlement of the apartment purchase, the Bartles were shocked to find that Blue Chip was in fact expecting them to take out the required additional borrowings (totalling some $490,000) as well. Despite misgivings, they saw no alternative if they wanted their fortnightly payments to continue, and so they completed further applications (including declarations of affordability) for Fastdoc 70 loans for the required amount, in two tranches: $125,791 in their personal names, secured against their home; and $366,291 in the name of Bartle Properties Limited, secured against the apartment (but also guaranteed by them and ultimately secured against their home as well). These loans were on similar terms to the initial loan.

(k) The Bartles had therefore unintentionally worked themselves into a position where they were personally responsible for all $630,000 of the borrowings in return for receiving $451 per fortnight from a $100 company that might stop paying them at any time. And that is exactly what happened: shortly after the purchase of the apartment settled, the payments to the Bartles stopped and the Blue Chip group collapsed. With the loans no longer being serviced, GE took enforcement action and the apartment was sold for only $250,000, leaving the Bartles owing nearly $400,000 against their home.

(l) In order to try and save their home, the Bartles commenced proceedings against GE, TML and Mathias based on various causes of action, including (as against GE) a claim that the loan contracts were oppressive in terms of section 118 of the CCCFA.[8]

(m) In the High Court, the Bartles prevailed against Mathias (on a cause of action in negligence) but not against GE. The claim against TML was not pursued, as by that stage TML was in liquidation and had no assets. In addition, Mathias had been declared bankrupt and his insurance was likely to be inadequate to meet the Bartles' claim, as he was facing numerous claims from other Blue Chip investors he had advised.

(n) The Bartles therefore appealed to the Court of Appeal, which (in three separate judgments) allowed the appeal. GE appealed to the Supreme Court, which allowed GE's appeal, essentially on the basis that GE had not had knowledge of any matter that might cause the loan contracts to be oppressive and that, in the absence of any such knowledge, the contracts could not be found to be oppressive.

Preliminary comments

It is hard to imagine an ordinary investor/borrower getting caught up in a more unfortunate and inappropriate set of circumstances, particularly where the aim was an income supplement of a very modest $451 per fortnight. Firstly, the Bartles allowed themselves to be lured into the Blue Chip web, which was always going to expose them to a serious risk of loss. Then Blue Chip referred them to a solicitor who failed to point out the risks they were taking on, and to a mortgage broker who inappropriately sold them a sub-prime product provided by a lender who was indifferent to the risks they were taking on[9]. To cap it all off, their timing was off: from a property market perspective, they were late into the Blue Chip scheme and, whereas others had got out with their money intact, the Bartles suffered when the property market fell.

[8] The Blue Chip group itself was not pursued because it was in liquidation and had no obvious assets.

[9] Referrals like this appear to have been part of the Blue Chip modus operandi. Without the involvement of players such as Mathias and TML, it is likely that many would-be investors would have had the risks drawn to their attention by more neutral parties and would have walked away from the Blue Chip offerings.

In the author's view, the key to the case against GE was not the excesses of the Blue Chip scheme, nor what (if anything) GE knew of them – that was something of a sideshow. The key was the sub-prime nature of the lending and the particular impact of that on the Bartles. On this analysis, the specific presence of Blue Chip in the picture is largely irrelevant. Any financially improvident venture that GE could have seen was financially improvident had it asked some basic questions about income, servicing ability and the like, would have been open to challenge on a similar basis.

Ultimately the case is about sub-prime lending and the relationships and structures that surround it. The situation in which GE found itself is not one that prime lenders would typically countenance. For this reason, the case was, in one sense, of little significance to the wider lending sector. It was concerned with a small subset of sub-prime loans, ie no-doc subprime loans that the borrower could never afford to service from the outset. A victory for the Bartles was always likely to be more of a comment on sub-prime lending than anything else, and it is fair to say that the Court of Appeal's decision in the Bartles' favour was very much taken by prime lenders in their stride.

The question that is posed in this paper is whether GE's victory may in fact do more damage to the wider lending sector than a victory for the Bartles would have done, in terms of legislative or other responses to the final outcome.

The significance of *GE Custodians v Bartle* as a case on oppressive contracts

GE Custodians v Bartle is a highly significant case in one particular respect: the lender (GE) accepted that the loans in question ought never to have been made, yet the loan contracts were found not to be oppressive[10]. Intuitively this seems odd. If, as Arnold J noted in his judgment in the Court of Appeal[11], the purpose of the CCCFA is partly to protect people against themselves, then surely a credit contract for a loan that <u>the lender itself</u> acknowledges should never have been made is fairly and squarely the kind of contract at which Part 5 is aimed? What better evidence could a borrower ask for than the lender's own admission that the contract should never have been entered into at all, particularly where the ultimate reason the contract was allowed to come into being is of

[10] The case was in essence an <u>oppressive contract</u> case in terms of s120(a) of the CCCFA, not an <u>oppressive conduct</u> case in terms of s120(b).

[11] *Bartle v GE Custodians Ltd* [2010] NZCA 174, [2010] NZLR 601 at [217].

the lender's own making (in this case because GE's lending processes involved no analysis of the Bartles' income or their ability to service the loans)?[12]

The answer to this is that it depends on whether the concept of oppression, in relation to a contract that is alleged to be oppressive, requires an element of knowledge or *mens rea* on the part of the lender. The Supreme Court seemingly pre-judged the issue to some degree, by defining the central issue as being whether the loan contracts:

> *"were oppressive and should be reopened in circumstances where GE says that it had no knowledge of any matter which might make any of the loan contracts oppressive or which should have put it on enquiry."*[13] (emphasis added)

From that opening position, the Court went on to formulate the main issue for determination by explicit reference to GE's knowledge:

> *". . . the case raises, apparently for the first time, the question of whether a credit contract can be found to be oppressive if the lender had no knowledge of matters external to it which might otherwise lead the court to the view that there was oppression."*[14]

The Court answered that question as follows:

> *"In our view, a credit contract should not be seen as oppressive unless the lender has a basis for knowing that to be so."*[15]

Thomas[16] considers this to be one of three significant errors made by the Supreme Court[17]. In Thomas' view, the knowledge (or culpability) of the lender should be irrelevant to the determination of whether a credit contract is oppressive. For Thomas,

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[12] As Thomas notes in his article (see n5 above) at p112, "there are shades of paradox in the notion that a loan which the lender would itself have shunned falls comfortably within the bounds of 'reasonable standards of commercial practice' ".

[13] *GE Custodians v Bartle* [2010] NZSC 146, [2011] 2 NZLR 31 at [2].

[14] *GE Custodians v Bartle* [2010] NZSC 146, [2011] 2 NZLR 31 at [45].

[15] *GE Custodians v Bartle* [2010] NZSC 146, [2011] 2 NZLR 31 at [47].

[16] See n5 above, at p98.

[17] The second alleged error (the Court's apparent failure to "have regard to . . . all of the circumstances relating to the making of the contract" in terms of section 124 of the CCCFA) is discussed later in this paper. The third alleged error (the Court's position on solicitor "independence") is addressed in my co-presenter Michael Robinson's paper on the case.

knowledge and culpability should be relevant only, if at all, to the determination of what remedies may be appropriate under section 127 of the CCCFA.[18]

However, our highest court has ruled that, without knowledge on the part of the lender, a credit contract cannot be held to be oppressive. Whether this is correct is a moot point. The reality is that, on the basis of the Supreme Court's decision, Part 5 of the CCCFA does not protect borrowers from themselves as comprehensively as some might previously have imagined. In particular, it does not necessarily provide relief where borrowers have entered into credit contracts they should not, on an objective basis, have entered into. To the extent that this is one of the policy aims of Part 5 of the CCCFA, the legislation, as interpreted and applied by the Supreme Court, appears to have failed to have achieved its purpose.

Analysis of oppressive contracts: a narrow or wide approach?

Thomas' second criticism of the Supreme Court's approach is that the Court's enquiry into the circumstances that might render the loan contracts oppressive was too narrow. In particular, he queries whether the Court fully embraced the purpose of the CCCFA, as set out in section 3 of the Act, and criticises the Court for not having proper regard to the statutory injunction contained in section 124 to "have regard to . . . all of the circumstances relating to the making of the contract" (emphasis added).

In particular, Thomas points to:

- The fact that the product sold to the Bartles (called "Fastdoc 70") was an inherently sub-prime product of a potentially predatory nature.[19]
- The fact that that product, which was designed principally for self-employed people with unverifiable income, was wholly unsuitable for the Bartles (as they were not self-employed and did not have unverifiable income[20]).

[18] Thomas makes this argument only in relation to oppressive contracts in terms of section 120(a) of the CCCFA. He leaves open the question of whether the position may be different in relation to oppressive conduct in terms of section 120(b) of the CCCFA (at page 105, n42).

[19] Thomas describes the Court's failure to acknowledge, or even mention, this as being "to ignore the elephant in the room" (at p103).

[20] Their income was readily verifiable and, if verified, would have been seen to be manifestly inadequate to service the loans.

- The grossly disproportionate risk borne by the Bartles[21] compared with the risk borne by GE[22].

- The fact that, as the loan was not serviceable, it was in reality an asset sale, not a loan.

- The fact that the Bartles would not be able to avoid a forced sale by refinancing in the event of the apartment not selling (or not selling at the requisite price), due to a lack of equity.

- The fact that the higher interest rates charged by GE were not justifiable by reference to increased risk on the part of GE[23].

- The fact that the use of the Fastdoc 70 product inherently led to an abandonment of normal mortgage lending standards[24].

- An unsustainable assumption on the part of GE that house prices would continue to rise.

- GE's actual knowledge of the risks inherent in the Fastdoc 70 product and the potential vulnerability of the Bartles.[25]

In short, Thomas considers that the Court should have had regard to a far wider range of factors, including economic ones. He refers to a decision of the Supreme Court of Massachusetts in *Commonwealth v Fremont Investment & Loan*[26] in which a wider approach of the type he advocates was taken.

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[21] The worst-case scenario for the Bartles – which was by no means an unlikely one, and which did of course eventuate – was that they would lose both the apartment and their home and remain liable for any shortfall under their personal covenants.

[22] The overall loan-to-value ratio was less than 70%, there was mortgage insurance in place, and loans of this type were typically sold into securitisation programmes (although evidence was adduced suggesting that the Bartles' loans were not in fact securitised).

[23] There was no increased risk for GE due to the arrangements described in n22 above – and arguably there was no risk for GE at all in light of those arrangements.

[24] No income details were required at all – merely a declaration that the borrowers could afford the repayments.

[25] Thomas describes it thus: "GE knew, because it had to know, that some borrowers would be hurt. In this case, it was Mr and Mrs Bartle. It is not that GE did not know that it was inevitable that some borrowers would be hurt; rather, it was that it did not know, or know for certain, the identity of those who would be hurt."

[26] *Commonwealth v Fremont Investment & Loan* 897 NE 2d 548 (Mass 2008).

The *Fremont* case can be distinguished in a number of respects, and exact parallels cannot be drawn[27]. However, there are sufficient similarities between the two cases for a meaningful comparison to be made between the respective approaches of the two courts[28], and it is instructive to do so. In particular, it is interesting to note that the Massachusetts court considered the case to be of sufficient public interest to solicit amicus briefs, and a significant number of such briefs were filed[29]. By contrast, the New Zealand court seemed to have regarded the case before it as essentially a private matter between the Bartles and GE, with little regard for the "bigger picture", despite the fact that there were some 300 other investors similarly affected (and potentially a much greater number affected by no-doc sub-prime products generally).

Similarly, it is interesting to note in the Massachusetts case that, after it had been determined by the original trial judge that the relevant loan contracts were "presumptively unfair", the need to strike a balance between the interests of the borrowers and the interests of the lender in terms of the granting of relief was carefully considered. Such an approach (ie the court finding that the contracts were oppressive but making orders that balanced the interests of the Bartles and GE) was obviously open to the New Zealand court, but was not taken.

One of the problems for the Supreme Court was, of course, was that it did not have before it evidence on all of the matters identified by Thomas, nor did it have the benefit of amicus briefs. In this regard, it is interesting that the Commerce Commission did not at any stage of the proceeding seek to exercise its power under section 112 of the CCCFA to appear and be heard, particularly given the number of investors who were in a similar

[27] *Fremont* was an appeal against a preliminary injunction restricting (but not removing) the lender's ability to foreclose on certain loans. In response to charges of unsound banking practices brought by the Federal Deposit Insurance Corporation, the lender had agreed (with no admissions of liability) to desist from certain lending practices, to give 90 days notice to the Attorney-General before foreclosing on certain loans, and to negotiate in good faith if the Attorney-General objected to any proposed foreclosure. In the event, the Attorney-General objected to virtually every proposed foreclosure and consequently filed for preliminary injunctive relief. The terms of the lending were also different from those in *GE Custodians v Bartle* in a number of respects, as were the terms of the relevant statute (which was concerned with "unfair and deceptive practices").

[28] Thomas points to the following common features: (a) (sub-prime) product features; (b) a lack of income verification; (c) high interest rates; (d) an initial interest-only period; (e) foreclosure was virtually inevitable unless property prices continued to rise; (f) the lender did not deal directly with the borrowers; and (g) the loans were on-sold, thereby insulating the lenders from loss.

[29] The Court specifically acknowledges briefs filed: (1) on behalf of Fremont, by New England Legal Foundation and Associated Industries of Massachusetts; the American Securitisation Forum and the Securities Industry and Financial Markets Association; and the American Financial Services Association, the Consumer Mortgage Coalition, the Housing Policy Council of the Financial Services Roundtable, and the Mortgage Bankers Association; and (2) on behalf of the Commonwealth, by WilmerHale Legal Services Center of Harvard Law School; and National Consumer Law Center, Center for Responsible Lending, AARP, National Association of Consumer Advocates, and National Association of Consumer Bankruptcy Attorneys. It is an interesting exercise to imagine what briefs might be filed if such briefs were solicited on the issue in New Zealand, and what the Supreme Court might make of those briefs

position to the Bartles, and given the wider public interest in sub-prime mortgages generally. That power was a new power under the CCCFA and, as far as the author is aware, it has never been invoked by the Commission in relation to Part 5 of the CCCFA. It would be interesting to know in what circumstances the Commission might be minded to invoke that power, given that the *Bartle* case was apparently not sufficiently compelling.

Again, there is room for the view that Part 5 of the CCCFA, as interpreted and applied by the Supreme Court, is not up to the job and that more robust protections may be required, at least for certain types of borrowers.

Responsible lending

Regulatory responses to inappropriate lending practices are often described as "responsible lending", "truth-in-lending" or "anti-predatory lending" regimes. None of these are terms of art, and any given regime may include a range of different measures aimed at protecting unsophisticated borrowers. There is a wide range of potential weapons at the legislator's disposal, including:

- promotion of education and financial literacy;
- disclosure;
- restrictions on loan terms (including, but not limited, limits on interest rates, fees and charges);
- sanctions in respect of oppressive[30] contracts and/or conduct;
- licensing of lenders and/or intermediaries;
- specific lender responsibilities aimed at ensuring that borrowers do not take on debt that they cannot afford and/or that is otherwise inappropriate for their purposes/circumstances.

In this paper, the term "responsible lending" will be used to describe the last of the measures set out above, ie a requirement for lenders to take steps to protect borrowers from themselves, even where such steps are not necessary (or even desirable) to protect the lender's own risk position. Such a measure is obviously a societal responsibility imposed on lenders to address a lack of sophistication on the part of borrowers with whom they deal, and to some degree is a measure of last resort.

[30] The term "oppressive" is used here in a non-technical (ie non-CCCFA) sense. Different jurisdictions use different terms, such as "unfair" and "unjust", to convey a similar concept.

Specific requirements around responsible lending vary from jurisdiction to jurisdiction, but at the heart of most of them is a requirement to ensure that the borrower can actually service, and ultimately repay, the loan (ie protecting borrowers from taking on debt they cannot realistically afford). This obviously requires the lender to make certain enquiries, and in some cases that requirement is accompanied by an obligation to verify the information provided by the borrower (ie protecting borrowers from any temptation to provide false information in order to gain access to credit). In essence, responsible lending requirements are intended to be a front-end prophylactic rather than an ambulance at the bottom of the cliff like Part of 5 of the CCCFA.

In order to be able to determine a borrower's ability to service and repay a loan, some quantitative or other criteria are clearly required. Different criteria have been adopted in different jurisdictions, for example:

- a debt-to-income ratio of no more than 50%[31];
- a requirement that repayment must be able to be made without the need to sell the debtor's primary residence[32];
- a requirement that repayment must be able to be made without the need to access any equity in any asset[33].

In addition to requirements around servicing and repayment, there may also be wider obligations to assess whether the loan meets the borrower's objectives and is otherwise fit for purpose, as in Australia[34].

As noted above, responsible lending requirements are essentially a measure of last resort. They are typically adopted only where other measures, such as disclosure, licensing, restrictions on usury and oppressive contract/conduct provisions have either failed, or are not trusted, to provide adequate protection. In this context, it is important to note that oppressive contract/conduct provisions do not typically require responsible lending per se. Rather they regulate, and potentially penalise, irresponsible (and arguably, in light of the Supreme Court's decision in *GE Custodians v Bartle*, only grossly

[31] [insert reference]

[32] [insert reference]

[33] [insert reference]

[34] National Consumer Credit Protection Act 2009

irresponsible) lending. They do not contain a positive duty to lend responsibly; only a strong incentive not to lend irresponsibly.[35] [36]

Responsible lending in New Zealand

In comparison with most other developed English-speaking jurisdictions, New Zealand has been slow to embrace the concept of responsible lending.[37] Whereas other jurisdictions have been enacting responsible lending requirements of one kind or another since at least as early as 2002[38], successive New Zealand governments have preferred a more light-handed approach, focusing on disclosure, literacy and education, and with the oppressive contract/conduct regime contained in Part 5 of the CCCFA as the measure of last resort.

In the absence of any moves to legislate, some parts of the New Zealand lending sector are already self-regulating to some degree[39]. Section 5.1(c) of the New Zealand Code of Banking Practice, to which eight major banks[40] currently subscribe, provides:

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[35] Under section 70(2) of the Australian Uniform Consumer Credit Code, one of the matters the Court could have regard to in determining whether a credit contract was "unjust" was whether the credit provider knew, or could have ascertained by reasonable inquiry, that the debtor could not pay in accordance with the terms of the contract or not without substantial hardship. Whilst this certainly provided an incentive for lenders to lend responsibly, there was no positive duty to do so, and an adverse finding against the lender was not necessarily determinative (although it would presumably have been persuasive).

[36] Positive duties and double negatives are common in responsible lending legislation. For example, one of the central obligations under Ch 3 of the Australian National Consumer Credit Protection Act 2009 is an obligation to conduct an assessment that the proposed credit contract is "not unsuitable" for the customer. Presumably it is considered too onerous to require lenders to reach a view that a credit contract is "suitable" for the customer, although the distinction in practical terms is not readily apparent.

[37] Canada is another jurisdiction notable for its lack of mandatory responsible lending requirements. Its Cost of Borrowing (Credit Business Practices Banks, Authorized Foreign Banks, Trust and Loan Companies, Retails Associations, Canadian Insurance Companies and Foreign Insurance Companies) Regulations is concerned more with disclosure than with responsible lending per se.

[38] For example (in the United States) the Massachusetts Predatory Home Loan Practices Act and (in Australia) section 28A of the Fair Trading Act 1992 (ACT) (relating to credit card providers). Other "truth-in-lending" legislation was enacted even earlier – see, for example, the North Carolina Anti-Predatory Lending Law, which was implemented progressively from 1999.

[39] It is interesting to conjecture whether these steps towards self-regulation may have raised the bar in terms of what constitutes "reasonable standards of commercial practice" in terms of section 118 of the CCCFA. Arguably at some point a tipping-point is reached and the self-regulated portion of the industry raises the standard for the industry as a whole. That issue is outside the scope of this paper.

[40] ANZ National Bank Limited (operating as ANZ and as The National Bank of New Zealand), ASB Bank Limited, Bank of New Zealand, Citibank, N.A., The Hongkong and Shanghai Banking Corporation Limited, Kiwibank Limited, TSB Bank Limited and Westpac Banking Corporation (New Zealand division).

"We will only provide Credit to you or increase your Credit limit when the information available to us leads us to believe you will be able to meet the terms of the Credit Facility…."[41]

A number of individual banks[42] have also issued customer charters or similar voluntary commitments containing provisions to similar effect.[43]

More recently, the Financial Services Federation has issued a set of "Responsible Lending Guidelines"[44], which includes the following section:

> *"**Deciding if a loan is right for you***
> *Lenders need to work out whether you are able to repay a loan. A responsible lender may decide not to give you a loan if they believe that:*
>
> - *you would be unable to repay the loan*
> - *you would find it extremely hard to repay the loan*
> - *the type of loan will not meet your goals or needs"*[45]

Political appetite for some kind of responsible lending regime does now appear to be growing. In the last 12 months or so, MPs from both Labour[46] and National[47] have introduced private member's bills aimed principally at loan sharks and other fringe

[41] The corresponding Australian and UK codes have not dissimilar provisions – see section 25.1 of the Australian Code of Banking Practice and section 50 of the UK Lending Code. Arguably, the Australian code is the weakest of the three from a consumer protection perspective.

[42] Including ANZ and The National Bank of New Zealand.

[43] See, for example, The National Bank of New Zealand's "Customer Commitment" document. Under the heading "We'll take your finances seriously and act responsibly" it is stated "We'll help you by only lending or advancing credit to you when we believe you can manage the repayments, taking into account what we know about your credit history."

[44] Financial Services Federation *Responsible Lending Guidelines – What you should expect from your lender when you are borrowing money*(published April 2011).

[45] Although GE clearly put in place operating procedures with its brokers to try and ensure its loans were "clean" from a CCCFA perspective, it was not, as far as the author is aware, subject to any self-imposed responsible lending obligations. It is interesting to consider what might have transpired if GE had been subject to any such obligations and the Bartles had had access to a dispute resolution scheme such as the New Zealand Banking Ombudsman scheme (ignoring, for this purpose, the monetary limits typically associated with the jurisdiction of such schemes).

[46] Carol Beaumont's Credit Reforms (Responsible Lending) Bill seeks to amend s118 of the CCCFA by including wording to the effect that "reasonable standards of commercial practice" require the lender to have a reasonably held belief that the debtor will be able to pay the amounts that fall due under the credit contract. The bill was voted down in May 2010.

[47] Sam Lotu-liga's more wide-ranging Moneylenders (Licensing and Regulation) Bill 2011 seeks to introduce specific factors to be taken into account in determining whether a contract is oppressive in terms of section 118 of the CCCFA, in a way not dissimilar to section 70(2) of the former Australian Uniform Consumer Credit Code (see n35 above).

lenders, but with potential impacts for the lending sector as a whole. A new text-a-loan service proposed by Ferratum, a Finnish-based company, has recently caused consternation in various circles, and as part of a wider review of consumer credit, the Government is arranging a "financial summit" in Auckland next month (August 2011) to which industry representatives and consumer groups will be invited. Responsible lending is very clearly on the agenda for that summit.[48]

The *Bartle* case and responsible lending

So where does *GE Custodians v Bartle* fit into this picture? Although stories about Blue Chip (and Mark Bryers in particular) still appear in the media from time to time, the Bartles themselves have been somewhat out of the spotlight since the initial flurry of reactions to the Supreme Court's decision in December last year. However, that does not mean they have been forgotten. Their plight, and the plight of others like them, may well come to the fore again as the debate about responsible lending gathers momentum and intensifies, as it appears it is destined to do.

Responsible lending requirements are not necessarily the right answer to the problem that the Bartles' situation exemplifies. However, it can be argued that the wider system has failed them: Blue Chip and TML are in liquidation with no apparent prospect of recovery; the Serious Fraud Office has decided not to lay charges against Blue Chip or its principals; the Commerce Commission has closed its Fair Trading Act investigation into Blue Chip; Jonathan Mathias is bankrupt and his indemnity insurance will be insufficient to provide meaningful compensation to his many out-of-pocket clients[49]; the Supreme Court has ruled that the GE loan contracts were not oppressive in terms of Part 5 of the CCCFA; and an attempt by other Blue Chip investors to have their sale and purchase agreements struck down on various grounds has failed in the Court of Appeal[50].

In all the circumstances, it will be no surprise if there is political appetite to look to the lending sector to shore up the system by imposing new mandatory responsible lending

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[48] See Ministry of Consumer Affairs media release dated 6 July 2001 at www.consumeraffairs.govt.nz/legislation-policy/policy-development/financial-summit

[49] The concentration risk associated with Mathias' practice raises an obvious question as to whether the legal profession's current requirements in relation to professional indemnity insurance are adequate. At one point Blue Chip clients made up approximately 75% of his practice.

[50] *Hickman& Ors v Turn and Wave Limited* [2011] NZCA 100.

requirements. If that happens, it is likely that it will be applied to the sector as a whole, notwithstanding that the problem really lies in the sub-prime and fringe lending spaces.

And if that happens, the irony will be that the lending sector as a whole would have been better off if the Bartles had prevailed in the Supreme Court on the issue of oppression. Such an outcome would have instilled confidence in Part 5 of the CCCFA and there would have been no need to look for more draconian measures to keep allegedly inappropriate lending practices in check.

A further irony is that a win for the Bartles on the oppression issue would not necessarily have produced a different practical outcome: as the *Fremont* case[51] so aptly demonstrates, a finding that a contract is oppressive[52] does not necessarily mean it will be struck down. Under section 127 of the CCCFA, the courts have a wide-ranging basket of remedies at their disposal to arrive at a just solution[53] and an open-ended discretion in terms of the matters to be taken into account. In the Bartles' case, factors such as GE's knowledge and culpability (or otherwise), the Bartles' part in their own misfortune (including signing an unconditional sale and purchase agreement), and the roles played by the other parties involved in the transaction (including Blue Chip, TML and Mr Mathias) might have pointed to a compromise remedy such as a lease for life[54], with or without some financial compensation or other adjustment.

As it is, the win for GE has the potential to make Part 5 of the CCCFA look as though it is short of teeth. Some will ask: if the facts and circumstances in the *Bartle* case were not sufficient to render the relevant loan contracts oppressive, then what facts and circumstances will ever be? Whatever the answer to that question, the blow that was seen by some to be struck to consumer protection in the *Bartle* case may add to the impetus for more robust protection in the future. And so a perceived win for the lending sector may ultimately, in the fullness of time, transpire to be a loss.

Submitted for publication: [22 July 2011]

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[51] See page 11 above.

[52] Or, in *Fremont* itself, "presumptively unfair".

[53] Specifically, section 127 gives the court the power to "make any orders that it thinks necessary to remedy the matters that caused the court to reopen the contract….".

[54] It has been reported in the media that GE has negotiated leases for life with a number of out-of-pocket Blue Chip investors. The author has not been able to obtain further details of these negotiated arrangements, which appear to be subject to confidentiality provisions.

THE NEW ZEALAND STATUTORY MANAGEMENT REGIME: WHAT IS IT AND WHAT DOES IT MEAN FOR MY CLIENT?[‡]

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> In New Zealand the insolvency regime is broadly on the lines of the traditional English-based system. ....
>
> [But] in the centre of this smooth-flowing river lies a rock which seeks to divert the strong current and throws up a mighty splashing in the process: the Corporations (Investigation and Management) Act 1989.
>
> This legislation allows the executive to appoint a statutory manager of a New Zealand company in the public interest and has been used either because of suspected misdoings or because of a labyrinthine corporate structure or to protect the public, usually meaning public shareholders or public bondholders. Creditors have virtually no influence on the proceedings. The manager has very wide powers to run the company. The stay freezes proceedings, executions, winding-up petitions, enforcement by secured creditors, repossessions under retention of title, hire purchase agreements, leases or mortgages, forfeiture of land leases, landlord's distraint, set-offs, and acceleration by secured creditors. Apart from that, the stay apparently does not nullify ipso facto clauses in ordinary commercial contracts.
>
> ... It is believed that the procedure has in practice usually been operated by statutory managers with proper attention to acquired rights, consistent with the New Zealand tradition of creditor protection. The procedure raises the question of whether it is right for the political executive to take strong-arm powers on the bankruptcy of ordinary commercial corporations.
>
> Phillip R Wood *Principles of International Insolvency* (2007, 2ed) at p 119

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1. INTRODUCTION

1.1 The New Zealand statutory management regime is a unique creature. While aspects of the regime are known to other forms of insolvency regimes in New Zealand and in other jurisdictions, the concoction formulated by the New Zealand Parliament when it enacted the New Zealand statutory management regime really has no equal.

1.2 The New Zealand statutory management regime has had some prominence in recent times. Having been used only once in the previous decade,[1] 2010 saw the statutory management regime used in two settings — each quite different. The first saw Aorangi Securities Limited, various charitable trusts, and Allan and Jean Hubbard placed into statutory management on 20 June 2010.[2] The Hubbards are the principal ultimate shareholders in South Canterbury Finance Limited ("**SCF**"), a then large mezzanine

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1 International Investment Unit Trust, Asset Protection, Timberland Trust, Donald Moris Rea, Catherine Linda Trenzona and Lisa Shirlee Talbolt were placed into statutory management on 3 July 2003 pursuant to the Corporations (Investigation and Management) Order (No 2) 2003.

2 Pursuant to the Corporations (Investigation and Management) Order 2010. Further related entities were placed into statutory management pursuant to the Corporations (Investigation and Management) Order (No 2) 2010 and the Corporations (Investigation and Management) Order (No 3) 2010. The author acts for Mr and Mrs Hubbard and it is therefore not appropriate for him to comment on this particular statutory management any further.

finance company. SCF was not placed into statutory management, but failed some 6 weeks later and was placed into receivership. The second use of statutory management in 2010 saw IDEA Services Limited and Timata Hou Limited placed into statutory management.[3] These companies are the service provider arms of IHC NZ Incorporated, a large charity directed at care and advocacy for people living with an intellectual disability. These settings are vastly different to the statutory managements of the past.[4]

1.3 The New Zealand statutory management regime is found in two Acts of Parliament: in Part 3 of the Corporations (Investigation and Management) Act 1989 ("**CIMA**") and in Part 5C of the Reserve Bank of New Zealand Act 1989 ("**RBNZ Act**"). The focus of this paper is the statutory management regime in the CIMA. The statutory management regime in the RBNZ Act — which can only apply to registered banks — is substantially similar to the regime in CIMA. For the sake of facilitating a discussion of the key points, this paper does not attempt to deal with the intricacies of the various differences between the two Acts.

1.4 This paper addresses:

(a) in part 2, the history of statutory management;

(b) in part 3, the key features of statutory management;

(c) in part 4, the circumstances in which statutory management can and has been used;

(d) in part 5, the practical implications and potential consequences of the statutory management regime;

(e) in part 6, criticisms of statutory management and arguments supporting retention of statutory management;

(f) in part 7, the future of statutory management and the prospects (or lack thereof) for reform.

1.5 The aims of the paper are fairly straightforward. The paper does not, for instance, seek to advance a particular theory of statutory management or advance a view on the merits or otherwise of retaining statutory management in its present or a modified form. Rather, the paper simply seeks to provide a broad overview of the statutory management regime in order to provide a foundation for further discussion and consideration.

2. HISTORY OF STATUTORY MANAGEMENT

2.1 Statutory management has a reasonably long history in New Zealand.[5]

Companies (Special Investigation) Act 1934 and related legislation

2.2 It was first implemented in the early 1930s to address concerns as to the financial viability of certain investment companies. There were also allegations of fraud. As a consequence of a commission of inquiry into those companies the legislature passed the Companies (Special Investigation) Act 1934. The Act empowered the Governor-

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3 Pursuant to the Corporations (Investigation and Management) Order (No 4) 2010. The author's firm acts for IHC and IDEA Services Limited and it is therefore not appropriate for him to comment on this particular statutory management any further.

4 See section 4 below for a brief overview of past uses of statutory management.

5 For a more detailed review of the history of statutory management in New Zealand, see Law Commission *Insolvency Law Reform: Promoting Trust and Confidence* (NZLC SP11, 2001) at pp 92 - 96.

General to appoint inspectors to investigate the affairs of these companies, but left the management of the companies in the hands of the directors.

2.3 Three months later, however, out of fears that the directors would dissipate remaining assets, the Companies (Temporary Receivership) Act 1934 was passed. This Act created a form of statutory management that bears some resemblance to what we have today. The Public Trustee was appointed as receiver and manager of the companies and their assets. Wide ranging powers were conferred on the Public Trustee. The Act required all persons having possession or control of any movable property belonging to one of the companies to deliver it to the Public Trust. The Act also imposed a moratorium that prevented proceedings being taken against the companies except by leave of the Court.

2.4 As a result of the inspectors' work, a web of questionable loan transactions was uncovered. Consequently, the Companies (Special Liquidations) Act 1934 was passed. That Act provided for the winding up of the companies by the Public Trust as liquidator. The Public Trust was subject to the control of the Court and depositors and creditors were able to apply to the Court in relation to the Public Trust's exercise of power.

Companies Special Investigation Act 1958

2.5 The next piece of legislation in this history is the Companies Special Investigations Act 1958. The Act was "rushed legislation" and was "passed through all stages in the House and enacted in one night".[6] The Act was intended to deal with the Intercity group of companies, and as enacted the Act only applied to the companies listed in the schedule. The Attorney-General said the legislation was necessary because of the complex, interlocked relationships of the companies, the strong suspicion of fraud, the need to act quickly to prevent the destruction of documents, the dispersal of assets, and the inadequacy of ordinary company law to deal with an interlocked group of companies in a swift manner.

2.6 The 1958 Act had similar features to the 1934 Acts. For example, the 1958 Act required all persons having possession or control of any movable property of one of the companies to deliver it to the receivers, even if they had a lien or charge over the property. A moratorium was also imposed: no action or proceeding could continued or be commenced against any of the companies or the receiver without the leave of the Court.

1963 Amendment

2.7 In 1963 the Act was amended so that it could apply to any company. The 1963 extension of the 1958 Act was made as a precaution to ensure that the mechanism would be available to address similar situations that may arise in the future without the need to pass urgent and specific legislation to deal with events requiring — or perceived to require — urgent intervention by the government. In order for that to occur, a new provision was inserted to provide for the circumstances in which a company could be declared by Order in Council to be subject to the Act:

> Where it is desirable for the protection of any of the shareholders or creditors (whether secured or unsecured) of any company or companies, or for the protection of any beneficiary under any trust administered by any company, or it is otherwise in the public interest, that the provisions of this Act should apply to any company or companies, and the said shareholders or creditors or beneficiaries or the public interest cannot be adequately protected under the Companies Act 1955 or in any other lawful way…

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6 *Hawkins v Minister of Justice* [1991] 2 NZLR 530 (CA) at 536 per Richardson J.

2.8 As we shall see, s 4(b) CIMA, which sets out the very criterion for application of CIMA, bears a close resemblance to this provision.

Cornish Companies Management Act 1974 and the Public Service Investment

2.9 The hope of the legislature that it would not need to pass specific legislation dealing with particular circumstances did not play out as legislators may have liked. After the passing of the 1963 amendment, two further specific Acts were enacted to address commercial failures that did not fall under the 1958 Act. These Acts — the Cornish Companies Management Act 1974 and the Public Service Investment Society Management Acts of 1979 — were passed under urgency with support from both sides of the House. The Cornish Companies Management Act 1974 (on which the Public Service Investment Society Management Acts of 1979 were modelled) placed the management of the companies in the hands of the statutory manager. The statutory manager was given extensive powers to run the businesses. A moratorium was also imposed. The statutory management could be terminated by the Governor-General, by Order in Council.

2.10 CIMA bears a closer resemblance to these Acts than it does to the 1934 and 1958 Acts.

Reserve Bank Amendment Act 1986

2.11 The Reserve Bank Amendment Act 1986 introduced a system whereby the Reserve Bank supervises, on an ongoing basis, registered banks. The system included a disclosure regime, empowers the Reserve Bank to require information from registered banks and to investigate them. The system also allows the Reserve Bank to declare a registered bank to be at risk and to advise and direct such banks. The Reserve Bank Amendment Act 1986 also set up a statutory management regime for registered banks.

2.12 The aims of the Reserve Bank Act are directed at promoting the maintenance of a sound and efficient financial system and avoiding significant damage to the financial system that could result from the failure of a registered bank. As will be explored below, the aims in CIMA are different.

Corporations (Investigation and Management) Act 1989

2.13 CIMA repealed the Companies Special Investigations Act 1958 and was largely modelled on the Reserve Bank Amendment Act 1986.

2.14 The then Minister of Justice, introducing the Bill that lead to CIMA, said that it had two broad purposes:[7]

> The first is to enable action to be taken earlier in instances when a company is, or may be, operating fraudulently or recklessly. The second is to enable companies to be given a decent burial when ordinary remedies are inadequate.

2.15 The problem with the Companies Special Investigations Act 1958 indentified by the then Minister of Justice was that it could only be applied "when ordinary remedies are inadequate" so "statutory management can only be used in extreme cases".[8] As a result, "the position of the companies concerned must have deteriorated to the point at which the position is difficult or even impossible to repair".[9] In other words, "the position must have deteriorated to the point [where] the only option is to kill or bury the company".[10]

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7 (13 September 1988) 492 NZPD 6494.
8 (13 September 1988) 492 NZPD 6494.
9 (13 September 1988) 492 NZPD 6494.
10 (13 September 1988) 492 NZPD 6494.

3. KEY FEATURES OF STATUTORY MANAGEMENT UNDER CIMA

Purpose

3.1 The long title to CIMA provides that it is "An Act to enable the Registrar of Companies and the Financial Markets Authority to determine whether corporations are at risk, to enable action to be taken in relation to such corporations in appropriate cases, and to repeal the Companies Special Investigations Act 1958". The "general objects" of CIMA are set out in s 5:

> (a) to confer powers on the Registrar of Companies to obtain information concerning, and to investigate the affairs of, corporations to which this Act applies:
>
> (b) in the case of a corporation that is, or may be, operating fraudulently or recklessly, to limit or prevent—
>
> (i) the risk of further deterioration of the financial affairs of that corporation; and
>
> (ii) the carrying out, or the effects of, any fraudulent act or activity:
>
> (c) in the case of a corporation referred to in section 4(b), to preserve the interests of its members or creditors or beneficiaries or the public interest:
>
> (d) to provide for the affairs of corporations to which this Act applies to be dealt with in a more orderly and expeditious way.

3.2 The purpose of CIMA has been explored in a number of cases. For example, in *McDonald v ACC (NZ) Ltd*,[11] Wallace J said:[12]

> the Act is specifically designed to deal with those situations where a company has been operating fraudulently or recklessly (s 4(a)) or, alternatively, where the ordinary law is inadequate (s 4(b)(iii)). The Act is intended to take over where the ordinary law cannot cope and stronger measures are needed. Situations where those measures are needed will include a major collapse of a large and interlocking group of companies with complex rights amongst creditors, shareholders and beneficiaries. A major collapse may also involve the public interest in a variety of ways and it is noteworthy that the references to public interest in ss 4 and 5 are carried through into s 41(1)(a).

3.3 A similar view was expressed in *Ararimu Farms and Investments Ltd v Stotter*:[13]

> the scheme of the Act is designed to deal with corporate collapses of such magnitude that the normal legal procedures available to a corporation, its members or creditors are totally inadequate.

3.4 Statutory management should not be seen as an alternative form of liquidation or other insolvency regime for at least three reasons. First, Part 3 of CIMA itself makes quite clear that it does not create an insolvency regime. In particular, a corporation under statutory management can only be liquidated in accordance with the usual procedures under the Companies Act 1993; in order for the liquidation procedures to operate, the statutory managers must make application under the Companies Act 1993 to place the corporation into liquidation.[14]

3.5 Second, as has been noted in the jurisprudence, the focus of Part 3 of CIMA is on the management of corporations to which it applies, not on the winding up of those

[11] [1990] 1 NZLR 227; (1989) 4 NZCLC 65,365; 3 BCR 431; 11 NZTC 6304.
[12] At p 238; p 65,375; p 6313.
[13] [1993] MCLR 1 (CA) at p 6.
[14] CIMA, s 52(1).

corporations. So, for example, in *McDonald v AGC (NZ) Ltd*, Wallace J stated that on a full reading of the CIMA:[15]

> …the emphasis in Part III of the Act is on management of the corporation or corporations. That again is a reflection of the objectives of the Act: see s 41(1) which refers to the need to preserve the interests of members and creditors of the corporation and to protect the beneficiaries or the public interest. Section 41(1) also refers to the need to resolve the difficulties of the corporation and to preserve its business as far as practicable. Those preservatory and protective functions are in turn reflected in the moratorium and other provisions of Part III. There is no emphasis on the winding up of the corporation. That is simply one of the options open to the statutory manager (s 52) who clearly must consider whether it is appropriate to petition for winding up. I add that I am generally in agreement with what is said concerning the objects of the Act in Wilson v Aurora Group Ltd [1990] 1 NZLR 61 with the qualification that the statutory manager has a clear obligation to have regard to the need to preserve the business or undertaking of the company.

3.6 Third, critical to the practical operation of statutory management from the perspective of third party creditors are, as will be seen, the moratorium provisions in Part 3 of CIMA. A moratorium is quite a different scenario to a liquidation, receivership or personal insolvency. The moratorium provisions reinforce the notion that statutory management is principally about the efficient and effective management of a corporation; not about its winding-up.

Other features

3.7 The remainder of this section of the paper seeks to address the following questions:

(a) Who can be subject to statutory management?

(b) When and how is an entity placed into statutory management, and when does statutory management end?

(c) Why is an entity placed into statutory management?

(d) What are the consequences of being placed into statutory management?

The "who": the entities that can be subject to statutory management

3.8 Any "corporation" is potentially subject to the statutory management regime in CIMA. For the purposes of CIMA, a "corporation" means a body of persons, whether corporate or not, and whether incorporated or established in New Zealand or elsewhere. So unlike earlier regimes its scope is not confined to companies as such; it can apply to other forms of corporate bodies and to trusts. However, the scope of the Act is not expressed as applying to every entity that that falls within the definition of "corporation". Rather, s 4 is narrower in scope and provides that:

> [CIMA] applies to any corporation—
>
> (a) that is, or may be, operating fraudulently or recklessly; or
>
> (b) to which it is desirable that this Act should apply—
>
> (i) for the purpose of preserving the interests of the corporation's members or creditors; or
>
> (ii) for the purpose of protecting any beneficiary under any trust administered by the corporation; or

[15] *McDonald v AGC (NZ) Ltd* [1990] 1 NZLR 227.

(iii) for any other reason in the public interest,—

if those members or creditors or beneficiaries or the public interest cannot be adequately protected under the Companies Act 1955 or the Companies Act 1993 or in any other lawful way.

3.9 In addition to corporations, an "associated person" of a corporation is potentially subject to the statutory management regime in CIMA. For the purposes of CIMA, a person is an "associated person" of a corporation if:[16]

(a) that person directly or indirectly controls the management of the corporation; or

(b) that person owns directly or indirectly,—

(i) in the case of a corporation that is a company registered under the Companies Act 1955, 20% or more in nominal value of the equity share capital (as defined in section 158 of that Act) of the corporation; or

(ii) in all other cases, 20% of the issued shares of the corporation, other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital:

(c) the corporation directly or indirectly controls that person; or

(d) the corporation owns directly or indirectly,—

(i) in the case of a person that is a company registered under the Companies Act 1955, 20% or more of the equity share capital (as defined in section 158 of the Companies Act 1955) of that person; or

(ii) in all other cases, 20% or more of the issued shares of that person, other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital.

The "when" and the "how": the commencement and termination of statutory management

3.10 Statutory management commences for a corporation or an associated person of that corporation when the Governor-General, by Order in Council, declares the corporation or the associated person to be subject to statutory management.[17] CIMA sets out a process that is to be followed prior to the Governor-General making such an order. That process requires the Financial Markets Authority ("**FMA**") to make a recommendation to the Minister of Commerce ("**Minister**") that statutory management should be declared.[18] In order to make that recommendation, the FMA has to be satisfied of a number of specified criteria, which are set out in more detail in paragraphs 3.13 to 3.17 below.[19] Upon receiving the FMA's recommendation, the Minister can decide to ignore the recommendation, or follow it. If the Minister wishes to follow the FMA's recommendation, he or she advises the Governor-General to make the required Order-in-Council. There is no other way for statutory management to be commenced under CIMA. Moreover, there is no judicial involvement in this process.

3.11 Statutory management potentially has no end: there is no specified time period for the statutory management. CIMA sets out two ways that statutory management can cease for the corporation or the associated person:

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17 CIMA, s 38(1)(a).
18 CIMA, s 38(1)(a).
19 CIMA, ss 39 and 40.

(a) when the Governor-General, by Order in Council, declares that the statutory management shall cease;[20]

(b) when the corporation or the associated person is put into liquidation on the application of the statutory manager.[21]

3.12 Other than through the mechanisms described above, there is no express provision in CIMA that gives anyone — for example, the corporation in statutory management, the associated person in statutory management, shareholders, secured creditors, unsecured creditors, even a statutory manager — an ability to seek to terminate the statutory management. Statutory management therefore commences in the context of an inherently political environment and — bar a statutory manager's successful application to liquidate — ends in one.

The "why": the grounds for placing a corporation or an associated person of a corporation in statutory management

3.13 In relation to a recommendation by the FMA to the Minister that a corporation should be placed into statutory management, s 39 CIMA provides:

> The FMA shall not make a recommendation under section 38 in respect of a corporation unless it is satisfied on reasonable grounds—
>
> (a) that the corporation is, or may be, a corporation to which this Act applies; and
>
> (b) that, in the case of a corporation that is, or may be, operating fraudulently or recklessly, it is desirable that the corporation be declared to be subject to statutory management for the purpose of—
>
> (i) limiting or preventing the risk of further deterioration of the financial affairs of the corporation; or
>
> (ii) limiting or preventing the carrying out, or the effects of, any fraudulent act or activity; or
>
> (iii) enabling the affairs of the corporation to be dealt with in a more orderly or expeditious way:
>
> (c) that, in the case of a corporation referred to in section 4(b), it is desirable that the corporation be declared to be subject to statutory management for the purpose of—
>
> (i) preserving the interests of its members or creditors or beneficiaries or the public interest; or
>
> (ii) enabling the affairs of the corporation to be dealt with in a more orderly or expeditious way.

3.14 When distilled to their bare essentials, these grounds are fairly light. By way of example, a close reader of the relevant provisions might observe that it is possible for statutory management to be imposed on a corporation where:

(a) it is desirable that CIMA apply to the corporation for any reason in the "public interest" and the "public interest" cannot be protected in any other lawful way (so the corporation is subject to CIMA under s 4(b)(iii)); and

[20] CIMA, s 62(1).
[21] CIMA, s 62(2).

(b) the FMA is satisfied (on reasonable grounds) that it is desirable for the corporation to be subject to statutory management for preserving the "public interest" (so the requirement in s 39(c) is met).

3.15 In relation to a recommendation by the FMA to the Minister that an associated person of a corporation should be placed into statutory management, s 40 CIMA provides:

> The FMA shall not make a recommendation under section 38 in respect of an associated person of a corporation unless it is satisfied on reasonable grounds that—
>
> (a) an Order in Council could be made in respect of that associated person on any of the grounds specified in section 39; or
>
> (b) the business and affairs of the corporation are so closely connected with that associated person that the statutory manager or statutory managers would be unable to exercise effectively the powers conferred by this Act in relation to the corporation unless the statutory manager or statutory managers is or are appointed as statutory manager or statutory managers of the associated person.

3.16 CIMA does not provide any guidance to the FMA as to how it should approach these grounds for making a recommendation in respect of an associated person of a corporation. In particular, there is no explicit guidance in CIMA on what is meant by "so closely connected" or on what level of difficulty is sufficient to met the "unable to exercise effectively" standard.

3.17 The Securities Commission, the predecessor to the FMA, has said that the factors to be considered before recommending that companies be placed in statutory management include:[22]

- a complex group of companies linked by shareholdings or inter-company debts;
- many creditors, unsecured or holding a range of different securities, affecting different companies in the group;
- no security document enabling the timely appointment of a receiver or manager for the group as a whole;
- the prospects of protracted litigation and expense to trace rights through a complex group;
- vulnerable assets, such as work-in-progress, under construction or development contracts;
- the effect on a market of the possibility of uncoordinated and distressed sales; and
- the effects of intervention and non-intervention upon the credit standings of New Zealand companies.

The "what": the consequences of being placed into statutory management

3.18 There are two significant immediate consequences of being placed into statutory management:

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[22] Securities Commission press release dated 3 August 1989 cited in Ross "Political Expediency and Misguided Insolvency Reform - The New Zealand Experience with the Corporations (Investigation and Management) Act 1989" Insolvency Law Journal (March 1994) 25 at 33. It is unclear whether the FMA still takes the same view.

(a) a wide-reaching moratorium is imposed preventing various proceedings or other enforcement action being taken or continued against the corporation by creditors and other claimants (including secured creditors);[23] and

(b) the management of the corporation is vested in the statutory managers.[24]

Moratorium

3.19 The moratorium in s 42 CIMA is wide-reaching. It prohibits:[25]

(a) any action or other proceedings in respect of any pre-statutory management contract or other obligation;[26]

(b) the enforcement of any judgment in respect of any pre-statutory management contract or other obligation;[27]

(c) the recovery of property in the possession of the corporation;[28]

(d) the termination of, or re-entry or distraint for rent in respect of, any tenancy;[29]

(e) the exercise of any right of set-off against the corporation;[30]

(f) the enforcement of securities;[31] and

(g) any application or resolution for liquidation.[32]

3.20 Notwithstanding the broad moratorium, there are a number of important carve-outs.

3.21 The principal carve-out is that the moratorium does not apply to post-statutory management contracts and obligations. In that regard, CIMA draws an important distinction between pre-statutory management contracts and obligations and post-statutory management contracts and obligations. As noted above, pre-statutory management obligations are covered by the moratorium. On the other hand, where the corporation under statutory management enters into a contract or incurs an obligation, the moratorium does not prevent a person from seeking to enforce such a contract of obligation.[33] The rationale for the moratorium can be readily discerned: why would anyone contract with a corporation in statutory management without being able to sue on the contract?

3.22 A second carve-out is that, except in the case of the prohibition against liquidation procedures, the statutory manager has waived the application of the moratorium.[34]

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23 CIMA, s 42.
24 CIMA, s 45.
25 *Brookers Insolvency and Practice* (loose-leaf) at 6-14.
26 CIMA, s 42(1)(a).
27 CIMA, s 42(1)(b).
28 CIMA, s 42(1)(f).
29 CIMA, s 42(1)(g).
30 CIMA, s 42(1)(h).
31 CIMA, s 42(1)(e). Importantly, the moratorium does not affect "the existence of any security over the property of any corporation or its priority over other debts": CIMA, s 42(4). This aspect of the CIMA regime is discussed in more detail below.
32 CIMA, s 42(1)(c).
33 CIMA, s 42(5) and (6). See for a recent practical application of this principle *Re Application by Simpson & Ors* HC Timaru CIV-2010-476-581, 17 March 2011 (costs of legal representation incurred after imposition of statutory management on Mr and Mrs Hubbard not affected by the moratorium).
34 CIMA, s 42(3).

3.23 Furthermore, the prohibition on brining / continuing proceedings does not apply to a proceeding brought for the purpose of determining whether any right or liability exists and for which leave has been obtained from the statutory manager or the High Court.[35] However, even if a party is able to obtain judgment *establishing* that a right or liability exists, the moratorium would prevent that party from seeking to *enforce* the judgment against the corporation.

Management of the corporation

3.24 The management of the corporation is vested in the statutory managers.[36] In doing so, CIMA gives the statutory managers wide powers (some of which are wider than what the corporation would ordinarily have). The statutory manager is given all of the powers, rights, and privileges of the corporation and generally all such powers, rights, and authorities as may be necessary to carry out "the powers" conferred by Part 3 of the Act.[37]. Additional or specific powers are provided by other provisions and include powers:

(a) to disclaim onerous property;[38]

(b) to suspend the discharge of any pre-statutory management obligation;[39]

(c) to carry on the business of the corporation;[40]

(d) to pay, or compromise with, any creditor or claimant;[41]

(e) to terminate any contract of service or agency;[42]

(f) to sell any part of the business undertaking of the corporation;[43]

(g) to apply to put the corporation into liquidation;[44]

(h) to trace property improperly disposed of;[45]

(i) to exercise certain powers of liquidators under the Companies Act 1993;[46]

(j) to apply to the Court for directions;[47] and

(k) to seek and be given additional powers by the Court.[48]

3.25 CIMA provides the statutory managers a non-exhaustive list of guiding principles to assist them in the exercise of their powers:[49]

> In the exercise of the powers conferred by this Part, a statutory manager of a corporation shall have regard to—

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35 CIMA, s 42(2).
36 CIMA, s 45.
37 CIMA, s 46.
38 CIMA, s 46(3).
39 CIMA, s 44.
40 CIMA, s 47.
41 CIMA, s 48.
42 CIMA, s 49.
43 CIMA, s 50.
44 CIMA, s 52.
45 CIMA, s 54.
46 CIMA, s 55.
47 CIMA, s 58.
48 CIMA, s 59.
49 CIMA, s 41(1).

> (a) the need to preserve the interests of members and creditors of the corporation, or, where appropriate, the need to protect the beneficiaries under any trust administered by the corporation or the public interest:
>
> (b) the need to resolve the difficulties of the corporation:
>
> (c) as far as practicable, the need to preserve the business or undertaking of the corporation.

3.26 A statutory manager will be conscious that these considerations may conflict with each other. For example, the need to preserve the interest of members of the corporations might be inconsistent with the need to preserve the interests of creditors. It is also notable that the underlying legal position is not an explicit consideration for a statutory manager.

Minimal Court involvement

3.27 Under CIMA the role of the Court is very limited. Moreover, the other provisions of CIMA do not contemplate very much Court involvement. The action is, initially, in the hands of the FMA and the Minister, and, later, in the hands of the statutory manager. The Court's role is confined to:

(a) granting leave under s 42(2) for an action or proceeding to be commenced or continued against a corporation "for the purpose of determining whether any right or liability exists";

(b) awarding compensation under s 49 to persons who have had service or agency contracts terminated by the statutory manager;

(c) hearing applications by any person adversely affected by any sale under s 50;

(d) ordering under s 54 the return of property improperly disposed of or a payment of a sum for the value of such property;

(e) applying under s 55 the voidable transaction and other provisions of the Companies Act 1993;

(f) giving directions under s 58 to the statutory as to the exercise of his or her powers or conferring additional powers under s 59 on a statutory manager (on the application of the statutory manager); and

(g) considering applications for judicial review of the actions of the Governor-General, the Minister, the Securities Commission, or the statutory manager. Although there is no express power to review in the Act itself, basic administrative law principles imply a power to review.

3.28 Some might view the lack of Court involvement as concerning; others might say it demonstrates the flexibility of the regime, allows the statutory manager to get on with the job, and minimises legal expense for all involved.

Summary of key features

3.29 In short, the key features of the statutory management regime in CIMA are:

(a) the range of entities potentially subject to statutory management is broad;

(b) statutory management can only be initiated — and be terminated — by the executive;

(c) the grounds on which an entity can be placed in statutory management are incredibly broad;

(d) upon a corporation being placed in statutory management, a wide-reaching moratorium is imposed preventing creditors and other claimants from pursuing or enforcing pre-statutory management claims, contracts or other obligations;

(e) the management of the corporation vests in the statutory manager and the statutory manager is given very wide powers to manage the corporation;

(f) there is a very limited role for the Courts.

4. WHEN HAS STATUTORY MANAGEMENT BEEN USED?

4.1 The purpose of this section is to provide some practical context to the discussion of statutory management. Statutory management under CIMA has been used in a variety of different circumstances in respect of corporations and to limited extent (and somewhat controversially) natural persons. Examples are discussed below.

Corporations

Equiticorp[50]

4.2 The size of the Equiticorp collapse was unprecedented in New Zealand experience. In January 1989 the Equiticorp Group announced that it was suspending business. An extensive memorandum addressed to the Securities Commission was prepared by professional advisers for the group and stated that the collapse was of such magnitude and so serious that Government intervention was necessary pursuant to the Companies Special Investigations Act 1958. The Securities Commission then recommended to the Minister of Commerce that the Governor-General make an Order in Council placing the companies in the Equiticorp Group under statutory management pursuant to that Act. The Order in Council was made on 22 January 1989 (and pursuant to the Corporations (Investigation and Management) Order 1989 the Equiticorp group was declared to be subject to statutory management under CIMA on 4 April 1989). The statutory management took some years to resolve.

Richmond Smart[51]

4.3 Richmond Smart Corporation was formed by a merger of Smart Group Limited and Richmond Development Corporation Limited and was a diverse group comprising 121 companies of which 93 were in New Zealand. Its principal divisions were a hotel division which owned and ran or had franchised nine hotels; an industrial division including series of industrial companies with diverse industries such as stainless steel manufacture and fabrication, timber processing and retailing, plumbing, roofing and conditioning contracting, alloy casting; a property division with a wide range of industrial, commerce, office properties of varying and often poor quality; an investment division with some investment in equities and an Australian division which was a diverse group involved in property development, shoe manufacture, tannery and fibreglass panels and products.

4.4 Immediately on merger the Group experienced financial problems and various bankers moved to improve their security position and reorganise their lending. This culminated in the Bank of New Zealand commissioning an investigating accountant's report which was followed by the formation of a working party of banks to speed up and control the

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[50] Aspects of this summary are taken from *Hawkins v Minister of Justice* [1991] 2 NZLR 530 (CA).
[51] Aspects of this summary are taken from the Securities Commission's 1992 Report on CIMA at appendix A.

sell down of assets. This was a two-tiered structure. The first tier was the five major banks whose representatives met weekly with Mr FN Watson of KPMG Peat Marwick as Chairman. The second tier was the remaining 12 banks whose representatives met monthly. Lending banks formed a working party which was in existence for a period of about four months, but failed to achieve its target because of increasing discontent among the banks themselves.

4.5 As part of the process to resolve the difficulties facing the Richmond Smart Group, it was proposed that the Group be brought under a scheme of arrangement under s 205 of the Companies Act 1955. This needed the unanimous consent of all banks but despite strenuous efforts by the major banks and the directors of the Group, such consent was never obtained.

4.6 The failure to achieve a s 205 scheme was critical and resulted in each bank moving to protect its own interests. The two major banks appointed receivers under debentures over part of the Group. Other banks and lending institutions took steps to appoint receivers of rents to properties over which they had security. One lender which had already issued winding up proceedings against Richmond Development Corporation Ltd set the proceedings down for hearing in the High Court.

4.7 There was no debenture over, or any lending to the holding company, Richmond Smart Corporation Ltd (although it had guaranteed a number of loans).

4.8 Two different receivers were appointed by different secured creditors over different parts of the Group, and indications were received from other lenders that they also would move to protect their interests. Notwithstanding all these formal appointments, there were still companies in the Group over which there were no debentures nor did the lenders hold securities enabling them to appoint receivers of rents of the properties affected. A number of companies continued to trade without "parental control".

4.9 Overall, there were 25 banks, 5,500 shareholders, 2,200 unsecured creditors, and 1,300 staff involved in the Group. There was also the effect on the general public and the tourist industry as local and overseas tourists would have lost their deposits on the hotel bookings when the hotels were forced to close.

4.10 It was recognised by the directors that individual receivers and managers of different segments of the Group might not respect other parts of the Group. In this critical situtation, the directors approached the Government and appointments were made on 3 March 1989 under the Companies and Special Investigations Act 1958 with KPMG Peat Marwick being appointed statutory receivers (with that process later transferred to the statutory management under CIMA).

4.11 It was very clear from the outset that the Group could not be traded out of its current predicament and that the best result for all parties would be an orderly sell down of all assets. A plan of realisation of assets was put into effect by the statutory managers and was substantially completed within a two and a half year period.

International Investment Unit Trust

4.12 In July 2003, the International Investment Unit Trust, related entities, and three natural persons were placed into statutory management pursuant to the Corporations (Investigation and Management) Order 2005. The International Investment Unit Trust is alleged to have been a vehicle for Donald Rea to run a ponzi scheme under which he received almost $29 million from investors who were promised yields of up to 72 per cent on investments in "private placement programmes" run by the top 25 European banks.[52] More than 250 investors from throughout the country, but mostly in Taranaki and the Bay of Plenty, were involved. They ranged from wealthy farmers, through to individuals nearing retirement looking to invest their life savings, to charities.[53]

Natural persons

4.13 Natural persons have been placed into statutory management on three occasions. At best, CIMA deals with natural persons in a fairly "awkward" manner[54] and one view is that statutory management was never intended to deal with natural persons.

John Baylis and Willard Amaru

4.14 On 16 December 1999 John Baylis and Willard Amaru were placed into statutory management as associated persons of IMI Pacific Group Limited and Walakahai Pacific Corporation Limited. The pair was accused of financial wrongdoing after statutory managers were called in to retrieve $8 million in investors' money funnelled into a labyrinth of family trusts, property and other personal assets.[55] About 200 investors — mostly from Wellington and Nelson — were promised up to 14 per cent a month return on their investments, at seminars held by the men. Investors were since told they would get back just 15c in every dollar invested in the two companies. The statutory management of Messrs Baylis and Amaru was terminated on 25 November 2002 pursuant to an Order in Council.[56] By that time they had been declared bankrupt and had received a 5 year ban from being a director.[57]

Donald Rea, Catherine Trezona and Lisa Talbolt:

4.15 On 3 July 2003, Donald Rea, Catherine Trezona and Lisa Talbolt were placed into statutory management as associated persons of the International Investment Unit Trust (described above). Just over a year later, on 5 July 2004, the statutory management of Ms Talbot was terminated pursuant to an Order in Council,[58] and then a further year later, on 11 July 2005, the statutory management of Ms Trezona was terminated pursuant to a further Order in Council.[59] Mr Rea died (while in statutory management) on the evening of the second day of a trial for charges brought by the Serious Fraud Office.

Allan and Jean Hubbard

4.16 As previously noted, on 20 June 2010 Allan and Jean Hubbard were placed into statutory management as associated persons of Aorangi Securities Limited and various charitable trusts pursuant to the Corporations (Investigation and Management) Order 2010. As at the date of this paper, they remain in statutory management though there are extant judicial review proceedings challenging the decisions to place them in statutory management.

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52 Geoff Cumming "Con or conspiracy - Don Rea's last stand" *The New Zealand Herald* 20 May 2006 <http://www.nzherald.co.nz/geoff-cumming/news/article.cfm?a_id=88&objectid=10382745>.

53 Geoff Cumming "Con or conspiracy - Don Rea's last stand" *The New Zealand Herald* 20 May 2006 <http://www.nzherald.co.nz/geoff-cumming/news/article.cfm?a_id=88&objectid=10382745>.

54 *Re Application by Simpson & Ors* HC Timaru CIV-2010-476-581, 17 March 2011 at [28].

55 Dita de Boni "Ban on pair in IMI and Walakahai Pacific fraud inquiry" The New Zealand Herald (New Zealand, 28 March 2001) <http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=179621>.

56 Corporations (Investigation and Management) Order 2002.

57 Dita de Boni "Ban on pair in IMI and Walakahai Pacific fraud inquiry" The New Zealand Herald (New Zealand, 28 March 2001) <http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=179621>.

58 Corporations (Investigation and Management) Order 2004.

59 Corporations (Investigation and Management) Order 2005.

5. PRACTICAL IMPLICATIONS AND CONSEQUENCES FOR PARTIES DEALING WITH A CORPORATION IN STATUTORY MANAGEMENT

5.1 The purpose of this section is to outline the kinds of issues that parties dealing with a corporation in statutory management may face.

5.2 The most obvious and immediate practical implication is, as has already been discussed, that a moratorium is imposed that prevents creditors and other claimants from enforcing pre-statutory management contracts and obligations. That moratorium can be waived by the statutory manager.

5.3 Parties dealing with the corporation in statutory management will be interested to know about a number of other matters, including:

(a) their ability to contract with a corporation in statutory management, and the legal position governing their relationship;

(b) in the case of secured parties, how their security is affected by the corporation's placement into statutory management, and what, for example, happens if a statutory manager attempts to sell an asset over which a secured party has security;

(c) the prohibition on the transfer and removal from New Zealand of the corporation's property without the permission of the statutory manager;

(d) the requirement to deliver property of the corporation to the statutory manager; and

(e) cross border enforcement issues.

Contracting with a corporation in statutory management

5.4 For parties concerned about the moratorium, as noted above, the moratorium in s 42 CIMA does not apply to post-statutory management contracts or obligations incurred by the corporation.[60] Moreover, the statutory manager's power to suspend payments does not apply to post-statutory management contracts and obligations.[61] It is therefore possible to enter into an enforceable contract with a corporation in statutory management.

5.5 The effect of s 45 CIMA is that the management of the corporation vests in the statutory manager and only the statutory manager can be engaged in the management of business of that corporation (unless the statutory manager gives someone else permission to do so). Accordingly, during statutory management — to state what is probably obvious — the only way that a corporation in statutory management can validly enter into a contract or otherwise incur an obligation is through or with the consent of the statutory manager. It is therefore important for parties dealing with a corporation in statutory management to ensure that they deal with the statutory manager and not just the directors or other officers of the corporation.

5.6 The position of a party who contracted with the corporation pre-statutory management might give rise to some complexities. To illustrate those complexities, take a supplier of goods to a corporation that has supplied goods to the corporation for a period of time pre-statutory management and which is owed money by the corporation at the time of statutory management. An interesting question arises as to whether or not the supplier has to continue to provide goods to the corporation despite not being paid or risk being

60 *Re Application by Simpson & Ors* HC Timaru CIV-2010-476-581, 17 March 2011 at [31].
61 *Re Application by Simpson & Ors* HC Timaru CIV-2010-476-581, 17 March 2011 at [33].

in breach of contract. On the one hand s 44(1) CIMA provides that the statutory manager of a corporation may, notwithstanding the terms of any contract, suspend in whole or in part the repayment of any deposit, or the payment of any debt, or the discharge of any obligation, to any person. Section 44(2) CIMA provides that the suspension by a statutory manager in whole or in part of the repayment of any deposit, or the payment of any debt, or the discharge of any obligation to any person shall not constitute a breach or repudiation of any contract entered into by the corporation with any person. No corresponding relief is given to the other party to the contract to cease provision under the supplier contract. So, prima facie, the supplier will have to continue to supply goods and face the possibility it will not receive payment for pre-statutory management debts.

5.7 The supplier's safeguard will in practice be to have ensured that statutory management constitutes an event of default under the relevant supply contract. What if the supply contract is silent on this point? It is arguable that the supplier will have to continue to supply the corporation with goods. On the positive side for the supplier, the moratorium and the power to suspend does not apply to post-statutory management obligations, so they can be assured of an entitlement to be paid for goods supplied post-statutory management (although when and whether payment occurs will depend on what assets the corporations actually has).

5.8 To take the example given a little further, it is possible for the supplier to bargain with the statutory manager and try and get the statutory manager to use his power under s 48(a) to pay any creditor or class of creditor of the corporation in whole or in part. That provision appears to allow the statutory manager an incredibly wide discretion to favour some creditors over others subject presumably to an unreasonableness restraint.

5.9 All in all, a party who has contracted, or is wishing to contract, with a corporation in statutory management will have to closely work through the provisions of CIMA in order to know where they lie. Even then, CIMA might not clearly provide for all situations and parties may find themselves in a position of uncertainty.

Position of secured creditor

5.10 Section 42(4) CIMA provides:

> Subject to the provisions of this Act, nothing in subsection (1) [ie the moratorium] affects the existence of any security over the property of any corporation or its priority over other debts.

5.11 What does this mean for secured creditors? Although it appears to say that a secured creditor's security interest remains intact, on a closer examination the position of secured creditors is significantly eroded when statutory management is imposed, particularly because of the potentially endless moratorium. In short, although a security interest remains in existence despite statutory management, a creditor's ability to take enforcement action based on the security is severely curtailed. Under CIMA the security is only of utility when the statutory manager chooses to sell the asset(s) that are subject to the security.

5.12 Section 50(1) CIMA empowers the statutory manager to sell or otherwise dispose of the whole or any part of the business undertaking of the corporation to such person, and upon such terms and conditions, as the statutory manager thinks fit. However, the plight of a secured creditor is not completely ignored in that s 51 CIMA sets out how the statutory manager is to apply proceeds of assets sold subject to security.

5.13 By way of illustration, if a statutory manager was to sell an asset that was subject to a security to a third party, s 51(2) CIMA requires the statutory manager to pay the person entitled to the security interest out of the proceeds of the sale or other disposition in priority to all claims other than the costs of the statutory manager in selling or disposing of the property over assets and certain claims in respect of preferential payments made under s 312 of the Companies Act 1993. Some might see this process as an erosion of what the secured party is ordinarily entitled to under its security interest (although others might say a secured creditor should be thankful its priority is recognised, at least in this limited context), in particular, there is an erosion of the secured party's ability to control the enforcement of its security.[62]

Prohibition on the transfer and removal from New Zealand of the corporation's property

5.14 It is unlawful to transfer or remove from New Zealand any property or assets of a corporation in statutory management except with the consent of the statutory manager.[63] Section 43(2) CIMA provides for offences where this prohibited is breached.[64]

The requirement to deliver property of the corporation to the statutory manager

5.15 Section 67(1) CIMA provides:

> It shall be the duty of all persons having possession and control of any books or records or documents or other property belonging to any corporation subject to statutory management, forthwith after it becomes subject to statutory management, to deliver or yield up possession of those books, records, documents, or other property to the statutory manager in respect of the corporation.

5.16 Failure to comply can result in a fine being imposed[65] or the Court may punish an offender as if the offender had been guilty of contempt of Court.[66]

Cross-border enforcement issues

5.17 Where the corporation has assets in overseas jurisdictions, a statutory manager may face difficulties being recognised by a foreign court because statutory management is commenced by executive order rather than judicial order. For instance, the statutory manager may not be able to utilise the UNCITRAL Model Law that has now been adopted in many countries, including New Zealand (in the Cross-Border Insolvency Act 2006) and Australia (in the Cross-Border Insolvency Act 2008), because statutory management may not fall within the definition of "foreign proceeding". A "foreign proceeding" is defined in Article 2 as "a collective judicial or administrative proceeding in a foreign State, including an interim proceeding, pursuant to a law relating to insolvency in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation". Leaving UNCITRAL to one side, another challenge a statutory manager may face is that it is unclear whether under private international law a statutory manager will be recognised as a representative of the corporation.

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62 Section 50(3) CIMA provides that the provisions of any agreement requiring any consent licence, permission or other authority shall not have any application in respect of any sale pursuant to the section, unless the Court, on application by any person who would be adversely affected, otherwise orders. In the author's view, the ability for a person adversely affected to make an application under s 50(3) CIMA is relatively narrow in that it is only triggered when the statutory manager takes steps to sell an asset; it cannot be used by, for example, a secured creditor to apply for an order forcing the statutory manager to sell an asset.

63 CIMA, s 43(1).

64 The penalties are significant: in the case of an individual, to imprisonment for a term not exceeding 3 years or to a fine not exceeding $50,000, and in the case of a corporation, to a fine not exceeding $250,000.

65 CIMA, s 67(2).

66 CIMA, s 67(3).

6. CRITICISMS OF STATUTORY MANAGEMENT AND ARGUMENTS SUPPORTING ITS RETENTION

Criticisms

6.1 Numerous criticisms have been levelled at statutory management. For example, in its 2001 review of insolvency law, the Law Commission outlined a number of criticisms that have been levelled at the statutory management regime:[67]

(a) *The distortion of market signals*: Those who make bad investment decisions should not receive the benefit of government intervention and support. Rather, weak businesses should be allowed to fail. As the risk of loss is priced into investments, government intervention by way of statutory management may distort those price signals.

(b) *Moral hazard*: The presence of statutory management relaxes incentives for shareholders and creditors to closely analyse the actions of management and in turn reduces incentives for management to perform.

(c) *Interference with creditors' rights:* Statutory management undermines confidence among those in the business community, who expect that contracts they enter into will be enforced. Such confidence is crucial for economic growth. Statutory management imposes a moratorium which prevents secured creditors from enforcing their valid contractual rights.

(d) *Negative effect on credit*: The uncertainty created by CIMA results in creditors, particularly overseas ones, seeking an increased return for that uncertainty. This raises the cost of credit and the cost of conducting business in New Zealand.

(e) *Political involvement:* The process for placing a corporation in statutory management is inherently political. Overseas financiers have concern that the Government would try to influence the outcome of a statutory management.

(f) *Transparency and accountability*: Transparency and accountability are vital to establishing trust and confidence in the insolvency process. As an insolvency procedure, statutory management is neither transparent nor accountable. The decision making process leading to a corporation being placed into statutory management is confidential. There is no explicit right for interested parties — for instance a secured creditor — to be heard as of right and to, for example, put forward alternative proposals. In terms of accountability, the statutory managers receive the benefit of an incredibly generous indemnity from the Crown in s 63 CIMA. The statutory decision makers (other than the Minister, whose actions are in any event paid for by the public purse) also have the benefit of that same indemnity under s 63 CIMA.

Benefits of statutory management

6.2 Against these criticisms, the Law Commission stated that statutory management has three potential benefits as an insolvency procedure:

(a) it provides an extraordinary procedure for business rehabilitation;

(b) it enables insolvencies involving groups of companies to be dealt with as a whole; and

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[67] *Insolvency Law Reform: Promoting Trust and Confidence* (NZLC SP11, 2001) at pp 90 - 91.

(c) it provides an emergency measure for ensuring the continuing supply of essential services if the companies which provide them are faced with collapse.

6.3 In its 1992 review, the Securities Commission did not articulate what it saw as the purpose of statutory management other than to address perceived deficiencies with the then corporate insolvency regime — particularly the lack of provision for the appointment of a single manger to take central control of a group in financial difficulty; timeliness; and the absence of any procedure by which a company in financial distress can obtain "breathing space" from creditor demands. That said, the Securities Commission's review notes that "in our view, the benefits of statutory management go beyond simply plugging the gaps that exist in our current corporate insolvency regime."[68] Those benefits are:

(a) *Statutory management allows a group of companies to be controlled by a single manager:*[69] A "mainstream administration regime" might be problematic in terms of determining which companies are members of a group, particularly where the "group" of companies was linked — from a legal perspective — fairly loosely, for example by nothing more than cross-directorships. The Securities Commission said that in such circumstances it is unlikely that regime would allow the appointment of a single manager ("particularly if there was any opposition to the application of the procedure" to a particular company). In addition, to do so "would seriously offend against the principle that each company is a separate legal entity". However, the Securities Commission saw substantial benefits in a "group" nonetheless being controlled by a single manager.

(b) *Statutory management imposes a moratorium that cannot be challenged:*[70] A "mainstream administration regime" would be likely to contain safeguards for claimants which would allow them to challenge the appointment and decisions of the administrator and the extent of any moratorium in place. In the vast majority of cases that is both necessary and appropriate. However, in some circumstances — the collapse of a large corporate group or where there is a great deal of acrimony between the various interested parties — it is unlikely to be in the interests of the majority of claimants to allow the insolvency process to become bogged down in litigation.

(c) *Statutory management can deal with a vehicle for carrying on business other than a company:*[71] The definitions of "corporation" and "associated person" are wide enough to cover a trust or partnership or unincorporated joint venture arrangement. CIMA also applies to the business of a body incorporated outside New Zealand to the extent that the body concerned has assets or business in New Zealand. The possibly wide net cast by the statutory management procedure has distinct advantages in addressing large scale or complex fraud affecting a group of interconnected companies, trusts, and other associations.

6.4 The broad reach of CIMA means that it is not necessarily confined to these objectives. Even though the there has been significant criticism levelled at statutory management, the prospects for reform seem slim.

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68 At p 3.
69 At p 22.
70 At p 22.
71 At p 23.

Recommendations made by the Securities Commission and the Law Commission to improve the statutory management regime

6.5 CIMA has been the subject of two fairly comprehensive reviews — first by the Securities Commission in 1992 (focused solely on CIMA) and then by Law Commission in 2001 (as part of a wider insolvency law review). These reviews have recommended reasonably substantial amendments to the statutory management regime. Despite this, CIMA has escaped any serious scrutiny by the legislature.

Retention of statutory management

6.6 Both the Securities Commission and the Law Commission recommended that statutory management be retained but in modified form. There were are number of other areas where the Securities Commission and the Law Commission were in broad agreement as to the work required to address CIMA's deficiencies.

Purpose of statutory management

6.7 The Law Commission's view was that statutory management should be used as a filter to determine which insolvency procedure should ultimately be used, or whether the corporation can be returned in a solvent state to its management. This view appears to have informed the Law Commission's approach to its review of CIMA in that the recommendations made by the Law Commission are generally aimed at confining the scope of the application of statutory management. The role for statutory management that the Securities Commission had in mind is described at paragraph 6.3 above.

6.8 Although the Securities Commission and the Law Commission might have viewed the purpose of statutory management slightly differently (the Securities Commission had wider designs in mind), as noted above, ultimately the recommendations each body made were broadly similar.

Period of statutory management and extension to initial term

6.9 Both the Securities Commission and the Law Commission recommended that statutory management be time limited. However, there was some divergence in the detail.

6.10 The Securities Commission recommended that the period of statutory management should be no more than six months. However, that period could be extended by the Securities Commission provided a reporting, notification, and consultation process was followed first.[72] As part of that process, the Securities Commission considered that any interested party should be entitled to apply to the Court for relief on the grounds that a corporation's affairs are being or have been managed in a manner which is oppressive and unfairly discriminatory to that party.

6.11 The Law Commission recommended the maximum period of statutory management should be three months. This timeframe is preferred because the object of statutory management is generally to bring order to a chaotic situation. The Law Commission considered that there should be provision for the statutory manager to apply to the Court for an extension of the statutory management for a period not exceeding a further three months. The application would be on notice to all affected parties, and a statutory manager would need to satisfy the Court that the extra time is needed to complete his/her investigation and to make a recommendation on the most appropriate way to deal with the corporation.

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[72] At p (i)-(ii).

Commencement of statutory management

6.12 In terms of the process for placement into statutory management, the Securities Commission and the Law Commission diverged about who should make the decisions:

(a) The Securities Commission considered that Courts should not be charged with the decision to place a corporation in statutory management and moreover considered that there should be no express right to apply to the Court for a review of the Commission's decision to place a corporation in statutory management. Rather, the Securities Commission considered that the initial application to place a corporation in statutory management should be made to the Registrar of Companies, who should then refer the application, together with a report on the corporation and the nomination of any persons for the proposed appointment as statutory managers, to the Securities Commission for its decision on whether or not the application should be granted and on what terms and conditions. In that regard, the Securities Commission recommended that the current responsibilities of the Minister under the Act be conferred upon the Securities Commission but that there otherwise be no general increase in the Commission's involvement in the statutory management process.

(b) The Law Commission's view was that a decision to invoke statutory management should be made by the High Court, because transparency and accountability are important when the legal rights of secured and unsecured creditors are to be severely restricted. Statutory management should be invoked by Court order on the application of the Registrar of Companies. The Court should be required to give reasons for any decision imposing statutory management which can be made available to all creditors on request. Prior to being appointed, statutory managers must satisfy the Court of their skill and competence before being appointed. The Law Commission recommended that both the Minister and the Securities Commission should be relieved of the decision-making and recommendatory functions respectively. However, the Securities Commission would retain a role in appointing (after consultation with interested parties) an advisory committee with whom the statutory manager can confer, and to whom the statutory manager can also report. Statutory management should be capable of termination on order from a Court, which can then determine whether to hand back control of the corporation to management, or place it into an appropriate insolvency regime.

Moratorium

6.13 Both the Securities Commission and the Law Commissions considered that the moratorium should be retained (indeed it is a crucial aspect of the statutory management regime):

(a) The Securities Commission recommended that the term of the moratorium should be co-extensive with the initial term of the statutory management set in the notice of appointment. Section 42 should be retained in its current form for the initial term of a statutory management, but subject to a standstill period of 28 days the statutory managers should be prevented from accessing funds subject to contractual rights of set-off, to a banker's right to combine accounts, and to rights of set-off on the part of a futures clearing house. If the term of a statutory management is extended, s 42 should continue in force, but secured creditors should be entitled to require the statutory manager to lift the moratorium in their favour under s 42(3) unless "good reason" exists for refusing to do so.

(b) The Law Commission did not make any detailed recommendations but saw the moratorium (taken together with a restricted timeframe for statutory management) as, on balance, justified. In particular, as the statutory management regime would be targeted (except in public interest situations) at dishonest, reckless or incompetent management which has reduced a business to chaos, the primary object of the standstill period is to bring order to chaos, and then allow the Court to choose the most appropriate insolvency regime as quickly as possible. The use of statutory management as a filter in that way justifies the invasive nature of the moratorium in respect of secured creditors.

Reporting requirements

6.14 CIMA is almost silent on reporting requirements. In fact, the only explicit obligation on the statutory manager to report is contained in s 41(2), which provides that the statutory manager has an obligation to provide the Registrar with such reports as the Registrar may require as to the state of the affairs and business of the corporation. There is no requirement to, for example, report to creditors on the progress of the statutory management. The Securities Commission and the Law Commission both recommended that reporting requirements be enhanced. For example, the Securities Commission considered that the statutory manager should be required to report to an independent body summarising the results of his or her investigation and giving details concerning the conduct of the statutory management. Recommendations as to whether the statutory management should be continued or discontinued should be made. Those proposals should be discussed with the Advisory Committee and comments of the Advisory Committee should be contained in the report.

6.15 However, not a single recommendation on any of these matters — either from the Securities Commission or the Law Commission — has been taken up. CIMA as currently enacted is substantially the same as it looked in 1989.[73]

7. THE FUTURE OF STATUTORY MANAGEMENT

7.1 The statutory management regime appears to be here to stay, at least in the foreseeable future. There does not appear to be any legislative or other governmental appetite for reform. If the recent use of statutory management is anything to go by, the Government is quite prepared to use statutory management when it considers it necessary or desirable.

7.2 For registered banks, statutory management is certainly here to stay, if the recent messages from the Reserve Bank in relation to the open bank resolution policy ("**OBR Policy**") are indicative of the Reserve Bank's views on the future of statutory management. In short, the OBR Policy is premised on banks being open rather than closed following a stress event. Recently, the Reserve Bank released a discussion paper on "pre-positioning requirements" that registered banks would have to implement to give effect to the OBR Policy. By way of outline, compliance with the proposed pre-position requirements would require a registered bank to ensure its systems would allow the Reserve Bank to appoint statutory managers at, say, 5pm on the day of a stress event, at which time the bank would close. The bank's position would then be calculated and a certain portion of depositors' accounts would be frozen. The other portion will be available to depositors when the bank reopens the next day — but to prevent a run on the unfrozen portion, the Government will provide a guarantee (though as proposed there will be no mandatory requirement for the Government to provide such a guarantee).

[73] There have been very few amendments to CIMA. In fact, there has been four amendment Acts (in 1993, 1994, 1999, and 2007) but each of them has only covered fairly minor and technical matters.

7.3 There are many things that could be said about the efficacy of the OBR Policy or the efficiency of imposing a further compliance cost on registered banks for the remote possibility that statutory management may be imposed. However, for the purposes of this paper, it is sufficient to say that, at least as far as it applies to registered banks, there is a clear signal from Government that statutory management is here to stay.

7.4 Finally, in terms of the future of statutory management, the recent trend to the harmonisation of commercial laws between New Zealand and Australia could see New Zealand repeal CIMA or could see Australia adopt CIMA. Nothing has been said by regulators in either country on the place of statutory management in the harmonisation movement to date.

8. CONCLUSIONS

8.1 Statutory management has a long history in New Zealand. It has been used recently and as far as the author can tell, it will remain in the statute books for the foreseeable future.

8.2 The grounds on which a corporation can be placed into statutory management are broad indeed. The process by which a corporation is placed into statutory management is hardly transparent. Both of these give rise to criticisms levelled against statutory management; and that is before even considering the substantive aspects of the regime. Those substantive aspects are that the statutory managers are given almost limitless discretion and powers (the exercise of which invokes an indemnity from the Crown) — though the statutory managers are guided by considerations specified in the CIMA. These considerations are however difficult to reconcile and in practice incompatible. The moratorium freezes a creditor or other claimant's rights against the corporation and in doing so curtails contractually agreed rights and obligations. There is very little Court involvement; and where the Court is involved it is only in confined respects.

8.3 That said, two substantial reviews (one in 1992 and the other in 2001) have supported retention of the statutory management regime albeit in a modified form. Both reviews saw statutory management and in particular the moratorium and group provisions as providing a useful additional tool in New Zealand's corporate stress toolbox. Disappointingly, the modifications suggested by the two reviews have not been taken up by the legislature. So statutory management, it would appear, is here to stay (and in unmodified form) and the best that can be done for now is to become familiar with the implications it has for our clients.

Regulators: Accountable to Stakeholders or a Law unto Themselves?

Joanna Bird*

'We are governed more and more by people we never elected, and who can't be turned out of office by our votes and who want more power than they ever have.'[1]

In this paper I will look at:

- What is accountability?
- Why should regulators be accountable?
- What should they be accountable for?
- What are the challenges involved in holding regulators to account?
- What are the existing accountability mechanisms for Australian regulators? I will focus on the accountability mechanisms for the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA).
- Are Australian regulators sufficiently accountable? Do we need more, fewer or different accountability mechanisms? This issue will largely be left to the panel discussion but I will offer some preliminary thoughts.

1. What is accountability?

There are constant calls for regulators to be more accountable.[2] But what does this mean? What do people actually want when they call for regulators to be more accountable?

* Associate Professor, Sydney Law School, University of Sydney. This paper has been prepared solely for the 28th Annual Banking & Financial Services Law Conference, 2011. It should not be reproduced in whole or part without the permission of the author.

[1] Ronald Reagan, quoted in Steven F. Hayward, 'Reagan and the Historians', *Claremont Review of Books*, vol. 7, no. 4, Fall 2007, as quoted in Berg, Chris, *The Growth of Australia's Regulatory State* (2008, the Institute of Public Affairs), p.81.

[2] For recent examples see Commonwealth of Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders* (June 2003) (Uhrig Report) pp.52 – 53; Berg, Chris, *The Growth of Australia's Regulatory State* (2008, the Institute of Public Affairs); Hyland, Margaret 'Is ASIC sufficiently accountable for its administrative decisions? A question of review' (2010) 28 *Company & Securities* LJ 32. As early as 1937 the Brownlow Commission in the United States of America warned about regulatory commissions being unaccountable: Lodge, Martin and Stirton, Lindsay 'Accountability in the Regulatory State', Ch 15 in Baldwin, Robert, Cave, Martin and Lodge, Martin (eds) *The Oxford Handbook of Regulation* (2010), p353. See also references listed in Baldwin, Robert and Cave Martin, *Understanding Regulation* (1999), fn.2, p. 286-7. Colin Scott points out that public lawyers almost universally regard accountability mechanisms as inadequate: Scott, Colin, 'Accountability in the Regulatory State' (2000) 27 *Jnl of Law & Society* 38, 42.

Definitions of 'accountability' generally focus on the idea of giving account of one's actions to some other person or body.[3] Under these definitions a regulator is accountable if it is required to explain or justify its actions to another person or body.

However, I suspect that at least some advocates for the increased accountability of regulators want more than explanation and justification. They want some response to the regulator's explanation or justification (above the non-binding recommendations or negative publicity that may follow the explaining and justifying). That response may be reversing the regulator's decision if it does not meet the required standard. Alternatively, it may be some sort of penalty if the regulator's actions do not meet the required standard, such as, removal from office in much the same way that directors may be removed from office, or not re-elected, if their performance does not meet the standard required by the company's members or that members of parliament may lose their seats if they or their parliamentary party fails to perform to the electorate's liking. The penalty may even be some form of civil or criminal sanction if the regulator's behaviour fails to meet the required standard, in much the same way that directors of a company may be liable if they fail to meet the standard of care of a reasonable director[4] or fail to act for a proper purpose in the interests of the company.[5]

I will call accountability mechanisms that merely require regulators to explain and justify their actions 'weak' accountability mechanisms and those that involve some sort of response if the regulator does not meet the required performance standard 'strong' accountability mechanisms.

2. Why should regulators be accountable?

Regulators are agents; they act on behalf of the government and, ultimately, on behalf of the public.[6] In acting on the government's and public's behalf they exercise fairly extraordinary powers. They exercise governmental or public powers, that is, they make laws or regulations; they compel compliance with their demands;[7] and, they impose penalties. Further, they receive a substantial amount of public money.[8]

[3] The Oxford English Dictionary defines 'accountability' as 'the quality of being accountable; liability to give account of, and answer for, discharge of duties or conduct; responsibility, amenableness.' See also Scott, Colin, 'Accountability in the Regulatory State' (2000) 27 *Jnl of Law & Society* 38, 40 and Lodge, Martin and Stirton, Lindsay 'Accountability in the Regulatory State', Ch 15 in Baldwin, Robert, Cave, Martin and Lodge, Martin (eds) *The Oxford Handbook of Regulation* (2010, Oxford University Press), p349.
[4] Section 180 *Corporations Act 2001* (Cth).
[5] Sections 181 and 184, *Corporations Act 2001* (Cth).
[6] Ogus, Anthony I, *Regulation: Legal Form and Economic Theory* (2004, Hart Publishing), p. 111.
[7] For example, ASIC can require a person to give reasonable assistance in connection with its investigations and to appear for examination on oath (s 19 *Australian Securities and Investments Commission Act 2001* (Cth)), inspect books (s29 *Australian Securities and Investments Commission Act 2001* (Cth)), and require the

Agents should be accountable to their principals for the manner in which they exercise the powers and discretions given to them by their principals and for the way in which they expend the principal's resources. Therefore, regulators should be accountable to the government and, ultimately, to the public.

Accountability is linked to legitimacy.[9] In democracies we tend to believe that the legitimacy of governmental or public power principally derives from accountability to the electorate.[10] As I said regulators exercise government or public powers and yet they are not directly elected; they do not have democratic legitimacy. Therefore, we need to find other ways to make regulators accountable to the public and, therefore, legitimate.

3. What should they be accountable for?

As stated above, regulators should be accountable for the way in which they exercise their powers and discretions and for the way in which they expend their resources. That is, they should be accountable for everything they do. Ogus talks of three types of accountability: financial accountability, procedural accountability and substantive accountability.[11] Regulators should satisfy high standards of financial management because they are spending public money. Regulators' procedures should be fair, impartial and comply with administrative law principles because they are exercising public power.[12] Finally, regulators should be accountable for their substantive decisions. They should be accountable for the policies and regulations they make. They should be accountable for their administration of the regulatory regime, for example, the way they conduct licensing processes, the approvals they give, and the way they maintain public records and registers. They should be responsible for their compliance and enforcement decisions. Finally, and perhaps most importantly, regulators should be responsible for their overall management of their regulatory regime, that is, the priorities they set and how they allocate their resources. All these substantive decisions should achieve the public interest goals of the regulatory regime that the regulator administers.

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production of books and documents (ss 30, 31, 32A and 33 *Australian Securities and Investments Commission Act 2001* (Cth).

[8] For example, ASIC is largely funded by allocation in the Federal budget. APRA is largely funded by levy on the industries it regulates: s 50 *Australian Prudential Regulation Authority Act 1998* (Cth) and *Financial Institutions Supervisory Levies Collection Act 1998* (Cth).

[9] Morgan, Bronwen and Yeung, Karen *An Introduction to Law and Regulation: Text and Materials* (2007, Cambridge University Press), p.221. Morgan and Yeung quote Jody Freeman who defines legitimacy as 'when the public accepts decisions without having to be coerced (Freeman 1999)': p.221.

[10] Berg, Chris, *The Growth of Australia's Regulatory State* (2008, Institute of Public Affairs), p. 58.

[11] Ogus, Anthony I. *Regulation: Legal Form and Economic Theory* (2004, Hart Publishing), p. 111.

[12] Administrative Review Council, *Administrative Accountability in Business Areas subject to Complex and Specific Regulation* (2008).

4. What are the challenges?

So far it all sounds very simple: regulators should be accountable for everything they do. Unfortunately, like most things in regulation, it is not so simple. There are two significant challenges facing those who wish to call regulators to account, especially those who wish to impose strong accountability mechanisms.

- First, for regulators at least, accountability is not an absolute good. We do not want endless quantities of it because in general it undermines other desirable attributes of a regulator, namely, independence, expertise and efficiency.
- Secondly, the accountability of regulators is hampered by the difficulty of effectively measuring and assessing their performance. It is very difficult to hold someone to account if you cannot actually determine when they have performed well and when they have performed badly.

Trade-off between accountability and independence, expertise and efficiency

Governments create independent regulatory bodies primarily[13] to ensure that various decisions are made by those with expertise, [14] and independence.[15]

Governments have decided that it is in the public interest if certain decisions are made by those who possess specialist expertise. The complex and technical nature of the modern world means that no one group is in a position to develop the expertise to successfully govern all aspects of modern society. Parliamentarians, as a group, are unlikely to develop the expertise necessary, for example, to determine the appropriate capital adequacy and liquidity standards for Australian Authorised Deposit-taking Institutions[16] one day and to determine whether to authorise the operation of a nuclear facility[17] the next.

Arguably, groups of public servants within government departments could develop this expertise and provide advice to their Ministers. However, governments have also decided that it is in the public interest for certain decisions to be made by those who are more

[13] See text at fn. 20 for a third reason. Regulators also allow the combination of different functions (eg regulation-making and enforcement) in a way that is not often possible in other institutions: Baldwin, Robert and Cave Martin, *Understanding Regulation* (1999, Oxford University Press), p. 70.

[14] In his 1938 book *The Administrative Process*, James Landis (one of the inaugural Commissioners of the Securities Exchange Commission) justified the creation of regulators substantially on the basis of expertise, arguing that the technical nature of their tasks meant specialisation and expertise were necessary: see McCraw, Thomas, K *Prophets of Regulation* (1984, Belknap Press), p. 213. See also Ogus, Anthony I. *Regulation: Legal Form and Economic Theory* (2004, Hart Publishing), p. 105.

[15] Ogus, Anthony I. *Regulation: Legal Form and Economic Theory* (2004, Hart Publishing), pp. 105 – 106; Baldwin, Robert and Cave Martin, *Understanding Regulation* (1999, Oxford University Press), p. 70.

[16] This is the responsibility of APRA.

[17] This is the responsibility of the Australian Radiation Protection and Nuclear Safety Authority.

independent of the political process.[18] That is, government has decided that the public interest will be better served if certain regulatory and administrative decisions are made by people who are separated from the political process. Such persons do not have to appeal to populism or appease vocal lobby groups to ensure re-election or re-appointment. They have the luxury of taking a long-term and expert view of the public interest, whereas the electoral cycle means that politicians, and those directly answerable to them such as government departments, have strong incentives to take a short-term view.

Therefore, the very purpose of regulators is undermined when they are held to account, especially using strong accountability mechanisms which lead to responses imposed by those who do not possess the same level of expertise and independence. This is the accountability dilemma:

> 'Particular institutions may be designated as regulators because their expertise and independence from political influence maximize the prospects of their fulfilling public interest goals. Those prospects are reduced if their judgments may be overridden by other bodies which do not combine the same degree of expertise and political independence.'[19]

I should add that the cynics may also add an additional reason for the creation of regulators, beyond expertise and independence. Governments and parliaments may create regulators out of a desire to distance themselves from potentially unpopular decisions.[20] For example, from a political perspective is it preferable for an independent body to decide to raise interest rates. Of course, if this is the reason for the creation of a regulator neither the government nor the parliament will have an interest in ensuring strong accountability mechanisms; the imposition of a strong accountability mechanism will involve some assumption of responsibility for assessing and perhaps changing the decision of the regulator. So even from the cynic's perspective there is a trade-off between accountability and the *raison d'etre* of the regulator.

Another trade-off is between accountability and efficiency. Accountability may significantly undermine efficiency. For example, every minute regulators spend explaining or justifying themselves to another party, such as a parliamentary committee, is a minute that the regulator is not performing its core functions. Consultation with stakeholders slows down a regulator's

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[18] Lodge, Martin and Stirton, Lindsay, 'Accountability in the Regulatory State', Chap 15 in Baldwin, Robert, Cave, Martin and Lodge, Martin *The Oxford Handbook of Regulation* (2010, Oxford, Oxford University Press), p. 350.

[19] Ogus, Anthony I. *Regulation: Legal Form and Economic Theory* (2004, Hart Publishing), p.117. See also Lodge, Martin and Stirton, Lindsay, 'Accountability in the Regulatory State', Chap 15 in Baldwin, Robert, Cave, Martin and Lodge, Martin *The Oxford Handbook of Regulation* (2010, Oxford, Oxford University Press), p. 350.

[20] Berg, Chris, *The Growth of Australia's Regulatory State* (2008, Instiute of Public Affairs), p. 58

response to regulatory issues,[21] as do requirements to produce and publish regulatory impact analyses.

This is not an argument that regulators should not be required to explain and justify their actions, consult or conduct regulatory impact analyses. In fact, the regulator's knowledge that it may be called on to explain and justify its actions creates strong incentives to ensure that its actions are, in fact, explicable and justifiable. Likewise consultation and regulatory impact analysis generally leads to improved regulatory decision-making. So in this way appropriate accountability mechanisms will significantly improve performance of the core functions of regulators.

Nevertheless, it must be acknowledged that accountability involves trade-offs; it distracts regulators from their core functions, slows down their responses and, as stated above, undermines their expertise and independence. It, therefore, has to be balanced against efficiency, expertise and independence. We must understand the costs of accountability and accept that the gains from accountability will eventually be off-set by losses. Baldwin and Cave summarise the challenge facing those who are devising accountability mechanisms:

> 'it would be a mistake to assume that any improvement in accountability that can be devised will always be in the public interest. As is usually the case in regulation, trade-offs are at issue. The abilities of regulators to develop and apply their expertise, to operate efficiently in pursuit of their mandate, and to function in a transparent and accessible manner, may all be prejudiced by ill-judged moves to increase accountability. Where, for instance, review procedures allow other institutions (be they ministers, courts, or specialist review bodies) to second-guess regulators, there may be a holding to account but there may also be: decisions by officials who are less expert than the specialist regulators being reviewed; duplications and confusion of policy; delays in processes; and the removal of real decision-making power to bodies less transparent and accessible in their operations than those under review.'[22]

When devising accountability mechanisms we have to find an uneasy balance between accountability and these other desirable attributes. Alternatively, we could try to find the Holy Grail of an accountability mechanism that does not negatively affect these other desirable attributes. (I will come back to this Holy Grail at the end of this paper.)

Difficulty of measuring and assessing regulatory performance

Another significant challenge confronting those calling for increased accountability of regulators stems from the difficulty of measuring and assessing substantive regulatory

[21] Lodge, Martin and Stirton, Lindsay, 'Accountability in the Regulatory State', Chap 15 in Baldwin, Robert, Cave, Martin and Lodge, Martin *The Oxford Handbook of Regulation* (2010, Oxford, Oxford University Press), p. 365.

[22] Baldwin, Robert and Cave Martin, *Understanding Regulation* (1999, Oxford University Press), p. .313.

performance. Given the complex nature of many regulatory mandates it is notoriously difficult to set meaningful performance measures or standards for regulators and to actually measure their substantive, as opposed to procedural or financial, performance.[23]

ASIC, for example, has a statutory mandate that involves both business facilitation and consumer protection.[24] Accordingly, it is constantly required to balance somewhat inconsistent goals. It also has an incredibly broad area of responsibility. It regulates corporations, consumer credit, financial markets and financial services. This brings with it responsibility for 1.77 million companies, 4,874 Australian financial services licensees, 16 licensed financial markets, 5 licensed clearing and settlement facilities, 5270 company auditors, 664 registered liquidators, and 4339 registered managed investment scheme[25] and now ASIC is also responsible for credit licensees. ASIC must decide on priorities amongst these areas of responsibility and allocate resources accordingly. It would be unrealistic to expect it to supervise each and every one of these entities, to prevent every breach of the law by these entities or to even respond to every breach of the law of which it becomes aware. In this complex environment how should one measure the performance of ASIC?

It is possible to count things, such as, the number of enforcement actions per year, the percentage of successful enforcement actions, and the average number of days taken to process a licence application. ASIC, in fact, does all of these things in its annual report.[26] However, all of these performance measures are ambiguous. Does a record number of enforcement actions mean that ASIC has been particularly effective or does it mean that ASIC has failed to create a compliant regulated population by educating and persuading that population as encouraged by advocates of responsive regulation?[27] Does a high percentage of successful enforcement actions mean that ASIC is a successful litigant, making the best use of its limited enforcement budget, or does it mean that ASIC is targeting only easy cases and letting the more complex cases go? Does speed in dealing with licence applications indicate that ASIC is efficient or does it indicate that ASIC's licensing process is not rigorous? Another measure used by ASIC, and other regulators,[28] is satisfaction of key stakeholders measured by way of stakeholder surveys.[29] However, this too is a highly ambiguous measure. Is an industry stakeholder's satisfaction with the performance of ASIC

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[23] Stern, Jon, 'The Evaluation of Regulatory Agencies' in Robert Baldwin, Martin Cave and Martin Lodge (eds), *The Oxford Handbook of Regulation* (2010, Oxford University Press) and Sparrow, Malcolm, *The Regulatory Craft* (2000, The Brookings Institution), pp. 113 – 117.

[24] Section 1(2) *Australian Securities and Investments Commission Act 2001* (Cth).

[25] All figures are from *AISC Annual Report 2009-2010*, p. 80.

[26] *ASIC Annual Report 2009-2010*, pp. 16 and 42. ASIC reports on the percentage of licence applications and variations completed within 28 days of receipt of a complete application.

[27] Ayres, Ian and Braithwaite, John *Responsive Regulation* (1992, Oxford University Press).

[28] Sparrow, Malcolm, *The Regulatory Craft* (2000, The Brookings Institution), p. 118.

[29] ASIC last did a stakeholder survey in 2010. The previous stakeholder survey was done in 2008: http://www.asic.gov.au/asic/asic.nsf/byheadline/ASIC+stakeholder+survey?openDocument (accessed 6 June 2011)

a sign that ASIC is doing a good job or that ASIC has been completely captured by the industry stakeholder and is doing its bidding? Given ASIC's mandate to facilitate business and to protect consumers, how should one balance industry satisfaction against consumer satisfaction?

No-one has very good answers to any of these questions; no-one can confidently assess ASIC's performance. The same analysis can be conducted in relation to the activities of many regulators. Essentially, no-one has come up with the perfect Key Performance Indicators for regulators. This is a significant impediment to effective accountability. Strong accountability mechanisms, in particular, require measuring the quality of a regulator's performance; we cannot respond if the regulator fails to meet the required standard unless we know what the required standard is and we can measure whether the regulator has meet it. Even weak accountability mechanisms are not particularly meaningful if those receiving the justification or explanation cannot discriminate between convincing and unconvincing justifications or explanations.

5. What are the existing accountability mechanisms?

Against this background, I will now look at the existing accountability mechanisms for Australian regulators. I will concentrate on accountability mechanisms for ASIC and APRA. There is, in fact, a broad array of accountability mechanisms and for ease of exposition I have grouped them by reference to the body to which the regulator is accountable. The key accountability mechanisms are also shown in Table 1.

Courts and tribunals

Australian regulators are accountable to courts and tribunals as part of the administrative law regime. In general, persons with standing can challenge the lawfulness of regulators' decisions by way of judicial or administrative law review in the courts.[30] Decisions can only be reviewed on the basis of *ultra vires* (misuse of power) or lack of procedural fairness. Further, the outcome of the review will generally be that the decision is remitted to the regulator to be made according to law. However, there is a stronger form of administrative law accountability available through independent tribunals such as the Administrative Appeals Tribunal (AAT).[31] A person whose interests are affected[32] by a regulator's decision can seek merits review of the decision through the AAT. In this review the AAT stands in

[30] Note that there are limitations on administrative law review. For example, under the *Administrative Decisions (Judicial Review) Act 1977* (Cth) a decision can only be reviewed if it is made under an enactment.

[31] There are also specialist Federal Tribunals, such as, the Takeovers Panel (which has the power to review decisions of the ASIC regarding whether to grant exemptions or modifications to Ch 6 or 6C during the life of a takeover: s 656A *Corporations Act 2001* (Cth)), the Social Security Appeals Tribunal and the Refugee Review Tribunal. There are also tribunals at the State level, such as the NSW Administrative Decisions Tribunal.

[32] Section 27 *Administrative Appeals Tribunal Act 1975* (Cth).

the place of the regulator and re-makes the decision.[33] Merits review through the AAT is only available where the legislation under which the regulator's decision is made provides a right of review to the AAT. The bulk of the decisions made by ASIC and APRA are subject to merits review by the AAT.[34] Under the *Administrative Appeals Tribunal Act 1975* (Cth) a person affected by a decision also has a right to apply for a written statement of the reasons for the decision.[35]

Administrative law accountability is strong accountability in that it involves a response to the regulator's failure to meet the required standards. However, judicial challenges on the basis of *ultra vires* or lack of procedural fairness are at the weaker end of the range of responses as the decision is simply remitted to the regulator to be made in accordance with law. The plaintiff is likely to feel that it has had a pyrrhic victory if the regulator makes the same decision, but according to law, the second time around. Review of decisions by a court on these bases is, on the other hand, not vulnerable to attack on the basis of lack of expertise. Judicial officers can be assumed to be experts on the requirements of procedural fairness and natural justice. Moreover, there is generally no difficulty measuring whether the regulator has actually complied with the standards of procedural fairness and natural justice.

The AAT delivers a much stronger response; the AAT can re-make the impugned decision. However, the AAT is slightly more vulnerable to criticism on the basis of expertise. The AAT tries to deal with this criticism by the creation of panels of experts. However, these panels may not have quite the same expertise as the regulator. Further, the AAT adjudicates the individual matter brought before it and will often have difficulty putting that individual matter into the broader context. Regulators make individual decisions about, for example, refusing a license or banning an individual, in the broad context of the market and its work in relation to that market. An individual decision will not just be designed to have an impact on the behaviour of the individual who it directly affects; it will also be designed to have a broader impact on the market. There is room to question whether the AAT is able to understand and take into account this broader context. There is, in fact, room to debate whether it should. The short point, however, is that if it is not able to do this its decisions might undermine the regulator's attempt to achieve its statutory mandate.

Finally, it should be acknowledged that administrative law review will undermine efficiency. Decisions that are supposed to be made quickly, such as, decisions banning an individual from participating in a certain industry in order to protect the general public, will be delayed

[33] Section 43 *Administrative Appeals Tribunal Act 1975* (Cth).
[34] See ss 1317A – 1317C, *Corporations Act 2000* (Cth), s 51A – 51D, *Banking Act 1959* (Cth), s 63 *Insurance Act 1973* (Cth) and s 334 *Superannuation Industry (Supervision) Act 1993* (Cth).
[35] Section 28.

by the review process. Moreover, both the individual seeking review and the regulator will expend resources in the review process.

Civil or criminal liability can create a strong form of accountability. It can ensure a penalty or remedy is imposed if behaviour falls short of a legal standard. For example, as stated above, directors of a company may be liable if they fail to meet the standard of care of a reasonable director or fail to act for a proper purpose in the interests of the company. Regulatory officers can be criminally liable for misuse of public funds. The *Financial Management and Accountability Act 1997* (Cth), which applies to both ASIC and APRA, imposes on regulatory officers[36] criminal penalties of up to 7 years imprisonment for improper use or handling of public money or property and other related offences, as well as liability for lost amounts.[37] However, compared to most, regulatory officers are insulated from civil liability. In general, they have immunity from liability for damages for an act or omission in performance of their functions, except in cases of bad faith.[38] There is a tort of misfeasance in public office which imposes liability on regulatory officers who cause loss or damage, but only where the regulatory officers act in bad faith.[39] To establish bad faith a plaintiff needs to establish either that:

- the officer was motivated by a purpose foreign to that for which the power or duty was bestowed and that the officer's conduct was undertaken with the intention of harming the plaintiff; or
- the officer's acts or omissions were undertaken in the knowledge that they were beyond power and were likely to harm the plaintiff.[40]

Given this high threshold, this action is rarely made out.[41]

Regulators' qualified immunity from civil liability supports the regulator's independence and, to a lesser extent, efficiency. As stated by Harlan J of the United States Supreme Court:

> 'It has been thought important that officials of government should be free to exercise their duties unembarrassed by the fear of damage suits in respect of acts done in the course of those duties – suits which would consume time and energies which would

[36] Liability is imposed on 'officers', that is, a person who is in or part of an agency covered by the Act: s 5.
[37] See ss 10 – 16, 26, 40 – 43, 60 and 61.
[38] See for example s 246 *Australian Securities and Investments Commission Act 2001* (Cth) and s 58 *Australian Prudential Regulation Authority Act* 1998 (Cth).
[39] Balkin, RP and Davis JLR, *Law of Torts* (4th ed, 2009, LexisNexis Butterworths, Australia), pp. 705 – 710.
[40] Balkin, RP and Davis JLR, *Law of Torts* (4th ed, 2009, LexisNexis Butterworths, Australia), p. 708.
[41] It was made out in *Rowan v Cornwall (No 5)* (2002) 82 SASR 152; on appeal *Cornwall v Rowan* (2004) 90 SASR 269. Without admission of liability, the Federal Government settled an action brought by Pan Pharmaceuticals and its former Chief Executive in relation to the Therapeutic Goods Authority actions against Pan Pharmaceuticals for $50 million plus legal costs: Therapeutic Goods Authority, *Media Statement: Commonwealth Government settlement with Pan Pharmaceuticals and its former Chief Executive* (14 August 2008).

> otherwise be devoted to governmental service and the threat of which might appreciably inhibit the fearless, vigorous, and effective administration of policies of government.' [42]

In other words, in this instance accountability is sacrificed to independence and efficiency.

Parliament

In Australia, regulators are accountable to parliament through the parliamentary committee system. The parliamentary committee system allows parliamentarians to directly question regulators (and other members of the executive government) about the broad range of their activities. Questions can be about anything, ranging from financial management, staffing, regulation or policy-making, administration of the law (such as licensing) and enforcement policy. (Although in practice specific questions about potential or individual enforcement actions may be 'batted away' by the regulator on the basis that the regulator does not want to prejudice its enforcement action.)

Parliamentary committees are generally specialised and this allows them to look at matters in detail and be directed and informed in their scrutiny. ASIC appears before Estimates but also has its own parliamentary committee, the Parliamentary Joint Committee on Corporations and Financial Services, which is responsible for oversight of its activities.[43] This Committee holds inquiries into specific policy matters relevant to ASIC's jurisdiction, such as the 2009 Inquiry into Financial Products and Services in Australia, which has lead to the Future of Financial Advice Reforms. It also holds 'oversight hearings' about ASIC's performance in general and examines ASIC's annual report. It then reports to both Houses of Parliament on the results of its inquiries. In 2009-2010 ASIC appeared before parliamentary committees on 11 occasions and the Parliamentary Joint Committee on Corporations and Financial Services tabled 3 statutory oversight reports.[44] This process would have consumed a considerable amount of senior resources at ASIC.

Accountability to parliament is reinforced by the requirement that regulators' annual reports be tabled in parliament. Both ASIC and APRA are required to report annually to the Commonwealth Parliament, through their Ministers and legislation sets out mandatory content for those reports.[45]

A regulator's knowledge that its actions will be subject to intense and public scrutiny through the Committee system acts as a powerful motivator to ensure that its actions are justifiable

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[42] *Barr v Matteo* 360 US 564 (1959), at 571.

[43] The duties of the Parliamentary Joint Committee on Corporations and Financial Services are set out in s 243 *Australian Securities and Investments Commission Act 2000* (Cth).

[44] *ASIC Annual Report 2009-2010*, p. 71.

[45] Section 136 *Australian Securities and Investments Commission Act 2001* (Cth) and s 59 *Australian Prudential Regulation Authority Act 1998* (Cth).

and explicable. Additionally, parliamentary scrutiny is one of the few mechanisms that looks at whether the regulator is achieving its statutory mandate as a whole. Parliamentary committees can question regulators on priority setting and resource allocation, rather than just ensuring accountability for individual decisions and acts. Annual reports should also concentrate on and explain these priorities and allocations.

However, these parliamentary reporting requirements are weak accountability mechanisms; they may lead to a significant amount of information being made public, but they do not lead to a response, other than political pressure, embarrassment or non-binding recommendations. Further, although parliamentary committees tend to be specialised and, therefore, able to develop a level of expertise, they are rarely able to develop the same level of expertise as the regulator itself. Finally, of course, excessive accountability to parliament and responsiveness to parliamentary pressure will undermine the independence of regulators and their efficiency. Ogus summarises the situation neatly:

> 'Accountability to Parliament may force disclosure of information which would not otherwise be available, and may facilitate public debate, but it is not clear that it provides a good medium for ensuring that regulators satisfy the three criteria which we have identified [financial accountability; procedural accountability; and substantive accountability]. Politicians rarely have the time and expertise to absorb the data and make detailed judgments on the financial management of regulatory bodies. They may provide a valuable, generalized overview of procedural fairness, but investigation of particular grievances normally requires a specialist institution. Nor are they well placed to monitor adherence to public interest goals, since they are vulnerable to the influence of private interest lobbying. More generally, increased parliamentary scrutiny may encourage greater governmental interference, which itself may attempt to capture short-term political gains.'[46]

One of the things that regulators do is make laws or regulations. Most of these laws or regulations will be legislative instruments[47] and therefore subject to parliamentary scrutiny under the *Legislative Instruments Act 2003* (Cth). The *Legislative Instrument Act* requires that, except in limited circumstances, the regulator conduct the consultation that it considers appropriate and reasonably practicable.[48] It also provides for parliamentary scrutiny of

[46] Ogus, Anthony I. *Regulation: Legal Form and Economic Theory* (Hart Publishing, 2004), p. 113.

[47] 'Legislative instrument' is defined in ss 5 – 9, *Legislative Instruments Act 2003* (Cth). In essence, a legislative instrument is an instrument in writing that is made in the exercise of a power delegated by Parliament and is of legislative character (ie determines the law or alters the content of the law, rather than applies the law in a particular case and has the effect of affecting a privilege or interest, imposing an obligation, creating a right, or varying or removing an obligation or right).

[48] Sections 17 – 18, *Legislative Instruments Act 2003* (Cth).

legislative instruments.[49] Essentially legislative instruments, and their explanatory statements, are tabled in both Houses of the Parliament.[50] Either House can pass a resolution disallowing the instrument.[51] The disallowance power is used, but not frequently: in 2010 there were two disallowances, in 2009 there were eight and in 2008 there were five.[52] None of these disallowances related to legislative instruments made by ASIC or APRA.

This strong accountability mechanism is vulnerable to the criticism that it undermines the independence and expertise of the regulators' regulation-making. However, the history of its use shows that it is not over-used or abused. Further, the fact that it is limited to the most parliamentary of the regulator's roles – regulation-making – means that it is an acceptable incursion into the independence of the regulator. Here, I would suggest the uneasy balance between accountability and independence is maintained. Further, the process is designed so as not to undermine efficiency unnecessarily. Legislative instruments are valid until disallowed and the disallowance must occur within a relatively short time-frame. The instrument must be tabled before both Houses of the Parliament within six parliamentary sitting days of its registration.[53] The motion to disallow must be given within 15 sitting days of the tabling and the fate of the instrument is then determined within a further 15 sitting days.[54]

Executive Government and Government Agencies

Regulators are generally[55] accountable to the executive government through a Minister.[56] In fact, the relevant Minister can often give a direction to the regulator.[57] Section 12 of both the

[49] Under s 46B, *Act Interpretation Act 1901* (Cth), certain non-legislative instruments are also subject to disallowance under the *Legislative Instruments Act 1901* (Cth). They will be subject to disallowance if they are expressly declared by the enabling provision or by legislation or legislative instrument under which they are made to be disallowable instruments for the purposes of s 46B.

[50] Sections 38 – 39 *Legislative Instruments Act 2003* (Cth).

[51] Section 42 *Legislative Instruments Act 2003* (Cth).

[52] Export Inspection (Establishment Registration Charges) Amendment Regulations 2009 (No. 1); Export Inspection (Quantity Charge) Amendment Regulations 2009 (No. 1); Health Insurance (Cataract Surgery) Determination 2009; Health Insurance (Dental Services) Amendment and Repeal Determination 2008; Higher Education Support Act 2003 - Amendment No. 2 to the Commonwealth Grant Scheme Guidelines No. 1 (23/02/2008); National Health Act 1953 - Amendment determination under subsections 85AB(1) and 85AC(1) - drugs on F1 and drugs in Part A of F2 (No. PB 2 of 2010); Road User Charge Determination 2008 (No. 1); Threat Abatement Plan for Disease in Natural Ecosystems caused by Phytophthora Cinnamomi (2009); Workplace Relations (Registration and Accountability of Organisations) Amendment Regulations 2007 (No. 1) Workplace Relations Amendment Regulations 2007 (No. 4). See http://www.comlaw.gov.au/Browse/ByTitle/LegislativeInstruments/Disallowed/0/0/ (accessed 14 June 2011).

[53] Section 38 *Legislative Instruments Act 2003* (Cth).

[54] Section 42 *Legislative Instruments Act 2003* (Cth).

[55] The Auditor-General is directly accountable to Parliament: s 8 *Auditor-General Act 1997* (Cth).

[56] Ministerial responsibilities are allocated in the Administrative Arrangements Order made by the Governor-General, on advice from the Federal Executive Council. This reporting relationship is reinforced by provisions such s 44A *Financial Management and Accountability Act 1997* (Cth) (which provides that the head of an Agency covered by the Act, such as ASIC and APRA, must give the Minister responsible for the Agency such reports, documents and information in relation to the operations of the Agency as that Minister requires and such reports, documents and information in relation to the financial affairs of the Agency as that Minister

Australian Securities and Investments Commission Act 2001 (Cth) and the *Australian Prudential Regulation Authority Act 1998* (Cth) allows the Minister to give a direction in writing to ASIC or APRA 'about policies it should pursue, or priorities it should follow.'[58] The Minister cannot give a direction about a particular case.[59] However, the Minister can direct that a particular matter be investigated by ASIC.[60] A direction (other than a direction that ASIC must investigate a particular case) must be published in the Gazette and laid before both Houses of Parliament.[61]

The International Monetary Fund commented negatively on this directions power in its 2006 Financial Sector Assessment of Australia.[62] It is an extremely strong accountability mechanism, which potentially severely impinges on the regulator's expertise and, in particular, independence from the political process. The giving of a direction to a regulator puts the regulator firmly in the political process. On one view this accountability mechanism is so strong it is very rarely used.[63] On this view, this power, and its limited use, are evidence of the uneasy, but positive, balance between accountability and independence that is achieved in practice. The power to give directions ensures accountability to government, but the value placed on the independence of regulators means that it would be politically unacceptable to use the power except in the most extraordinary cases.[64]

Having said this it is possible that, behind the scenes, the directions power could lead to significant actual Ministerial interference in the regulatory process. The mere threat of a direction could encourage a regulator to follow the wishes of the Minister because few regulators would want to be on the receiving end of a direction. In fact, s12 of the *Australian Securities and Investments Commission Act 2001* (Cth) and the *Australian Prudential*

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requires) and s 136 *Australian Securities and Investments Commission Act 2001* (Cth) and s 59 *Australian Prudential Regulation Authority Act 1998* (Cth) (which require ASIC and APRA to provide annual reports, covering certain matters, to their responsible Minister). See, generally ,Commonwealth of Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders* (June 2003) (Uhrig Report) pp. 33-34.

[57] Commonwealth of Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders* (June 2003) (Uhrig Report) p.38 and p.62.

[58] Section 12(1).

[59] Section 12(3).

[60] Section 14 *Australian Securities and Investments Commission Act 2001* (Cth).

[61] Section 12(5) *Australian Securities and Investments Commission Act 2001* (Cth).

[62] International Monetary Fund, *Australia: Financial Sector Assessment Program – Detailed Assessment of Observance of Standards and Codes: IMF Country Report 06/415* (2006), at pp 41, 85 and 125.

[63] In September 1992 the then Attorney-General gave a direction to ASIC's predecessor body, the Australian Securities Commission, to require increased cooperative arrangements between the Director of Public Prosecutions and the Australian Securities Commission. No other direction appears to have been given to ASIC or APRA.

[64] The Statement of Expectations (SOE) from the Treasurer to ASIC's Chairman and the SOE from the Treasurer to APRA's Chairman, both dated 20 February 2007, state that the Minister would only use the directions power in 'rare and exceptional circumstances': http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_Statement_of_Expectations.pdf/$file/ASIC_Statement_of_Expectations.pdf and http://www.apra.gov.au/AboutAPRA/upload/Statement-of-Expectations-from-Treasurer-20-Feb-07.pdf.

Regulation Authority Act 1998 (Cth) seems to facilitate such intentional or unintentional Ministerial or political influence. It provides that before giving a direction the Minister must notify ASIC or APRA that it is 'considering giving the direction'. It is impossible to know how often this has been done or how often a Minister has more informally indicated that he or she is inclined to give a direction if something does not happen. We do know that there are situations in which the Minister has informally requested that ASIC does certain work.[65] This may suggest that the uneasy balance is a bit off kilter and in practice there is too much accountability to the executive government and too little independence.

Another mechanism designed to enhance accountability to the Minister is the Ministerial Statement of Expectations (SOE) and the regulator's Statement of Intent (SOI). The SOE and SOI owe their birth to the 2003 *Uhrig Report*.[66] Recognising Ministers' reluctance to use directions powers,[67] Uhrig recommended[68] that Ministers should communicate government's expectations of statutory authorities, such as regulators, in a public, written SOE. According to Uhrig, this would ensure 'individuals responsible for the performance of statutory authorities clearly understand the expectations of government including the outcomes for which they would be held accountable.'[69] Uhrig did recognise the need for the SOE to be carefully drafted so as not to undermine the independence of the statutory authority.[70] Uhrig recommended that the statutory authority respond to the SOE in a public, written SOI which outlines how the authority will meet the government's expectations and which identifies Key Performance Indicators (KPIs) against which the authority's performance can be measured.

In practice the SOE and SOI mechanism has enhanced neither transparency nor accountability. The then Treasurer provided SOEs to the Chairmen of ASIC and APRA on 20 February 2007. The APRA Chairman provided an SOI in response on 18 May 2007 and the ASIC Chairman provided ASIC's SOI on 27 June 2007. Neither APRA's nor ASIC's SOI actually contain KPIs. Both regulators express an intention to develop new KPIs but also note the difficulty of devising meaningful measures. The SOEs and SOIs are still

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[65] For example, the Hon Nick Sherry, then Minister for Superannuation and Corporate Law, asked ASIC to facilitate the use of forecasts of superannuation end benefits: Speech to the Institute of Actuaries Financial Services Forum 2008, Melbourne, 19 May 2008 http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2008/013.htm&pageID=005&min=njs&Year=&DocType=1. Interestingly, ASIC has still not finished this work.

[66] Commonwealth of Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders* (June 2003) (Uhrig Report)

[67] Commonwealth of Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders* (June 2003) (Uhrig Report), p. 38.

[68] Commonwealth of Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders* (June 2003) (Uhrig Report), pp. 59 – 61.

[69] Commonwealth of Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders* (June 2003) (Uhrig Report), p. 60

[70] Commonwealth of Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders* (June 2003) (Uhrig Report), p.60.

available on the websites of the respective regulators[71] but appear to have little, if any, ongoing relevance. Given their vague and platitudinous content, they are certainly unlikely to provide any concrete guidance on the government's expectations or on how the regulators intend to give effect to the government's expectations. Uhrig stated that the SOE and SOI should be reviewed at least annually and more regularly if circumstances, such as a new Minister or Head of Department, required.[72] A measure of the lack of relevance or importance of the SOEs and SOIs is the fact that they have not been updated since their original issue in spite of a change in government and a number of changes in Minister.

The regulatory impact analysis (RIA) requirements imposed by the executive government on government departments and agencies, such as regulators, create a form of accountability in relation to regulation making. RIA is 'the process of examining the likely impacts of a proposed regulation and a range of alternative options which could meet the government's policy objectives.'[73] There are different RIA requirements for federal government regulatory proposals[74] and Council of Australian Government (COAG) regulatory proposals.[75] There are also different RIA requirements at State and Territory level.[76] I will concentrate on the standard federal government requirements that apply to ASIC and APRA.

The federal government's requirements are administered by the Office of Best Practice Regulation (OBPR), which is a division of the Department of Finance and Deregulation. While these requirements apply to regulation making activities only, regulation is defined broadly as '[a]ny 'rule' endorsed by government where there is an expectation of compliance.'[77] The key component of the RIA requirements is the obligation to prepare a Regulatory Impact Statement (RIS). A RIS is a document that 'formalises and provides evidence of the key steps taken during the development of the regulation and the costs and benefits of each option' available to address the particular regulatory problem.[78] A RIS is required for all decisions made by the government and its agencies that are likely to have a regulatory impact (positive or negative) on business or the not-for-profit sector, unless that

[71] See http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_Statement_of_Expectations.pdf/$file/ASIC_Statement_of_Expectations.pdf and http://www.apra.gov.au/AboutAPRA/upload/Statement-of-Expectations-from-Treasurer-20-Feb-07.pdf.

[72] Commonwealth of Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders* (June 2003) (Uhrig Report), p. 60.

[73] Australian Government, *Best Practice Regulation Handbook* (June 2010 edition), p. 7, para 2.1. http://www.finance.gov.au/obpr/proposal/handbook/docs/Best-Practice-Regulation-Handbook.pdf

[74] See Australian Government, *Best Practice Regulation Handbook* (June 2010 edition).

[75] See *Best Practice Regulation: A Guide for Ministerial Councils and National Standard Setting Bodies* (COAG 2007).

[76] For details about the RIA requirements at State level: see Office of Best Practice Regulation 2010*, Best Practice Regulation Report 2009-10*, Department of Finance and Deregulation, Canberra, Appendix B, pp. 68 – 87.

[77] Australian Government, *Best Practice Regulation Handbook* (June 2010 edition), p. 9, para 2.10.

[78] Australian Government, *Best Practice Regulation Handbook* (June 2010 edition), p. 7, para 2.3.

impact is of a minor or machinery nature[79] and does not substantially alter existing arrangements.

The process of developing a RIS has four stages:[80]

- *Notifying the OBPR* – Once an agency makes a decision that regulation may be necessary it is required to inform the OBPR. The OBPR will decide, based on information provided by the agency, whether a RIS is required.
- *Preparing the RIS* – If a RIS is required it is prepared by the agency. The OBPR does not mandate a format for the RIS but states that generally it should set out:

  ‘1. the problem or issues that give rise to the need for action
  2. the desired objectives
  3. a range of options (regulatory and non-regulatory, as applicable) that may constitute feasible means for achieving the desired objectives
  4. an assessment of the impact (costs, benefits and, where relevant, levels of risk) of a range of feasible options for consumers, business, government and the community
  5. a consultation statement
  6. a conclusion and recommended option, and
  7. a strategy to implement and review the preferred option.’[81]

  The RIS requirements are scalable: the more significant the impacts of the regulatory proposal the more detailed the analysis in the RIS must be. The RIS must be certified by the relevant agency head or deputy head. The adequacy of the RIS is then assessed by the OBPR. The regulatory agency must also prepare a one-page summary of the RIS which must be approved by the OBPR as a fair, balanced and accurate summary of the RIS.[82]
- *The decision-making stage* – The RIS, the OBPR’s assessment of its adequacy and the one-page summary are then presented to the decision-maker prior to the decision

[79] ‘”Minor” changes refer to those changes that do not substantially alter the existing regulatory arrangements for businesses or not-for-profit organisations, such as where there would be a very small initial one-off cost to business and no ongoing costs. “Machinery” changes refer to consequential changes in regulation that are required as a result of a substantive regulatory decision, and for which there is limited discretion available to the decision maker’: Australian Government, *Best Practice Regulation Handbook* (June 2010 edition), p. 10, para 2.14.
[80] See Australian Government, *Best Practice Regulation Handbook* (June 2010 edition), pp. 10 – 20.
[81] Australian Government, *Best Practice Regulation Handbook* (June 2010 edition), p. 14, para 2.24. If a regulatory proposal restricts competition the RIS must also demonstrate that the preferred option generates a net benefit to the community as a whole and that the only way to achieve the relevant objective is to restrict competition: p .61
[82] The one-page summary requirement was introduced in the June 2010 edition of the *Best Practice Regulation Handbook.* It seems to be an acknowledgement that the decision-makers do not always have time to read the complete RIS and, in the past, frequently did not.

being made. The RIS is supposed to assist the decision-maker reach an informed decision.

- *Publication* – The RIS then has to be published, on a central online public register of all RISs and, where appropriate, as an attachment to the explanatory memorandum or explanatory statement. This is where the process breaks down. The RIS approved by the OBPR will recommend an option. However, the decision-maker is presumably entitled to prefer an alternative option. If that were not the case the actual regulatory decision would be made by those preparing the RIS and the decision-maker would be a rubber stamp. However, if the decision-maker does not follow the option approved in the RIS, the publication of the RIS would be highly embarrassing to the agency.[83] There is a significant tension between the RIS's role as a decision-making tool and its role as a transparency measure, documenting, explaining and justifying the regulatory decision. The attempt to use the document to achieve both ends means that neither may be achieved. In practice there is a temptation to ensure that the RIS actually documents the decision already endorsed by the decision-maker. Further, if that is not achieved, and the decision-maker reaches a decision that is inconsistent with the approved RIS, generally, the RIS is subsequently amended, with the approval of the OBPR. The *Best Practice Regulation Handbook* (June 2010 edition) does not clearly acknowledge this. It does, however, note that:

> '2.38 There is scope for RISs to be modified after the decision maker's consideration but prior to publication:
>
> - where a draft RIS refers to commercial-in-confidence or national security information, or
> - to include analysis of the option adopted where that option was not considered in the original RIS.
>
> 2.39 While it may be possible to add further information to give greater context to the decision, as a general principle information on the options considered will not be able to be removed. Any changes to the RIS intended for publication need to be approved by the OBPR.'[84]

The use of the RIS as a transparency document means that it frequently becomes a document that merely justifies a decision already made.

The strength of the federal government's RIA requirements, as an accountability measure, is that they are mandatory and compliance with them is assessed, and reported on, by the

[83] This problem is also recognised by the OECD: *OECD Reviews of Regulatory Reform: Australia 2010 Towards a Seamless National Economy* (OECD 2010), p. 106 which suggests the original RIS should be published but acknowledges this can create 'some confusion'.
[84] Australian Government, *Best Practice Regulation Handbook* (June 2010 edition), p. 20.

OBPR. That is, whenever a government department or agency makes regulation they are required to comply with the RIA requirements and the OBPR makes the judgment about both whether those requirements are triggered and whether they are complied with. However, the requirements are mandatory by Executive order, not as a matter of law. The government has agreed that, in the absence of exceptional circumstances as agreed by the Prime Minister, a regulatory proposal that requires a RIS cannot go to Cabinet or other decision maker, such as the Commission of ASIC or APRA's executive group, unless RIA requirements have been complied with. However, the only sanction for failure to comply is negative publicity. In this sense the RIA requirements are a weak accountability mechanism. As evidence that governments and regulators are not perfect when it comes to complying with regulatory requirements imposed on them, compliance rates are dropping. Compliance rates have fallen, from 90 per cent in 2007-08 to 84 per cent in 2009-10; there were 12 non-complying regulations last year.[85] However, ASIC and APRA are fully compliant.[86]

Most advanced countries have similar RIA processes. Australia's process is highly ranked. The OECD has described it as 'among the most rigorous and comprehensive in the OECD'.[87] The Australian RIA requirements do have much to recommend themselves. They impose a disciplined and systematic approach to regulation making on regulation-makers. However, it is important to keep some scepticism about the process and to understand the impact that it has on efficiency. There are incredible implementation challenges. The RIS requires assessment of costs and benefits but certain things are very difficult to assess, especially *ex ante*. In particular, benefits are hard to measure; future benefits are almost impossible to measure, identify and sensibly analyse. In practice, so many assumptions have to be made that the analysis becomes incredibly tenuous. As noted above, the insistence that the RIS is both a transparency document and a decision-making tool mean that it is challenging to prevent the drafting of the RIS becoming a time-consuming and expensive process of justifying decisions already made. I suspect those who are actually involved in the RIA process have some scepticism about it, privately doubting whether it would itself, in all cases, survive a rigorous cost-benefit analysis.[88]

Apart from the OBPR there are a number of other bodies which effectively regulate the regulators. For example, Auditors-General, Ombudsmen, and specialist bodies such as the

[85] Office of Best Practice Regulation 2010, *Best Practice Regulation Report 2009-10*, Department of Finance and Deregulation, Canberra, p. 15.

[86] See *Annual Compliance Reports* from 2005 to 2010 available at http://www.finance.gov.au/obpr/reporting-publications/publications.html#annual_compliance (accessed 14 June 2011).

[87] *OECD Reviews of Regulatory Reform: Australia 2010 Towards a Seamless National Economy* (OECD 2010), pp. 15 – 16.

[88] Lave concludes that cost-benefit analysis is so costly to perform that 'it ought not be applied to every problem or applied lightly. Few issues are worthy of a formal benefit-cost analysis': Lave, Lester B, 'Benefit-Cost Analysis: Do the Benefits Exceed the Costs?', Chap 6 in Ogus, Anthony I (ed) *Economics and the Law* (2001, Elgar Publishing). p. 466.

Inspector-General of Taxation all play a role in ensuring the accountability of regulators.[89] In general, these regulators of the regulators provide weak accountability in that they cannot impose any response; they only make recommendations, generally to the Minister or the regulator concerned.

The Auditor-General, supported by the Australian National Audit Office, audits the financial statements of Commonwealth agencies, such as ASIC and APRA.[90] The Auditor-General must report to the agency's responsible Minister about whether the financial statements have been prepared in accordance with the Finance Minister's Orders and give a true and fair view of the matters required by those Orders. The audit report has to be included in an agency's annual report which is tabled in Parliament.[91] The Auditor-General also conducts performance audits of agencies, such as ASIC and APRA.[92] Performance audits conducted by the Auditor-General include:

- ASIC's Processes for Receiving and Referring for Investigation Statutory Reports of Suspected Breaches of the Corporations Act 2001 (January 2007);
- ASIC's Implementation of Financial Services Licences (January 2006);
- Bank Prudential Supervision (July 2005);
- APRA's Prudential Supervision of Superannuation Entities (September 2003); and
- Bank Prudential Supervision (May 2001).

The Auditor-General can also conduct a review or examination of a particular aspect of the operations of the whole or part of the Commonwealth public sector.[93]

In Australia, there are Ombudsmen at the State and Territory and Federal level.[94] They have broad powers to investigate potential maladministration by regulators. The Commonwealth Ombudsman, for example, can investigate either following a complaint, or of its own motion, action by a regulator that relates to 'a matter of administration'.[95] When investigating complaints the Ombudsman seeks explanation and justification from the relevant regulator. The Commonwealth Ombudsman receives complaints about ASIC and APRA.[96] Most complaints about ASIC relate to the imposition of late fees (although these complaints have

[89] This list could be further extended. For example, the Office of the Australian Information Commissioner monitors, investigates and reports on compliance by agencies with the *Freedom of Information Act 1982* (Cth) and privacy requirements and the Productivity Commission's regular reviews of regulatory burden could be characterised as an accountability mechanism.
[90] Sections 12 *Auditor-General Act 1997* (Cth) and s 57 *Financial Management and Accountability Act 1997* (Cth)
[91] Section 57 *Financial Management and Accountability Act 1997* (Cth).
[92] Sections 15 *Auditor-General Act 1997* (Cth).
[93] Section 18 *Auditor-General Act 1997* (Cth).
[94] See generally Head, Michael *Administrative Law: Context and Critique* (2nd ed, 2008, Federation Press), pp. 71 – 77.
[95] Section 5 *Ombudsman Act 1976* (Cth).
[96] See , for example, *Commonwealth Ombudsman Annual Report 2009-2010*, pp. 124 – 126.

recently reduced) and its failure to investigate or take action in relation to alleged misconduct. Most complaints about APRA relate to the processing of applications for early release of superannuation benefits.

Uhrig recommended the creation of a new regulator of regulators, an Inspector-General of Regulation. He modelled his proposed Inspector-General of Regulation on the Inspector-General of Taxation. The Inspector-General of Taxation can identify systemic problems with the administration of the tax laws[97] and, therefore, operates one of the few accountability mechanisms that examines the overall regulatory approach of a regulator. The Inspector-General reviews and reports on the systems established by the Australian Taxation Office to administer the tax laws, and the systems established by tax laws.[98] The Minister may direct that the Inspector-General conduct a review and the Minister, the Commissioner of Taxation, the Parliament or a Parliamentary Committee may all request a review.[99] The Inspector-General of Taxation can also conduct a review on his or her own initiative following, for example, complaints by individual tax payers, tax professionals or the Ombudsman.[100] After conducting a review, the Inspector-General gives a written report, which may include recommendations, to the Minister and the report is made public.[101] When conducting a review the Inspector-General may invite submissions from the public and has broad powers to request or require information, documents and evidence from tax officials.[102]

Urhig envisaged that the Inspector-General of Regulation would 'investigate systems and procedures used by regulatory statutory authorities to administer regulation and to recommend improvements where appropriate'[103] and 'would provide the community with a mechanism to ensure that the regulators are being held to account for the way in which they exercise their powers.'[104] Uhrig saw the Ombudsman as providing an avenue to ensure accountability in relation to services or administration, whereas the Inspector-General of Regulation would provide an avenue for complaint about systemic regulatory issues. He stated:

> 'Where statutory authorities provide services, dissatisfied individuals are able to seek redress through the Ombudsman. Where a pattern of complaints emerges, the Ombudsman has the power to undertake investigations into systemic issues. However,

[97] Section 3 *Inspector-General of Taxation Act 2003* (Cth).
[98] Section 7 *Inspector-General of Taxation Act 2003* (Cth).
[99] Section 8(2) and (3) *Inspector-General of Taxation Act 2003* (Cth).
[100] Section 8(1) *Inspector-General of Taxation Act 2003* (Cth).
[101] Sections 10 and 11 *Inspector-General of Taxation Act 2003* (Cth).
[102] Sections 12 – 21 *Inspector-General of Taxation Act 2003* (Cth).
[103] Commonwealth of Australia, Review of the Corporate Governance of Statutory Authorities and Office Holders (June 2003) (Uhrig Report), p. 90.
[104] Commonwealth of Australia, Review of the Corporate Governance of Statutory Authorities and Office Holders (June 2003) (Uhrig Report), p. 68.

in the case of systemic regulatory issues, it is the opinion of the review that the business community will be more inclined to seek an investigation of issues through an Inspector-General of Regulation.'[105]

The government did not accept Uhrig's recommendation to create an Inspector-General of Regulation.[106]

The ultimate response to failure to meet a required standard of performance is removal from office by the person to whom you are accountable. This is a strong and effective accountability mechanism. For example, under Australian law members' power to remove directors from office[107] significantly enhances the accountability of directors to members. Senior officials at regulators can generally be removed from office by the executive government but only in limited circumstances. In order to reinforce their independence from the political process, senior officials at regulators are generally given a form of tenure.[108] For example, the Governor-General, who would, of course, act on the advice of the executive government, may terminate the appointment of an ASIC Commissioner only on the grounds of misbehaviour, physical or mental incapacity, certain absences from duty, breach of legislative requirements relating to disclosure of conflicts of interests, bankruptcy, and paid employment outside the duties of his or her office without consent of the Minister.[109] The requirements in relation to APRA are almost identical, although there is a specific provision stating that the appointment of a member of APRA is immediately terminated if the member becomes a director, officer or employee of a body regulated by APRA and another provision stating that the member may be removed from office if the member is or becomes a director, officer or employee of a body operating in the financial sector, other than a body regulated by APRA, and the Minister considers that the person is, will be, or could be, prevented from the proper performance of the functions of his or her office because of resulting conflicts of interest. [110]

The purpose of this limitation on removal from office is clearly to ensure the independence of regulators. It ensures that a regulatory official cannot be removed from office merely

[105] Commonwealth of Australia, Review of the Corporate Governance of Statutory Authorities and Office Holders (June 2003) (Uhrig Report), p. 68.
[106] Senator Nick Minchin Media Release 57/04 Australian Government Response to Uhrig Report (12 August 2004)
http://parlinfo.aph.gov.au/parlInfo/download/media/pressrel/Y8GD6/upload_binary/y8gd62.pdf;fileType%3Dapplication%2Fpdf (accessed 14 June 2011).
[107] Public company directors can be removed by resolution of the members, regardless of anything in the company's constitution, and any contractual agreement between the company and the director or the members and the director: s203D *Corporations Act 2001* (Cth). For proprietary companies the power to remove directors by resolution is a replaceable rule: s203C *Corporations Act 2001* (Cth).
[108] See also s 13 *Competition and Consumer Act* 1974 (Cth).
[109] Section 111 *Australian Securities and Investments Commission Act 2001* (Cth).
[110] Section 25 *Australian Prudential Regulation Authority 1998* (Cth).

because he or she has made a decision that is unpopular with the executive government or parliament. However, this of course does limit the accountability of regulators when compared to other agents. The limitation on the right to dismiss regulatory officials is an example where, in the trade-off between independence and accountability, independence won.

Finally, before moving onto accountability to the general public, I should note the role of funding in accountability. Posner argued that American regulators are subject to market accountability because they compete for funding:

> 'the agency's head is answerable to both the legislative and (if he desires promotion or reappointment) to the executive branches. Legislative oversight of agencies is too little emphasized. Unlike business firms, government agencies must go to *their* capital markets – the legislative appropriations committees – every year. There is competition among agencies for the largest possible slice of the appropriations pie, and the agency that has a reputation for economy and hard work enjoys an advantage in the competition, for only in the exceptional case will it be to the legislators' advantage that the agency's personnel be lining *their* pockets (whether with pecuniary income or with non-pecuniary incomes such as leisure).'[111]

I think there is little evidence of this competition for funding in Australia. In fact, poor, rather than good, performance tends to be rewarded by more money from the government because it is often assumed or argued that poor performance by regulators is caused by lack of resources. However, in Australia the executive government can, and does, use tied funding to exert control over the resource allocation of regulators and ensure that regulators deliver projects that the government considers to be important, such as certain high profile enforcement actions. Over the years the federal government has allocated significant funds to ASIC for specific projects.[112] As noted by the International Monetary Fund, this has the potential to impede the independence of ASIC.[113]

The public

Direct accountability to the general public is limited. As a general proposition, accountability to the general public is achieved indirectly through accountability to the government and, in particular, the parliament which represents the general public. There are, however, some direct accountability mechanisms.

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[111] Posner, Richard, 'Theories of Economic Regulation', (1974) 5 *The Bell Jnl of Economics and Management Science'*, 335, 338 – 9.

[112] See, for example, Media Release No 34 from the Treasurer *Increased Budget Funding for ASIC* (9 May 2006), which indicates about $146 million of funds allocated to ASIC over a four year period will be tied to certain activities.

[113] International Monetary Fund, *Australia: Financial Sector Assessment Program – Detailed Assessment of Observance of Standards and Codes: IMF Country Report 06/415* (2006), at pp. 98 and 125.

As noted above, administrative law mechanisms provide a mechanism for individual members of the public affected by regulators' decisions to seek review of those decisions through courts or tribunals. Additionally, individuals or entities who suffer loss because of a regulator's conduct have a very limited right to sue for damages, where there is bad faith. The regulatory impact analysis requirements referred to above mean that regulators have to consult with members of the public who are affected by their regulatory proposals and the RIS must note how the regulator has responded to this consultation. This too creates a form of accountability to the public. The Ombudsman process is specifically designed to provide an avenue for members of the public to complain about the administration of government, including the administration of regulators.

Freedom of Information legislation[114] also supports direct accountability to the public. Subject to limited exceptions, Freedom of Information legislation gives members of the public the right to access information held by regulators. This information will explain why regulators have acted as they have. This is a weak accountability mechanism but it is a useful way to ensure information about the broad range of regulators' activities is made public, generally via the intervention of the media. However, it should not be thought that this accountability mechanism has no downsides. Studies indicate that transparency measures, such as Freedom of Information legislation, can merely encourage regulators 'to hide away from being held to account' by ensuring that real decision-making is not recorded in a way that could be made public.[115] Moreover, Freedom of Information legislation imposes a significant financial and time burden on regulators.[116] Finally, it should be noted that in Australia regulators also tend to voluntarily make a significant amount of information public.[117]

The Rule of Law Institute of Australia has argued that Senate Estimates Committees should take evidence and potential questions directly from the public.[118] In practice interest or lobby groups and other members of the public already feed evidence and questions to parliamentary

[114] There is freedom of information legislation at the Federal and State and Territory level. At the Federal level see *Freedom of Information Act 1982* (Cth).

[115] See Lodge, Martin and Stirton, Lindsay 'Accountability in the Regulatory State', Ch 15 in Baldwin, Robert, Cave, Martin and Lodge, Martin (eds) *The Oxford Handbook of Regulation* (2010), p. 364.

[116] Fung, Archon, Graham, Mary and Weil, David *Full disclosure : the perils and promise of transparency* (2007, Cambridge University Press), pp. 27 – 8.

[117] Australian regulators make a significant amount of information available, largely through their websites. Regulators also publish specific documents explaining their regulatory approach. For example, ASIC's Regulatory Guides explain when and how ASIC will exercise specific powers under legislation, explain how ASIC interprets the law, describe the principles underlying ASIC's approach and give practical guidance (for example, describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations). It should also be noted that recent amendments to the *Freedom of Information Act 1982* (Cth) require agencies, including Federal regulators, to proactively publish information, including information in documents to which the agency routinely gives access in response to freedom of information requests: see Part II *Freedom of Information Act 1982* (Cth).

[118] Rule of Law Institute of Australia, *ROLIA Senate Estimates Survey No. 2* (August 2010), p.22. http://www.ruleoflawaustralia.com.au/Downloads/Senate_Estimates_Survey_2.pdf (accessed 14 June 2011).

committees. However, the Rule of Law Institute of Australia's proposal would formalise this process and may make it easier for ordinary members of the public, as opposed to lobby groups, to have input into the process.

6. Are Australian regulators sufficiently accountable?

As stated above the issue of whether Australian regulators are sufficiently accountable will largely be left to the panel discussion but I will offer a few thoughts.

Australian regulators are not perfectly accountable. However, I think that, on balance, they are probably sufficiently accountable. This is all that can be hoped for and, in fact, all that we should strive to achieve given the need to balance accountability against other important attributes, namely, independence, expertise and efficiency.[119]

There is a web of accountability mechanisms which is, perhaps, more comprehensive than those calling for increased accountability recognise. Given the breadth of the existing accountability mechanisms and the competing public interests, the real challenge for those calling for more accountability is to explain:

- exactly what additional accountability mechanism they would impose
- how it would ensure accountability,
- why that mechanism would not merely duplicate existing accountability mechanisms; and
- how that mechanism would not unacceptably undermine independence, expertise and efficiency.

I will tentatively suggest two mechanisms that might survive this challenge. However, first I want to stress that my general conclusion that Australian regulators are probably sufficiently accountable should not be mistaken for an argument that Australian regulators are perfect. Of course, like most organisations, they could always do a better job. For regulators doing a better job means that they can improve in terms of:

- effectiveness (that is, achieving their regulatory mandate),
- efficiency (achieving their mandate in the most cost efficient way), and
- respect for non-instrumental values (such as, procedural fairness, proportionality, predictability and transparency).[120]

[119] See Lodge, Martin and Stirton, Lindsay 'Accountability in the Regulatory State', Ch 15 in Baldwin, Robert, Cave, Martin and Lodge, Martin (eds) *The Oxford Handbook of Regulation* (2010), p. 367

[120] Freiberg, Arie *The Tools of Regulation* (2010, The Federation Press), pp. 258 – 268.

However, subject to the two possible mechanisms discussed below, I think that increased accountability mechanisms are highly unlikely to help Australian regulators do a better job along any of these dimensions.

Tentative suggestions: additional accountability mechanisms

My first suggestion is more a substitution than an addition. As Table 1 shows, Australian regulators are subject to oversight by a number of other regulators. Just as regulatory overlap, duplication and complexity is inefficient for the business community, so is it inefficient for Australian regulators. There must be some scope to bring together the roles of the government authorities that oversee and ensure the accountability of regulators, into a Super-regulator of Regulators. The case seems compelling in relation to those bodies, such as the OBPR, Ombudsman and the Auditor-General that only have roles in relation to other government authorities. Rationalisation of the accountability of regulators would not just improve efficiency for regulators. Currently there are so many 'regulators of regulators' and such a complex array of accountability mechanisms that certain things may 'fall through the cracks'.

My second suggestion relates to governance. The governance arrangements of ASIC and APRA are very different from those of the Australian companies they regulate.[121] They are also very different from those of some key comparable foreign regulatory authorities which have governing boards with a majority of non-executive directors and separate Chairs and Chief Executive Officers (CEOs).[122] Both ASIC and APRA have governing bodies that are comprised of full time executives.[123] Further, there is no separation of the role of Chair and Chief Executive Office. In both organisations, the Chairman is effectively the Chief Executive Officer and the Chair of the governing body.

The use of a board, comprising of executive and non-executive directors, to govern Australian regulators has been firmly rejected in Australia. The HIH Royal Commission rejected this typical public company governance structure largely because the board of a

[121] They are inconsistent with *ASX Corporate Governance Principles and Recommendations* (2007, 2nd ed). See Recommendation 2.1 (a majority of the board should be independent directors), Recommendation 2.2 (the chair should be an independent director) and Recommendation 2.3 (the roles of chair and chief executive officer should not be exercised by the same individual.)

[122] For example, the United Kingdom Financial Services Authority has a board, the majority of members of which are non-executive. The Deputy Governor (Financial Stability) of the Bank of England, is an ex officio director. One of the non-executive members is Deputy Chairman and 'lead' non-executive. The Hong Kong Securities and Futures Commission has a Commission consisting of full-time executive officers and part-time non-executive officers and the role of Chairman and Chief Executive Officer are separate.

[123] Note the *Australian Securities and Investments Commission Act 2001* (Cth) does allow the appointment of part-time Commissioners: s 9(3). However, there has never been an appointment of a part-time Commissioner. Under s 16 *Australian Prudential Regulation Authority Act 1998* APRA must have between 3 and 5 members and three must be full-time. APRA has had full-time members only following the Government's acceptance of the HIH Royal Commission recommendation in relation to the governance of APRA: recommendation 18. Prior to this APRA had non-executive directors.

government regulator could not appoint the CEO. Owen J said, in relation to the then governing board of APRA which consisted of a majority of part-time directors:

> The imposition of a governance board between the chief executive and the Treasurer has the potential to cloud the line of accountability, especially as it is the board and not the Treasurer that sets the duties of the chief executive.
>
> The chief executive is answerable to the board—although it does not appoint him or her—as well as to the Treasurer. At the same time, the board carries responsibility for the performance of APRA but does not appoint the person who runs the organisation on its behalf.
>
> While individuals of the kind who are appointed to APRA's board would no doubt be able to play a valuable advisory role—including acting as a commercial sounding board—there is a question as to the utility of non-executive board input into how a regulatory body such as APRA carries out its statutory role.[124]

The *Uhrig Report* also firmly rejected the use of public company type boards for regulators for similar reasons. Uhrig argued that the power of the board is significantly 'derived from the ability to appoint and remove the CEO, appoint the chairman and new directors, finalise and approve strategy, define the values and culture, 'say no' to management and give final approval to the sale and purchase of significant assets.'[125] When these powers are diluted or modified, as they inevitably are in a regulator, a board of directors is, according to Uhrig, rendered useless. It has no ability to ensure effective oversight of the performance of management. Moreover, the presence of a board dilutes the accountability of the CEO and management to the Minister, as the CEO and management may effectively play the board and the Minister off against each other.[126]

Yet the public company governance system seems to work in foreign regulators, such as the Hong Kong Securities and Futures Commission and the United Kingdom Financial Services Authority. Further, there is an argument that this is the way to ensure accountability without undermining independence and expertise. The non-executive directors can ensure that the regulator is aware of and responsive to the needs of the ultimate stakeholders, the public, just as a key role of non-executive directors in a public company is to ensure accountability to

[124] *The HIH Royal Commission Report* (2003) at section 8.5.1

[125] Commonwealth of Australia, Review of the Corporate Governance of Statutory Authorities and Office Holders (June 2003) (Uhrig Report), p. 65.

[126] Commonwealth of Australia, Review of the Corporate Governance of Statutory Authorities and Office Holders (June 2003) (Uhrig Report), pp. 66 – 67.

members of the company.[127] However, the presence of non-executive directors on the board of a regulator does not undermine the independence of the regulator.[128] In other words the use of a public company style board is the holy grail of accountability mechanisms for regulators – a mechanism that ensures accountability without undermining independence or expertise.

Both these suggestions are very tentative for two reasons: first, I think that on balance Australian regulators are sufficiently accountable, and secondly, further work would need to be done to ensure the viability of either of these mechanisms. The arguments against the use of independent, non-executive directors in the *HIH Royal Commission Report* and the *Uhrig Report* are strong but, nevertheless, there is scope for more research on the most effective and efficient corporate governance mechanisms for regulators.

[127] ASX Corporate Governance Council, Corporate Governance Principles and Recommendations with 2010 Amendments (2nd Edn, 2010), p.3 and Petra, Steven T., 'Do outside independent directors strengthen corporate boards?' (2005) 5(1) *Corporate Governance* 55

[128] See the discussion in Enriques, Luca, 'Regulators' Response to the Current Crisis and the Upcoming reregulation of Financial Markets: One Reluctant Regulator's View' (2008-20090 30 U. Pa. J. Int'l Law 1147, at pp. 1149 – 1151.

Table 1: Key accountability mechanisms

	COURTS AND TRIBUNALS		PARLIAMENT		EXECUTIVE and GOVERNMENT AGENCIES		PUBLIC
	Judicial review	**Merits review**	**Parliamentary Committees**	**Parliament: Legislative Instruments Act**	**Ministerial direction**	**Other monitoring bodies**	**Freedom of Information**
Financial accountability						Auditor-General	
Procedural accountability				Legislative instruments		OBPR Auditor -General	
Substantive - regulation				Legislative instruments			
Substantive – administration of the law		Decision re-made, *de novo*				Ombusdsman Auditor -General	
Substantive – enforcement					Cannot give a direction about a specific case	Ombudsman	
Substantive – overall management							

Strong accountability ie accountability mechanism that leads to a response where the regulator has failed to meet the required standards

Weak accountability ie accountability mechanism that merely involves the regulator giving an account of its actions. It does not lead to a response (other than perhaps non-binding recommendations or negative publicity)

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Regulator Power and Accountability

Presentation to BFSLA Conference

5 Aug 2011

Richard Gilbert
Chief Executive Officer
Rule of Law Institute of Australia

RoLIA

The Rule of Law Institute is an independent non-profit association formed to uphold the rule of law in Australia.

The Institute's objectives are:

- To foster the rule of law in Australia.
- To promote good governance in Australia by the rule of law.
- To encourage truth and transparency in Australian Federal and State governments, and government departments and agencies.
- To reduce the complexity, arbitrariness and uncertainty of Australian laws.
- To reduce the complexity, arbitrariness and uncertainty of the administrative application of Australian laws

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RoLIA advocates:

- On legislation which respects the rule of law.
- On the need for education on the rule of law.
- Against excessive use of power by the executive.
- On enhanced parliamentary scrutiny of our regulators
- On the need for a free press
- On the independence of open courts

Coercive powers of Federal Regulators

- Require compulsory attendance at examination to answer questions
- Require production of documents/books
- Require reasonable assistance (including preparing documents/statements)
- Require person to allow search of premises without prior notice (ATO only)
- Departure prohibition orders (ATO only)
- Phone taps and phone records access

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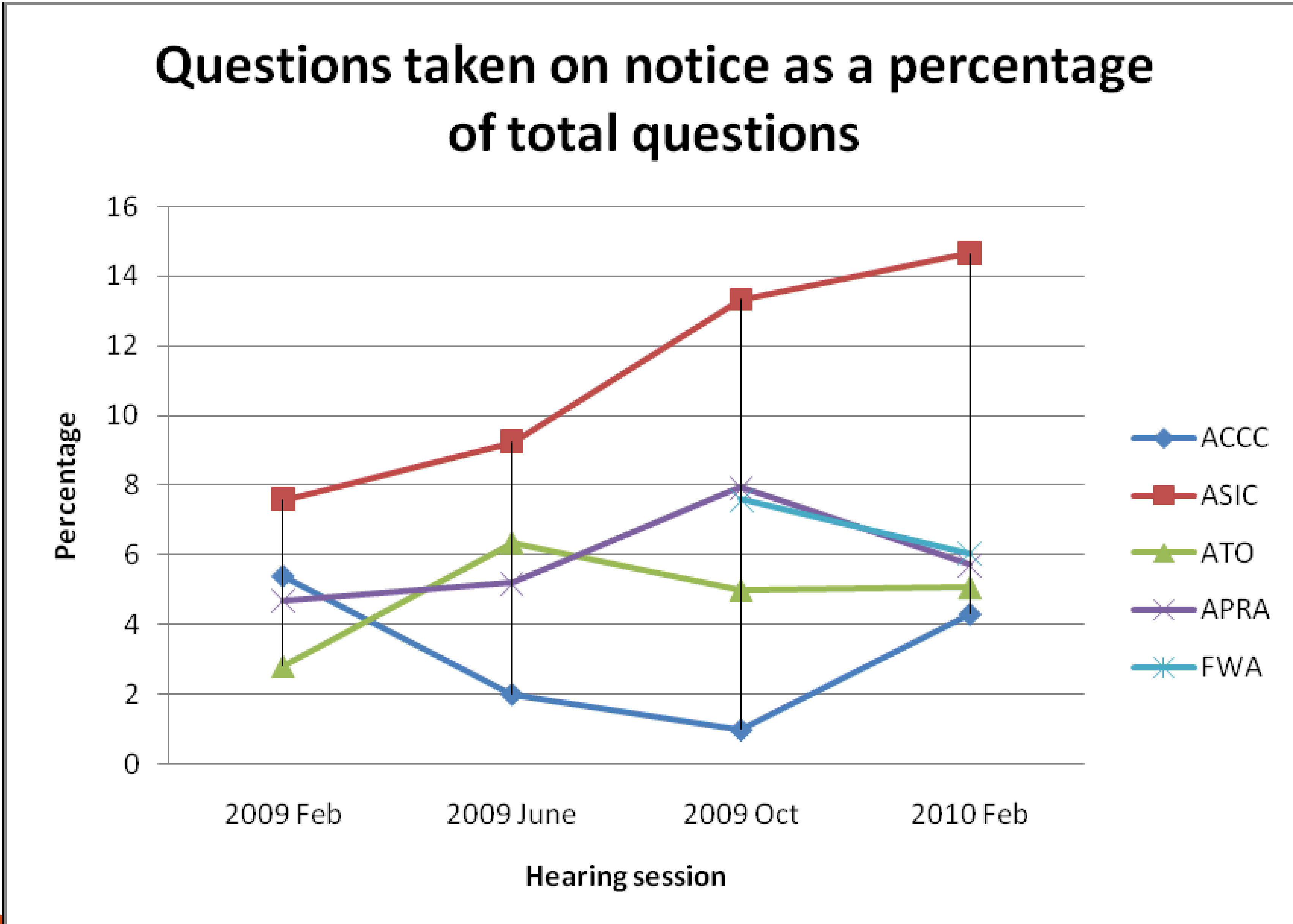
The *Building & Construction Industry Improvement Amendment Act* 2005

Senator Penny Wong on the ABCC coercive powers (Second reading speech for Bill introducing above Act, Thurs 18 August 2005 – Bill later passed without amendments):

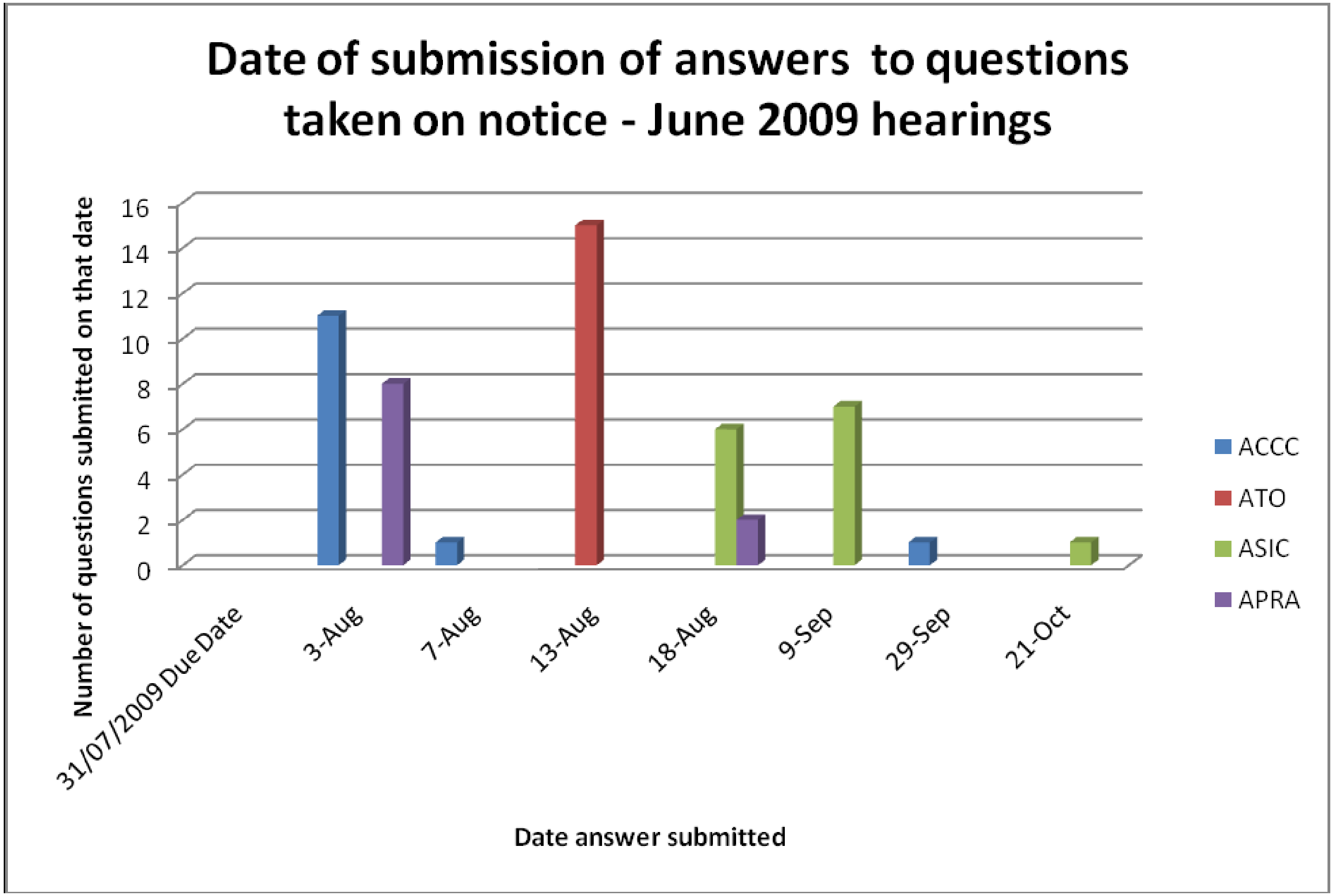
"…They were very substantial coercive powers—powers that Labor still says are inappropriate. They certainly give very substantial rights to the task force, arguably rights far greater than police have, so you have the bizarre situation where building union officials and employees in the construction industry actually have fewer rights in relation to investigation by the task force than a criminal might have in relation to investigation by police…."

Regulators – accountable to who?

- The Parliament?
- The Minister?
- The community?
- Those who pay the freight?
- Consumers?


Questions taken on notice as a percentage of total questions
16
14
12
10
8
6
4
2
0
Percentage
2009 Feb
2009 June
2009 Oct
2010 Feb
Hearing session
ACCC
ASIC
ATO
APRA
FWA

Adherence to Senate Orders



ASIC Coercive powers

The five most frequently used powers by ASIC over the period 1 July 2007 to 17 June 2010 are:

Section 33 of the ASIC Act- notice to produce documents in person's possession (6984 occasions);

Section 30 of the ASIC Act- notice to produce books about affairs of body corporate or registered scheme (5687 occasions);

Section 19 of the ASIC Act- notice requiring appearance for examination (3354 occasions);

Section 31 of the ASIC Act- notice to produce books about financial products(1430 occasions); and

Section 912C of the Act- direction to provide a statement (939 occasions).

Source: Senate Economics Committee answers to questions on notice, June 2010 session, Question BET 24.

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So what re the numbers!

- A low number of power uses could indicate a lazy regulator?
- A rapidly increasing number could show that the regulator is out of control (few internal controls)?
- Dissected numbers could show systemic issues in one area of ASIC.
- What happens at the interview stage – procedural rules and equity?
- Over-use of powers can impact on the cost of compliance and efficiency – not a rule of law issue.

Publication of data in annual reports 2009-2010

Reporting item	ACCC	ACC	APRA	ATO	ASIC	ABCC
Number of notices	x	x				x
Notices by type (for interview or document production)	x	x				x
Notices by area of compliance		x				
Challenges to the validity of notices	x	x				x
Search warrants sought	x					
Warrants executed/granted	x			x*		
Description of matters for which warrants sought	x					
Explanation of the powers and how they work		x				x
State by state breakdown						x
Proceedings begun for failure to attend examination		x				x
Breakdown by type of examinee Eg management or employees						x
Outcome of examinations (proceedings commenced, investigation closed etc).						x
Legal representation at interview						x
Explanation of why increase/decrease in number of notices		x				
Telecommunications warrants						

*The ATO disclosed on its use of access-without-notice powers by stating they used the powers on 10 occasions. It is the only regulator with these powers; the other regulators must apply to Court for a warrant which is then executed by the AFP.

Information disclosed about coercive powers

Regulator	Specific information/ document on website	Coercive powers Policy available on website	Some information on website	No information on website	Disclosed information at Senate estimates hearings	General statistics in annual report on use of powers
ACCC	☑	☑				☑
APRA				☑		
ATO	☑	☑			☑	Mention of access-without notice powers only
ASIC				☑	☑	
ABCC	☑	☑				☑

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Examinations/notices to attend examinations per Federal Regulator

	2007/2008	2008/2009	2009/2010
ASIC	1175	1065	1069 (till 17 June 2010)
ACCC	163	35	75
ACC	895 summons, 760 exams	627 summons, 527 exams	169 exams
ABCC	54	60	27

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Administrative Review Council Principles

The ARC May 2008 report on The Coercive Information Gathering Powers of Government Agencies produced 20 principles on how coercive powers should be used.

The Government has not responded.

ASIC has (to its credit).

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The ARC principles

Principle 1 – 'Last resort' usage

Principle 2 - Cost benefit necessary

Principle 3 - Record keeping

Principle 4 - Transparency***

Principle 5 – Training re contempt of court

Principle 6 - Authorisation and delegation

Principle 7 – Delegation to senior officers

Principle 8 – Training

Principle 9 - Accountability****

Principle 10 – CP officer for each agency

Principle 11 - Sharing resources and experience

Principle 12 - Conflict of interest

Principle 13 - Identity cards

Principle 14 – Details in notices

Principle 15 - Specificity in notices

Principle 16 -Examinations and hearings

Principle 17 - Privilege to be upheld

Principle 18 - Disclosure of information

Principle 19 - Inter agency triggers

Principle 20 - Record management

***** ASIC reports it does not comply with these principles.**

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In relation to information gathering generally

- Consider voluntary surveys first and/or sample surveys
- Seriously test the cost and benefits of complex and onerous data collection
- Use questionnaires which can be easily completed and collated
- Try to publish data so that it benefits the market
- Publish composite data only
- Avoid secrecy and confidentiality clauses where possible
- Respect privacy principles

Regulators and codes of ethics

- APRA Act 1998

  SECT 48AC mandates a APRA Code of Conduct

- Report on operation of the code?

- Disclosure of interests – along lines of parliamentary register of pecuniary interest?

- What about the other regulators – where are their codes?

Rule of Law Institute of Australia

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(02) 9251 8000

Thank you

28th ANNUAL CONFERENCE OF THE BANKING & FINANCIAL SERVICES LAW ASSOCATION

GOLD COAST, QUEENSLAND
4 - 6 AUGUST 2011

AUSTRALIAN/NEW ZEALAND CASE LAW UPDATE — NEW ZEALAND

HON JUSTICE MARK O'REGAN
President, Court of Appeal of New Zealand[1]

[1] Thank you for the opportunity to address you. I am going to deal with a case on banking mandates and a case about the nature of "unclaimed money". It will not surprise you, given my historic connection with the PPSA in New Zealand, that I will then do a sort of pot-pourri of recent PPSA cases. I realise that, for Australian participants these will be jumping the gun somewhat, because your PPSA has not yet come into force, but I hope these cases will have some interest for you in illustrating the kinds of issues that the Australian PPSA will throw up. I will mention how the issues dealt with in the recent New Zealand cases would affect the equivalent sections in the Australian PPSA (with an appropriate disclaimer, given my lack of familiarity with the Australian PPSA). I will also mention a couple of recent securities law cases.

Banking

Westpac New Zealand Ltd v MAP & Associates Ltd: breach of mandate and dishonest assistance

[2] This case was an unsuccessful appeal by Westpac against a High Court decision finding that Westpac had breached its mandate with MAP and Associates Ltd, a small accounting firm in Hamilton.[2] MAP was appointed as deposit agent for funds to be paid to shareholders from the sale of a small, private Bolivian bank (Prodem) to a Venezuelan state-owned bank (Banco Industrial de Venezuela, CA (BIV)). It was to hold the purchase price in escrow until due diligence was carried out and the sale was finalised. Approximately US$50 million was credited by BIV to MAP's account with Westpac in

1 I acknowledge with appreciation the contribution of my clerk, Amelia Keene, to the preparation of this paper.

2 *Westpac New Zealand Ltd v MAP & Associated Ltd* [2010] NZCA 404, [2011] 2 NZLR 90.

2006. BIV then assigned its rights to Bandes, another Venezuelan publicly owned bank. MAP advised that the funds should be disbursed in February 2008. Westpac became concerned due to a number of incongruities:

(a) It had originally been told it would hold the funds for a week;[3] in fact they were held for 21 months. Much of what it was told in 2007 about when it would settle proved unreliable.

(b) In February 2007, Westpac's Compliance Department had received a notice alerting the banking community to large payments being made from Bolivia and the need to treat them with caution.

(c) Westpac had been in touch directly with BIV and had received conflicting correspondence, including an indication that the sale had been cancelled.

(d) There were some difficulties establishing the details of the beneficiaries (account details were provided, but two names had been omitted).

(e) Westpac made some inquiries in February 2008 which led it to suspect or believe that the apparent principal of the consultancy firm charged with arranging the sale, a Mr Lara, was not in fact a director of that firm at the relevant time and neither was he a lawyer from a law firm based in Panama, as MAP had advised.[4]

(f) Some of the translations from the Spanish documents to English were inaccurate. In particular, the Spanish version of the escrow agreement did not seem to record Mr Anker as being the Seller's representative, whereas the English did.[5]

(g) The bank's original instructions were to pay the Bolivian shareholders. It was told a $600,000 fee would be paid to the consultants.[6] Its 2008

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3 At [54].
4 At [15].
5 At [58].
6 At [5].

instructions were to pay funds to persons not named as "sellers" in the escrow agreement. In fact, an affidavit filed later in the proceedings revealed that the consultants were to be paid $26 million from the funds.[7]

(h) Westpac received a letter in November 2007 which mentioned the assignment from BIV to Bandes, but the assignment was not specifically drawn to its attention. The Court found that it had at least been told of the assignment in a meeting on 31 January 2008.[8]

[3] Westpac did not disburse the funds as requested by MAP and instead suggested that MAP should apply to Court for orders for disbursement of the funds. The High Court ordered that it pay the funds.[9] It then issued a second judgment in which it found that Westpac had breached its mandate to MAP.[10] This second decision was upheld on appeal by the Court of Appeal. The Court discussed the scope of dishonest assistance and concluded on the facts that the circumstances were insufficient to justify Westpac's refusal to follow instructions on the basis that it would have been liable for dishonest assistance had it released the funds.

[4] There was some discussion of the scope of dishonest assistance. The Court held that the concept of a "reasonable banker" was helpful, following *US International Marketing Ltd v National Bank of New Zealand Ltd*.[11] The Court set out the law as follows:

> [46] Accordingly, we consider that a bank will be liable for dishonest assistance where it has actual knowledge of the circumstances of the transaction (the subjective element) such as to render its participation contrary to normally acceptable standards of honest conduct (the objective element). In assessing whether its participation is contrary to such standards, the concept of the reasonable banker may well prove helpful. In this context, factors such as the significance or unusual nature of the transaction, the customer's banking practices, banking practices within the relevant industry and statutory reporting requirements will be relevant.

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7 At [24].
8 At [14].
9 *MAP & Associates Ltd v Westpac Banking Corporation Ltd* HC Auckland CIV-2008-404-1373, 1 April 2008.
10 *MAP & Associates Ltd v Westpac Banking Corporation Ltd* (No 2) HC Auckland CIV-2008-404-1373, 10 March 2009 at [38]–[40].
11 At [46], *US International Marketing Ltd v National Bank of New Zealand Ltd* [2004] 1 NZLR 589 (CA) at [9] per Tipping J, at [78] per Glazebrook J.

> [47] Further, a bank may be liable even though it does not have actual knowledge of the circumstances of the transaction but has a well-grounded suspicion about them. In that situation the bank may be required to make further inquiry. A negligent failure to make inquiry will not establish liability. Rather, wilful blindness or a deliberate failure to make inquiry in order to avoid acquiring unwelcome knowledge is necessary.

[5] The Court found that Westpac should have disbursed the funds by 2 March 2008. By that time, it had received a letter from Mr Anker, who held a power of attorney for Prodem, confirming the beneficiaries and the transfer instructions. MAP had confirmed that Mr Anker held a power of attorney and Westpac had no grounds to doubt this. The Court found that Westpac's suspicions appeared to have been fuelled by a lack of familiarity with the practices and customs of those it was dealing with. It noted that it would have found expert evidence on international banking transactions such as these helpful. Ultimately, Westpac had to pay interest from the 2 March 2008 until the date of disbursement, at the rate set by the Judicature Act 1908. An award of indemnity costs made in the High Court was overturned.

[6] It might be said that this is a small price to pay in the face of potential liability if the funds were wrongfully disbursed. On the other hand, the consequences of wrongfully withholding funds can be much worse. In the *US International* case the appellant claimed that the failure to access funds had led to his being unable to complete a land purchase, meaning he forfeited his deposit of approximately $731,000 (the Court's decision was limited to liability and did not quantify the damages).

[7] The case has been welcomed by commentators for reiterating "the critical importance to commerce of banks honouring their mandates" and confirming the application of the "reasonable banker" test.[12] The lesson arising from the case has been described as "that [banks] should give precedence to their customer's interests and instructions and only ignore them in the most exceptional circumstances when the evidence that the funds belong to a third party is clear and established."[13]

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12 At [62]; Christopher Hare "Banking Law" [2011] 1 NZLR 121 at 156–157.
13 Hare, at 157.

[8] Whether this position is correct remains to be tested. The Supreme Court granted leave to appeal on the question of whether Westpac breached its mandate[14] and the appeal was heard on 31 May 2011. The decision has been reserved.

Westpac Banking Corporation v The Commissioner of Inland Revenue: unclaimed cheques and bank drafts

[9] The Unclaimed Money Act 1971 provides that unclaimed money should forfeit to the Crown. Unclaimed money includes:[15]

> Any other money, of any kind whatsoever, which has been owing by any holder for the period of 6 years immediately following the date on which the money has become payable by the holder.

[10] The question before the Supreme Court was whether unpresented bank cheques and bank drafts constitute unclaimed money for the purposes of the Unclaimed Money Act[16]. As Alan Tyree notes, an astonishing one percent of all bank cheques are not presented within six months of issue, so the sum at stake was potentially large.[17] If they are unclaimed money, the amounts must be paid to the Commissioner for Inland Revenue. If not, then, after six years, the bank will get a windfall. To fall under the definition of "unclaimed money", the money must have been owing for a period of six years. The question before the Supreme Court was whether, from the time of purchase of a bank cheque or bank draft, the money is "owing" and payable to the bank.

[11] I am sure it is unnecessary to explain bank drafts and bank cheques to an audience of banking and finance lawyers. Nevertheless, in the age of credit cards and internet transfers, a short definition, taken from the judgment, seems appropriate.[18] A bank draft is like a foreign currency cheque, which a New Zealand bank will issue. The payee (or its indorsee) named in the draft will then present it at a foreign bank, which will pay the amount denominated in a particular foreign currency. A bank cheque is a form of promissory note[19] whereby the drawer, a New Zealand bank, promises it will pay a

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14 *Westpac New Zealand Ltd v MAP & Associates Ltd* [2011] NZSC 1.
15 Unclaimed Money Act 1971, s 4(1)(e).
16 *Westpac Banking Corporation v Commissioner of Inland Revenue* [2011] NZSC 36, [2011] 2 NZLR 726.
17 Alan L Tyree "Unclaimed money" [2011] NZLJ 135.
18 At [3]–[4].
19 By section 84 of the Bills of Exchange Act 1908.

stipulated amount to the named payee (or its indorsee) on presentment of the draft. The named payee is usually not a customer of the New Zealand bank. A bank cheque is not a bill of exchange in terms of the Bills of Exchange Act 1908,[20] but a bank draft is.

[12] The case was an attempt by Westpac and other banks (the banks) to re-litigate a decision of the Privy Council in *Commissioner of Inland Revenue v Thomas Cook (New Zealand) Ltd*.[21] The Privy Council had decided the appellant company was liable to the Commissioner in respect of similar instruments to bank drafts, referred to as "international cheques". It held that to become payable, it was enough that the cheque had been issued. It was not necessary for it to be presented. As Lord Brown of Eaton-under-Heywood rather colourfully observed:[22]

> That surely would be the greatest nonsense of all: to say that money can only become unclaimed money once it has in fact been claimed.

[13] The Supreme Court reconsidered the point, but came to the same conclusion as the Privy Council. An amount may be payable (for the purposes of the Unclaimed Money Act) without actually being due (it becoming due on presentment).[23]

[14] In Australia, the equivalent unclaimed money legislation for "Authorised Deposit Taking Institutions" (ADIs) is s 69(1) of the Banking Act 1959. It provides:

> For the purposes of this section, unclaimed moneys means all principal, interest, dividends, bonuses, profits and sums of money legally payable by an ADI but in respect of which the time within which proceedings may be taken for the recovery thereof has expired, and includes moneys to the credit of an account that has not been operated on either by deposit or withdrawal for a period of not less than seven years.

[15] Unlike in the New Zealand context, the section contemplates that proceedings might be taken to recover the sum. For the amounts referred to in the first part of the section, they become unclaimed moneys once any causes of action have expired, for the balance of an account, they become unclaimed moneys once they have not been operated on for seven years.

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20 Bills of Exchange Act 1908, s 3(1).
21 *Commissioner of Inland Revenue v Thomas Cook (New Zealand) Ltd* [2005] UKPC 53, [2005] 2 NZLR 722.
22 At [16].
23 At [46].

[16] In a recent case note, Alan Tyree and John Sheahan concluded that Australia is trapped in the position considered to be "the greatest nonsense of all" by the Privy Council whereby money can only become unclaimed money once it has been claimed.[24] This is because in considering when the sums become "legally payable" for the purposes of s 69(1) of the Banking Act 1959 (Cth), s 58 of the Cheques Act 1986 (Cth) applies. This provides, in respect of bank drafts and bank cheques:

> ... a person who is the drawer or an indorser of a cheque is not liable on the cheque unless the cheque is duly presented for payment.

[17] The problem is that liability seems to rest on presentment. Whether Mr Tyree is right, and whether, if he is, Australian law mandates a nonsense, is something I leave in the capable hands of my judicial colleagues on this side of the Tasman.

PPSA

Tubbs v Ruby 2005 Ltd: the "ordinary course of business"

[18] *Tubbs v Ruby 2005 Ltd* involved the "ordinary course of business" test in the PPSA.[25] Mr Tubbs and Mr Gower were successful in the Court of Appeal on an appeal against a High Court decision declining to grant an injunction to freeze the proceeds of a sale by Ruby 2005 Ltd of timber it purchased from Waimate Timber Processing Ltd. Mr Tubbs and Mr Gower were receivers of Waimate, appointed by ANZ National Bank.

[19] The case was factually quite complex. Waimate and Ruby were closely related companies (Ruby's corporate shareholder has the same directors and shareholders as Waimate). They entered into an agreement whereby Ruby would buy timber from Waimate at market value when Waimate needed to achieve sales. The timber would then be Ruby's and would be stored separately by Waimate until a buyer could be found, at which time it would be sold and the profits accounted to Ruby. These transactions occurred frequently between 2005 and 2008. However in 2007, a fraudulent manager at Waimate sold Ruby's stock without authorisation and without properly accounting for it to Ruby. While insolvent, Waimate replenished the Ruby stock. Ruby then decided to sell

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24 Alan Tyree and John Sheahan SC "Unclaimed Money: The Final (NZ) Word" (2011) 22 JBFLP 124 at 127.

25 *Tubbs v Ruby 2005 Ltd* [2010] NZCA 353.

its stock to an overseas customer of Waimate, under its name. Soon after the sale, Waimate went into receivership. It is the proceeds of that sale that is now in issue.

[20] ANZ had a perfected security interest over Waimate's timber. It said that Ruby was effectively an unsecured creditor and therefore ANZ had priority. The Court rejected this argument. It said that Ruby was the owner of the timber under the agreement between Waimate and Ruby, and this trumped ANZ's interest.

[21] The Court also considered whether the transaction was carried out "in the ordinary course of business" under s 53 of the PPSA. The Court upheld the receivers' appeal that it was reasonably arguable that the transaction was outside the "ordinary course of business" and hence it would be appropriate to grant an interim injunction. It held that the timber sold by Waimate between 2005 and 2008 was within the ordinary course of business. That is, entering into an arrangement with a related party to ease financial pressure is within the ordinary course of business.[26] The key consideration was that the timber was sold at market price.

[22] However the Court was concerned about the 2009 transactions. It noted that there was a lack of evidence as to what knowledge Ruby had of its stockpile being depleted during 2009 (after the fraud by the manager had been discovered). If Ruby authorised the depletion, then it would simply become an unsecured creditor. When Waimate replenished Ruby's pile, it would have been replenishing it with Waimate's timber, over which ANZ had a perfected security interest. The Court held that these were arguably not sales and were outside the ordinary course of business either because they were in satisfaction of Waimate's existing debt; or because they were to account to Ruby for Waimate's conversion (through the fraud) of Ruby's stock. Accordingly, there was an arguable case the bank's interest survived the 2009 transaction and an injunction should be issued over the proceeds.

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26 Compare: *Orix New Zealand Ltd v Milne* [2007] 3 NZLR 637 at [70], where Rodney Hansen J cites with approval Canadian jurisprudence suggesting that a private sale between two parties would not be within the meaning of "ordinary course of business": *Royal Bank of Canada v 216200 Alberta Ltd* (1986) 51 Sask R 146, at [22].

[23] In the decision under appeal,[27] the High Court judge had cited with approval the criteria from *Fairline Boats Ltd v Leger* for the "ordinary course of business" test:[28]

> (a) transaction type — the transaction should be one that is a normal part of the seller's business;
>
> (b) place of sale — if made at the seller's business premises, it is more likely to be in the ordinary course of business;
>
> (c) parties to the transaction — if the purchaser is an ordinary everyday consumer, the likelihood of a sale in the ordinary course of business is greater;
>
> (d) quantity of the goods sold — if a large number of items are sold, many more than normally sold and forming a substantial portion of the seller's stock, this counts against it being a sale in the ordinary course;
>
> (e) price charged — if market price is charged, then the sale is more likely to be considered one in the ordinary course of business;
>
> (f) advertising — if the seller advertises, holding itself out to the public as conducting a certain business, the transaction is more likely to be in the ordinary course;
>
> (g) percentage of overall sales volumes.

[24] The Court of Appeal also cited *Fairline* but did not expressly endorse those criteria. *Fairline* is a case from Ontario, where the equivalent PPSA provision does not refer to the "ordinary course of business *of the seller*", but simply "the ordinary course of business". The Court of Appeal of Saskatchewan (where the wording is the same as in New Zealand) has suggested that caution is needed before applying Ontario cases.[29] It applies the test from the point of view of the seller: what is the ordinary course of business of the seller, whereas the Ontario approach is broader and looks to general commercial practice.[30] Nevertheless, the *Fairline* test is phrased in the context of the seller, and to some extent the differences between the approaches may be theoretical.

[25] In *Tubbs*, the decisive factor for the 2005–2008 transactions was the fact that Ruby had paid market value for the timber. For the 2009 transactions, the difficulty was that it

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27 *Tubbs v Ruby 2005 Ltd* High Court Timaru CIV 2009-476-615 26 February 2010 at [38].

28 *Fairline Boats Ltd v Leger* (1980) 1 PPSAC 218 (Ont HC); *Tubbs v Ruby 2005 Ltd* [2010] NZCA 353 at [22] and [38].

29 *Camco Inc v Olson Realty* (1979) Ltd (1986) 50 Sask R 161 (Sask CA).

30 *Agricultural Commodity Corp v Schaus Feedlots Inc* (2001) 2 PPSAC (3d) 270 (Ont SCJ); upheld on appeal: *Agricultural Commodity Corp v Schaus Feedlots Inc* (2003) 4 PPSAC (3d) 266 (Ont CA).

was not clear whether Ruby had agreed to lend the timber or not. If it had, the transactions were simply to dispose of a past debt, but in doing so ANZ's security was undermined. Because the case came to the Court as an appeal against an interlocutory application, the Court only had to decide that it was arguable that ANZ's security should have priority.

[26] The Australian PPSA adopts an "ordinary course of business" rule from the point of view of the seller as well. Section 46(1) provides that:

> **46 Taking personal property free of security interest in ordinary course of business**
>
> Main rule
>
> (1) A buyer or lessee of personal property takes the personal property free of a security interest given by the seller or lessor, or that arises under section 32 (proceeds—attachment), if the personal property was sold or leased in the ordinary course of the seller's or lessor's business of selling or leasing personal property of that kind.

[27] Accordingly, any New Zealand authorities are likely to be highly relevant.

Rabobank New Zealand Ltd v StockCo Ltd: "seriously misleading"

[28] *Rabobank New Zealand Ltd v StockCo* raised the issue of when a financing statement will be "seriously misleading" under the PPSA.[31] StockCo is a provider of lifestock financing. It retains ownership of the stock. The farmer in this case was a Mr Campbell. StockCo (or Mr Campbell acting as StockCo's agent) would purchase bulls (either from a third party or directly from Mr Campbell) and bail them to Mr Campbell. Mr Campbell paid interest on the purchase price to StockCo and would repay the purchase price once the stock was on-sold or slaughtered. Where the stock was purchased from a third party, this gives rise to a PMSI, which, if properly registered, takes priority over other security interests, such as that held by Rabobank. Where purchased direct from the farmer, no PMSI arises, since a purchase made under sale and leaseback arrangement is not a PMSI. Instead, Rabobank would agree to release certain stock from its general security, since the purchase money was being paid into a Rabobank account.

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31 *Rabobank New Zealand v StockCo Ltd* HC Napier CIV-2009-441-207, 11 March 2011 per Simon France J.

[29] Rabobank raised a number of factual challenges to StockCo's security interest in the stock. However, for our purposes, the main legal issue was whether StockCo had a perfected PMSI over certain stock (those bulls purchased from a third party in 2007). StockCo had registered a financing statement. Rabobank challenged this statement as being seriously misleading under s 149 of the PPSA and therefore invalid. Section 150 goes on to state that a registration will be invalid if there is a seriously misleading defect in the name of the debtor stated.[32] The test is expressed as an objective one so it will not be necessary to prove that the defect actually misled the other party.

[30] There were a number of issues with the financing statement. First, it recorded Mr Campbell's name as "Alex Campbell" instead of the name as it appeared on his passport "Alexander Campbell".[33] The Court held that this was not sufficiently misleading to meet the standard in s 150. Second, Mr and Mrs Campbell had set up a partnership, but had not properly taken the steps to give effect to the partnership. No tax number had been obtained and it had never filed returns. For all intents and purposes, the farm operated as it always had, as the sole business of Mr Campbell. The financing statement was signed by both Mr and Mrs Campbell and the debtor recorded as an organisation as "AM and MJ Campbell". Rabobank challenged this as misleading. It said that the partnership's trading name of "Awapapa Station" ought to have been used (as recorded in the partnership deed).

[31] As Eady and Jackson noted in a 2006 Law Society paper, the Courts could have adopted two approaches to the test:[34]

> ... the test applied could be whether a person searching the PPSR and taking all prudent steps to ascertain whether there were any financing statements registered in respect of particular collateral would realise that the particular financing statement did relate to that collateral. Such a test may require searchers to use wildcard searching functions and the like. At the other end of the scale, the courts may take a strict approach that any error in a field which could be searched on will make a financing statement seriously misleading.

[32] The Judge adopted the broader, more purposive approach. He found that the partnership deed had never been brought into effect and the trading name of Awapapa

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32 The same provisions are included in the Australian PPSA: s 164 provides the registration will be invalid if there is a "seriously misleading defect" in any data.

33 Personal Property Securities Regulations 1999, schedule 1, cl 2(2).

34 Peter Eady and Adam Jackson "PPSA – a review four years on" (paper presented to New Zealand Law Society Seminar, October 2006) at 36.

Station was not used. Indeed, Rabobank had conceded that AM and MJ Campbell was a trading name used by the Campbells. The Judge accepted the evidence that anyone searching on the register would have searched by name and by any trading name, and would have found the financing statement. There was no risk that third parties would have been misled by the failure to refer to trading name in the partnership agreement of Awapapa Station.[35]

[33] The case illustrates the difficulties that can arise in accurately recording the debtor details. Technically, the legal owners are the partners, which suggests that the two names of the individuals should be noted. On the other hand, a partnership is an organisation and must be registered as such.[36] Clause 6 of the Regulations recognises this difficulty, stating that if the name of the organisation is not set out in the constitution then the trading name it is commonly known by will suffice. In the Campbells' case, it was not clear which rule should apply. Most mail and invoices was addressed to Mr Campbell, some to the partnership and some to Mr and Mrs Campbell as individuals. The partnership deed gave the trading name as Awapapa Station but the Judge found the parties had not given effect to this. In this factual context, the Judge's purposive approach seems appropriate, but does highlight the difficulty that can arise simply in recording a name correctly.

[34] The Judge said he would have taken a similarly robust approach to Rabobank's financing statements (which were challenged by StockCo: it was unnecessary to decide the point because StockCo succeeded in establishing that it had a perfected PMSI). Rabobank had not been particularly diligent in accurately recording the stock released from its general security. The Judge described its approach as "haphazard".[37] At times the stock numbers were significantly understated. This was quite different to *Simpson v New Zealand Associated Refrigerated Food Distributors Ltd*, where a secured party overstating its security interest was found not to be misleading since a searcher could have inquired and ascertained the correct position.[38] Nevertheless, the Judge tentatively held that anyone checking the security would have realised that stock numbers fluctuate and would have

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35 At [77].
36 Personal Property Securities Regulations 1999, schedule 1, cl 6 and 7.
37 At [86].
38 *Simpson v New Zealand Associated Refrigerated Food Distributors Ltd* [2007] 2 NZLR 130 (CA).

been on notice that there was a general security interest and made further inquiries.[39] Accordingly the error was not considered to be significant. This accorded with the broad purpose of the financing statement. It was intended only to notify a third party in generic terms of a possible security interest in the debtor's property. If a third party required further information in regards to certain collateral, then they could use the procedure set out in s 177(1)(c) of the PPSA.[40]

[35] Rabobank had used the trading name "Awapapa Station" and Stockco challenged this as seriously misleading. The Judge did not decide the point as the facts were unclear about the name used by the Campbells at the relevant time. But he said if the correct trading name was Mr Campbell's or A J and M J Campbell, the registration would have been seriously misleading.

Rabobank New Zealand Ltd v McAnulty: bailments

[36] *Rabobank New Zealand Ltd v McAnulty* raised a tricky issue on the correct interpretation of the definition in the PPSA of a "lease for a term of more than 1 year".[41] The case involved a thoroughbred stallion owned by a Syndicate that had decided to put the horse out to stud. It bailed the horse with a stud farm. The stud farm then went into receivership and the question was whether Rabobank, which held a perfected interest over all of the farm's property, had priority in the stallion.

[37] Under the PPSA, a lease is deemed to be a security interest if it is a "lease for a term of more than 1 year."[42] Such a lease is defined to include a "lease or bailment".[43] There were two issues before the Court of Appeal. The first was whether the arrangement fell within the definition of a "lease for a term of more than 1 year". The second was whether the exclusion to that definition applied: that the bailor was not in the business of leasing.[44]

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39 At [94].
40 Compare Personal Property Securities Act 2010 (Cth), ss 274–283.
41 *Rabobank New Zealand Ltd v McAnulty* [2011] NZCA 212.
42 Personal Property Securities Act 1999 (NZ), s 17(1)(b).
43 Personal Property Securities Act 1999 (NZ), s 16(1)(a).
44 Personal Property Securities Act 1999 (NZ), s 16(1)(c)(i).

[38] The arrangement with the stud farm was nothing like a lease. The stud farm cared for the horse and organised its nominations, and in return received a fee and a share of the nominations. The bailor paid the bailee, rather than the bailee paying rent to the bailor. The Court decided that the agreement was a lease for a term of more than one year but found that the business exclusion in s 16(1)(c)(i) applied: that the arrangement was a "lease by a lessor who is not regularly engaged in the business of leasing." To achieve this result, the Court had to read the word "lease" in (c) as a shorthand for "lease or bailment" as used in paragraph (a), which it justified on the basis of the presumption against absurdities in legislation.

[39] The Court rejected the Canadian jurisprudence on the meaning of "regularly engaged in business", which suggested a single transaction could constitute regular engagement in the business of leasing if it was a "proper component" of the business.[45] Instead, the Court applied a commonsense interpretation of the phrase that would exclude bailments where the bailor was not intending to profit from the lease.[46] It was unlikely that a syndicate that had merely entered into one arrangement was "regularly" bailing. Here, the bailor was paying the bailee to care for the horse. The bailment was excluded from the scope of s 16(1)(a) and since it agreed that it was not otherwise a security interest for the purposes of s 17, the PPSA did not apply.

[40] The Australian PPSA is much clearer than the New Zealand PPSA on this issue. It adopts the term "PPS lease" to include a lease or bailment.[47] Under s 12, the interests of a lessor or bailor of a PPS lease is deemed to be a security interest whether or not it "in substance" secures payment or performance of an interest. The Australian courts will not have to rely on the word lease to convey the concept of bailment as well. Section 13(2)(a) provides an express exception where the bailor is not regularly engaged in the business of leasing goods. Further, s 13(3) provides that the definition applies only to bailments where the bailee provides value. It is likely that this section was intended to exclude bailments where the bailee does not pay rent, although it might be argued that the word "value"

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45 *Rabobank* at [46]–[48]; See *David Morris Fine Cars Ltd v North Sky Trading Inc* (1994) 8 PPSAC (2d) 112 (ABAQ); aff'd *David Morris Fine Cars Ltd v North Sky Trading Inc* [1996] 7 WWR 332 (ABCA); *Paccar Financial Services Ltd v Sinco Trucking Ltd* (1987) 7 PPSAC 176 (SKQB) and *Karkoulas v Farm Credit Canada* (2005) 8 PPSAC (3d) 249, additional reasons at (2005) 9 PPSAC (3d) 142 (SKQB).

46 *Rabobank* at [40]–[41].

47 Personal Property Securities Act 2009 (Cth), ss 10 and 13.

includes a bailee who provides non-cash consideration. Section 10 defines "value" as "consideration that is sufficient to support a contract", which might mean that only purely gratuitous bailments are excluded by s 13(3). This could be used to justify departing from *Rabobank*, in that there seems to be a statutory indication that where consideration is paid by the lessee it will constitute a PPS lease. Further, the inclusion of the separate category of "bailments" at all might suggest that something other than a lease arrangement was intended to be caught.[48]

[41] The Australian courts may look to New Zealand's jurisprudence in interpreting the business exception to require that the bailor is actually intending to make a profit from the bailments and that there must be more than one such arrangement intended for it to be "regularly engaged" in this business. It is unfortunate that the Canadian and New Zealand courts appear to have parted ways in this respect, and, until a case is decided, it will not be clear what approach the Australian courts will adopt.

[42] For Australian practitioners seeking to get to grips with the effect of the Australian PPSA, the *Rabobank* decision highlights the importance of considering the PPSA implications of any lease or bailment agreement entered into and being aware of the deeming provisions of the PPSA. The Syndicate in *Rabobank* gave evidence that:

> The February Syndicate did not at the time nor has it ever owed any money to [the Stud Farm] or to Rabobank. ... Words like "security" never entered the discussions between [the Stud Farm] and the February Syndicate. We didn't even know that there was something called the Personal Properties Securities Act.

[43] The Syndicate were lucky that the business exception applied and they could avoid the effect of the PPSA. If it had not applied, they would have lost a million dollar horse for a failure to register a financing statement.

[44] In the event of bankruptcy, winding up or administration, the position of a holder of an unperfected interest is even starker under the Australian PPSA. Whereas the failure to perfect in New Zealand means the security is subordinated to perfected security interests,

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48 Note, however, that paragraph (c) of the definition of "grantor" in s 10 of the Australian PPSA refers to "a lessee under a PPS lease", rather than "a lessee or bailee under a PPS Lease". Contrast this with s 13 where the phrase "lessee or bailee" is used.

my understanding is that in Australia it will effectively relegate the security holder to being an unsecured creditor.

The Healy Holmberg Trading Partnership v Grant: priority by perfection?

[45] This case concerned the PPSA priority rules. The case involved the Healy Holmberg Trading Partnership (Healy) which agreed to make loans to LBD Civil Ltd (LBD), which LBD used to buy vehicles and equipment. On 29 January 2006, Healy registered a financing statement on the PPSR. Another creditor, RIGA Investments Ltd (RIGA) loaned LBD money and registered a financing statement on the PPSR on 9 August 2007. LBD was placed into voluntary liquidation on 17 April 2008. The liquidators asked for copies of Healy's security agreements. There was some delay before these were provided. The liquidators became suspicious and engaged a documents expert who deposed that the agreements had most probably been executed as a stack on 31 August 2007 and had been backdated (some to as early as 2005). The Court accepted that the agreements were signed, at the earliest, on 31 August 2007. The issue then was whether Healy had priority.

[46] The High Court held that "the greatest priority is given to a security interest holder who perfects first".[49] Since Healy had not executed security agreements before RIGA registered (it not being contested that RIGA had perfected its interest), RIGA had priority:[50]

> HH cannot claim that its time of registration is the time of priority pursuant to s 66 given its failure to comply with s 36 and the fact that, at the time of registration, there was no security agreement, oral or otherwise capable of being perfected. Therefore perfection pursuant to s 41 could only occur upon attachment pursuant to s 40, being the time that security agreement was reduced to writing as per s 36.

[47] Professor Gedye has suggested that, even accepting the factual findings, the views expressed by the Associate Judge on priority by perfection are incorrect.[51] He says that priority is not governed by perfection, but, most commonly, by registration under the residual priority rule in s 66(b)(i) of the PPSA. He says that if priority is determined by a first to perfect rule, then it undermines the purpose of the PPSA to provide clear and

[49] At [33].
[50] At [66].
[51] Mike Gedye "First to perfect?" [2011] NZLJ 123.

certain priority rules where the priority of creditors can be ascertained from a search of a centralised securities register.

[48] The priority provisions in the Australian PPSA follow substantially the same regime as that followed in the New Zealand and Canadian PPSAs. Under s 19(1)(b)(iii) of the Australian PPSA, the security interest is enforceable against third parties only if in writing.[52] But there is greater flexibility in the Australian provision for an act or omission to be used to confirm a term where the grantor has not signed the written agreement. The residual priority rules in s 66 of the New Zealand PPSA are reflected in s 55 of the Australian PPSA and are substantially the same.

Marac Finance Ltd v Greer: PPSA and the Land Register

[49] Another PPSA case that merits a brief mention is a High Court decision *Marac Finance Ltd v Greer*.[53] The case involved a mortgagee (Equitable) with a mortgage registered under the register set up by the Land Transfer Act 1952 and a financier (Marac) that had registered a general security interest over all present and after-acquired property of the debtor. Equitable had received all the rent paid since the debtor had gone into receivership. Marac sued saying it had priority and was thus entitled to the rent. The question was thus whether the first-ranking mortgagee trumped the first-ranking security interest under the PPSA. The Judge focused on s 23(e) of the PPSA, which provides:

> (e) An interest created or provided for by any of the following transactions:
>
> (i) The creation or transfer of an interest in land:
>
> (ii) A transfer of a right to payment that arises in connection with an interest in land, including a transfer of rental payments payable under a lease of or licence to occupy land, unless the right to payment is evidenced by an investment security:

[50] He concluded that s 23(e)(ii) excludes rent paid from the scope of the PPSA because rent is a right to payment that arises in connect with an interest in land.[54] This

52 Mirrors s 36 of the Personal Property Securities Act 1999 (NZ).
53 *Marac Finance Ltd v Greer* HC Auckland CIV-2010-404-4957, 17 March 2011.
54 At [38].

leaves priority in rental payments to be decided under the Land Transfer Register in the same way as would occur in any other contest as to priority between mortgages.[55]

[51] There is a similar provision in the Australian PPSA. Section 8(1)(f)(ii) of the Australian PPSA provides that the Act does not apply to "the creation of an interest in a right to payment, or the creation or transfer ... of a right to payment, in connection with an interest in land, if the writing evidencing the creation or transfer specifically identifies that land".

Toll Logistics (NZ) Ltd v McKay: common law liens under the PPSA

[52] Section 93 of the PPSA gives a super-priority to any common law lien. It provides:

> **93 Lien has priority over … security interest relating to same goods**
>
> A lien arising out of materials or services provided in respect of goods that are subject to a security interest in the same goods has priority over that security interest if—
>
> (a) The materials or services relating to the lien were provided in the ordinary course of business; and
>
> (b) The lien has not arisen under an Act that provides that the lien does not have the priority; and
>
> (c) The person who provided the materials or services did not, at the time the person provided those materials or services, know that the security agreement relating to the security interest contained a provision prohibiting the creation of a lien by the debtor.

[53] Subject to a number of conditions, the holder of a lien has priority over the holder of a perfected security interest.[56] The example given in the PPSA is where person A has a perfected interest in person B's car. B then takes it to person C, a mechanic, for repairs. If person C holds a common law lien over the car, that will trump person A's perfected interest.

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55 At [40].

56 Section 66 provides that a perfected security interest has priority over an unperfected security interest, and that first to register has priority, but it is a default rule. So a perfected security interest will be trumped by any other interest that is given priority by the Act, including a common law lien under s 93.

[54] In *Toll Logistics*, the issue was whether there was a common law lien that would give Toll priority before ASB, which held a perfected security interest.[57] Toll was a warehouse operator and provided a number of logistical services to Scene 1 Entertainment Ltd (Scene 1), including breaking down pallets, re-packaging and transporting. Toll held approximately 500,000 of Scene 1's DVDs, worth approximately $2.6 million, when Scene 1 was put into receivership. ASB was owed about $7 million and sought to recover some of this sum by selling the DVDs. Toll was owed about $280,000 and claimed that it had priority as it had a general packer's lien. The Court found that New Zealand courts have not recognised a packer's lien without proof of custom to support it, and that Toll had not so proved.[58] In so finding, the Court took its cue from a High Court of Australia case: *Majeau Carrying Co Pty Ltd v Coastal Rutile Ltd*, where the majority held that no general warehouseman lien arose in common law and that the evidence that it was custom in the Brisbane area did not support its existence.[59] This suggests that the Australian courts would also adopt an approach whereby Toll would not have priority under the PPSA.

[55] The Court also noted that to the extent Toll had entered into a contractual lien this displaces any common law lien, and would have meant that Toll did not have priority in any case. This is because only "liens... created by any other Act ... or by operation of law" are excluded from the scope of the PPSA.[60] Although the language of s 93 refers to "lien" this has to be read subject to s 23.

[56] The case is primarily interesting for the discussion of common law liens. From a PPSA perspective, it is one of only a few cases concerning s 93 and may be helpful to future courts seeking to interpret the section:[61]

> Section 93 of the PPSA may be viewed as a limited exception to the broad intention to codify the law of security interests in personal property. While the existence of common law liens was accepted by s 93 as an exception to this general intention, anything other than a cautious approach to the recognition of common law liens is not justified.

57 *Toll Logistics (NZ) Ltd v McKay* [2011] NZCA 188, [2011] 2 NZLR 601.
58 At [55].
59 *Majeau Carrying Co Pty Ltd v Coastal Rutile Ltd* (1973) 129 CLR 48.
60 Section 23(b).
61 At [60].

[57] The High Court has subsequently found a common law lien in at least one case. In *StockCo Ltd v Walker*, the Court found that StockCo's perfected security interest in stock was trumped by a common law lien held by Ms Walker, a third party who was grazing the stock.[62] The Court placed importance on the fact that the grazing contract expressly linked payment with her fattening the bulls up. It was not merely a contract of agistment, but one of improvement. The contract did not mention liens. Since Ms Walker had possession of the stock, she had a common law lien and was entitled to retain possession until payment of the money owed to her under the grazing contract.

[58] *Toll Logistics* is relevant in Australia since the applicable provisions of the Australian PPSA are substantially the same.[63]

Securities

Hickman v Turn and Wave Ltd: the meaning of "debt securities"

[59] This case[64] concerned the "Blue Chip" a property investment scheme that was also the subject of the Bartle litigation dealt with at another session of this conference.[65] The appeal concerned a certain scheme promoted by the Blue Chip group. The scheme sought investors who signed agreements to purchase apartments in Auckland as part of their investments with Blue Chip. The developers of the apartments were found to be independent of the scheme. The investors signed the sale and purchase agreements directly with the developers and signed an investment agreement with Blue Chip. The purchase was subject to a deed of nomination whereby Blue Chip undertook to lease out the apartments on behalf of the investor, with payment of the rent guaranteed by Blue Chip. The relevant Blue Chip companies collapsed. The developers then called on the investors to settle.

[60] The appeal raised a number of issues, but I will focus on the securities issues. The investors argued that both the investment agreements and the sale and purchase

62 *StockCo Ltd v Walker* HC Napier CIV-2011-441-110, 24 June 2011.
63 See ss 8, 73 and 140.
64 *Hickman v Turn and Wave Ltd* [2011] NZCA 100.
65 *Bartle* was another case resulting from the collapse of the Blue Chip group: *Bartle v GE Custodians Ltd* [2010] NZCA 174, [2010] 3 NZLR 601; overturned on appeal: *GE Custodians Ltd v Bartle* [2010] NZSC 146, [2011] 2 NZLR 31. I do not discuss it in this paper because it is the subject of another session at this conference.

agreements were void as the investment agreements constituted "debt securities"[66] under the Securities Act 1978. Since (as was common ground) there was no registered prospectus relating to the scheme, the offer and allotment of securities to the public would contravene the Securities Act and would be void.[67] To succeed, the investors also had to show that the Blue Chip investment agreements were not exempted from the Securities Act[68] and that the sale and purchase agreements could not be severed from the Blue Chip investment agreements and/or were tainted by their illegality and therefore void and of no effect.

[61] The offer of the Blue Chip scheme to the public could contravene the Securities Act only if the offer amounted to an offer of securities. Section 2D(1) defines security as "any interest or right to participate in any capital, assets, earnings, royalties, or other property of any person; and includes– ... (b) a debt security". Section 2 defines "debt security" as "any interest in or right to be paid money that is, or is to be, deposited with, lent to, or otherwise owing by, any person". The definition sets out a number of examples that are said to be included within the concept of debt security, such as debentures, bonds, notes, certificates of deposit and convertible notes. The Court found that "debt security" should be interpreted to cover situations where there is a repayment obligation on the offeror and that the "otherwise owing" reference had to be read as taking meaning from the preceding words, "deposited with" and "lent to". The examples included within the definition reinforced this. None of the agreements entered into with Blue Chip placed a binding obligation on Blue Chip to repay the amount paid by the investor. This factor was determinative in the Court's reasoning to conclude that they were not debt securities.

[62] The Court relied on a Privy Council decision in respect of New Zealand, *Culverden Retirement Village v Registrar of Companies*.[69] A retirement village offered to the public opportunities to purchase units in the village. It was a term of the sale and purchase agreement that upon ceasing to live in the unit, the village would buy it back at a set price. The transaction amounted to a debt security whereby the owner of the retirement village

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66 As defined by the Securities Act 1978 (NZ), s 2.
67 Securities Act 1978 (NZ) ss 33(1) and 37(4).
68 Section 5(1)(b).
69 *Culverden Retirement Village v Registrar of Companies* (1996) 1 BCSLR 162 (CA) at 166; [1997] 2 NZLR 257 (PC) at 261.

issued the occupier a right to be paid money on the eventual re-transfer of the unit.[70] The exemption in s 5(1)(b) for real estate did not apply since the buy-back condition was a "cardinal feature" of the transaction.[71]

[63] The Court went on to consider whether, if there had been debt securities, the agreements would be exempted under s 5(1)(b) as agreements "in respect of... any estate or interest in land". It held that it would not have been open to the issuer to rely on the exemption in respect of the agreements, following *Culverden*.[72] Any money due, as under the buy-back option, such as repayment of the deposits and payment of reasonable settlement costs, would not be exempted as they were unusual and important parts of the arrangement. However the leases would have been exempted, since they are not unusual and clearly related to land.

[64] Even if the appellants had succeeded in persuading the Court that some aspects of the Blue Chip scheme fell within the definition of "security" and that the exemptions in the Securities Act did not apply, they would still have needed to show that the sale agreements under which the investors bought the apartments were tainted by the illegality (non-compliant offers of securities). The Court upheld the High Court finding that there was no tainting. There was no evidence to show the sale agreements had as their purpose the promotion of the agreements said to contain the non-compliant offers of securities and the apartment developers (and sellers of the apartments) did not have actual or constructive knowledge of those agreements.

[65] Investors have applied for leave to appeal to the Supreme Court on the issues relating to the definitions of "security" and "debt security".

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70 The Securities Act has since been amended so that security interests in retirement villages are covered, see s 107(2) of the Retirement Villages Act 2003 and s 5(1)(b)(k) of the Securities Act.

71 At 260.

72 At [342], [349] and [351].

R v Steigrad: criminal liability under s 58 of the Securities Act

[66] *R v Steigrad* involved a challenge to the particulars of an indictment for one of five directors charged with breaches of the Securities Act following the collapse of one of New Zealand's finance companies, Bridgecorp Ltd, in 2007.[73]

[67] Mr Steigrad submitted that he had been wrongly charged under s 58 for prospectuses and investment statements that were accurate when first distributed and merely became untrue because of an intervening change of circumstance. The High Court accepted that distribution occurred once: at the initial act of making the document available. This was overturned by the Court of Appeal, which held that distribution may be continual and occur through the many different ways the information is available to the public. Each of these distributions may technically constitute a breach of s 58. Therefore information included in the prospectus and investment statement that subsequently became untrue did give rise to criminal liability under s 58. One strong factor supporting the Court's decision was the change in the wording of the legislation from the original "issued" to "distributed", suggesting a broader meaning was to be attached to "distributed" that would include continuing availability of the documents.[74]

[68] The Court recognised that its decision could be criticised by practitioners questioning the practicalities of refreshing an investment statement and prospectus each time the financial situation changes. To take one example from Mr Steigrad's case, one of the charges related to a claim in the prospectus that said Bridgecorp had never missed an interest payment or repayment of principal when due. Three months after its registration, this statement was no longer true. The decision places a positive obligation on directors (and their advisors) to continue monitoring the accuracy of the statements and prospectuses, particularly where the financial viability of the company takes a turn for the worse. The Court said:[75]

> Concerns about compliance costs on promoters and directors cannot be allowed to neuter what this Court has held to be the "broad statutory goal" of the

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[73] *R v Steigrad* [2011] NZCA 304; on appeal from decision of High Court: *R v Petricevic* HC Auckland CRI-2008-004-29179, 25 March 2011.
[74] At [98].
[75] At [114].

> S[ecurities]Act: facilitating "the raising of capital by securing the timely disclosure of relevant information to prospective subscribers for securities".

[69] But the Court also suggested that the defence of reasonable belief might be extremely important in this context, since only "reasonable" monitoring of the ongoing accuracy of statements would be required.[76] Careful consideration of what is reasonable on the facts of each case will be required. Moreover, the no fault defence should ensure that directors are not held responsible for breaches of the Securities Act that occur after they have resigned, but relating to statements they authorised that were correct at the time.

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76 Testing of the scope of this defence has already generated a number of interesting cases in the New Zealand context, the most recent of which being the successful prosecution of the directors of failed finance firm Nathans Finance Ltd: *R v Moses* HC Auckland CRI-2009-004-1388, 8 July 2011.

28th Annual Conference of the Banking and Financial Services Law Association
4-6 August 2011

Australian and New Zealand Case Law Update – Australia

Robert McDougall[*]

1 One of the difficulties of the topic is that it involves much reading and analysis, but provides little of general application. Bearing that in mind, I propose to spend most of my time discussing the decision of the Full Court of the Federal Court of Australia in *Leveraged Equities Ltd v Goodridge*[1].

2 The significance of that decision lies partly in what it has to say about assignment and novation of commercial agreements (or, more accurately, of rights and obligations under commercial agreements), and partly from the fact that the High Court of Australia has dismissed an application for special leave to appeal, although without endorsing all aspects of the reasoning of the Full Court[2].

3 To the extent that time permits, I will move to a very recent decision of the Court of Appeal of the Supreme Court of Queensland, *Platinum United II Pty Ltd v Secured Mortgage Management Ltd (in liq)* [3] (dealing with the question of whether there is any obligation to make discretionary advances under a commercial loan facility agreement), the decision of the High Court in *Public Trustee of Queensland v Fortress Credit Corporation (Aust) 11 Pty Ltd* [4] (dealing with the question of whether the conversion of an

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[*] Judge, Supreme Court of New South Wales.

I acknowledge with thanks the contributions of my tipstaff, Ms Karen Petch and of the tipstaff to the Honourable Justice Barrett, Mr Nicholas Mirzai, to the preparation of this paper.

[1] [2011] FCAFC 3.
[2] [2011] HCATrans 154.
[3] [2011] QCA 162.
[4] [2010] HCA 29; (2010) 241 CLR 286.

existing unsecured liability into a secured liability 'varied' the terms of, and the rights and liabilities arising under, an existing charge or created a new charge), the decision of the Court of Appeal of New South Wales in *International Litigation Partners Pte Ltd v Chameleon Mining NL* [5] (dealing with the question of whether a litigation funding agreement is a financial product, derivative, or a credit facility) and, perhaps, some recent single judge decisions: *Brighten Pty Limited v Bank of Western Australia Limited*[6]; *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd*[7]; *Re Australian Property Custodians Holdings Ltd; ex parte Horne*[8]. Once all that has been done, I will turn to the wider lessons that may be derived from the cases.

***Goodridge*: the facts, the issues and the decision at first instance**

4 Mr Ross Goodridge, a barrister, made a margin lending loan and security agreement ("LSA") with Macquarie Bank Limited in May 2003. As one would expect, the LSA contained provisions permitting Macquarie to make a margin call on short notice, and authorising Macquarie to sell securities if the margin call was not satisfied within the specified time.

5 Initially, Mr Goodridge used the facility to acquire shares in listed companies. However, by late 2008, his "portfolio" consisted of only one investment: more than 5,600,000 units in the Macquarie Countrywide Trust ("Trust").

6 In January 2009, Macquarie sold its margin loan book to the appellant Leveraged Equities Limited. The transaction was, and the documents pursuant to which it was effected were, complex. There was an intermediate sale of the assets to BNY Trust Company of Australia Ltd and an on-sale to Leveraged Equities.

[5] [2011] NSWCA 50.
[6] [2010] NSWSC 133
[7] [2010] NSWSC 233
[8] [2010] VSC 492

7 A month later, on 5 February 2009, Mr Goodridge's assets in the Trust had a market value of a little of $1,000,000.00, and his loan balance was about $860,000.00. Leveraged Equities made a margin call on 5 February 2009. Mr Goodridge made arrangements to satisfy that margin call by directing an imminent distribution from the Trust, of the order of $174,000.00, to be credited to Leveraged Equities in satisfaction of the margin call. For reasons beyond Mr Goodridge's control, those instructions were not carried out, and the distribution was paid into his cash management account. That did not matter a great deal, because Leveraged Equities was able to, and did, draw on that account in satisfaction of the margin call.

8 By 23 February 2009, the market value of units in the Trust had dropped further. It is clear from the findings of the primary judge (Rares J) that officers of Leveraged Equities were becoming uncomfortable with its exposure to Mr Goodridge and his single-security portfolio[9]. On 23 February 2009, Leveraged Equities made what it said were two margin calls: one, by email sent at 2:05pm; and the other, by email sent at 6:29pm. There was an intermediate email (sent at 3:57pm) confirming the earlier margin call and asking how it would be satisfied.

9 The principal issues before the primary judge (leaving aside issues as to the efficacy of the arrangements made between Macquarie and BNY, and questions of unconscionable conduct) were in substance:

(1) did the transactions and transaction documents between Macquarie, BNY and Leveraged Equities effect an assignment and novation of the contract between Mr Goodridge and Macquarie, so that Mr Goodridge and Leveraged Equities became parties to a contract on the terms of the LSA, and so that Leveraged Equities was able to enforce the relevant provisions of the LSA against Mr Goodridge?

(2) Were the asserted margin calls made on 23 February effective (or was either of them effective), so that Mr Goodridge was required to comply with them according to their terms?

(3) Regardless of the efficacy of the margin calls, was Leveraged Equities in any event entitled to sell units in the Trust so as to bring Mr Goodridge's loan balance into compliance?

10 Clause 21.2 of the LSA provided that Macquarie could assign, transfer, novate or otherwise deal with in any manner all or any part of the benefit of the LSA and any of its rights, remedies, powers, duties and obligations under it, to any person, "without the consent of the Borrower".

11 Somewhat mysteriously, despite the width of cl 21.2, cl 21.4 authorised Macquarie or its assignee or transferee "to assign its rights and novate its obligations under this Agreement, or any part of this Agreement, to any trustee or manager of any securitisation programme".

12 On 7 January 2009, Macquarie made a "Transfer Proposal" to BNY, as acquiring trustee. By cl 5 of that proposal, once BNY held the benefit of the "Assigned Assets", Macquarie thereupon and without the need for any further act assigned all its legal right, title and interest in those assets to BNY.

13 By cl 6 of the proposal, the parties agreed that with effect on and from the "Assignment Date", BNY "will assume the duties, obligations and liabilities of MBL under or in respect of each Assigned Asset".

14 Put simply, the case for Leveraged Equities was that cl 21 of the LSA authorised assignment and novation, and that this was precisely what was effected by the transfer proposal of 7 January 2009.

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[9] *Goodridge v Macquarie Bank Limited* [2010] FCA 67 at [35] and following.

15 Then, on 8 January 2009, BNY as "outgoing trustee," Leveraged Equities as "incoming trustee" and another company associated with Leveraged Equities and its parent as "manager" entered into a "Deed of Termination and Appointment", the effect of which was intended to be that Leveraged Equities would become trustee of the trust (of which the assigned assets, including Mr Goodridge's LSA, were assets) in place of BNY.

16 Leveraged Equities' case was that the 8 January deed had the effect of assigning and novating to it, as incoming trustee, the benefits and obligations accruing and arising under the assigned assets, including Mr Goodridge's LSA.

17 There was an issue as to notice. It is not necessary to deal with this.

Reasoning: novation

18 Rares J considered the question of novation[10]. The steps in his Honour's reasoning were, in substance:

(1) it is essential for the existence of a contract that there be a voluntary assumption by each party to it of a legally enforceable duty to the other [11]: *Australian Woollen Mills Pty Ltd v The Commonwealth*[12]; *Ermogenous v Greek Orthodox Community of SA Inc*[13].

(2) Novation is the making of a contract between A and C in consideration of the discharge of a previous contract made between A and B, so that under the new contract C assumes the obligations to A that B had under the earlier contract[14]: *Olsson v Dyson* [15].

[10] At [87] and following.
[11] At [104].
[12] (1954) 92 CLR 424 at 457.
[13] (2002) 209 CLR 95 at 105 [24] – [25].
[14] [2010] FCA 67at [106].

(3) There are no particular formal requirements to achieve a novation; and it may be sufficient if the relevant intention (objectively ascertained) can be spelled out of several contractual documents, or several clauses in the one contractual document[16]: *Federal Commissioner of Taxation v Sara Lee Household and Body Care (Australia) Pty Ltd*[17].

(4) Because novation is a transaction by which all parties to a contract agree that a new contract is substituted for an existing contract, and involves the extinguishment of one set of obligations and the creation of substituted obligations, intention (express or implied) is crucial to show novation[18]: *Fightvision Pty Ltd v Onisforou*[19].

(5) Accepting that, in searching for intention to novate, the court should not take a narrow or pedantic approach, particularly in the case of commercial arrangements[20], nonetheless there was here no consent from Mr Goodridge to became a party to a new contract, because the prospective consent given by cl 21 did not identify any such new contract[21].

(6) By cl 21, Mr Goodridge authorised Macquarie to act on his behalf to bind him to a novated contract with a third party[22]; but in this case there was as a matter of fact no novation from BNY to Leveraged Equities[23], so that even if there had been a novation of the LSA from Macquarie to BNY, there was no further novation from BNY to Leveraged Equities.

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15 (1969) 120 CLR 365 at 388 – 391 (Windeyer J).
16 [2010] FCA 67 at [108].
17 (2000) 201 CLR 520 at 532 – 533 [16-18].
18 At [112].
19 (1999) 47 NSWLR 473 at 491-492 [78].
20 [2010] FCA 67at [112], citing *Fightvision* at 493 [86] and *Upper Hunter County District Council v Australian Chilling and Freezing Co Pty Ltd* (1968) 118 CLR 429 at 437.
21 At [116].
22 At [117].
23 At [119] presumably referring back to [89] and following.

(7) Consent to any novation or assignment should not be implied from the events of February 2009[24].

Reasoning: assignment

19 Rares J dealt with the question of assignment separately from the question of novation: not surprisingly, since novation deals with what is in substance the transfer of the burden of contractual obligations from one person to another, whereas assignment deals with the transfer of property, namely the thing in action constituted by the benefit of a contractual promise.

20 Rares J started with the proposition that there was a distinction between "the nature of an assignment" on the one hand, and "the consequence of giving notice of the assignment" on the other[25]. No question of notice, or for that matter of effect in equity in the absence of notice, can arise unless there is something capable of being categorised as an assignment: namely, "an immediate disposition of a legal or equitable right, title or interest"[26].

21 The primary reason that Rares J gave for rejecting the respondents' case based on assignment was that the rights and obligations under the LSA were so interconnected that the rights were incapable of separate assignment. This arose, his Honour held, because the LSA did not provide for "a static or unchanging liability due by Mr Goodridge to" Macquarie, but included, whilst there was no default, a right to "draw down further on the margin loan up to [the] limit" if there were sufficient security[27]. Because, in his Honour's view, there had been no novation of Macquarie's obligations under the LSA to Leveraged Equities, the consequence of any assignment would have been a "tripartite putative relationship in which there w[as] one lender, [Macquarie], and a different assignee creditor, Leveraged Equities": a situation which was "byzantine to

[24] At [122] - [124].
[25] At [168].
[26] Ibid.
[27] At [175].

say the least"[28]. That produced, in his Honour's view, an "unworkable situation"[29] and hence, a situation in which it was "impossible… to bifurcate the lending obligations and rights"[30].

22 Thus, whilst "the courts should strive to give effect to commercial dealings and contracts"[31], there could be no "separation of [Macquarie's] existing legal right to a debt and supporting security owed by Mr Goodridge from its continuing obligation to lend to him"[32]. Thus there was no effective assignment.

23 His Honour also held, as a question of fact, that no notice of the assignment had been given, and thus, even if there were an assignment, it could not be effective at law because the requirements of s 12 of the *Conveyancing Act* 1919 (NSW) had not been satisfied[33].

Reasoning: the margin calls

24 The issues as to the efficacy of the margin calls said to have been made on 23 February 2009 turned in large part on cll 5.1 and 5.2 of the LSA. Those provisions had been amended, pursuant to Macquarie's unilateral right to do so subject to the giving of notice (which Rares J found had been done)[34]. By cl 5.1, if the total loan balance exceeded or in Macquarie's opinion was likely to exceed the aggregate of the "Market Based Limit" (of the securities) and the "Buffer", then Macquarie might in its discretion require Mr Goodridge to pay a sum up to the amount by which the total loan balance exceeded, or was likely to exceed, the market based limit. By cl 5.2, Mr Goodridge was required to comply with any such margin call by 2:00pm on three business days after it was made "unless otherwise notified by Macquarie Bank Limited in its absolute discretion".

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28 At [177]; see also at [184].
29 At [188]; see also [177] and [184].
30 See at [192].
31 At [196].
32 At [200].
33 At [147].
34 At [12].

25 The market based limit of the securities was derived by applying a lending ratio (which might vary from time to time) to the market value of the underlying securities at any given time; and the buffer was a percentage of that market based limit as determined by Macquarie from time to time. By cl 7.1 of the LSA, Macquarie had the right to require Mr Goodridge to make payments due under the LSA in any manner that Macquarie might determine, "including by way of a direct debit authority". A direct debit authority was indeed given by Mr Goodridge: in his application form.

26 The first margin call (in view of the conclusions of the Full Federal Court, I will not refer to the "purported" or "alleged" margin calls) specified an amount a little over $130,000.00, and asked Mr Goodridge to advise "how this will be satisfied by 2:00pm tomorrow". The second margin call made on 23 February, for a little over $190,000.00, specified that the amount of the margin call "must be satisfied by COB tomorrow" and asked Mr Goodridge to advise how this would be done.

27 It was Mr Goodridge's case, which Rares J accepted, that had he been given the time specified by cl 5.2 of the LSA to meet the margin calls, he could have raised the necessary funds by way of loan[35]. The issue was whether, on its proper construction, cl 5.2 of the LSA authorised Leveraged Equities to require that the amount of a margin call be paid in less than the stipulated time. Rares J held that it did not[36]. His Honour gave several reasons:

(1) the obvious meaning of the concluding words of cl 5.2 was to excuse Mr Goodridge from compliance if the lender so determined; i.e, if the lender told him that he need not comply within the time specified[37].

[35] See at [62].
[36] At [64] for the reasons following at [65] to [72].
[37] At [66].

(2) The construction for which Leveraged Equities argued did not fit with the other provisions of the LSA, specifically with the right given to Mr Goodridge to satisfy any margin call by providing further security by 2:00pm on the following business day[38].

(3) Clause 5.2 did not in express words authorise the lender to fix a shorter time for compliance; and the construction for which Leveraged Equities contended was inconsistent with explanations given to Mr Goodridge and other borrowers when cl 5.2 was amended. As his Honour said, "[t]he right of a banker to require a customer to pay a debt on demand is significantly different to its right to require the customer to pay the debt after… a particular period of notice"[39].

Reasoning: cl 5.7

28 Clause 5.7 of the LSA gave rights, which appeared to be in addition to those arising under cll 5.2 and 5.4 following a margin call. For convenience, I set out cl 5.7, and the following subcl, cl 5.8:

> 5.7 Without limiting the Bank's rights following a Margin Call, if at any time the Total Loan Balance exceeds the aggregate of the Market Based Limit and the Buffer, the Borrower and the Securities Owner irrevocably authorise the Bank (and its officers and agents), as their respective several attorney, to sell or redeem (at the Bank's discretion) all or any part of the Secured Property as would produce sufficient funds to enable the Borrower to satisfy a Margin Call. If it becomes necessary to sell Securities which are listed for quotation on the ASX, such Securities may be sold through any broker nominated by the Bank at the broker's prevailing private client brokerage rates.
>
> 5.8 The Borrower is responsible for monitoring the Total Loan Balance and the Market Based Limit and is liable for payment of any Margin Call at the time at which the relevant Margin Call arises, irrespective of when or whether or not any notice to pay a Margin Call is given by the Bank.

[38] At [67], [69] – [70].
[39] At [68].

29 Leveraged Equities submitted before Rares J and the Full Court that cl 5.7 gave an independent right to sell securities at any time after a margin call had been made, regardless of whether the time for compliance with the margin had arrived. Rares J rejected that argument, because "[i]t produces a very unreasonable and uncommercial result"[40]. That uncommercial result arose, his Honour held, because, following a margin call, Mr Goodridge had various alternative ways that he could satisfy it; and an immediate sale would cut across the exercise of those rights[41].

30 Thus, his Honour concluded, cl 5.7 operated only when the time for compliance with a margin call had arrived and Mr Goodridge did not comply[42]. His Honour observed that the LSA was "a carefully drawn document that, in general, offers broad rights and powers to the Bank, which drafted it"[43]. As his Honour pointed out, if the drafting did not do what the lender wanted then it could protect its position by redrafting its terms; the court should not go beyond the ordinary and natural meaning of the words used in an attempt to give even wider powers to the lender[44].

The decision of the Full Court

31 The principal judgment was given by Jacobson J. Finkelstein J agreed with Jacobson J, as did Stone J. However, Stone J made "some short additional observations". It is convenient to start by pointing out her Honour's criticisms of the documentation:

> This appeal turned in large part upon issues of construction which would not have arisen had the Loan and Security Agreement (LSA) been competently drafted. As Jacobson J has commented, the difficulties in this litigation owe much to the fact that the language used in the documentation of the contractual arrangements between the parties lacks clarity. It is difficult to understand how the imprecision and ambiguity of

40 At [74].
41 At [75] – [76].
42 At [77].
43 At [82]
44 At [82].

> the documentation could have escaped the scrutiny of competent and sophisticated parties and their advisors. Some few examples will suffice to make the point[45].

32 As her Honour pointed out, "any uncertainty on the point could have easily have been avoided by an explicit reference to the lender's right to require compliance within a period of less than 3 days". Again, as her Honour pointed out[46], the issues under cl 5.7 "would not have arisen had this clause explicitly referred to the fact that a lender could [sell the borrower's securities] without giving notice to the borrower and without making a margin call".

33 It is easy to be wise after the event, but it cannot be said that the wording of the relevant provisions of the LSA was clear and unambiguous. Where parties negotiate a contract on equal terms, and without any suggestion of a vitiating factor, they may bargain for such terms as they wish; and as the decision in *Platinum United*[47] makes clear, if an extremely one sided contract results from that process, the fact that it is one sided, and favours inordinately the interests of one party over the other, is not a bar to enforcement according to its terms (objectively ascertained).

34 There is an obvious interest in certainty. Parties to any contract should know, without the need for litigation, what are their rights and liabilities under it. Although that is true of all contracts, it is a matter of particular significance in substantial commercial contracts, particularly those which are used for numerous dealings (as here, between a bank and numerous borrowers). If a party to such a contract wishes to have strong rights, it should stipulate for them in clear and unambiguous language, so that the other party can accept or reject the proffered contract, depending on its assessment of the value of the benefits that might flow to it from acceptance. In short, confused and unclear drafting helps no one.

[45] At [3].
[46] At [6].

35 Since the point of this paper is not to give a lecture about Drafting 1.01, I will move on to the substance of the Full Court's decision.

Unconscionability

36 Perhaps the issue of unconscionability deserves first, but brief, mention. Mr Goodridge argued that ss 12CA and 12CB of the *Australian Securities and Investment Commission Act* 2001 (Cth) applied, and that the conduct of Macquarie and Leveraged Equities was either unconscionable under the general law (so as to fall within s 12CA) or unconscionable within the wider provisions of s 12CB. Rares J appeared to hold that the services provided to Mr Goodridge under the LSA were of a kind ordinarily acquired for personal, domestic or household use (s 12CB(5))[48]. That was because Mr Goodridge's stated purpose for entering into the facility was to provide for his retirement[49].

37 This issue was dealt with briefly in the Full Court. Jacobson J pointed out that when Mr Goodridge entered into the LSA, he had acknowledged that the funds would be applied wholly or predominately for business or investment purposes, and that his evidence as to subjective purpose was not relevant[50]. In any event, Jacobson J said, absent some conduct on the part of Leveraged Equities or Macquarie which amounted to taking improper advantage of Mr Goodridge (and, in his Honour's view, there was no such conduct), there was nothing unconscionable in Leverage Equities' protecting itself against a fall in the value of its securities by exercising the legal rights given to it for that very purpose[51].

38 The first reason given is sufficient to dispose of the case based on s 12CB. The second can only relate to the case based on s 12CA, and on the general law concept of unconscionability which that section picks up. It

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[47] [2011] QCA 162
[48] [2010] FCA 67 at [211].
[49] See at [211], [210].
[50] [2011] FCAFC 3 at [416].
[51] At [417].

may very well be correct; but it is, if I may say so, an extremely summary way of disposing of what in many cases is a complex factual question[52].

Reasoning: novation

39 In relation to novation, the Full Court departed from the reasoning of Rares J in two respects. First, and to the extent that Rares J had concluded that it was not possible for one party to a contract prospectively to authorise the other party unilaterally to novate it[53], the Full Court said that his Honour's approach was wrong in principle[54]. Secondly, to the extent that Rares J had not entirely rejected the possibility of prospective consent to novation, but had held that the contract to be created by novation was one "on uncertain and unidentified terms, or was not sufficiently identified[55], the Full Court thought that sufficient certainty was given by the wording of cll 21.2 and 21.4 of the LSA[56].

40 I start with the question of principle: is possible, by appropriate contractual drafting, to give prospective consent to a novation so that, when the novation is effected, it is binding on the person who gave the consent?

41 It is not entirely clear that Rares J had answered the question that I have just stated at the level of principle. I have summarised the steps in His Honour's reasoning at para 18 above. His Honour was sceptical of the proposition for which Leveraged Equities contended: that there could be prospective consent, or the waiver of any need to consent, to novation[57]. In the following paragraphs, Rares J expressed doubt that there could be a novation without actual consent to the proposed transaction[58]. However, the essence of his Honour's reasoning was that neither clause of the LSA

[52] I note that when the High Court refused special leave to appeal, it expressed no view on this aspect of the Full Court's reasoning: [2011] HCATrans 154 at [7].
[53] See [2010] FCA 67 at [103], [106].
[54] [2011] FCAFC 3 at [302] – [317]
[55] [2010] FCA 67 see at [120] (from which the quoted words come), [116].
[56] [2011] FCAFC 3 at [328] for the reasons given from [318] - [328]
[57] [2010] FCA 67 at [100].
[58] At [101]-[102]

relied upon, cl 21.2 or cl 21.4, "gave the bank authority to novate to any person without Mr Goodridge's consent"[59].

42 Thus, as Moore-Bick LJ pointed out in *Habibsons Bank Ltd v Standard Chartered Bank (Hong Kong) Ltd*[60], it does not appear that Rares J entirely rejected the possibility that there could be advance consent to a novation[61]. On a close reading, it may well be that all that Rares J was saying was that, if this were possible, it did not occur in the present case: particularly because the subject matter of the postulated novation was too nebulous or uncertain to form the basis of a contract by novation. (Hence, I think, the need for Rares J to deal with and distinguish the old case of *Carlill v Carbolic Smoke Ball Co*[62], dealing with acceptance of offers to all the world and the creation thereby of a contract without the offeror's knowing of the acceptance. His Honour contrasted this situation with "[t]he nebulous words of cll 21.2 and 21.4" which did not, in his Honour's view, identify any particular contractual relationship or consideration for a novation"[63].)

43 Certainly, in *Habibson's Bank* at first instance, Cooke J thought that Rares J had denied the proposition that a party to a contract could consent in advance to its novation, saying that this view was "wholly uncommercial", a "purist point", and contrary to the proper development of the law of contract[64].

44 The Full Court pointed out that there was authority contrary to the view expressed (at least tentatively) by Rares J on the question of principle. One was the decision of Finn and Sundberg JJ in *Pacific Brands Sport and Leisure Pty Ltd v Underworks Pty Ltd*[65]. Their Honours there stated, admittedly by the way, a number of "relatively non-contentious

59 At [103].
60 [2010] EWCA Civ 1335.
61 At [22].
62 [1893] 1 QB 256.
63 At[120].
64 *Habibson's Bank Ltd v Standard Chartered Bank (Hong Kong) Ltd* [2010] EWHC 702 (Comm) at [28].
65 (2006) 149 FCR 395.

propositions"[66] in relation to novation. One of those was that whilst novation will ordinarily require the agreement of the parties to the novated contract, the original contract might, on its proper construction, authorise one party to put another contracting party in its place without the need for further express agreement.

45 Further, in *Argo Fund Ltd v Essar Steel Ltd*[67], Aikens J observed that it was possible to create a fresh contract by novation of an existing contract, without the need for further express agreement, where the original contract itself contained the mechanism (advance consent) for that to occur[68].

46 Jacobson J referred to these and other authorities, and concluded that if Rares J had intended to answer the question of principle in the negative, he was in error[69]. In other words, the decision of the Full Court is authority for the proposition that, in principle, a properly drafted novation provision in a contract may enable one party to replace itself with a substituted party by novation, without the need for further consent from, or a fresh tripartite contract involving, the other party.

47 Jacobson J moved next to the terms of cll 21.2 and 21.4[70]. The question essentially was whether the subject matter of the novation was sufficiently defined, in the LSA, to give content to any advance consent which Mr Goodridge had given by the terms of cl 21.2.

48 I should step aside for a moment and note that the words used by cl 21.2 were that the lender could assign, transfer, novate and otherwise deal with all or any part of the benefit of the LSA, and any of its rights, remedies, powers, duties and obligations under it, "without the consent of" Mr Goodridge. It may sound a little strange to talk of a clause which purports to authorise something to be done without consent as being a clause in

[66] At [32]
[67] [2005] 2 Lloyds Rep 203.
[68] At [50], [51].
[69] [2011] FCAFC 3 at [302] and following.
[70] [2011] FCAFC 3 at [318] and following.

which consent is given to the doing of that thing. This semantic difficulty is perhaps more apparent than real. I think the better view of cl 21.2, in so far as it referred to the specified acts being done without the consent of Mr Goodridge, is that it meant without his express consent to any of those acts, given at the time they were undertaken or proposed to be undertaken. Put shortly, cl 21.2 effectively operates as giving consent by Mr Goodridge to the specified acts being performed or undertaken by Macquarie in the future without his further express contemporaneous consent to those acts. It is in this, somewhat perplexing, sense that I suggest that cl 21.2 gave Mr Goodridge's advance consent to any future assignment, novation or dealing falling within it.

49 Coming back to the reasoning of Jacobson J: it is clear that his Honour found the language of cll 21.2 and 21.4 less than satisfactory[71]. The ultimate question, as his Honour identified, was whether cll 21.2 and 21.4 sufficiently described, as his Honour said, what it was to which prospective consent had been given[72]. Jacobson J answered that question by saying that Mr Goodridge consented, by the mechanism of cl 21.2, "to the introduction of a new lender who was substituted for Macquarie on the same terms and conditions as the LSA" [73]. Thus, his Honour concluded, there was no uncertainty about the terms and conditions of the new contract to which Mr Goodridge had in advance consented to be a party[74].

50 If I may say so, with respect, this conclusion involves some creative interpretation. Clause 21.2 was not limited (and hence cl 21.4 was not limited) to a novation of the whole of the LSA. As I have now noted twice, what could be assigned was the whole or any part of the benefit of the LSA. What could be novated was any or all of Macquarie's rights, remedies, powers, duties and obligations under the LSA. On its face, cl 21.2 contemplated that there could be assignment of some only benefits, and novation of some only obligations. How one proceeds from there to

[71] See at [320] and following, noting in particular [322] and [324].
[72] At [325].
[73] At [327].
[74] At [328].

say that, on its proper construction, cl 21.2 is limited to authorising in advance novation of the whole of the LSA is not explained. Perhaps I should not dilate on this point, for fear of being found to be another purist who has wholly uncommercial views inconsistent with the proper development of the law of contract.

Reasoning: assignment

51 The Full Court held that the relevant rights were assignable. This arose, in their Honours' view, because "the question is essentially one of construction of the contract"[75], and the express provisions of the LSA specifically provided for the assignment of all or any part of the benefit of the LSA, and all or any rights, remedies, and powers there under, without the consent of Mr Goodridge[76].

52 Thus, according to the Full Court, on the proper construction of the relevant terms of the LSA, the alleged inseverability of right and obligation was not a reason for denying assignability. The conclusion that the rights were capable of assignment meant, necessarily, that the assignment that was effected, was valid at least in equity, because there is no requirement for notice to perfect an equitable assignment (notice is of course relevant to questions such as priorities, and to whether the assignment is effective in law)[77].

53 The Full Court concluded, contrary to Rares J, that notice of the assignment had been given. There was evidence of "a reliable system for despatching documents… and evidence that the system was followed"[78] and "no evidence that the letters were returned, or of any defect in the system"[79].

[75] At [363].
[76] At [357], referring in particular to cl 21.2 of the LSA.
[77] At [386].
[78] At [397]
[79] At [397].

54 Thus, the statutory presumption of delivery, flowing from (among other things) s 160 of the *Evidence Act* 1995 (Cth) was raised unless there was some reason to raise a doubt about the presumption; and there was no such reason[80].

55 Thus, on the view taken by the Full Court, the assignment was effective at law as well as in equity.

Reasoning: the margin calls

56 Jacobson J commenced his discussion of the proper construction of cl 5 by referring to the nature of the relationship between Macquarie and Mr Goodridge. Rares J had characterised that relationship as being one of banker and customer[81]. However, Jacobson J said, the relevant relationship was that "of lender and borrower under a special form of revolving credit facility…"[82]. Thus, his Honour said:

> The proper construction of cl 5 is therefore informed by the fact that the parties to the LSA were parties to a margin lending agreement under which both borrower and lender had substantial exposure to movements in the market price for the securities which formed Macquarie's security for the advances[83].

57 Against that background, Jacobson J said:

> Clause 5 was one of a number of provisions in the LSA which were intended to give protection and assurance to the lender that the loan would be repaid in full despite the volatility and unpredictability of markets for listed securities[84].

58 Further, his Honour said:

> A deterioration in the market price was intended to be at the risk of the borrower and the provisions of cl 5 were intended to protect the lender against that risk by imposing an obligation to satisfy

[80] At [400].
[81] [2010] FCA 67 at [77].
[82] [2011] FCAFC 3 at [138].
[83] Ibid.
[84] At [139].

> margin calls in accordance with the terms of that clause. Thus the risk of deterioration in the market was transferred to the borrower by the entitlement of the lender to make a margin call. The price of a failure to satisfy a call was that the borrower was in default under cl 13... [85].

59 All this may be accepted. But it may be accepted, equally, that one of the purposes of cl 5 was to provide the borrower, Mr Goodridge, with time to meet a margin call and a variety of ways in which he could do so. The first of those matters is shown most clearly by the amendment to cl 5.2 in April 2004[86], increasing the period for satisfying a margin call from 1 to 3 business days. The second is shown by clauses such as 5.3 and 5.4 (a margin call may be satisfied by the provision of additional securities) and 5.5 (a margin call may be satisfied by payment of cash)[87].

60 To say that cl 5 is intended to protect the lender against a decline in the market value of the underlying securities is true enough. But that simple statement does not recognise, let alone do justice to, the range of subjects with which individual subclauses of cl 5 are concerned. Read as a whole, it is clear from cl 5 that, although the balance may well be tilted in favour of the lender, nonetheless it contains important rights that are intended to provide some degree of assurance for a borrower, in the position of Mr Goodridge, faced with a sudden drop in the value of his securities.

61 Jacobson J observed that cl 5 was not "expressed in a way which leaves it free from debate"[88], and thus that it was "the failure of the draftperson(s) of the scheme to express it in the clarity of language which ought to be expected from such a document, that give rise to the difficulties which have arisen in this litigation"[89].

62 His Honour then set out, in summary form, the elements of cl 5, including the rights (or perhaps more alternatives) that it gave to Mr Goodridge to

[85] At [142].
[86] To which Rares J referred at [2010] FCA 67 at [12].
[87] Rares J referred to those clauses at [14].
[88] [2011] FCAFC 3 at [151].
[89] At [152]

satisfy any margin calls[90]. He observed, as Rares J had done, that there were different time limitations within the different subclauses of cl 5, and stated that those inconsistencies bore on the question of construction[91].

63 Jacobson J then turned specifically to cl 5.2[92]. That clause too, his Honour said, involved difficulties. As his Honour said:

> The discretion conferred on the lender to "otherwise notify" the borrower is of wide import but it is silent as to whether the lender may notify the borrower of a shorter period for compliance than the three business days specified in the operative part of the clause[93].

64 In his Honour's view, there were three reasons why cl 5.2 did so operate:

(1) first, restricting the proviso to extension of time would be make it otiose because a lender in Macquarie's position could always, as a matter of discretion, extend the time for compliance with any contractual obligation owed by a borrower[94].

(2) Secondly, his Honour said, the form that cl 5.2 now bears was introduced by way of amendment. The effect of the amendment was to increase the time for compliance from one business day to three. As cl 5.2 was drafted originally, there was no proviso to "otherwise notify". (This may be seen as also supporting the first of his Honour's reasons.) Thus, the extension of the time for compliance from one business day to three "unless otherwise notified" suggests, his Honour said, that the purpose of the proviso, and its meaning, was to permit Macquarie to reduce the time for compliance if it wished to do so[95].

[90] At [153] and following.
[91] At [161].
[92] At [167] and following.
[93] At [167].
[94] At [169]
[95] At [171].

(3) Thirdly, his Honour said, that construction of the proviso gained some support from the commercial purpose and objects of the transaction, and of cl 5 as one of the stipulations giving effect to the transaction: harking back to what his Honour had said as to the protections that cl 5 was intended to assure to Macquarie[96]. His Honour supported this by reference to authority; it is not necessary to go to the cases to which his Honour referred.

65 His Honour recognised that when cll 5.2 and 5.4 were read together, inconsistency arises if cl 5.2 is construed so as to permit Macquarie, should it wish to do so, to require a margin call to be paid on demand[97]. But his Honour said that this was not the issue; the issue was whether the proviso to cl 5.2 had that effect. If I may say so, there is an element of circularity in this aspect of his Honour's reasons.

66 Thus, Jacobson J concluded, the proviso to cl 5.2 should be construed in the manner for which Macquarie and Leveraged Equities contended. It followed that the margin calls were not ineffective because they did not allow three business days for compliance[98].

Reasoning: clause 5.7

67 Again, Jacobson J commented on the drafting of cl 5.7: his Honour did not consider it "to be entirely clear"[99].

68 However, as his Honour said, the condition for the exercise of the cl 5.7 power was different from the condition for the exercise of the cl 5.1 power (to make a margin call). The power conferred by cl 5.7 depended on the existence of an objective fact: namely, that the total loan balance exceeded the aggregate of the market based limit and the buffer. That is correct. But it may be said, equally, that cl 5.1 had two alternative

[96] At [172] and following.
[97] At [180].
[98] At [181].
[99] At [182].

conditions for the exercise of the power to make a margin call. One of those was, likewise, a matter of objective fact: that the total loan balance exceeds the aggregate of the market based limit and the buffer. The other, which was a true alternative, was that in Macquarie's opinion it was likely to do so[100].

69 Another point of difference identified by Jacobson J was that the power of sale conferred by cl 5.7 was narrower by that conferred in the event of failure to meet a margin call[101]. That is undoubtedly correct.

70 Jacobson J said that the differences between cll 5.1 and 5.7 suggested that cl 5.7 had different work to do[102]. The difficulty, his Honour said, was to determine when the power given by cl 5.7 was enlivened[103].

71 His Honour did not agree with the interpretation given by Rares J. That was because, in essence, Rares J held that Macquarie could only sell under cl 5.7 once Mr Goodridge had failed to meet a margin call[104]. But failure to meet a margin call was in itself an event of default and there was thus a right to sell without the need for cl 5.7. Presumably, as Jacobson J said (in my view correctly), cl 5.7 was not inserted into the LSA to deal with the consequences of failure to meet a margin call[105].

72 The real problem with cl 5.7 arose from its introductory words, which were followed by the power to sell or redeem the underlying securities. The clause read, in part:

> Without limiting the Bank's rights following a Margin Call, if at any time the Total Loan Balance exceeds the aggregate of the Market Based Limit and the Buffer, … the Bank… [is authorised] to sell or redeem… all or any part of the Secured Property as would

[100] At [183] and following.
[101] At [187] – [190].
[102] At [191].
[103] At [192].
[104] AT [194].
[105] At [199] - [200].

> produce sufficient funds to enable the Borrower to satisfy a Margin Call. …[106]

73 It will be seen that the concept of "Margin Call" appears twice: first, in the introductory words intended to preserve all other rights of Macquarie, and secondly in directing the extent of the authority to sell: namely, to produce enough money to meet a Margin Call.

74 Rares J had considered that the words "if at any time" which were the starting words of the grant of authority to sell had to be read in conjunction with the immediately preceding words "following a Margin Call", and thus concluded that the power to sell was only enlivened once a margin call had been made. Jacobson J said that this approach transposed the language of the clause and read it in a syntactically inconsistent way[107]. His Honour pointed out, and I agree, that the words "if at any time" qualify the circumstances in which the power to sell is enlivened.

75 However, the real difficulty arises from the purpose for which the power of sale is given: to produce enough funds to satisfy a margin call. As I understand the reasoning of Jacobson J, his Honour considered that those words referred to a margin call whether or not it had been communicated. That view appears to have based on the circumstance that a margin call could be made where the total loan balance exceeded the aggregate of the market based limit and the buffer.

76 I have to say that this approach to construction is not without its difficulties. I do understand that the "*contra proferentem*" rule is not in fashion these days, and that there are good reasons why this is so. But, equally, it is a little difficult to understand why a power given for the purpose of satisfying a margin call can be exercised even where, although the right to make a margin call has been enlivened, no such call has been made.

[106] At [5]
[107] At [196].

77 That is, perhaps, a way of pointing out the real difficulties of reconciling the inconsistent provisions with which cl 5, read overall, abounds. It is the court's duty, in construing such provisions, to attempt to read them harmoniously and to make sense of them all[108]. In the process of performing that aspect of the task of construction on cl 5, something or other has to give. If there were some residual room for the *contra proferentem* rule to operate, this might perhaps be an example where it should have been applied.

Platinum United v Secured Mortgage Management

78 This appeal concerned a commercial loan facility agreement made:

(1) to refinance an existing loan facility; and

(2) thereafter, at the discretion of the lender, to provide construction funding for a residential unit development.

79 The appellants (plaintiffs), the borrowers, sued the respondent (defendant) as lender, alleging that the respondent had breached its obligations under the agreement by failing to provide progressive funding for the cost of construction. The claim was struck out, on the basis that under the agreement the respondent had an absolute discretion whether or not to provide finance. The appellants appealed.

80 The argument focused on cll 2.2, 2.4 and 2.5 of the loan agreement, and with the interest obligation set out in cl 5.2.

81 By cl 2.2, the purpose of the loan was stated to be:

> …assisting with refinance of the existing loan facility and thereafter to provide, at the discretion of the Lender, progressive funding against the cost of construction of [the specified development]…

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[108] *Australian Broadcasting Commission v Australasian Performing Right Association Limited* (1973) 129 CLR 99 at 109 (Gibbs J).

82 By cl 2.4, the loan facility was to be "drawn in one lump sum and then made available to the borrower progressively…".

83 By cl 2.5.1, the balance of the "Cash Advance" (presumably, after refinancing the existing loan facility) was to "to be made available at the Lender's absolute discretion to be drawn down progressively by the Borrower".

84 By cl 5.2.1(f), interest was payable from the date of the first drawdown "on the full amount of the Cash Advance as if it had been drawn in one lump sum"; and that was so, as the paragraph stipulated, "[e]ven though the loan is drawn down progressively against the value of construction".

85 The "Cash Advance" was defined to mean the whole principal amount of the facility together with capitalised interest, costs and fees.

86 Fraser JA gave the principal judgment. Chesterman JA agreed, and Fryberg J agreed "generally".

87 Fraser JA noted that cl 2.5.1 conferred an "absolute discretion", and noted that it was implicit in the nature of an absolute discretion, to do or refrain from doing something, that the party on whom the absolute discretion was conferred had no obligation to act reasonably in its exercise[109]. However, his Honour said, the question in this case was a different one: namely, whether the discretion given was whether or not to provide progressive construction finance[110].

88 His Honour noted the principles relevant to the construction of commercial contracts[111]. They are well known, and I will not repeat them.

[109] [2011] QCA 162at [5].
[110] Ibid.
[111] At [6].

89 The principal argument for the appellants was that because the loan facility was to be drawn in one lump sum, there was no discretion whether or not to advance any part of it; at most, the discretion related to the timing of the payment of advances[112]. However, as Fraser JA pointed out, the purpose of cl 2.4 (specifying that the amount of the facility be drawn in one lump sum) was to identify the basis for calculation of interest, and the cross-reference to the "purposes set forth in clause 2.2 hereof" picked up the discretion to provide construction funding, which was amplified in cl 2.5.1[113].

90 The appellants argued that if the agreement were to be so construed, then the respondent's lending obligations, at least in relation to construction finance, were illusory. This, the appellants said, was a manifestly absurd result. Fraser JA concluded that although the relevant provisions of the agreement favoured the respondent over the appellants, that was at most a "reflection of the parties' apparently unequal bargaining positions", and not something "so obviously unreasonable as to justify the significant departure from the text"[114] which would be required if the appellants' view of the discretion were correct.

91 The significance of this decision can be shortly stated. The process of construction of commercial contracts should strive to give them an operation consistent with business commonsense, and to avoid manifestly absurd results. However, the fact that application of the ordinary processes of construction demonstrates that a contract is significantly one sided does not, of itself, suggest that the construction is wrong, or justify departure from the ordinary English meaning of the words used. More generally, the decision reinforces the proposition that when the parties to a contract confer an "absolute discretion" on one of them to do, or not to do, a particular act, they should be taken to have intended that the words they used should operate according to their ordinary meaning, with the result

[112] At [7]-[8].
[113] At [8].
[114] At [12].

that the discretion, in relation to its subject matter, is not constrained by considerations of good faith or reasonableness.

Public Trustee v Fortress Credit Corporation

92 I understand that the decisions of the primary judge[115] and of the Queensland Court of Appeal[116] have been discussed earlier, and I will look briefly at the way the High Court[117] dealt with the issue.

93 You will recall that Fortress agreed to lend money to Octaviar Castle Pty Limited and that the parent company, Octaviar Limited, guaranteed that loan. The guarantee was secured by a fixed and floating charge over the assets of Octaviar in favour of Fortress, and that charge was duly registered. The charge secured payment by Octaviar to Fortress of all "Secured Money". That expression was defined to mean all moneys that were or might became payable by Octaviar "under or in relation to a Transaction Document". That expression was defined to mean, among other things, any document which Fortress and Octaviar agreed in writing was a Transaction Document.

94 Subsequently, Fortress lent money to a company, Young Village Estates Pty Limited (YVE). Octaviar guaranteed that loan also. Subsequently, Octaviar and Fortress agreed in writing that the YVE guarantee was a Transaction Document for the purposes of the charge.

95 In due course, the indebtedness of Octaviar Castle to Fortress was repaid. The charge was not discharged. Fortress contended that the charge remained on foot, and secured the liability of Octaviar to Fortress on the YVE guarantee (which liability had not been discharged).

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[115] *Re Octaviar Limited; Re Octaviar Administration Pty Limited* [2009] QSC 37.
[116] *Public Trustee of Queensland v Octaviar Limited* [2009] QCA 282.
[117] (2010) 241 CLR 286

96 Section 266(3) of the *Corporations Act* 2001 (Cth) provided that, where a charge has been varied so as to increase the debt or increase the liabilities secured by it, and the company giving the charge is wound up or put into administration or executes a deed of company arrangement, then the charge is void as a security, to the extent of the increase in the debt or liability, unless notice was given within the timeframe specified.

97 The primary judge held that the charge was void as a security, to the extent that it purported to secure the liability of Octaviar to Fortress under the YVE guarantee. The Court of Appeal allowed an appeal from the decision of the primary judge. The High Court dismissed the appeal from the Court of Appeal.

98 The starting point in the reasoning of the High Court was that the definition of Transaction Document was "ambulatory", and included both documents that, at the time the charge was executed, had already been agreed to be Transaction Documents, and documents that thereafter were agreed to be Transaction Documents. Thus, the court said, "[t]he charge, from the time of its creation, always encompassed a liability that might be or become owing under a document that was or became a Transaction Document by the parties agreeing so in writing". It followed in turn, their Honours said, that "[t]he charge always secured that "prospective liability"[118].

99 Their Honours then pointed out that the result of the dealings in relation to the YVE guarantee was that in due course it became, when hitherto it had not been, a Transaction Document. But this, they said, "did not vary the meaning of Transaction Document… and consequently the meaning of Secured Money…"[119]. Section 266 was concerned with variations in the terms of a charge; a variation to the class of Transaction Documents did not involve either a variation to the terms of the charge or to the rights and obligations to which the terms of the charge gave rise[120].

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[118] At [22].
[119] At [23].
[120] Ibid.

100 Further, their Honours said, the “terms of the charge”, for the purposes of the *Corporations Act*, were the terms contained in the written instrument and any further terms which might be implied in fact [121]. That was consistent with the underlying purpose of registration of charges: to give those who are contemplating lending money to a company the ability to find out whether there are charges and if so, their terms.

101 The practical significance of this decision is that it focuses attention on the wording of the legislative scheme, and confines the statutory consequences of non-registration accordingly. Thus, it has the effect of validating the drafting technique employed in this case, and no doubt in hundreds of other transactions over recent years.

International Litigation Partners v Chameleon Mining

102 The appellant (defendant below), ILP, agreed to fund litigation commenced by the first respondent (plaintiff below), Chameleon, in the Federal Court. At no time was ILP licensed to deal in financial products for the purposes of Ch 7 of the *Corporations Act* 2001 (Cth). The funding agreement provided that it could be terminated if there were a change of control of Chameleon, and that if that happened, a termination fee would be paid. Otherwise, ILP was entitled to a funding fee calculated in accordance with whatever sum might be awarded to Chameleon on resolution of the proceeding.

103 A change in control of Chameleon occurred in August 2010, when a company known as Cape Lambert Resources Limited acquired, among other things, the right to appoint 50% of Chameleon’s board of directors. When that happened, Chameleon purported to give ILP notice of rescission of the funding agreement. It relied on s 925A of the *Corporations Act*. The underlying assumption was that the funding

[121] At [27].

agreement was a financial product provided by ILP when it was not licensed to do so, nor exempt from being licensed.

104 The primary judge held, in substance, that Chameleon was not entitled to rescind the funding agreement, and that in the circumstances it was obliged to pay Chameleon only the early termination fee and not any funding fee[122].

105 The Court of Appeal held, by majority (differently constituted on different sub-issues, and for varying reasons) that the funding agreement was a financial product and, thus, that Chameleon's rescission was valid. However, the Court of Appeal held (unanimously) that, in the events that had happened, the primary judge was correct to conclude that only the early termination fee was payable.

106 I propose to focus on the reasoning involving "financial product".

107 The starting point is of course s 763A of the *Corporations Act*, which (subject to s 763E and also to s 762B), provides that a financial product is a facility through which, or the acquisition of which, a person does one or more of:

(1) making a financial investment;

(2) managing financial risk; or

(3) making non-cash payments.

108 Those three categories are dealt with in, respectively, s 763B (financial investment), s 763C (financial risk) and 763D (non-cash payments).

109 The court held that the funding agreement was a financial product because, through it, Chameleon managed financial risk. As Hodgson JA

put it, the funding agreement "was a facility through which CHM managed financial risk…, in that it managed the financial consequences to itself of certain things happening (namely, adverse costs orders and loss of litigation, and possibly also, the incurring of its own costs through pursuit of the litigation)…" [123].

110 Giles JA pointed out that the relevant inquiry is not whether the purpose or a purpose of entering into the funding agreement was something other than the management of financial risk, but whether, by the agreement, Chameleon did so[124]. It is an inquiry into the way in which the funding agreement operates, not into the purposes of the funded party (in this case, Chameleon) in seeking to manage its financial risk in that way[125].

111 The real divisions of opinion in the Court of Appeal arose in relation to the operation of ss 763E and 762B. For convenience, and acknowledging that all of you will have those sections at your mental fingertips, I set them out:

> 763E What if a financial product is only incidental?
>
> (1) If:
>
> a) something (the ***incidental product***) that, but for this section, would be a financial product because of this Subdivision is:
>   i. an incidental component of a facility that also has other components; or
>   ii. a facility that is incidental to one or more other facilities; and
>
> b) it is reasonable to assume that the main purpose of:
>   i. if subparagraph (a)(i) applies—the facility referred to in that subparagraph, when considered as a whole; or
>   ii. if subparagraph (a)(ii) applies—the incidental product, and the other facilities referred to in that subparagraph, when considered as a whole;
>
>   is not a financial product purpose;
>
> the incidental product is not a financial product because of this Subdivision (however, it may still be a financial product because of Subdivision C).
>
> (2) In this section:
> ***financial product purpose*** means a purpose of:

122 *Chameleon Mining NL v International Litigation Partners Pte Limited* [2010] NSWSC 972.
123 [2011] NSWCA 50 at [122].
124 At [38] and following, in particular at [44].
125 Ibid.

a. making a financial investment; or
b. managing financial risk; or
c. making non-cash payments.

762B What if a financial product is part of a broader facility?

If a financial product is a component of a facility that also has other components, this Chapter, in applying to the financial product, only applies in relation to the facility to the extent it consists of the component that is the financial product.

112 Both sections have at their heart the idea that a financial product may be a component of a facility that has other components (which other components, by necessary implication, are not individually, and do not together amount to, a financial product). For s 763E to operate, the financial product must be no more than "an incidental component" of the overall facility. The limitation imposed by the word "incidental" is not to be found in s 762B.

113 The consequences of the two sections are different. If s 763E applies (and it applies if, among other things, the overall purpose[126] is not a "financial product purpose") then the incidental product is not a financial product because of Subdiv B of Div 3 of Ch 7 (which is the subdivision including sections 763A and following). If s 762B applies, Ch 7 applies to the facility: but only to the extent that it consists of the financial product.

114 Thus, the consequence, if s 763E applies, is that the incidental component is relevantly not a financial product, even though, standing alone, it would be. By contrast, if s 762B applies, the "financial product" component remains a financial product, but the rest of the overall facility is not.

115 As was apparently raised in the course of argument[127], s 762B appears to apply where a facility has severable parts, one of which is a financial product and the others of which are not, whereas s 763E applies where the financial product is incidental to, but not severable from, the overall facility. That, no doubt, is why s 763E applies only where, among other

[126] In referring to "overall purpose", I am combining the alternative elements set out in s 763E(1)(b), referring back to the two limbs of para (a).

things, the financial product is “incidental” to the overall facility, whereas s 762B may apply even if the financial product component of the overall facility is more than incidental.

116 Once it is concluded that Chameleon entered into the funding agreement to manage the financial risk to itself (in terms of its own costs and adverse costs) of prosecuting the Federal Court proceeding, it is difficult to see how that could have been merely “incidental” to some other and larger purpose, and thus how s 763E could operate. Equally, if severability is the key to s 762B (and I think that this must be so), it is difficult to see what other purposes there were from which the purpose of managing financial risk could be severed. Giles JA said as much in his brief reasons dealing with ss 762B and 763E[128].

117 In relation to s 762B, the obvious problem, from ILP’s perspective (and this may explain why ILP had not referred to s 762B in its written submissions[129]) is that even if s 762B applied, the exemption that it provides would extend to the non-financial product components, but not to the component that was a financial product. Thus, as Giles JA put it, the section would have “no relevant exclusory effect”[130]. Alternatively, as Young JA put it, if s 763E did not apply then, even if s 762B did apply, the rights of the “consumer” would still apply to the severable financial product component[131].

118 I do not propose to analyse the disparate strands of reasoning in more detail, because they were very closely connected to the particular facts and to the terms of the funding agreement. I will conclude with the warning given by Young JA:

> … if you find wide words in a statute to protect the investing public, and the circumstances of the case come within the literal words

[127] Young JA at [173].
[128] At [92].
[129] See Giles JA at [90].
[130] At [92].
[131] At [183].

> [sic], there is no reason to read down those general words, unless, at least, one can "glean from the legislative provisions an overall purpose which, being limited in scope, justified a reading down of the definition. …[132]

119 Whilst not wishing to return to Elements of Drafting 1.01, this case affords yet another example of the dangers in proceeding to litigation on ill-drafted documents.

Brighten v Bank of Western Australia

120 The plaintiffs sought a declaration that particular events of default had not occurred under a facility agreement and mortgage, and sought an interlocutory injunction restraining the defendant bank from appointing receivers.

121 The plaintiffs were guarantors of a loan made to a company to enable it to purchase the Fairmont Resort at Leura. The borrower fell into default. The court appointed a receiver on 11 December 2009, but the order appointing the receiver limited his powers. In particular, it reserved "the day to day operation, control, management and administration of the hotel / business" to the plaintiff Brighten, provided that "there shall be full transparency and supply of information to the Receiver so as to enable him to have as complete an understanding of the business as he thinks is necessary".

122 The bank sought to appoint receivers on an unrestricted basis – i.e., in effect, to oust Brighten from the day to day operation, control, management and administration of the hotel / business.

123 The essential question was whether it had been open to the bank to find, in its absolute discretion, that there had been events that had a material

[132] At [208], invoking the reasoning of the High Court in *Australian Softwood Forests Pty Limited v Attorney General for New South Wales* (1981) 148 CLR 121 at 129 – 130.

adverse effect on the business, assets and financial condition of Brighten and the borrower[133].

124 Einstein J concluded that "it is quite plain that the plaintiffs failed dismally in their efforts to show that they have a serious, not a speculative case which has a real possibility of ultimate success" [134]; and likewise, they "failed dismissally in their efforts to show that the balance of convenience is in favour of continuing… [the status quo]… up to a final hearing"[135].

125 Further, and as what I would have thought was in any event a dispositive consideration, the Court pointed out that the plaintiffs had not brought into court the amount of the mortgage debt, as the price for restraining the bank's exercise of its powers of sale[136]: *Inglis v Commonwealth Trading Bank of Australia*[137].

126 This decision is important because it emphasises that, even on an interlocutory application, an exercise of an "absolute discretion" requires very substantial grounds of challenge, and it reinforces the ongoing importance of *Inglis*.

127 It may interest you to know what has happened since Einstein J handed down his judgment. On 16 March 2011, Hammerschlag J entered judgment in favour of the bank against Brighten and Mr Kwok in the sum of about $13.5 million[138]. On 19 July 2011, Hammerschlag J dismissed an application by Brighten to extend the time for compliance with a statutory demand served upon it by the bank[139]. In the meantime, Brighten and Mr Kwok had sought an order for preliminary discovery of documents against the receivers, to see if there was some cause of action for negligence in connection with the receivers' sale of the Resort. On 20 July 2011, I

[133] At [30].
[134] At [45].
[135] At [45].
[136] At [50].
[137] (1972) 126 CLR 161.
[138] *Brighten & Ors -v- Bank of Western Australia Limited* [2011] NSWSC 816.
[139] [2011] NSWSC 801.

dismissed that application, on the basis that there was no reason to think that Brighten and Mr Kwok had any claim against the receivers. Presumably, the last steps in this litigious saga will be applications for the making of a winding up order for Brighten, and a sequestration order against Mr Kwok.

Buzzle Operations v Apple Computer Australia

128 Buzzle was a reseller of Apple products. It entered into a reseller agreement with Apple, and gave a charge over its assets, in return for which Apple provided stock on credit. Buzzle failed. Apple appointed receivers. Buzzle went into liquidation.

129 The liquidators sought to challenge a number of payments, on various bases:

(1) relying on s 267 of the *Corporations Law* (as it then was), on the basis that Apple was an "officer" or "associated person" of Buzzle;

(2) the payments in question were "uncommercial transactions" (s 588FB, s 588FF of the *Corporations Law*); Apple relied on s 588FG;

(3) Apple and its finance director were shadow directors of Buzzle and accordingly, were liable pursuant to s 588G for more than $12 million of liabilities said to have been incurred through insolvent trading whilst they were directors; and

(4) Alternatively, by reason of the relationship flowing from the shadow directorships, the payments were unfair preferences, and voidable pursuant to s 588FE.

130 The decision is fact – driven, and the reasoning of White J requires close attention to be paid to the facts.

131 As to the first issue (based on s 267), White J held that Apple was not an officer or associated person of Buzzle simply because of Apple's ability to affect Buzzle's financial position through crystallisation of the charge. His Honour said that the definition of "officer" in s 9 of the *Corporations Law*:

> should be taken as referring to a person who, in his or her management of the affairs of the corporation, has the capacity to affect significantly the corporation's financial standing[140].

132 Further, his Honour held that Apple or its finance director could only be an "associated person" of Buzzle if they were "acting in concert" and with a common object or purpose[141]. His Honour held that there was no common purpose and the existence of the charge did not provide one.

133 Significantly, White J held that Apple did not become an officer or associated person simply because, in its position as chargee, it required Buzzle to make certain changes to its business practices. That was because, his Honour found, the ultimate decision to accept or reject the recommendation remained with Buzzle, and its board and had the ability to control that decision[142].

134 As to the uncommercial transaction argument based on s 588FB, White J held that the payments in question were not uncommercial transactions, but in any event, if they were, the defences were made out. The Court of Appeal overturned the former conclusion[143], but upheld the latter[144].

135 The defence was made good because the payments were made in good faith and without grounds for suspecting insolvency, and Apple did not in fact suspect insolvency at the times the payments were made[145].

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140 At [126].
141 At [135].
142 At [127] to [129].
143 [2011] NSWCA 109 at [3],[287].
144 At [171].
145 At [159].

136 As to the "shadow director" point, White J noted that there was nothing inherently incongruous in a body corporate's becoming a shadow director, because, by definition, there was no valid appointment and hence no requirement that a shadow director be a natural person[146]. His Honour held that to be a shadow director, the person or corporation must instruct the directors how to act, and in effect be in control of the board[147]. If the board of a company, acting independently, is able to conclude as a matter of its own judgment that a transaction on which a third party insists is in the best interests of the company, the third party will not be a shadow director simply because it does so insist[148].

137 It may be noted that although the Court of Appeal upheld the decision on this point, their Honours considered that the focal question was to look at who is controlling the decisions of the company, and not to look at the finer detail of the influence of the putative shadow director on particular aspects of the company's activity[149].

Australian Property Custodian Holdings

138 Section 436C(1) of the *Corporations Act* authorises "[a] person who is entitled to enforce a charge on the whole, or substantially the whole, of a company's property" to appoint, by writing, an administrator of the company if the charge has become and remains enforceable. In this case, a secured creditor pursuant to a registered charge appointed the applicants as administrators of the company. The first question was whether the appointment was valid. The second question was whether, if the answer to the first question were "no", s 447A should be utilised to validate the appointment with retrospective effect.

139 The company was the trustee of a trust. The assets that were the subject of the charge did not include the assets held by the company in its

[146] [2011] NSWSC 801 at [231].
[147] At [241] – [242].
[148] At [243].
[149] [2011] NSWCA 109 at [205].

capacity as trustee. Nor did they include the sum of $5 million held by the company on deposit at the National Australia Bank. That sum was so held by the company as a condition of its Australian Financial Services License.

140 As a matter of arithmetic, the charged assets were about 68% of the company's total assets. Sifris J held that the charge was not over the "whole or substantially the whole of the company's property" but was merely "over a significant part of the company's assets" [150].

141 A wider submission had been put to Sifris J[151]. The submission appears to have been that, for the purposes of s 436C(1), the "property" of the company should be taken to include not only property held by it beneficially, but also property held by it as trustee: that is to say, property in which it had the legal, but no beneficial, interest. That was, I think, an ambitious submission. Where a trustee is authorised to raise money, for the purposes of execution of the trusts, on the security of the trust property, that is one thing. But where a trustee wishes to raise money for its own purposes, on the security of its own assets, that is another. In the latter situation, the lender should be able to take security over all the assets owned by the trustee in its personal capacity, knowing that it can enforce that security in the usual way (including, in the case of a registered charge, by appointment of administrators). The lender would not be entitled to have recourse to the assets held by the trustee as trustee. It is difficult to understand why, for the lender's security to be enforceable (by the appointment of administrators), the charge should be required to extend to assets that cannot properly be subject to it and to which the lender could not properly have recourse. Such a construction of s 436 (1) would seem to encourage breaches of trust, and to put lenders at risk of being complicit in those breaches. But since Sifris J did not venture on this question, I will say no more.

[150] [2010] VSC 492 at [8].
[151] See at [9].

142 I turn to s 447A. By subs (1), the court is authorised to "make such order as it thinks appropriate about how this Part is to operate in relation to a particular company". As Sifris J observed, that section "has been interpreted very broadly by the courts", but its "precise ambit and extent… has yet to be worked out" [152].

143 Sifris J expressed doubt that s 447A was "broad enough to overcome the defect in the appointment arising out of the limited Charge despite the fact that the requirement in s 436C that the appointee be entitled to enforce the charge over the whole or substantially the whole of the company's property is a specific precondition to the validity of the appointment…"[153].

144 I share his Honour's reservations. The power given by s 447A(1) is one to make orders about how Part 5.3A of the *Corporations Act* operates in relation to a particular company. It assumes that the Part (or a particular provision of the Part) has been engaged. It is at least arguable, as Sifris J pointed out, that where the operation of the Part, or of a particular section, is not engaged then s 447A has no work to do[154]. It is equally arguable that s 436C(1) is not engaged at all except where the appointment comes within its terms: that is to say, except where the appointment is made by a secured creditor who holds security over the whole or substantially the whole of the company's property.

145 The alternative course that commended itself to Sifris J, was to use s 447A to validate the appointment of the administrators pursuant to s 436A. That section authorises a company to appoint an administrator where its board has resolved that it is or is likely to become insolvent, and that an administrator should be appointed. Sifris J said that it "was the clear intention of the directors of the company" to appoint administrators; that was "what they always had in mind and what was always intended to be achieved on the day, one way or another"[155]. Thus, as his Honour said:

[152] At [24].
[153] At [27]; and note also [22].
[154] At [27].
[155] At [22]

> An appointment was always contemplated by the directors of the company in circumstances that but for the defective appointment would have been made. All relevant matters that needed to be considered for a valid s 436A appointment were considered, but not implemented for the reason given. I propose to implement it by recourse to s 447A of the Act. It ought to be done because everyone intended it to be done and acted on the basis that it was done[156].

146 As Sifris J said, either the directors or the court could appoint administrators "today"[157]. The question was whether s 447A should be used to validate the defective appointment, which would have the effect of regarding or treating as valid that which was, in fact, invalid. A number of decisions were analysed[158] which led Sifris J to the conclusion that s 447A could be utilised to validate, in effect retrospectively, that which had been at the time it was done invalid. Sifris J said:

> If the section can be used to cure a defective appointment which is probably void *ab initio*, it should be used where in all the circumstances an appointment was intended and indeed assumed to have taken place[159].

147 If I understand the reasoning correctly, Sifris J was prepared to use s 447A to validate the appointment of the administrators, as though that had been done by s 436A, but not to confirm or authorise their appointment by a secured creditor who did not fall within the terms of the statutory grant of power that alone would have authorised it to appoint administrators. This is a fine distinction; but it may be that, in any event, a similar result could have been reached under s 1322(4).

Conclusions

148 It is difficult to draw any general principles from the disparate collection of cases that I have dealt with in this paper. One recurrent theme is that of

[156] At [28].
[157] At [30].
[158] At [31] to [34].
[159] At [36].

the importance of careful and precise drafting. The courts do what they can to give meaning to contractual documents. However, in doing so, the courts seek to find the intention of the parties, objectively ascertained. That exercise is carried out by seeking to ascertain the meaning that the words used by the parties in their contract would have to a reasonable third person who knew all relevant facts prior to and surrounding the making of the contract. I have no doubt that, in some cases, the construction so arrived at (and, as a matter of legal technique, properly arrived at) may not reflect what the parties actually intended. If the parties express their intentions in clear, precise and unambiguous words, there is little likelihood that the courts will arrive at a construction different from the actual (corresponding) intention of the parties.

149 The courts seek to make sense of contractual bargains. That is why particular clauses are interpreted in context, and by reference to all other relevant provisions of the contract. One of the prime functions of construction is to attempt to render different provisions of the contract harmonious. Another function is to seek to give meaning to each and every provision. Again, the courts will be aided, in performing those tasks, if the parties use clear, precise and unambiguous language.

150 The decision of the Full Federal Court in *Goodridge* is of particular significance in that it demonstrates that the courts should give effect to the parties' objectively ascertained contractual intention, even if the outcome may seem harsh. That is shown even more forcefully by the decision in *Platinum United.* The courts are often faced with the submission that a particular outcome is "uncommercial". But that submission begs the question: "from whose perspective?" Black letter interpretation focuses on the words used in their context, and assumes that the consequences were intended. It promotes a measure of certainty. From my perspective, that is preferable to subjective considerations, and partisan appeals to "uncommerciality".

151 In considering the operation of statutory protections enacted for the benefit of "consumers", it is necessary to understand that the courts will give as wide a meaning to such provisions as their language will reasonably allow. Thus, if a particular factual situation falls within such a statutory provision, it is likely that the courts will hold that the statutory provision is applicable.

152 Equally, where a dispensing or validating power is given in wide terms, the courts will seek to administer it accordingly, and not to read it down. Having said that, it is always best (although, no doubt, a counsel of perfection) to seek to avoid a situation where it is necessary to invoke dispensing or validating powers.

153 May I conclude by saying that it has been a pleasure to attend this part of your conference, and to have had the opportunity to speak to you?

AUSTRALIASIAN FORUM SHOPPING

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INTRODUCTION

1. Following the emergence of the global financial crisis, various major disputes arose from the transactional collapses following the implosion of several major international financial institutions. In this context, forum shopping and jurisdictional competence have emerged as central issues in some of the more complex cases. As Fleming states "[i]n a crisis that stretched across the globe, the phenomenon of claimants shopping for the best jurisdiction was inevitable".[1] As commerce is increasingly conducted across jurisdictional boundaries, the number of cross-border disputes is naturally increasing. As such, it is important that lawyers advising on international transactions and litigation are familiar with the issues that may arise in respect of forum shopping.

2. Mr Bell SC's paper raises practical issues to consider when drafting choice of law and jurisdiction clauses. This paper helps place that discussion in a broader context by focusing on issues where the forum in which a dispute will be determined is, in itself, in dispute. In particular, it discusses:

   (a) the concept of forum shopping generally, including the reasons why parties do it and why its practice is traditionally considered to be undesirable;

   (b) how parties can influence or challenge the forum in which a dispute will be heard; and

   (c) recent developments which may have an impact on forum shopping by Australasian clients.

THE CONCEPT OF FORUM SHOPPING

What is forum shopping?

3. Black's Law Dictionary defines forum shopping as "the practice of choosing the most favourable jurisdiction or court in which a claim might be heard".[2] Clients bringing or defending proceedings will often prefer to do so in their own jurisdiction for various reasons of expense, convenience and familiarly with the procedural and substantive rules. Multinational companies may be more concerned with staging proceedings in the jurisdiction that best suits them tactically.

[1] J Fleming "After the storm" (2009) 91 *European Lawyer* 10, 13.

[2] Black's Law Dictionary (9th ed, 2009, Westlaw International Online) (accessed 1 July 2011).

4. Commenting on the approach of United States courts, Lord Denning famously stated:[3]

> As a moth is drawn to the light, so is a litigant drawn to the United States. If he can only get his case into their courts, he stands to win a fortune. At no cost to himself, and at no risk of having to pay anything to the other side. The lawyers there will conduct the case 'on spec' as we say, or on a 'contingency fee' as they say. The lawyers will charge the litigant nothing for their services but instead they will take 40% of the damages, if they win.... If they lose, the litigant will have nothing to pay to the other side. The courts in the United States have no such costs deterrent as we have. There is also in the United States a right to trial by jury. These are prone to award fabulous damages. They are notoriously sympathetic and know that the lawyers will take their 40% before the plaintiff gets anything. All this means that the defendant can be readily forced into a settlement. The plaintiff holds all the cards.

5. The practice of forum shopping appears to have existed for a long time. The classical conception of it involves a plaintiff attempting to have a dispute heard in an advantageous forum. However, defendants may also forum shop through applications for a stay or anti-suit injunction or through pre-emptive declaratory relief.[4] Parties may take steps to influence the dispute forum long before any specific dispute arises; for example, when they elect where to incorporate.

6. While its practice is prevalent throughout the world, the phrase 'forum shopping' carries a pejorative connotation.[5] The most prominent objection to forum shopping is that it is contrary to 'decisional harmony'[6] – the notion that the venue in which a dispute is heard ought not affect its outcome. As consistency of outcomes is a fundamental tenet of any legal system,[7] it is considered unjust if the result of a case should hinge on technical differences between jurisdictions.[8] The traditional private international law jurisdiction selection rules were designed, in Savigny's words, to ensure that the applicable law is not determined by the 'unilateral discretion of one party'.[9] As such, it is customary to regard the attainment of uniform solutions as the chief purpose of private international law. If complete decisional harmony was achieved, the practice of forum shopping would wither. However, the goal of harmonization and unification of internal laws or choice of law rules, while realised in some regions and fields, remains a utopian ideal.[10]

7. There is also a concern about the extent to which forum shopping may negatively affect the public perception about the fairness of the legal system, as it is thought that it subjects parties to the additional cost and inconvenience of participating in litigation beyond their own legal system in

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[3] *Smith Kline & French Laboratories Ltd v Bloch* [1983] 2 All ER 72 at 74.

[4] A Bell "The Why and Wherefore of Transnational Forum Shopping" (Feb 1995) *The Australian Law Journal* (69) 124 at 125-126.

[5] F K Juenger "Forum shopping, domestic and international" (1989) 63 *Tulane Law Review* 553 at 553.

[6] See F K Juenger "What's Wrong with Forum Shopping" [1994] *Sydney Law Review* (16) 5 at 6.

[7] See Hart *The Concept of Law* (Oxford University Press, Oxford, 1961), 155.

[8] See "Forum shopping reconsidered" 103 (7) *Harvard Law Review* (1990) 1677; *Stevens v Head* (1993) 112 ALR 7 (HCA) at 31.

[9] F K Juenger "Forum shopping, domestic and international" (1989) 63 *Tulane Law Review* 553 at 558.

[10] A Bell *Forum shopping and venue in transnational litigation* (Oxford University Press, Oxford, 2003) at para 2.01.

circumstances where such participation may be intentionally oppressive.[11] Where particular courts are overburdened, there may also be a concern that a reputation as a favourable forum for certain types of case will increase the judicial workload and prevent the timely achievement of justice in other cases.[12]

8. It has been argued that forum shopping is detrimental to the rule of law in the sense that it detracts both from its predictability (the law should be sufficiently predictable to guide human behaviour so that citizens may formulate and execute their endeavours with confidence) and consistency (individuals should not be exposed to the requirements of contemporaneously valid but inconsistent laws).[13] This is because, if the legal consequences of a party's actions depend on the laws of multiple jurisdictions, it is much more difficult for the party have certainty as to their legal rights and obligations.

9. However, reasonable people disagree as to extent to which forum shopping is objectionable. Many commentators support the wider acceptance of forum shopping as a normal aspect of litigation strategy.[14] The attitude in the United States appears to be more liberal than in other common law jurisdictions. For example, in the Supreme Court decision in *Keeton v Hustler Magazine,*[15] the Court allowed a defamation action brought in New Hampshire by a plaintiff based in New York to continue even though the limitation period in the defendant's place of incorporation (Ohio) had run out. The New Hampshire limitation period was significantly and uniquely longer than other states. The Court held this even though few magazines were sold in New Hampshire and the injury to reputation there was minimal. Rehnquist CJ noted (at p779) that the plaintiff's:

> ... successful search for a state with a lengthy statute of limitations is no different from the litigation strategy of countless plaintiffs who seek a forum with favourable substantive or procedural rules or sympathetic populations.

10. Similarly, in *Goad v Celotex Corp*[16] the Fourth Circuit Court noted that "[t]here is nothing inherently evil about forum-shopping" calling it a "spectre, or ... strawman, depending on whose ox is being gored". Lord Simon Glaisdale in *The Atlantic Star* stated:[17]

> "Forum shopping" is a dirty word; but it is only a pejorative way of saying that, if you offer a plaintiff a choice of jurisdictions, he will naturally choose the one in which he thinks his case can be most favourably presented: this should be a matter neither for surprise nor for indignation.

[11] F Ferrari "'Forum Shopping' Despite International Uniform Contract Law Conventions" (51) 3 *The International and Comparative Law Quarterly* (July 2002) 689 at 707.

[12] "Forum shopping reconsidered" 103 (7) *Harvard Law Review* (1990) 1677 at 1678.

[13] See B R Opeskin "The Price of Forum shopping" (1994) *Sydney Law Review* (16) 14.

[14] See F K Juenger "What's Wrong with Forum Shopping" [1994] *Sydney Law Review* (16) 5; "Forum shopping reconsidered" 103 (7) *Harvard Law Review* (1990) 1677 at 1691.

[15] *Keeton v Hustler Magazine* 465 US 770 (1984).

[16] *Goad v Celotex Corp* 831 F 2d 508 (1987) at 512.

[17] *The Atlantic Star* [1974] AC 436 at 471.

11. It has also been acknowledged by English commentators that there is intrinsic value in allowing foreign parties access to domestic courts. Cheshire, North & Fawcett have observed that:[18]

> ... there is a public interest in allowing trial in England of what are, in essence, foreign actions. When foreigners litigate in England this forms a valuable invisible export, and confirms judicial pride in the English legal system.

12. This accords with the view that forum shopping is less a problem and more an example of informed consumers making purchasing decisions in a manner that improves the efficiency and effectiveness of legal systems internationally. This view relies on the idea of 'regulatory competition'.[19] Taking a long term view, forum shopping may improve legal systems through constructive comparison with others.[20] This is essentially the "race to the top" theory. "Race to the bottom" theorists argue that such competition results in a systematic lowering of regulatory standards leading to high costs to the consumers and state as a whole, and thus calls for more centralised law and policy making.[21]

13. Irrespective of the differing views as to forum shopping, it is undeniably an issue that will form part of the strategy of cross-border litigation for many years to come. As such, lawyers advising on international transactions should see knowledge as to the potential benefits presented by the pluralism of legal cultures as simply an emerging part of their advisory role.

Why shop around?

14. In international disputes, where the dispute is determined may be an important strategic issue as it may affect the cost and ultimate result of the dispute, whether in terms of substantive decision or settlement. The main reason parties forum shop is the international diversity of internal substantive laws, choice of law rules and procedural rules.[22] When considering whether to select a particular forum, a wide range of legal and practical factors may be relevant.

15. These factors include:[23]

    (a) *Familiarity*: the shopper may have a significant amount of experience in a particular jurisdiction or may wish to exploit the other party's lack of familiarity.

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[18] Cheshire, North & Fawcett *Private International Law* (11th ed, Oxford University Press, Oxford, 1987) at 233.

[19] A M Sachdeva "Regulatory competition in European company law" 30(2) *European Journal of Law & Economics* (2010) 137 at 138.

[20] "Forum shopping reconsidered" 103 (7) *Harvard Law Review* (1990) 1677 at 1689.

[21] A M Sachdeva "Regulatory competition in European company law" 30(2) *European Journal of Law & Economics* (2010) 137 at 138-139.

[22] A Bell *Forum shopping and venue in transnational litigation* (Oxford University Press, Oxford, 2003) at para 2.07.

[23] See Rhys Clift "Forum Shopping, Anti-Suit injunctions and EU Law: A Brief Overview" (ICLG Guide to International Arbitration 2007, Global Legal Group) at p 30.

(b) *Procedural laws*: as procedure is governed by the law of the forum (the *lex fori*),[24] the decision as to forum will dictate the procedure which applies. Common areas of procedural difference are in relation to discovery,[25] limitation,[26] interest rates,[27] security for costs, appealability, evidence,[28] class actions,[29] and joinder. The classification of 'substantive' and 'procedural' law can often be difficult.[30] The broader the interpretation of what is 'procedural', the greater the incentive for forum shopping.[31]

(c) *Substantive laws*: where parties have a choice of (substantive) law clause, the mandatory substantive laws of a forum (which apply regardless of choice of law) may influence the attractiveness of a forum. Mandatory substantive laws are typically designed to protect public interests.[32] Examples of laws that are (arguably) mandatory are consumer protection laws,[33] exemption clause controls,[34] personal injury legislation,[35] investor protection legislation,[36] and

[24] Matters of substance by the law chosen by the forum court to apply based on the parties' choice or otherwise (the *lex causae*).

[25] For example, while common law legal systems generally require comprehensive exchange of documents, civil law systems tend to require production of a much narrower category of documents.

[26] Krauskopf & Tkacikova "Competition law violations and private enforcement: forum shopping strategies" 4(1) *Global Competition Law Review* 26, 37. The limitation period may start to run from the accrual of the cause of action, the date the wrongful conduct ceased, the date the infringement was reasonably discoverable or (in the competition law context) the date the investigation commenced. One of the major reasons for forum shopping among the Australian states/territories was the New South Wales six year limitation period (as compared to the three year period for personal injury in other states): Peter Nygh "Choice of Law Rules and forum Shopping in Australia" (1995) *Public Law Review* (6) 237 at 237-8.

[27] One of the major reasons for forum shopping among the Australian states/territories was the difference in pre-judgment and post-judgment interest rates across them: Peter Nygh "Choice of Law Rules and forum Shopping in Australia" (1995) *Public Law Review* (6) 237 at 237-8.

[28] For example, Court as opposed to party appointed expert witnesses: Krauskopf & Tkacikova "Competition law violations and private enforcement: forum shopping strategies" 4(1) *Global Competition Law Review* 26 at 37.

[29] Some jurisdictions have advanced rules to allow for class actions (United States) and others do not (NZ)).

[30] This can be the case when determining issues relating to limitation, proper parties, set-off, counterclaim and remedies: Goddard & McQueen *Private International Law in New Zealand* (NZLS Seminar, 2001) at pp 121-125.

[31] A Bell "The Why and Wherefore of Transnational Forum Shopping" (Feb 1995) *The Australian Law Journal* (69) 124 at 126.

[32] G A Bermann "Introduction: Mandatory rules of law in international arbitration" 18 *American Review of International Arbitration* 1, 1-2. Mandatory law will usually involve three elements: (i) an intention to protect an interest despite ordinary choice of law rules; (ii) a close connection with state interests; and (iii) a need for protection: P Nygh *Autonmy in International Contracts* (Clarendon Press, Oxford, 1999) 205.

[33] For example, Credit Contracts and Consumer Finance Act 2003 (NZ) s 137(b), Consumer Credit Contract Act 1974 (UK) and Trade Practices Act 1974 (Aus), Fair Trading Act 1986 (NZ): see A Bell *Forum shopping and venue in transnational litigation* (Oxford university Press, Oxford, 2003) at para 5.38.

[34] For example, s27(2) of the Unfair Contract Terms Act 1977 (UK).

[35] For example, Law Reform (Personal Injuries) Act 1948 (UK) and Fatal Accidents Act (UK), Accident Compensation Act 2001 (NZ) s299: A Bell *Forum shopping and venue in transnational litigation* (Oxford university Press, Oxford, 2003) at para 5.38.

[36] For example, Companies Act 2006 (UK), Companies Act 1993 (NZ) and Corporations Act 2001 (Aus): A Bell *Forum shopping and venue in transnational litigation* (Oxford university Press, Oxford, 2003) at para 5.45.

employment laws.[37] Parties may also have preferences as to the non-mandatory substantive laws of a particular jurisdiction in circumstances where there is no applicable choice of substantive law and potential liability in more than one jurisdiction.

(d) *Available remedies:* A good example of the remedy differences is the attitude towards damages awards in New Zealand, Australia and England as compared to the United States jury awards.[38] Rules as to the mitigation of damages[39] and freezing and search orders[40] also differ.

(e) *Choice of law rules:* common law jurisdictions tend to focus on domicile whereas civil law jurisdictions focus on nationality. Some jurisdictions have no doctrine of forum non conveniens or there may be very different conceptions of 'appropriateness' as to forum.[41]

(f) *Recognition/enforcement:* Enforcing a judgment in a foreign jurisdiction can be complicated, slow, expensive and, in many cases, very difficult to achieve at all. Arbitral awards present less risk regarding enforcement as arbitral awards, at least for commercial matters, can be readily enforced in a wide range of countries under the New York Convention of 1958.

(g) *Judicial characteristics*: courts may have particular expertise in resolving technical disputes. The perceived ability of the judiciary, generally or in a particular area, may influence the decision. Further, some courts may develop a reputation for being more liberal or strict in a particular area perceivably to the advantage of the shopper.[42]

[37] Mandatory laws are to be distinguished from the exclusionary rule applied to foreign revenue (e.g. Income Tax Act), penal (e.g. Crimes Act) and other public laws which will not be enforced by domestic courts. Nor are they to be mistaken for the rule that foreign laws may not be enforced on the grounds that they are contrary to local fundamental public policy (*ordre public*): Cheshire, North & Fawcett *Private International Law* (14th ed, Oxford University Press, Oxford, 2008) at 121-151.

[38] See F K Juenger "Forum shopping, domestic and international" (1989) 63 *Tulane Law Review* 553, 556.

[39] Krauskopf & Tkacikova "Competition law violations and private enforcement: forum shopping strategies" 4(1) *Global Competition Law Review* 26, 34.

[40] A Bell *Forum shopping and venue in transnational litigation* (Oxford university Press, Oxford, 2003) at para 2.04.

[41] See Andrew Bell "The Why and Wherefore of Transnational Forum Shopping" (Feb 1995) *The Australian Law Journal* (69) 124 at 135.

[42] An example of this phenomenon in the United States is the District Court for the Eastern District of Texas in Marshall, Texas which became a popular forum for patent lawsuits because it found in favour of the plaintiff 78% of the time, compared to a national average of 59%. Yan Leychkis "Of fire ants and claim construction: an empirical study of the meteoric rise of the Eastern District of Texas as a pre-eminent forum for patent litigation" (2008) *Intellectual Property Law Review* (40) 139-233.

(h) *Deference to party autonomy*: while a choice of law clause will usually be given full effect in Australasia, in some States of the United States, such clauses will be subjected to a reasonableness test and will be disregarded completely in some civil law jurisdictions.[43]

(i) *Practitioner quality*: a shopper may perceive an advantage from the general competence level of practitioners in a particular forum.

(j) *Costs award expectations:* Recoverable legal costs in the English system are typically in the region of 60-70% of total costs incurred. In New Zealand, it can be much lower, with the use of a fixed schedule of recoverable amounts for steps in a proceeding.

(k) *System costs*: for example, it will generally cost less to bring a claim in Wellington than it will in London or New York. Systems have different rules regarding contingency fees. Such fees are generally acceptable in the United States but prohibited or restricted in most other common law jurisdictions.[44]

(l) *Speed:* the shopper may wish for the dispute to resolved as quickly or as slowly as possible for tactical reasons and certain forums will have reputations for fast or slow resolution.[45]

(m) *Administrative (in)convenience*: locating the trial in a particular jurisdiction may be particularly convenient for the shopper or particularly inconvenient for the other party.

(n) *Press and political factors:* particularly in areas of ongoing regulator involvement, such as competition law, forum shoppers will take into account the extent to which the claimant's business/industry can receive considerable media coverage as there are numerous cases where media coverage has pushed courts and the government towards outcomes.[46]

FORUM CHALLENGES

16. The question of where a dispute will be determined depends on two legal issues:

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[43] Goddard & McQueen *Private International Law in New Zealand* (NZLS Seminar, 2001) at pp 133 and 164.

[44] Krauskopf & Tkacikova "Competition law violations and private enforcement: forum shopping strategies" 4(1) *Global Competition Law Review* 26 at 31.

[45] There is an interesting phenomenon in the European Union in the intellectual property context whereby defendants will intentionally file proceedings seeking declaratory relief in a jurisdiction where courts are notoriously slow in order to reduce the pressure to reach a settlement. This action is referred to as a 'torpedo': Stothers (et al) "Forum shopping and 'Italian torpedoes' in competition litigation in the English courts" 4(2) *Global Competition Litigation Review* (2011) 67 at 67.

[46] The extent of lobbying or special interest groups' operation in respect of the claimant's industry may also have an impact: Krauskopf & Tkacikova "Competition law violations and private enforcement: forum shopping strategies" 4(1) *Global Competition Law Review* 26 at 32.

(a) *jurisdiction*: when a case is filed, the court decides whether it has jurisdiction; and

(b) *forum conveniens* ('appropriate forum'): where courts in more than one country have jurisdiction, in which Court should the dispute most appropriately be tried in the interests of the parties and for the ends of justice.[47]

17. When a foreign defendant is served with proceedings, they may challenge the proceeding on the basis that the forum court is not the appropriate forum for determination of the dispute. In New Zealand, this may be via an appearance protesting jurisdiction and subsequent application to dismiss the proceedings (where the *plaintiff* bears the onus of showing the forum court is the appropriate court)[48] or, where no protest was filed or the defendant is held to have submitted to the Court's jurisdiction, via an application for a stay (where the *defendant* bears the onus of showing the forum court is not the appropriate court).[49] In the first case, the application asserts that there is no jurisdiction and in the second case, that jurisdiction ought not be exercised. As such, to avoid the onus, defendants must file a protest to jurisdiction.

Forum non conveniens

18. Forum non conveniens is one of the central methods of combating forum shopping. Generally, if proceedings are served on a defendant in circumstances where they feel that plaintiff has failed to bring the action before the 'natural forum', the defendant may seek a stay/dismissal of the proceeding in the forum Court on the ground that it is forum non conveniens - that there is another Court with jurisdiction to hear and determine the matter in which the proceeding could be more appropriately tried in the interests of the parties and for the ends of justice. If the forum Court does not consider that it is the *forum conveniens*, it will allow the objection and grant a stay or dismissal of proceedings unless justice requires otherwise.[50]

19. The doctrine of forum non conveniens is based on the principle of comity (mutual respect). The forum court must respect the right of a foreign court to assume jurisdiction. If the foreign court has reasonably concluded that there was no more convenient forum, comity requires the forum court to respect the decision of the foreign court. A court must balance the interests of the parties

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[47] *McConnell Dowell Constructors Ltd v Lloyd's Syndicate 396* [1988] 2 NZLR 257 (CA) at 280.

[48] HCR rr 5.49 and 6.29.

[49] HCR r 15.1; see *McGechan on Procedure* (Brookers online) at HR6.29.05 and Brooker's Civil Procedure (Brookers online) at HC5.4910A.

[50] *Laws of New Zealand: Conflict of Laws: Jurisdiction and foreign Judgments* (LexisNexis online) at para 27-28; Goddard & McQueen *Private International Law in New Zealand* (NZLS Seminar, 2001) at p 43.

acknowledging there is injustice, not only when a plaintiff is allowed to pursue the action in a forum inconvenient to the defendant, but also when a plaintiff is not allowed a timely trial.

20. Generally, the court will not grant relief if it would unjustly deprive the plaintiff of advantages in the first instance forum. Nevertheless, there should be a real and substantial connection between the venue and the cause(s) of action. Where there is more than one Court with jurisdiction to hear and determine a claim, the forum conveniens is the forum with which the action has the most real and substantial connection.

21. Factors which are relevant to the determination of forum conveniens include: the relative cost and convenience of proceeding in each jurisdiction; the location and availability of documents and witnesses; the existence and state of litigation in another jurisdiction; whether all relevant parties are subject to the forum jurisdiction, so that all issues can be resolved in one hearing; whether the law governing the dispute is the law of the forum; the existence of an agreement to submit to a particular jurisdiction or a clause relating to the appropriateness of a particular forum; the strength of the plaintiff's case; the likely location of enforcement; the genuineness of the defendant's objection to forum; procedural advantages in one jurisdiction; and a decision in another jurisdiction that it is forum conveniens.[51]

22. Where more proceedings in respect of the same subject matter have been commenced in more than one forum at the same time, the situation is referred to as *lis alibi pendens* – 'dispute elsewhere pending'. While English law had traditionally regarded *lis alibi pendens* as an independent ground for the granting of a stay, it has been absorbed into the development of the doctrine of forum non conveniens.[52]

23. The doctrine of forum non conveniens was developed by the Scottish courts in the 19th century, adopted in the United States (with some modifications) and later in England. It has since been adopted throughout the common law, most notably in Canada, Hong Kong, New Zealand, Singapore and India.[53] Anomalously, Australia has taken a different approach to determining which court should hear a dispute. New Zealand, England and most other common law countries apply the broad principles set down by the House of Lords in *Spiliada Maritime Corp v Cansulex Ltd,*[54] which requires the court to decline to exercise jurisdiction where there is a more appropriate forum for the trial of the

[51] *Laws of New Zealand: Conflict of Laws: Jurisdiction and Foreign Judgments* (LexisNexis online) at para 30; Goddard & McQueen *Private International Law in New Zealand* (NZLS Seminar, 2001) at p44.

[52] R Mortensen "Duty Free Forum Shopping: Disputing Venue in the Pacific" (2001) 32 VUWLR 673 at 678.

[53] Dicey, Morris & Collins *The Conflict of Laws* (14th ed, 2006, London, Sweet & Maxwell) vol 1, para 21-011.

[54] *Spiliada Maritime Corp v Cansulex Ltd* [1987] AC 460 (HL).

action. Australian courts have generally applied the test adopted by the High Court of Australia in *Voth v Manildra Flour Mills Pty Ltd*,[55] which requires the court to decline to exercise jurisdiction only where it is clearly an inappropriate court to decide the dispute.[56] The *Voth* approach is narrower than the *Spiliada* approach in that it only requires the court to consider its own appropriateness to determine the proceedings rather than undertake a comparative exercise with other foreign courts.[57]

Jurisdictional challenges

24. Where a foreign defendant has been served outside New Zealand with New Zealand proceedings, they may file an appearance objecting to the Court's jurisdiction.[58] The defendant may then apply to dismiss the proceeding for want of jurisdiction. The plaintiff can apply to set aside the appearance.[59] Other than forum grounds, the basis of challenge may, for example, be on grounds that the plaintiff does not have an arguable case on the merits or that the court does not have subject matter jurisdiction.[60]

25. Where such jurisdictional protest is made, the Court must dismiss the proceeding unless the party effecting service (usually the plaintiff) establishes:[61]

   (a) in the case of service without the court's leave (see para 36 below): (i) there is a good arguable case that the claim falls wholly within one of the categories for which leave to serve is not required and that the Court should assume jurisdiction because there is a serious issue to be tried on the merits, New Zealand is the appropriate forum for the trial and any other relevant circumstances support an assumption of jurisdiction; or (ii) leave would have been granted if sought and the failure to apply should be excused; or

   (b) in the case of service with leave: leave was correctly granted in the light of the evidence now before the court.

[55] *Voth v Manildra Flour Mills Pty Ltd* (1990) 97 ALR 124 (HCA).

[56] The Australian forum will be regarded as 'clearly inappropriate' only if "...continuation of the proceedings in... [the Australian]... Court would be oppressive in the sense of 'seriously and unfairly burdensome, prejudicial or damaging' or, vexatious, in the sense of 'productive of serious and unjustified trouble and harassment'": *Henry v Henry* (1996) 185 CLR 571 at 587.

[57] Dicey, Morris & Collins *The Conflict of Laws* (14th ed, 2006, London, Sweet & Maxwell) vol 1, para 21-011. *Trans-Tasman Court Proceedings and Regulatory Enforcement: A Public Discussion Paper by the Trans-Tasman Working Group* (August 2005) at p 27; see R Mortensen "Duty Free Forum Shopping: Disputing Venue in the Pacific" (2001) 32 VUWLR 673 at 676-678.

[58] HCR r 5.49.

[59] HCR r 5.49(3).

[60] For example, disputes regarding foreign immovable property are determined by the forum where it is located

[61] HCR r 6.29.

26. Defendants must be careful not to take any steps from which it may be inferred that they have submitted to jurisdiction (or waived their right to object) as, if a defendant takes a step that is necessary or useful only if jurisdiction is conceded (responding to a summary judgment application for example), then by that step a defendant submits to New Zealand jurisdiction.[62]

Injunction and declaratory relief

27. Defendants may seek an 'anti-suit' injunction restraining a plaintiff from commencing or pursuing foreign proceedings where such proceedings would be oppressive or vexatious. This may be, for example, where the plaintiff cannot possibly succeed, if they sue in more than one jurisdiction without substantial reasons, if the conduct of the foreign proceedings would interfere with the due process of the domestic court or if the foreign court has assumed jurisdiction either without considering whether there was an alternative forum or reached an obviously unreasonable conclusion on the merits (i.e. forum non conveniens).[63]

28. In *Société Nationale Industrielle Aerospatiale v Lee Kui Jak*[64] Lord Goff stated four principles applicable to the granting of anti-suit injunctions: (a) the injunction is granted when the 'ends of justice' require it; (b) it is granted against the plaintiff in the foreign proceedings in personam and not against the foreign court itself; (c) it is only granted against a person 'who is amenable to the jurisdiction of the [local] court, against whom an injunction will be an effective remedy'; and (c) the jurisdiction is one that should be exercised with caution (because such injunctions are an indirect attack on the jurisdiction of the foreign court contrary to the principle of comity).

29. Defendants can also strike pre-emptively by commencing proceedings for declaration of non-liability. In New Zealand, this would be by way of relief under the Declaratory Judgments Act 1908.

[62] McGechan on Procedure (Brookers online) at para HC5.49.07.

[63] *Laws of New Zealand: Conflict of Laws: Jurisdiction and foreign Judgments* (LexisNexis online) at para 37; Goddard & McQueen *Private International Law in New Zealand* (NZLS Seminar, 2001) at p 51; Rhys Clift "Forum Shopping, Anti-Suit injunctions and EU Law: A Brief Overview" (ICLG Guide to International Arbitration 2007, Global Legal Group) at p 31.

[64] *Société Nationale industrielle Aerospatiale v Lee Kui Jak* [1987] AC 871 (PC).

AUSTRALASIAN FORUM SHOPPING – RECENT DEVELOPMENTS

Trans-Tasman Proceedings Act 2010

30. The strength of the trans-Tasman social and economic ties is well-recognised and has lead to various integration and cooperation initiatives.[65] Such close ties also lead to a greater number of legal disputes with a trans-Tasman element. The Trans-Tasman Proceedings Act 2010 (the **TTPA**) forms part of the longstanding agenda for the trans-Tasman harmonisation of regulatory frameworks to create a "Single Economic Market" - a seamless business environment.[66]

31. In 2003, the Trans-Tasman Working Group on Court Proceedings and Regulatory Enforcement, comprising senior officials from Australia and New Zealand, was established to review trans-Tasman cooperation in court proceedings and regulatory enforcement. Following an extensive consultation process, the key recommendation was that a 'trans-Tasman regime' be introduced modelled on the Australian Service and Execution of Process Act 1992 (Cth) (**SEPA**), which governs the service of proceedings between Australian states/territories. The report stated:[67]

> With the exception of some reforms to the Australian and New Zealand civil justice systems in the early 1990s, including the development of a trans-Tasman evidence regime, the two countries generally treat cross border civil disputes involving the other in the same way as they would treat a dispute involving any other foreign country. This does not reflect the special relationship between Australia and New Zealand, which share a common law heritage and very similar justice systems. For these reasons, and because of the confidence that both countries have in each other's judicial and regulatory institutions, many of the safeguards required for interaction with more distant, dissimilar countries are unnecessary.

32. The New Zealand and Australian governments agreed to adopt the reforms (the agreement between the two governments is appended as schedule 1 of the TTPA).[68] The New Zealand and Australian Trans-Tasman Proceedings Bills received royal assent on 31 August and 13 April 2010. They will come into force by order in council/proclamation on a date yet to be determined. The New Zealand Ministry of Justice informally advises that they hope the Acts will come into force in the second half of this year but they are unsure whether this will be achieved.

33. The stated purposes of the TTPA are to (s3): (a) streamline the process for resolving civil proceedings with a trans-Tasman element in order to reduce costs and improve efficiency; (b) minimise existing impediments to enforcing certain Australian judgments and regulatory sanctions; and (c) implement

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[65] Such as the 1973 Trans Tasman Travel Arrangement and the 1983 Australia New Zealand Closer Economic Relations Trade Agreement (CER).

[66] Colin James "The elusive single economic market" Legal Research Foundation Conference (9 March 2007).

[67] Trans-Tasman Working Group "Trans-Tasman Court Proceedings and Regulatory Enforcement" (December 2006), 8.

[68] Schedule 1 Trans-Tasman Proceedings Act 2010. On signing the Agreement, the Hon Lianne Dalziel (Minister of Commerce at the time) called it "an unprecedented level of cooperation between Australia and New Zealand in civil court proceedings": Hansard (24 August 2010), Raymond Huo MP.

the Trans-Tasman Agreement in New Zealand law. (Australia's equivalent legislation is the Trans-Tasman Proceedings Act 2010 (Cth) (the **Australian Act**)).

34. The Australian Act and TTPA will be referred to collectively as the '**new rules**'. Australian and New Zealand drafters worked closely to ensure that the two Acts are aligned as far as possible. Any differences between the two reflect differences in drafting style between New Zealand's Parliamentary Counsel Office and the Australian Office of Parliamentary Counsel. In some cases, they also reflect differences in the domestic legal and political context.[69] While this paper focuses on the TTPA, the observations made will also generally be applicable to the Australian Act.

35. The new rules contain a number of significant changes for commercial legal advisers. First, they allow for New Zealand proceedings to be served in Australia (and vice versa) without needing to seek leave or establish a connection with the jurisdiction. Secondly, they adopt a common statutory test for *forum non conveniens* to replace potentially inconsistent rules in New Zealand and Australia (see para 23 above). Thirdly, they provide for mutual recognition and enforcement of specified Australian judgments or tribunal decisions, including those given in trans-Tasman market proceedings. Fourthly, they empower New Zealand courts to give interim relief in support of Australian civil proceedings (and vice versa). Fifthly, they allow people in Australia to appear remotely in New Zealand civil proceedings (and vice versa).

Service and enforcement

36. Australia and New Zealand currently treat each other as they treat other foreign countries when it comes to cross-border service and the recognition and enforcement of judgments.[70] Courts in both countries have jurisdiction to allow service of civil proceedings on a defendant overseas. Under current New Zealand law, originating documents may be served on a defendant outside on New Zealand without leave in specified situations.[71] In any other case, originating documents may only be served out of New Zealand with the leave of the Court (r 6.28).[72] Under current law, to serve an Australian defendant in a New Zealand proceeding, the *plaintiff* must establish that the New Zealand

[69] Trans-Tasman Proceedings Bill Departmental Report Part 1 (May 2010) at para 13; Supplementary report (July 2010).

[70] There are some limited exceptions to this, including special arrangements for enforcing each other's tax judgments and lower court money judgments: See Foreign Judgments Act 1991 (Cth) and Reciprocal Enforcement of Judgments Act 1934 (NZ).

[71] These include where damage was sustained in New Zealand, where the disputed contract was made, performed or breached in New Zealand or governed by New Zealand law, where the subject property of the proceeding is in New Zealand, where the defendant is domiciled or ordinarily resident in New Zealand, where the defendant has submitted to the Court's jurisdiction or where it is sought to enforce any judgment or arbitral award: HCR r 6.27.

[72] For leave to be granted, the *plaintiff* must satisfy the Court that (a) the claim has a real and substantial connection with New Zealand; (b) there is a serious issue to be tried on the merits; (c) New Zealand is the appropriate forum for the trial (forum conveniens); and (d) any other relevant circumstances support an assumption of jurisdiction.

Court is the forum conveniens unless the proceeding fits within one of the categories specified in r 6.27.

37. However, different rules apply when a court is asked to recognise or enforce a judgment of a foreign court under the Foreign Judgments Act 1991 (Cth) (**FJA**) and Reciprocal Enforcement of Judgments Act 1934 (NZ) (**REJA**) or the common law.[73] The basic problem is that, although Australasian courts have jurisdiction to allow service of proceedings on a defendant overseas, if that defendant does not submit to the court's jurisdiction, the resulting judgment may not be enforceable in the other country. This gives the defendant an incentive to ignore the proceedings, knowing they are safe from enforcement action.

38. Under TTPA s13, a plaintiff in a New Zealand proceeding may serve a defendant in Australia with any originating document without obtaining leave to do so and without any need to show a connection with New Zealand or forum conveniens. Documents served in Australia must be served in the same way that is required or permitted under New Zealand procedural law.

39. Upon being served with New Zealand proceedings, the defendant can seek security for costs (s20) and can seek to have the proceeding stayed on the grounds that an Australian court has jurisdiction and is the more appropriate court to determine the dispute (ss21-22) taking into account specified factors (set out below). The new rules effectively shift the burden of showing forum non conveniens onto the *defendant*.

40. The new rules also: (a) prevent courts from granting anti-suit injunctions against proceedings in the foreign court on the ground that the foreign court is not the appropriate forum for the proceeding (to prevent circumvention of the new rules which provide for forum questions to be determined in the context of a stay application);[74] (b) apply only to actions in personam (i.e. binding only the parties to the proceeding and not attaching to the property);[75] and (c) do not touch the *Moçambique*[76] rule under

[73] Trans-Tasman Working Group "Trans-Tasman Court Proceedings and Regulatory Enforcement" (December 2006) at p11. One of the grounds for setting aside registration under the FJA and REJA (reflecting the common law) is that the foreign court did not have jurisdiction over the defendant: Section 7(2)(a)(iv) FJA and s6 REJA. Jurisdiction is established by either: (a) the defendant's presence or residence in the forum country at the time proceedings were issued; or (b) the defendant's submission to the forum court's jurisdiction by voluntarily appearing in the proceedings (other than to protest jurisdiction) or by agreement between the parties before the proceedings began: AG Dept (Aus) and Ministry of Justice (NZ) "Trans-Tasman Court Proceedings and Regulatory Enforcement: A Public Discussion Paper by the Trans-Tasman Working Group" (August 2005) at p 10.

[74] TTPA s 28.

[75] TTPA s 12(2)(b).

[76] After the leading authority *British South Africa Company v Companhia de Moçambique* [1893] AC 602.

which a court generally has no power to determine matters of title to, or possession of, immovable property (primarily land) located outside its jurisdiction.[77]

Forum non conveniens

41. The TTPA shifts the burden of showing forum non conveniens onto the *defendant* as proceedings that would previously have required the plaintiff to obtain leave to serve originating documents (requiring the plaintiff to establish forum conveniens) can be served without leave under the new rules. The defendant may then seek a stay on grounds of forum non conveniens.

42. As noted above at paragraph 23, New Zealand and Australia have different rules regarding forum non conveniens in that an Australian court will decline to exercise jurisdiction only where it is *clearly inappropriate* for it to decide the dispute (considering only its own appropriateness) whereas New Zealand courts will decline jurisdiction where there is a *more appropriate* forum for the trial of the action (considering the appropriateness of the foreign court).

43. Under current law, there is a risk that, where there are concurrent proceedings in New Zealand and Australia, the Australian court will refuse a stay because it does not consider Australia a clearly inappropriate forum and the New Zealand court will similarly refuse a stay because it considers New Zealand to be the more appropriate forum.[78] Adopting the SEPA approach, the new rules create a common rule whereby the court, upon application for a stay will assess whether the foreign court: (a) has jurisdiction and (b) is the *more appropriate* forum (the approach taken currently by New Zealand courts).

44. In determining whether the foreign court is the more appropriate Court to determine a dispute under the TTPA, the forum Court must not take into account where the proceeding was commenced but it must consider (s24(2)): (a) the parties' places of residence or, if a party is not an individual, its principal place of business; (b) the likely witnesses' places of residence; (c) where the subject matter is situated; (d) any non-exclusive jurisdiction agreement; (e) the most appropriately applicable law; (f) whether a related or similar proceeding has been commenced in Australia; (g) the financial circumstances of the parties; and (h) any other relevant matters.

[77] Despite the fact that this rule has been abolished in NSW and ACT, it is still otherwise in force throughout Australasia, it was thought that while domestic reforms may progressively abolish the rule, it was premature to effect abolition under the TTP: Trans-Tasman Working Group "Trans-Tasman Court Proceedings and Regulatory Enforcement" (December 2006) at p13.

[78] This is exactly what occurred in a 1993 matrimonial property proceeding. Proceedings were underway in both New Zealand and Australia. Neither court stayed the proceedings before it. Fortunately, the parties settled their dispute so that a 'race to judgment' did not occur. Otherwise, the party who first obtained judgment would have the advantage of being able to enforce that judgment in the other country: *In the Marriage of Gilmore* (1993) 100 FLR 311 and *Gilmore v Gilmore* [1993] NZFLR 561.

45. The Brussels Convention of 1968 and the EU Council Regulation (EC) 44/2001 govern choice of jurisdiction and recognition and enforcement of judgments among EU members.[79] Both the Convention and Regulation provide that proceedings must generally be commenced in the country of the defendant's *domicile*.[80] The Working Group considered adopting this approach. It ultimately recommended against it on the bases that it was better suited to civil law jurisdictions, that it did not address other issues the SEPA model did and that there were other concerns regarding the EU model.[81] A domicile-based rule still allows for some forum shopping.[82]

46. However, there could be more scope for jurisdictional argument under the TTPA's open assessment of the 'most appropriate forum'. Concern regarding the potential for inconsistent application in New Zealand and Australia was voiced during the consultation process but the Working Group dismissed the concern on the basis that likelihood of inconsistency was "sufficiently unlikely as to not require a legislative solution".[83] While the new rules ameliorate the risks of inconsistency through a common non-exhaustive list of factors for Australasian courts to consider when determining the appropriate forum, there remains a risk of inconsistent application.

Enforcement scope

47. Under the FJA and REJA, only final and conclusive money judgments of certain courts of the other country can be registered and enforced,[84] except for some provision for enforcement of non-final and non-monetary judgments made in certain competition proceedings relating to trans-Tasman markets.[85]

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[79] Rhys Clift "Forum Shopping, Anti-Suit injunctions and EU Law: A Brief Overview" (ICLG Guide to International Arbitration 2007, Global Legal Group) at p 32. Note that Denmark is still subject to the Brussels Convention and that Switzerland, Iceland and Norway are subject to the Lugano Convention of 1988 containing similar rules.

[80] However, there are alternatives in specific contexts. For example, in contractual disputes, a defendant can be sued where the contract was (or was to be) performed and in tort claims, the defendant may be sued where the harmful event occurred or may occur. Where more than one court has jurisdiction and proceedings have been filed in both, priority is decided on a 'first to file' rule: Rhys Clift "Forum Shopping, Anti-Suit injunctions and EU Law: A Brief Overview" (ICLG Guide to International Arbitration 2007, Global Legal Group) at p 32; Trans-Tasman Working Group "Trans-Tasman Court Proceedings and Regulatory Enforcement" (December 2006) at p 11; King & Colbran "Forum shopping" 149(18) *Solicitors Journal* (May 2005) 531, 532; Krauskopf & Tkacikova "Competition law violations and private enforcement: forum shopping strategies" 4(1) *Global Competition Law Review* 26 at 36.

[81] Some of the concerns were the complexity of the rules regarding domicile and the view that the 'first to file' rule is arbitrary and undesirable: AG Dept (Aus) and Ministry of Justice (NZ) "Trans-Tasman Court Proceedings and Regulatory Enforcement: A Public Discussion Paper by the Trans-Tasman Working Group" (August 2005) at p 13.

[82] For example, a claim for declaration of non-liability where the 'natural' defendant attacks the natural plaintiff can found jurisdiction in the natural plaintiff's jurisdiction (because the natural defendant becomes the plaintiff).

[83] Page 18 of the report.

[84] Reciprocal Enforcement of Judgments (Australian Inferior Courts) Order 1992; Part 1A of the Reciprocal Enforcement of Judgments Act 1934. Similarly, at common law in New Zealand and Australia (applicable where no reciprocal arrangement exists), judgment is enforced only if it is final, conclusive and for a definite sum of money.

[85] Section 32B of the Federal Court of Australia act 1976 (Cth); see Mortensen, Read *Private International Law in Australia* (LexisNexis Butterworths Australia, Sydney, 2006) at 158-159; Part 1A of the Reciprocal Enforcement of Judgments Act 1934.

The current rules extend enforcement to specified categories of non-money judgments by order in council but no specifications have ever occurred. As such, orders for specific performance or injunctions are currently unenforceable.

48. The new rules extend the types of judgments that will be enforceable trans-Tasman to include: (a) final non-money judgments, such as final injunctions and orders for specific performance; (b) decisions of mutually agreed tribunals or decision classes of such bodies; (c) civil pecuniary penalty orders (unless specifically excluded by order in council) – a 'negative list' approach; and (d) criminal fines for regulatory offences if specifically declared to be included order in council – a 'positive list' approach. The new rules also provide that certain judgments of tribunals as designated by order in council will be enforceable (s55).

49. Enforceability will not extend to proceedings governed by existing co-operative schemes and which require a high level of court supervision, such as probate, estate administration, child care and welfare, relationship maintenance and proceeds of crime (s54(2)). Registered judgments may be set aside where enforcement is contrary to local public policy (s 61(2)(b)).

50. The new rules mean that parties will have more enforcement options and a higher likelihood of enforcement success. Accordingly, there is a greater risk of default judgments being granted by foreign courts against New Zealand defendants and then enforced in New Zealand. New Zealand defendants may no longer be able to simply ignore proceedings in reliance of the foreign court's lack of jurisdiction over them.

Interim relief

51. At New Zealand and Australian common law, a court can grant interim relief only where necessary to protect an applicant's rights until final judgment is given in proceedings before that court. The two jurisdictional requirements for such relief are that: (a) there must be an underlying substantive cause of action that can be decided in the proceedings; and (b) the court must have jurisdiction to grant final relief against the defendant.[86] As such, under current law, orders for interim relief cannot be obtained in one country in support of proceedings in another – they can only be awarded by the court determining the substantive dispute.

52. The new rules enable orders for interim relief to be made by a court other than that seized of the substantive dispute. The scope of available relief is wide (e.g. search and freezing orders). A

[86] AG Dept (Aus) and Ministry of Justice (NZ) "Trans-Tasman Court Proceedings and Regulatory Enforcement: A Public Discussion Paper by the Trans-Tasman Working Group" (August 2005) at p 21.

'negative list' approach is taken, excluding orders as to interim payments, discovery, property arrest warrants and relief under part 4 (subparts 1 and 2) of the Evidence Act 2006 (dealing with evidence from overseas or to be used overseas). Interim relief will only be granted if such relief would have been granted had the proceeding been local.[87]

Forum shopping concerns

53. The new rules raise a number of potential concerns. The Working Group was aware of the forum shopping risk that a lack of legal consistency facilitates. The discussion document states:

> This proposal does not address the related problem of having different jurisdictions applying different 'choice of law' rules. These rules decide the substantive law that applies to the proceedings. In some areas of law, choice of law rules tend to favour the law of the forum. Because of this, the outcome of proceedings may vary depending on where the dispute is decided. Plaintiffs may select a court to exploit this to their advantage. However, making the *forum non conveniens* rules consistent, as proposed, should significantly reduce trans-Tasman forum shopping. This is because one factor to be taken into account in deciding the appropriate court is the law to be applied in the proceedings. Achieving uniform outcomes would require harmonisation of Australian and New Zealand laws or harmonisation of choice of law rules. Neither is proposed in this paper. The Working Group suggests this be left for future progressive reform.

54. This passage shows that the Working Group had a narrow view of the reasons why parties shop around. As set out above, aside from choice of law rules and substantive law, parties may forum shop for a variety of reasons. It is unclear whether specifying the applicable law as a factor to be considered in determining the appropriate forum will have a significant impact on whether a party will seek to forum shop. To illustrate, if a contract specified that New Zealand law applied but courts in New Zealand and Australia both had jurisdiction, the choice of New Zealand law would not determine which forum was 'more appropriate' – it would simply be one of several factors.

55. The notion that common criteria for determining the appropriate forum will reduce forum shopping assumes parties will refrain from shopping in the belief that different courts will come to the same decision as to forum conveniens. However, as noted above, there remains a risk of courts differing as to the appropriate forum or parties may perceive there is sufficient risk of that to shop.

56. In this light, it is unclear whether the TTPA will reduce forum shopping. In fact, the increased ease of initial service and the lack of restrictions on where proceedings may be filed may encourage some plaintiffs to forum shop between Australian state jurisdictions and New Zealand. Under the new rules, once proceedings have commenced, defendants will bear the burden of demonstrating that the proceedings should be brought in another jurisdiction. Plaintiffs may be encouraged by this shift in the burden of establishing forum (non) conveniens to defendants. There is a risk these changes will

[87] See TTPA ss 31-32.

cause cost and inconvenience to foreign defendants and may increase the amount of time and money spent in jurisdictional disputes.

57. In response to concerns raised during the consultation process as to shifting the forum conveniens 'burden' to the defendant, the Working Group indicated that, as leave is not required in many instances under current law (in such case the defendant already bears the burden), the shift will be limited in practice.[88] This is true in the sense the range of cases for which leave is not currently required is broad (see para 36 above).

58. An example of this is that large companies may seek to consolidate their debt recovery processes in one jurisdiction, on the basis that small debtors will not consider it worthwhile to challenge the claims due to the costs and practical difficulties associated with remote litigation. While there is some evidence that such practices have occurred under the SEPA rules (on which the TTPA service rules are based),[89] the Working Group reported that there is "little concrete evidence" that this has been a real problem under SEPA. It recommended that such issue be dealt with in future should they emerge.[90] This risk has been reduced by the requirement that documents set out the defendant's rights.[91]

59. The SEPA rules were developed to deal with service issues in Australia and it could be argued that they are not be suitable in an international context. There is a difference between an Australian court exercising automatic jurisdiction over a person who is resident in another state within Australia and doing so over a person who is resident in New Zealand. Whether an Australian resident is sued in their home state or another state, they are still being sued in their own country and may still have recourse to the overarching jurisdiction of the Australian federal laws and courts. In contrast, while Australia and New Zealand have very close ties, they are separate countries with separate judicial, legislative and administrative structures. There is no trans-Tasman court to resolve any conflicts that may arise between competing judgments of the Australian and New Zealand courts.[92] The goal of

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[88] Trans-Tasman Working Group "Trans-Tasman Court Proceedings and Regulatory Enforcement" (December 2006), 11.

[89] For example, the Victoria Legal Aid report on "Debt Recovery Law and Procedure in Victoria" suggests that national debt collection firms in Australia have engaged in forum shopping to the detriment of small debtors: AG Dept (Aus) and Ministry of Justice (NZ) "Trans-Tasman Court Proceedings and Regulatory Enforcement: A Public Discussion Paper by the Trans-Tasman Working Group" (August 2005) p 16.

[90] Trans-Tasman Working Group "Trans-Tasman Court Proceedings and Regulatory Enforcement" (December 2006) at pp 12-13.

[91] TTPA s15.

[92] While this situation may be rare, it will create a serious issue under the new rules as both Australian and New Zealand judgments will be entitled to automatic enforcement in both countries.

harmonisation may also be hindered by the courts taking different approaches to the application of the new rules.

60. The additional cost/inconvenience potentially caused to foreign defendants by the new rules is, however, ameliorated by the allowance for remote appearances without leave.[93]

Substantive and procedural differences?

61. As explained above, there is potential for the new rules to encourage forum shopping. However, such shopping may be discouraged by the fact that the procedural and substantive laws of New Zealand and Australia are highly harmonised, so the advantages of shopping are reduced.

62. Recent years have seen significant steps towards trans-Tasman harmonisation of laws and standards. There has been development of laws relating to competition, securities, takeovers, consumer protection, electronic transactions, disclosure regimes, cross-border insolvency, tax, company administration, accounting standards, financial services and reporting, intellectual property, food standards and therapeutic goods.[94] There are various trans-Tasman harmonisation and cooperation initiatives currently underway in respect of these areas.[95] Examples in the banking context include rules for regulator cooperation in fulfilling statutory banking supervision objectives and to avoid actions that could have a detrimental effect on financial system stability in the other country[96] and a mutual securities offer recognition scheme.[97]

63. However, despite such initiatives, there remain notable differences as between New Zealand and Australian law and as between the states/territories of Australia.[98] For example:

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[93] For example, via telephone/video-link by counsel and defendants in stay application hearings (ss 19, 23(4) and 39).

[94] See Ministry of Foreign Affairs & Trade "The Australia – New Zealand Closer Economic Relationship*"* (2005) at p 29; Australian Government Productivity Commission "Australian and New Zealand Competition and Consumer Protection Regimes" (16 December 2004); Australian Standing Committee on Legal and Constitutional Affairs "Harmonisation of legal systems" (November 2006), chapter 3.

[95] See Press Release by Bill English "Ministers English and Swan progress trans-Tasman relationship" (14 July 2011).

[96] The Reserve Bank of New Zealand Amendment Act 2006 (NZ) and the Financial Sector Legislation Amendment (Trans-Tasman Banking Supervision) Act 2006 (Cth). See also Australian Standing Committee on Legal and Constitutional Affairs "Harmonisation of legal systems" (November 2006) at pp 43-46.

[97] The Securities (Mutual Recognition of Securities Offerings—Australia) Regulations 2008. See Australian Standing Committee on Legal and Constitutional Affairs "Harmonisation of legal systems" (November 2006) at pp 48-49

[98] Colin James "The elusive single economic market" Legal Research Foundation Conference (9 March 2007); Australian Standing Committee on Legal and Constitutional Affairs "Harmonisation of legal systems" (November 2006), chapters 3 and 4; B R Opeskin "The Price of Forum shopping" (1994) *Sydney Law Review* (16) 14 at 19-20.

(a) Securities law: Australia has criminal offence provisions for serious contraventions of general duties - company directors can be prosecuted if they are reckless and fail to exercise their powers for a proper purpose. New Zealand has no such provisions.[99]

(b) Contract interpretation: Following the Supreme Court's decision in *Vector*,[100] New Zealand courts may be more able to look at pre-contractual negotiations when interpreting contracts. In Australia, the clear rule is that pre-contractual negotiations are irrelevant.[101] A party seeking to minimise the expense of litigation arising out of a trans-Tasman contract may prefer to have a dispute determined under Australian contract law to avoid the potential expense of having to deal with pre-contractual material.

Enforcement of foreign penalties

64. Under current law civil pecuniary penalty orders[102] and criminal fines for regulatory offences are unlikely to be enforceable trans-Tasman.[103] This follows the well-established common law rule that courts of one country will not enforce the penal or public laws of foreign countries.[104]

65. The TTPA extends the scope of enforceable trans-Tasman judgments to include: (a) civil pecuniary penalty orders unless excluded by order in council ('negative list' approach); and (b) criminal fines for regulatory offences if specifically declared to be included order in council ('positive list' approach). These will be enforceable as if they were civil judgments. New Zealand businesses/individuals operating in trans-Tasman markets will be exposed to the risk of fines and penalties imposed by the Australian courts following Australian regulator prosecutions. While the same applies to Australian businesses/individuals, the issue is likely to be more significant for New Zealanders who will now be subject to significantly greater exposure.[105]

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[99] Earlier this year, the New Zealand cabinet agreed a new liability framework under which reckless or intentional breaches of duty could result in criminal liability: Ministry of Economic Development "Review of Securities Law: Discussion Paper" (June 2010) p185; Minister of Commerce "Securities Law Review: Additional policy decisions and costings" (May 2011) at p 2.

[100] *Vector Gas Limited v Bay of Plenty Energy Limited* [2010] NZSC 5.

[101] See Kavanagh and West "Traps for lawyers advising on trans-Tasman contracts" *NZ Lawyer* (3 June 2011) at p10.

[102] Under the restrictive trade practices provisions of the Commerce Act 1986 (NZ) and the Trade Practices Act 1974 (Cth), for example.

[103] AG Dept (Aus) and Ministry of Justice (NZ) "Trans-Tasman Court Proceedings and Regulatory Enforcement: A Public Discussion Paper by the Trans-Tasman Working Group" (August 2005) at pp 40 and 43.

[104] Dicey, Morris & Collins *The Conflict of Laws* (14th ed, 2006, London, Sweet & Maxwell) vol 1, paras 5-020 and 5-028.

[105] New Zealand businesses and individuals will be directly exposed to the Australian regulatory enforcement, including higher fines and penalties from across the Tasman. For example, the maximum fines under the Trade Practices Act (Cth) for misleading and deceptive conduct are A1.1 million for companies or A$220,000 for individuals, compared with NZ$200,000 for companies and NZ$60,000 for individuals under Fair Trading Act (NZ).

66. This step is considered to be justified by the strong mutual interest in the integrity of trans-Tasman markets and the effective enforcement of regulation. The new rules aim to prevent people evading regulatory responsibilities by moving themselves or their assets between countries. The Working Group discussion paper notes the integrated nature of the Australasian markets, with common market participants, mutual recognition regimes for goods and occupations[106] and the convergence of regulation in areas such as food standards and product safety standards.

67. David Goddard QC, a member of the Working Group, stated that new rules "represent the furthest reaching proposals of this kind as between any two sovereign States with separate legal systems".[107] While concern has been expressed that this is a significant incursion on national sovereignty,[108] the Working Group considered that any sovereignty concerns were outweighed by the mutual benefit of mutual enforcement.[109]

68. It is unclear why civil penalties and regulatory fines are treated differently (negative list v positive list).[110] The more liberal position taken regarding civil penalties may be a product of the historical aversion to cross-border enforcement of penal laws. However, both are in essence punitive and the civil/criminal distinction may be little more than nomenclature.[111]

69. Direct and mutual enforcement of regulatory penalties may be seen by some as undesirable as, while regulatory proceedings will be mutually enforceable, there can be no assurance that the New Zealand and Australian regulatory regimes will move in the same direction. As such, there is a risk of contradictory regulation in areas like competition, securities and consumer protection.[112]

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[106] Under the Trans-Tasman Mutual Recognition Arrangement.

[107] David Goddard QC "Case study: Trans-Tasman court proceedings and regulatory enforcement", presented Legal Research Foundation Conference (9 March 2007); referred to in Hansard (24 August 2010) by Charles Chauvel MP and others.

[108] Hansard (24 August 2010), Keith Locke MP.

[109] It suggested that sovereignty concerns in respect of the positively-listed criminal offences could be addressed by ensuring a real connection between the country imposing the criminal fine and the conduct amounting to the offence by specifying the statutes to which enforcement applies or the circumstances in which fines would be enforced in the other country: AG Dept (Aus) and Ministry of Justice (NZ) "Trans-Tasman Court Proceedings and Regulatory Enforcement: A Public Discussion Paper by the Trans-Tasman Working Group" (August 2005) pp 41 and 46.

[110] The Working Group discussion paper simply states that "[t]he Working Group does not propose that all criminal fines should be enforceable in the other country. The reason for enforcement is the mutual interest in the integrity and effectiveness of certain of each other's regulatory regimes. The guiding principle for enforcement on a trans-Tasman basis is that the fine arises from a regulatory regime impacting on the effectiveness, integrity and efficiency of trans-Tasman markets, or confidence in those markets. Using this yardstick, areas such as securities offerings to the public, competition law, consumer protection and product safety provisions, occupational regulation, insider trading and prudential regulation are clear candidates."

[111] For example, a fine under s40 of the Fair Trading Act 1986 (e.g. misleading and deceptive conduct) is a criminal penalty whereas a fine under s80 of the Commerce Act 1986 (restrictive trade practices) is a civil penalty.

[112] Some may suggest that this is immaterial as the regime relates only to enforcement and not to primary regulation. However, the line between the two may be blurred e.g. where one country's domestic court imposes a penalty that takes

70. The emphasis during the legislative process has been on using the principle of mutual recognition to support the concept of an integrated trans-Tasman market. However, potential issues which have been identified include:[113]

(a) The 2008 Agreement indicates that only fines for criminal regulatory offences that "affect the effectiveness, integrity and efficiency of trans-Tasman markets and in which both Parties have a strong mutual interest" will be nominated. However, much of the New Zealand legislation listed for likely inclusion are of largely domestic relevance.[114]

(b) Anecdotal evidence suggests New Zealand and Australia have different regulatory mindsets and the two countries are far from coordinated.[115] While mutual enforceability may foster a coordinated approach, there may be a period of dysfunctional regulatory overlap.[116]

(c) Where there is a true trans-Tasman nexus (i.e. contravening conduct which affects both jurisdictions) the proposed regime may increase the risk of double penalisation. In this light, it may fall to the regulators' discretion to ensure a harmonised approach.

Conclusion

71. The TTPA is a significant step towards the integration of New Zealand and Australia's legal and regulatory environments. Improving the ease of trans-Tasman service and enforcement appears to be a positive step. However, the new rules also bring new risks. Under the new rules, plaintiffs will not have to show any justification for issuing proceedings in one country against a defendant in the other. Defendants must now persuade the Court that it should not exercise jurisdiction, diminishing defendants' protection from ill-founded claims. The new rules expose New Zealand businesses and individuals to the significantly higher fines imposed by Australian regulation.

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account of trans-Tasman conduct or the seizure of a company's New Zealand assets to satisfy an Australian regulatory penalty: D Kalderimis "Trans-Tasman integration: court proceedings and enforcement" (www.chapmantripp.com, 18 December 2009).

[113] D Kalderimis "Trans-Tasman integration: court proceedings and enforcement" (www.chapmantripp.com, 18 December 2009).

[114] For example, the document proposes to allow cross-border enforcement of criminal penalties under the Commerce Act, Companies Act, Fair Trading Act, Securities Acts, Takeovers Act, Financial Reporting Act, Credit Contracts and Consumer Finance Act, as well as "occupational regulation legislation". The Working Group did, however, acknowledge that industry-specific parts of the legislation listed may perhaps be excluded: AG Dept (Aus) and Ministry of Justice (NZ) "Trans-Tasman Court Proceedings and Regulatory Enforcement: A Public Discussion Paper by the Trans-Tasman Working Group" (August 2005) at pp 7 and 45.

[115] The New Zealand Commerce Commission is unlikely to accept arguments that a New Zealand penalty should be reduced to take account of penalties imposed in Australia in respect of the same or related conduct. Likewise for the Australian Securities and Investments Commission.

[116] See the Hansard discussion on 25 August 2010 by Hon Lianne Dalziel.

72. The advantages of the TTPA have come with some mutual cession of legal sovereignty. To the extent the regulatory mindsets of both countries differ, the integration created by the Act may generate some friction in the short to medium term. There is possibly a greater likelihood of companies being drawn into litigation across the Tasman or of falling within the reach of both Australian and New Zealand regulators. There is therefore a risk that the new rules could potentially increase litigation and compliance costs for trans-Tasman businesses.

Company incorporation

73. Forum shopping is generally considered to occur when a party selects a forum in which to progress their claim, i.e. upon commencement of proceedings.[117] However, a party forum shops in the broader sense any time it makes a decision that will affect the forum for the dispute.[118] An expanded notion of forum shopping captures actions which occur prior to commencement of proceeding whereby a party makes an election which will influence where a dispute will likely be held.[119] As a learned yet unnamed Harvard author stated[120] "businesses enjoy one of the most significant forum-shopping powers available – the decision where to incorporate".

74. A business may incorporate in a particular jurisdiction in order to place itself within that jurisdiction or to generate a veneer of association with the country even if the activities of the business are not in actuality conducted in that jurisdiction – an 'incorporation of convenience'. However, incorporation in a jurisdiction may work to a business' advantage or disadvantage. There may be advantages to incorporation in a particular locality or to operating through an incorporated subsidiary in a particular state (tax, corporate rules etc). It may also render the business more susceptible to its activities being caught as locally domiciled and thus subject to local law and courts or it might serve to usefully separate the local and international operations of the business.

75. A good illustration of forum shopping by incorporation is the tendency of companies to incorporate or reincorporate in Delaware.[121] The internal affairs of US corporations are governed by the law in the state of incorporation. Accordingly, corporations can choose the corporate law applicable to their

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[117] See F K Juenger "Forum shopping, domestic and international" (1989) 63 *Tulane Law Review* 553 at 554.

[118] See "Forum shopping reconsidered" 103 (7) *Harvard Law Review* 1990 1677 at 1677-1678.

[119] This may be through the inclusion of a choice of forum/jurisdiction clause in a contract or the incorporation of an entity through which to do business in a particular jurisdiction or otherwise. While such elections may occur prior to contemplation of any dispute, they will have a direct impact on where any dispute is heard such that they are a form of forum shopping. The characteristics of the forum may be one of several factors influencing the decision as to where a business should incorporate a new company. In some cases, forum characteristic may be a major factor.

[120] "Forum shopping reconsidered" 103 (7) *Harvard Law Review* (1990) 1677 at 1692.

[121] Bradley & Schipani "The Relevance of the Duty of Care Standard in Corporate Governance 75 Iowa Law Review 1, 65 (1990).

internal affairs by incorporating in the state of their choice. In a recent national survey conducted of United Stated closely-held corporations, 33% of those with 1000 or more employees and 50% of those with 5000 or more employees were incorporated in Delaware.[122] Delaware also dominates the market for incorporation of publicly listed corporations.[123] The study suggested that this phenomenon resulted from: (a) the perception that the Delaware judiciary is of very high quality; and (b) the protection of the 'exculpation statute', which allows corporations to limit the personal liability of directors for certain types of duty violations in the corporate charter.[124]

New Zealand company incorporation rules

76. New Zealand's rules for company incorporation, contained in the Companies Act 1993, are more liberal than those of other economically similar jurisdictions like Singapore, Australia or Canada, all of which require at least one director to be resident in the state of incorporation. Incorporation requires a name, one or more shares, one or more shareholders and one or more directors. New Zealand also makes more use of the internet for the registration process, does not impose an annual licensing fee (anomalously) and the application fee is low by international standards.

77. While the administrative ease of these rules is attractive to foreign interests, it leaves the registration regime vulnerable to misuse by illegitimate offshore operators. New Zealand corporate lawyers will intermittently receive requests from foreign persons to either incorporate a new company in New Zealand or register an existing foreign company as an overseas company in circumstances where there is no nexus (other than the registration/incorporation) between the entity's operations and New Zealand. This may be done simply to associate the company with an advanced western economy considered to be politically neutral or to create scope for an argument that operations will be governed by New Zealand law where advantageous.

78. There is evidence that individuals and groups (mostly offshore) are misusing the New Zealand company incorporation process. A recent, and highly-publicised, example was the incident involving

[122] Of those incorporating outside the state where their primary place of business is located (i.e. their 'home state') within these brackets, 77% and 83% were incorporated in Delaware. Damman & Schundeln "The incorporation choices of privately held corporations" (27) 1 *Journal of Law, Economics & Organization* (2011) 79 at 83-84.

[123] Delaware has been a popular destination for IPO firms, having approximately 70% of IPO firm incorporations between 1978 and 2000 and 95% of those outside their home state: Damman & Schundeln "The incorporation choices of privately held corporations" (27) 1 *Journal of Law, Economics & Organization* (2011) 79 at 83-84.

[124] The Delaware statute enables a corporation to state in its certificate of incorporation (or later with shareholder approval) that a director shall not be personally liable to the corporation or its shareholders for damages for breach of any duty owed to the corporation or its shareholders (subject to some limited exceptions): Damman & Schundeln "The incorporation choices of privately held corporations" (27) 1 *Journal of Law, Economics & Organization* (2011) 79 at 89 and 92; Bradley & Schipani "The Relevance of the Duty of Care Standard in Corporate Governance 75 Iowa Law Review (1990) 1 at 43; W Felton "Director and Officer Exculpation Statutes in an Post-Enron World" (www.greenbaumlaw.com).

SP Trading Limited in late 2009/early 2010. Whilst registered in New Zealand, it was controlled overseas.[125] SP Trading was involved in chartering a plane that departed from North Korea and was intercepted in Bangkok carrying 35 tonnes of weapons in contravention of UN prohibitions on trading in arms with North Korea. SP Trading had no business presence in New Zealand. The person behind it had moved to Vanuatu by the time issues arose, putting them beyond the reach of sanction.[126]

79. The New Zealand Reserve Bank has similar concerns with respect to "overseas financial institutions" of which approximately 100 have been incorporated in New Zealand over the past three or so years. Such shell companies are used to carry on banking activities without the necessary controls, and many appear to be engaged in fraudulent activities.[127]

Legislative initiative

80. In essence, whilst registration in New Zealand should subject companies and those involved in them to New Zealand law, in practice, gaps in the regime may mean that does not in fact occur. As a result, in the short term, there is an initiative underway by the Ministry of Economic Development to implement several limited amendments to the Companies Act 1993 and Limited Partnerships Act 2008 to strengthen the regime.[128] There are four broad reform proposals:

(a) requiring companies to appoint at least one director or an agent who is ordinarily resident in New Zealand to enable the Registrar to confirm the bona fides of those behind the company, test the accuracy of the personal particulars supplied during registration and (where appropriate) hold someone to account for any breaches of law;

(b) requiring directors to supply date and place of birth information for official purposes only;

(c) requiring all companies to apply for an IRD number as part of their registration application process to provide some disincentive for incorporations of convenience; and

(d) enhancing the Registrar's ability to investigate, respond to or remedy issues regarding the bona fides of directors and shareholders and any integrity or registration compliance issues. This

[125] Its sole director was a New Zealand-based nominee who had signed a power of attorney handing over authority to two foreign individuals and the sole shareholder, another New Zealand company, held the shares on trust for the same two people.

[126] Minister of Commerce Report to Cabinet Economic Growth and Infrastructure Committee "New Zealand Company Registration Process" (File no: M/007/AL/004/014) (late 2010).

[127] Minister of Commerce Report to Cabinet Economic Growth and Infrastructure Committee "New Zealand Company Registration Process" (File no: M/007/AL/004/014) (late 2010).

[128] Minister of Commerce Report to Cabinet Economic Growth and Infrastructure Committee "New Zealand Company Registration Process" (File no: M/007/AL/004/014) (late 2010).

may include powers to: (i) require someone to confirm/correct the register; (ii) 'flag' a record on the Companies Office website as being under enquiry as to the information integrity; (iii) remove disqualified/prohibited people from the register who are acting in contravention of disqualification/prohibition; (iv) ban a person from directorship or management where they have provided inaccurate information to the Registrar or have persistently failed to comply with Companies Act or Financial Reporting Act requirements.

81. The Minister of Commerce's office advises informally that the bill to effect these changes is being drafted with the aim of introducing it to the house in October. The Ministry considers that the reform will generate little compliance burden for New Zealand companies and that any burden is justified by the preservation of New Zealand's international reputation. It acknowledged that further reforms in the medium term will be required to address the issues comprehensively.[129]

82. The Ministry of Justice are also considering substantive anti-money laundering reform in connection with New Zealand's assessment by the Financial Action Task Force (**FATF**), to which the New Zealand Government is obliged to respond to by October 2011. One of the proposed reforms is to bring company formation agents within the scope of the anti-money laundering legislation, requiring them to be supervised and to undertake due diligence on their customers.

CONCLUSION

83. As the global economy becomes more integrated with the increase of cross-border trade and the commercial relationships which naturally ensue, forum shopping is likely to become a more significant issue in future for larger companies. While various multilateral and bilateral cooperation and harmonisation initiatives may reduce the incentive for shopping, it is unlikely that absolute harmonisation will be realised as along as there are independent sovereign states. As such, there will always be some shopping incentive. Forum shopping may occur when a dispute arises or when parties are negotiating their contractual arrangements. It pays for both commercial and litigation lawyers to be aware of the benefits and pitfalls of jurisdictional diversity and the strategies they may employ to ensure that clients make the most of such diversity.

[129] For example, (a) regulation/prohibition of nominee directors; (b) recording the beneficial ownership of shares in a company; (c) measures concerning open-ended powers of attorney; (d) identification or verification of the identity of directors and shareholders by way of, for example, a unique identifier such as a passport or driver licence; (e) dealing with issues of shell financial institutions; and (F) regulations of company formation agents by including them as reporting entities under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009.

Your law or mine? Choice of Law Issues in Banking and Financial Transactions

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Introduction

MANY LAWYERS NOW IN PRACTICE WOULD NOT HAVE STUDIED A CURRICULUM WHERE THE SUBJECT OF CONFLICT OF LAWS, WHETHER FEDERAL OR INTERNATIONAL, WAS A COMPULSORY SUBJECT. THOSE WHO, LIKE ME, HAD 72 HOURS OF ITS COMPLEXITY, PROBABLY HAVE SOME PARTICULAR INTELLECTUAL SCARS. FOR ME, THE GREATEST OF THESE WAS THE MYSTERY OF CLASSIFICATION OF LEGAL CONCEPTS DRAWN FROM DIFFERENT AND CONFLICTING LEGAL SYSTEMS. SADLY, IN THE 50 PLUS YEARS SINCE I WAS A LAW STUDENT, THAT ITCHY SCAR HAS NOT GONE AWAY AND IT CONTINUES TO HAUNT ME AND THE LAW. ONE RELEVANT EXAMPLE COMES FROM THE IMMINENTLY OPERATIVE FEDERAL LEGISLATION ON PERSONAL PROPERTY SECURITIES LAW,[1] AND IS DISCUSSED BELOW.

MY PAPER IS NOT A DETAILED EXAMINATION OF THE LAW, BUT RATHER IT LEAPS FROM ALP TO ALP ON SOME SPECIFIC ISSUES, WITHOUT TIME TO TRAVERSE THE CREVASSES AND RAVINES OF THE LAW. FORTUNATELY, WE HAVE AN EXCELLENT TEXT TO TURN TO IN AUSTRALIA, ALTHOUGH NOT SADLY IN NEW ZEALAND.[2]

Is this a simple choice?

1. “YOUR LAW OR MINE?”. THE CHOICE IS NOT A SIMPLE UNITARY CHOICE. IN THE CASE OF COMPLEX TRANSACTIONS EMBODIED IN A NUMBER OF CONTRACTS OR OTHER INSTRUMENTS, THERE MAY BE DIFFERING APPLICABLE LAWS. WHEN THOSE INTERLOCK, AS WHERE CALLING ON A GUARANTEE IS PRECIPITATED BY AN EVENT OF DEFAULT OR A BREACH AS DEFINED IN ANOTHER DOCUMENT, OR WHERE AN ARBITRATION CLAUSE HAS A SEPARATE GOVERNING LAW, THE RELATIONSHIP CAN BECOME INTERESTING.

What system of law governs choice of law issues at common law?

OUR INHERITANCE OF ENGLISH CASE LAW GAVE US A FOUNDATION. THAT INHERITANCE PETERS OUT IN THE 1980S AS ENGLISH LAW IS MORE DIRECTLY AFFECTED BY ITS OBLIGATIONS AS A MEMBER OF THE EUROPEAN UNION TO GIVE EFFECT TO AGREED RULES ON JURISDICTION AND CHOICE OF LAW.

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[1] Personal Property Securities Law (PPSA) 2010 to come into operation October 2011

[2] Nygh’s Conflict of Laws in Australia,(Nygh’s) M Davies, A Bell, P Le Gay Brereton (8th ed) 2010.

OUR AUSTRALIAN APPROACH TO CHOICE OF LAW ISSUES WHERE PARTIES HAVE MADE NO EXPRESS EFFECTIVE CHOICE IS SET OUT IN AKAI V PEOPLES INSURANCE CO [3].

> "...THERE IS, IN TRUTH, ONLY ONE QUESTION ... AND THAT IS WHETHER, UPON THE PROPER CONSTRUCTION OF THE CONTRACT (WHICH MAY INCLUDE AN EXPRESSION OF CHOICE IN DIRECT LANGUAGE) THE COURT PROPERLY MAY CONCLUDE THAT THE PARTIES EXERCISED LIBERTY GIVEN BY THE COMMON LAW TO CHOOSE A GOVERNING LAW FOR THEIR CONTRACT. IF THE ANSWER TO THIS IS IN THE NEGATIVE, THEN THE LAW ITSELF WILL SELECT A PROPER LAW"[4]

THE DEFAULT SETTINGS APPEAR TO BE:

(I)FORMATION: THIS INCLUDES OFFER & ACCEPTANCE & CONSIDERATION (IF NEEDED) (LEX FORI) THE LAW OF THE FORUM.[5]

(**II)STATUS , POWERS AND CAPACITY:**

-GOVERNED EITHER BY LEX DOMICILII (LAW OF THE DOMICILE) OR LEX CAUSAE (THE GOVERNING OR APPLICABLE LAW)

- IN CASE OF CORPORATIONS, IT IS ALWAYS THE LEX DOMICILII - I.E. THE PLACE OF RESIDENCE, INCORPORATION AND CONTROL

(III)FORMALITIES: (NB MUST CHARACTERISE AND DISTINGUISH)

IF PROCEDURAL - LEX FORI (LAW OF THE FORUM)

IF SUBSTANTIVE - LEX CAUSAE OR LEX FORI

EG THE LAPSE OF TIME - WHETHER LIMITATION OR PRESCRIPTION DETERMINES ITS EFFECT.

THIS CHARACTERISATION DONE BY LAW OF FORUM , BUT HAVING REGARD TO INCIDENTS UNDER LEX CAUSAE.

(IV) MATERIAL OR ESSENTIAL VALIDITY _ LEX CAUSAE

BUT EXCEPTIONS :

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[3] (1996) 188 CLR 418.

[4] Per Toohey, Gaudron, & Gummow JJ.

[5] Oceanic Sun Shipping v Fay (1988) 165 CLR 197; Nygh: "Reasonable Expectations of the Parties as a Guide to the Choice of Law in Contract and in Tort" (1995) 251 Receuil des Cours 268, 314-6; 252 Receuil des Cours 1. This is not consistent with Art 3.4 of the Rome Regulation on Choice of Law Applicable to Contractual Obligations (Rome I), which prefers the governing law. Rome I applies to obligations between members of the European Union except Denmark. In Denmark, the same result is reached through other means.

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(A)CONTRACT ILLEGAL AT PLACE OF PERFORMANCE

(B) CONTRACT CONTRA PUBLIC POLICY OF FORUM

(V)INTERPRETATION - LEX CAUSAE

(V) EFFECT - SUBSTANTIVE ISSUES - LEX CAUSAE

(VII) DISCHARGE - LEX CAUSAE

- BUT EXCEPTIONS E.G. EFFECTS OF MORATORIA, EXCHANGE CONTROL, INDEXATION, REVALORISATION, ANNULMENT, TAXATION , FRUSTRATION, ACTS OF STATE ,

MATTERS OUTSIDE PROPER LAW:

(I) CAPACITY - PERSONAL LAW (EXCEPT INDIVIDUALS)

(II)FORMALITIES - ESPECIALLY FOR BONDS, LAW OF PLACE OF ISSUE OTHERWISE LEX LOCI CONTRACTUS (THE PLACE OF CONTRACTING)

-DETAILS OF PERFORMANCE - LEX SOLUTIONIS (THE PLACE OF PERFORMANCE)

Codification

2. WE MOVE AWAY FROM THE CASE LAW FOR TOTAL OR PARTIAL STATUTORY CODIFICATION. THIS MAY BE GIVING EFFECT TO AN INTERNATIONAL AGREEMENT OR REFLECTING INTERNATIONAL PRACTICE OR MAY BE PART OF OUR COLONIAL LEGACY.

EXAMPLES – SEE APPENDIX

- BILLS OF EXCHANGE ACT (CTH) 1909 SS 77 & 77A
- CHEQUES ACT (CTH) 1986 S 117
- INSURANCE CONTRACTS ACT 1984 S 8
- CARRIAGE OF GOODS BY SEA ACT (CTH) 1992 S 11
- COMPETITION AND CONSUMER LAW (CTH) 2010 SCHEDULE 2 (AUSTRALIAN CONSUMER LAW) SS 67 & 68
- PERSONAL PROPERTY SECURITIES ACTS 2010, PART 7.

THE CODIFICATION OF THE RULES ABOUT GOVERNING LAW IN RELATION TO CHOICE OF LAW IN TRANSACTIONS INVOLVING PERSONAL PROPERTY SECURITIES AS DEFINED IN THE NEW ACT IS AN EXAMPLE OF MANY OF THE ISSUES THAT ARISE. THIS IS NOT A COMPLETE CODIFICATION, SO THERE ARE AREAS WHERE THE GAPS LEFT ARE FILLED BY REFERENCE TO THE PRINCIPLES OF PRIVATE INTERNATIONAL LAW, THAT MUST BE APPLIED BY AUSTRALIAN COURTS.[6] IT MUST ALSO BE

[6] But see Goode: "Rule, Practice, and Pragmatism in International Commercial Law " (2005) 54 ICLQ 539. In this Mann lecture, Sir Roy Goode makes the point that sometimes general principles do not solve the problem. What is

REMEMBERED THAT AUTONOMY (THE ABILITY TO CHOOSE THE GOVERNING LAW)IS RESTRICTED TO CONTRACT[7], AND THAT THERE IS NO CHOICE OF LAW IN RELATION TO PROPRIETARY INTERESTS. NOR IS THERE A CAPACITY TO CHOOSE A LAW OTHER THAN THAT PRESCRIBED BY THE STATUTE, WHERE THE STATUTE MAKES THAT LAW A MANDATORY LAW.

BUT HOW WIDELY CAN SUCH A STATUTE CAST ITS SHADOW? IN AKAI, THE HIGH COURT APPLIED THE INSURANCE CONTRACTS ACT TO IGNORE A CHOICE OF ENGLISH LAW AS THE GOVERNING LAW OF AN INSURANCE CONTRACT. BUT AN ENGLISH COURT WOULD NOT BE UNDER THE SAME LIMITATION, NOR WOULD AN AUSTRALIAN COURT EXPECT IT TO BE[8]. IN AKAI, THE MAJORITY MADE IT CLEAR THAT IT WAS ENTIRELY A MATTER FOR THE FOREIGN COURT, AS IT WOULD BE IN AUSTRALIA WERE THE SITUATIONS REVERSED, TO DECIDE WHETHER A FOREIGN MANDATORY LAW WOULD APPLY[9]. PRIVATE INTERNATIONAL LAW IS THE BATTLEGROUND WHERE THE VALUES OF SEEKING A UNIFORM RESULT, NO MATTER WHERE A DISPUTE IS RESOLVED, CONFLICT DIRECTLY WITH THE VALUES OF NATIONAL INTEREST. IN THIS CONFLICT, THE OVERRIDING COMMERCIAL VALUE OF GIVING EFFECT TO THE REASONABLE EXPECTATIONS OF THE PARTIES SEEMS TO DISAPPEAR[10]. ALTHOUGH COMITY HAS BECOME AN IMPORTANT CONCEPT IN SOME ASPECTS OF CONFLICT OF LAWS[11], IT DOES NOT ALWAYS GIVE THE ANSWER.

A choice is one of domestic law

3. TO WHAT DOES THE REFERENCE APPLY? IN THE CASE OF A CONTRACT REFERENCE, IT IS TO THE PARTICULAR DOMESTIC LAW, AS IT OPERATES FROM TIME TO TIME. THERE IS NO RENVOI OR REFERENCE TO ANOTHER SYSTEM OF LAW, AS MIGHT OCCUR IF THE REFERENCE WERE TO THE SYSTEM OF PRIVATE INTERNATIONAL LAW. EACH SYSTEM OF PRIVATE INTERNATIONAL LAW IS A DOMESTIC SYSTEM AND EACH WILL DIFFER IN ITS SUBSTANCE AND IN THE WAY IT HANDLES PROCEDURAL ASPECTS OF ISSUES RAISED BY A REFERENCE TO A FOREIGN LAW.

THIS RAISES TWO FURTHER ISSUES OF RELEVANCE TO BANKING AND FINANCIAL TRANSACTIONS.

Can that law chosen be frozen at a particular point of time?

4. CAN THE REFERENCE BE TO A SYSTEM OF LAW AS AT A PARTICULAR DATE, SO FREEZING THE CONTENT OF THE REFERENCE? THIS IS IMPORTANT IN TAX OR ROYALTY MATTERS AS IS CURRENTLY BEING SEEN IN WESTERN AUSTRALIA. THERE ARE A NUMBER OF TECHNIQUES THAT CAN BE USED,

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needed is a transaction-specific solution as in the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary 2006 . This Convention is not yet in force.

[7] This may be contentious. However both the Rome Regulation and the US Restatement (2nd) of Conflict of Laws uphold this.

[8] Akai Pty Ltd v People's Insurance Co Ltd [1988] 1 Lloyds Rep 90.

[9] This would be the case under Rome 1.

[10] Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd (2000) 203 CLR 579, 589. "What matters is what each party by words and conduct would have le a reasonable person in the position of the other to believe. References to the common intention of the parties are to be understood as referring to what a reasonable person would understand by the language in which the parties have expressed their agreement."

[11] Voth v Manildra Flour Mills (1990) 171 CLR 538

INCLUDING INCORPORATION BY REFERENCE OF CRITICAL DEFINITIONS. BUT IF THE PURPOSE IS TO LIMIT ANY CHANGES IN THE FUTURE, WHERE THE CONTRACT IS WITH A STATE OR A STATE AGENCY, THE EFFECTIVENESS CENTRES AROUND "STABILISATION CLAUSES"[12].

AS PART OF THE CONTINUING DEBATE ABOUT STATE CONTRACTS IN THE TWENTIETH CENTURY, THE INTERNATIONAL COURT OF JUSTICE HAS UPHELD THE VALIDITY OF SUCH CONTRACTS IN ISSUES BETWEEN STATES. THIS WAS FURTHER EXTENDED TO ARBITRATION AGAINST STATES IN THE 1970S, EVEN BY NON-STATE PARTIES. SUCH CLAUSES ARE NOW COMMON IN OIL AND GAS AND ENERGY CONTRACTS GENERALLY, BUT DRAFTING THEM HAS ITS PERILS[13]. THERE IS ALWAYS A RISK FROM BEING TOO CAUTIOUS AS THE PARTIES IN CAC V CHALK[14] DISCOVERED NOT TOO FAR FROM THE GOLD COAST WHEN THEY SOUGHT TO ENTRENCH THEIR ROYALTY RIGHTS THROUGH LEGISLATION, ONLY TO DISCOVER THAT THE BILATERAL CONTRACT RIGHTS HAD MERGED INTO STATUTORY RIGHTS WITHIN THE SOLE CONTROL OF THE LEGISLATURE.

SO THERE IS LITTLE CHANCE OF DRAFTING SO AS TO AVOID A CHANGE IN THE GENERAL LAW. A CURRENT EXAMPLE WOULD BE THE INCREASE IN THE SCOPE OF THE MEANING OF SERVICES IN THE DEFINITIONS IN THE COMPETITION AND CONSUMER ACT, WHICH HAS BEEN BROUGHT ABOUT BY THE FUNDAMENTAL CHANGES IN THE MEANING OF "PERSONAL PROPERTY RIGHTS" BECAUSE OF THE PERSONAL PROPERTY SECURITIES ACT 2010. A FURTHER CHANGE IS THE CONVERSION OF THE CONDITIONAL SALE PROVISION INTO A RETENTION OF TITLE SECURITY INTEREST, WHICH WILL REQUIRE COMPLICANCE WITH THE PPSA TO BE UPHELD. GIVEN THAT THERE IS NO CORRESPONDING CHANGE IN ENGLISH LAW, A CONTRACT OF SALE WITH A RETENTION OF TITLE CLAUSE FROM AN ENGLISH SELLER TO AN AUSTRALIAN BUYER, WHERE THE GOODS ARE IMPORTED INTO AUSTRALIA, WILL MEAN THAT SO FAR AS ENGLISH LAW IS CONCERNED, THERE IS AUTONOMY TO CHOOSE A GOVERNING LAW, BUT WHEN THE GOODS ARE SUBJECT TO ANY LITIGATION IN AUSTRALIAN COURTS, THE PROVISIONS OF THE PPSA WILL APPLY NOTWITHSTANDING A CONTRARY CHOICE OF LAW. THIS ILLUSTRATES BOTH THE RISKS OF CHANGE, AND THE PROBLEMS OF CLASSIFYING INTERESTS AS CONTRACTUAL OR PROPRIETARY.

What exactly is your law?

6. THE REFERENCE TO THE LAW OF A JURISDICTION DOES NOT ABSOLVE THE USER FROM UNDERSTANDING THE LEGAL SYSTEM TO WHICH REFERENCE IS MADE. A NOTORIOUS EXAMPLE IN THE FIELD OF BANKING AND FINANCE IS HAZELL V HAMMERSMITH & FULHAM BOROUGH COUNCIL[15], WHERE IT WAS UNDERSTOOD THAT THE CAPACITY OF THE COUNCIL TO ENTER INTO SWAPS TRANSACTIONS WAS GOVERNED BY ENGLISH LAW, BUT THERE WAS A FAILURE TO APPRECIATE THAT LOCAL GOVERNMENT HAD RESTRICTIONS NOT FOUND IN THE CASE OF THE MAJORITY OF CORPORATIONS. THIS RAISES THE REAL DEVIL OF CHOICE OF LAW. IF IT IS NOT "MY LAW", HOW DO

[12] A typical stabilisation clause "…this concession shall throughout the period of its validity be construed in accordance with the Petroleum Law and the Regulations which were in force on the date of execution of the Agreement. …any amendment to repeal such Regulations shall not affect the contractual rights of the parties".
[13] Drafting Stabilisation Clauses in International Energy Contracts: Some Pitfalls for the Unwary, AFM Maniruzzaman vol 5, Oil, Gas & Energy Law Intelligence, (2007).
[14] [1976] Qd R 231.
[15] 1992 AC 1.

YOU KNOW WHAT IT IS. THIS PROBLEM ARISES AT THE STAGE OF NEGOTIATION AND DRAFTING, BUT IT IS A PARTICULAR PROBLEM IN DISPUTE RESOLUTION.

Depecage or Issue by Issue Choice of Law

7. BEFORE MOVING TO THE ISSUE OF HOW DO YOU PROVE FOREIGN LAW, THERE ARE SOME FURTHER COMPLICATING ISSUES. THE FIRST IS DEPECAGE OR ISSUE BY ISSUE CHOICE OF LAW[16]. MUST THERE BE A SINGLE GOVERNING LAW TO E.G.INTERPRET THE WHOLE CONTRACT? MUST THERE BE A SINGLE UNITARY CHOICE OF THE LEX CAUSAE OR THE GOVERNING LAW? THE POSSIBILITY OF A FORM OF DEPECAGE IS INHERENT IN THE COMMON LAW ANALYSIS ABOVE, BUT CAN ONE SPLIT THE CONTRACT PROVISIONS ANY OTHER WAY? IT IS BROADLY ACCEPTED THAT THE SAME GOVERNING LAW MUST APPLY TO ALL PARTIES TO A SINGLE CONTRACT, SO THAT THE QUESTION "YOUR LAW OR MINE?" CAN NOT BE ANSWERED " YOU HAVE YOUR OBLIGATIONS GOVERNED BY YOUR LAW AND I WILL HAVE MY OBLIGATIONS GOVERNED BY MINE". THIS ISSUE MOST COMMONLY ARISES WHERE THERE IS A STATUTORY BASIS GOVERNING CHOICE OF LAW. DEPECAGE IS PERMITTED UNDER ROME I.

Can you "float" the choice of law ?

8. CAN YOU HAVE A FLOATING CHOICE OF LAW. IN OUR LEGAL SYSTEM, YOU CAN NOT[17]. THE PARTIES OBLIGATIONS HOWEVER, INCLUDING CHOICE OF LAW, CAN BE CHANGED BY MUTUAL CONSENT.

The effects of the choice of the method of dispute resolution

9. DISPUTE RESOLUTION IS A CRITICAL LEVER. THERE ARE SIGNIFICANTLY DIFFERENT PRACTICES IN RELATION TO ARBITRATION FROM THOSE IN LITIGATION. IT IS A RULE IN MOST ARBITRATION REGIMES, INCLUDING ICC, ICSID, AND UNCITRAL THAT, IF THE PARTIES HAVE NOT MADE AN EXPRESS CHOICE OF LAW, IT IS OPEN TO THE ARBITRATORS TO MAKE SUCH A CHOICE, SUBJECT ONLY TO THE FACT THAT THEY CANNOT CHOOSE A LEGAL REGIME THAT WOULD HAVE THE EFFECT OF AVOIDING THE CONTRACT. IT IS ALSO NOTEWORTHY THAT ARBITRATION CONTRACTS ARE EXCLUDED FROM THE OPERATION OF ROME I.

IT IS THE EXPRESS EXPECTATION THAT THE STATUTORY CODIFICATIONS IN AUSTRALIA APPLY TO COURTS, AND THE POSITION IN RELATION TO ARBITRATION IS UNCLEAR. THE PPSA MENTIONS EXPRESSLY THAT IT IS TO BE APPLIED IN AUSTRALIAN COURTS, AND THIS SHOULD APPLY TO PROCEEDINGS TO ENFORCE ARBITRAL AWARDS IN AUSTRALIA. BUT HOW FAR THAT WOULD GO ONLY TO A MERITS BASED REVIEW OUTSIDE THE SCOPE OF AN ENFORCING COURT IS A GOOD QUESTION, TO WHICH I DO NOT HAVE AN ANSWER.

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[16] Tomlinson v First Pennsylvania Banking & Trust Co. [1961]A.C.1007 Hamlyn v Taliskers Distillery [1894] A.C. 202 ; Weckstrom v Hyson [1966] V.R. 277; Samarni v Williams [1980] 2 NSWLR 389; Wanganui Rangitikei Electric Power Board v AMP (1934)50 CLR 581, 604. The Australian and New Zealand cases reflect a concern with this approach.

[17] The Armar 1981 1 WLR 207.

Can you choose a law which is not a national law as a governing law?

10. CAN YOUCHOOSE, NOT THE LAW OF A PARTICULAR JURISDICTION, BUT A SET OF GENERAL PRINCIPLES OF LAW? THIS WAS FURIOUSLY REJECTED IN THE 1980S IN ENGLAND, NOTABLY BY MANN, AND BY THE COURT OF APPEAL.[18] BUT CERTAINLY THIS IS POSSIBLE WHERE THE DISPUTE IS ARBITRATED, AND IT IS NO IMPEDIMENT EVEN IF THE MATTER COMES TO AN ENFORCING COURT[19]. TO MY KNOWLEDGE, THERE IS NO AUSTRALIAN AUTHORITY. THE DRAFTING OF THE REGULATION IN THE EU REGENERATED THIS DISPUTE, AND IT WAS FINALLY RESOLVED IN FAVOUR OF A LIBERAL REGIME OF CHOICE OF LAW, WHERE THE SCOPE OF THE GOVERNING LAW IS SUBECT ONLY TO THE DISCIPLINE OF CERTAINTY.

Are there relevant international Conventions affecting Australia?

11. AUSTRALIA IS NOT YET A PARTY TO INTERNATIONAL CONVENTIONS ON CHOICE OF LAW THAT WOULD SIGNIFICANTLY AFFECT OUR PRACTICE. THERE ARE TWO TO CONSIDER: THE HAGUE CONVENTION ON THE LAW APPLICABLE TO CERTAIN RIGHTS IN RESPECT OF SECURITIES HELD WITH AN INTERMEDIARY 2006 AND THE UN CONVENTION ON THE ASSIGNMENT OF RECEIVABLES IN INTERNATIONAL TRADE 2001. NEITHER OF THESE IS IN FORCE, AND IT IS UNLIKELY THAT AUSTRALIA WILL ACCEDE TO THE LATTER CONVENTION. THERE ARE ALSO CURRENT NEGOTIATIONS BETWEEN AUSTRALIA AND NEW ZEALAND. THESE MAY AFFECT RULES ON THE CHOICE OF FORUM SITUATION, BUT NOT NECESSARILY THE CHOICE OF LAW.

THE UN CONVENTION ON THE ASSIGNMENT OF RECEIVABLES IN INTERNATIONAL TRADE 2001 DEALS WITH BOTH SUBSTANTIVE RIGHTS AND OBLIGATIONS AND ALSO CHOICE OF LAW RULES. THIS CONVENTION EXCLUDES INTERMEDIATED SECURITY INTERESTS FROM THE CHOICE OF LAW RULES ON RECEIVABLES.

SHOULD AUSTRALIA ACCEDE TO EITHER OF THESE CONVENTIONS, THEN THE CONFLICTS RULES IN THE PPSA WILL REQUIRE SOME MODIFICATION.

THERE IS A FURTHER POSSIBILITY THAT CAN ARISE IN THE CASE OF A BILATERAL OR MULTILATERAL FREE TRADE AGREEMENTS (FTAS). THESE AGREEMENTS COVER BOTH TRADE AND INVESTMENT, AND USUALLY HAVE VERY WIDE DEFINITIONS OF THE COVERED INVESTMENTS THAT WILL INCLUDE CONTRACT RIGHTS AND ANY OTHER LEGAL ITEM OF VALUE. WHEN TRANSACTIONS ARE ENTERED INTO UNDER THESE AGREEMENTS, THEY SOULD SPECIFY THEIR OWN GOVERNING LAW. THERE IS A FIERCE CURRENT CONTROVERSY IN INTERNATIONAL INVESTMENT LAW AS TO WHETHER ANY BREACH OF SUCH A CONTRACT AMOUNTS TO A BREACH OF THE TREATY, AND BECOMES SUBJECT POSSIBLY TO TWO DIFFERENT DISPUTE RESOLUTION REGIMES, ONE OF WHICH IS IN THE TREATY AND THE OTHER IS IN THE

[18] Amin Rasheed Shipping Corporation v. Kuwait Insurance [1984] A.C.50; Mann: " Rejection of "delocalised" Contracts" (1984) 33 ICLQ 193

[19] [1988] 3 W.L.R. 230 (HL) sub nom Deutsche Schachtbau und Tief bohrgesellschaft v Shell International Trading Co.

CONTRACT[20]. THE EFFECT OF THESE CLAUSES IS TO CREATE AN OBLIGATION IN THE STATES THAT ARE PARTIES TO THESE TREATIES TO OBSERVE OBLIGATIONS BY OTHER PARTIES THAT ARE COVERED BY THE TREATY. OPINION IS EQUALLY DIVIDED ALTHOUGH MY OPINION IS THAT IT IS POSSIBLE TO SEPARATE OUT TWO DISPUTES IN THESE CASES: ONE BETWEEN THE STATES PARTY TO THE TREATY AND THE OTHER BETWEEN THE CONTRACTING PARTIES. A RECENT EXAMPLE FROM THE SPATE OF DISPUTES ARISING IN ARGENTINA IS COMPAÑÍA DE AGUAS DEL ACONQUIJA S.A. AND VIVENDI UNIVERSAL S.A. V. ARGENTINE REPUBLIC. [21] THERE WAS A BREACH OF CONTRACT ALLEGED BETWEEN A FRENCH COMPANY AND A PROVINCIAL GOVERNMENT IN ARGENTINA. THIS WAS GOVERNED BY PROVINCIAL LAW AND HAD AN EXCLUSIVE JURISDICTION CLAUSE. THE CONTRACT FELL WITHIN THE FRANCE ARGENTINA BILATERAL INVESTMENT TREATY. COULD A PRIVATE AGREEMENT OVERRIDE A TREATY IN RELATION TO DISPUTE SETTLEMENT AND CHOICE OF LAW? CLEARLY NOT, BUT DID TWO DISPUTES RUN IN PARALLEL OR WAS THERE ONLY ONE?

But the real problem is ....how do you prove foreign law?

12. FOR ME, THE OVERIDING PROBLEM IS A PRACTICAL ONE. HOW DO YOU PROVE THE APPLICABLE RULES AND CONCEPTS OF FOREIGN LAW IN OUR COURTS? FOREIGN LAW OCCUPIES A PECULIA R POSITION I[22]N OUR SYSTEM IN THAT ITS EXISTENCE AND CONTENT ARE A MATTER FOR EVIDENCE BEFORE THE COURT. ALTHOUGH TREATED AS A MATTER OF FACT, IT IS EXCLUSIVELY RESERVED FOR DECISION TO A JUDGE. IF THERE IS NO SATISFACTORY EVIDENCE OF FOREIGN LAW, THERE IS A REBUTTABLE PRESUMPTION THAT IT IS THE SAME AS THE LAW OF THE FORUM.

THE POSITION IS MITIGATED SLIGHTLY BY AMENDMENTS TOTHE EVIDENCE ACTS[23] THAT NOW PERMIT USE OF PUBLISHED PRIMARY SOURCES OF LAW. BUT IN SOME CASES THIS CAUSES MORE PROBLEMS THAN IT SOLVES. THE COMBINATION OF EXPERT EVIDENCE AND FOREIGN LAW AND AN ADVERSARY SYSTEM COMPOUND THIS ISSUE, AND IT IS ONE FROM WHICH OUR COLLEAGUES IN A CIVIL LAW SYSTEM ARE MERCIFULLY RELIEVED. I REFER YOU TO AN EXCELLENT SEMINAR GIVEN LAST MAY AT THE SYDNEY LAW SCHOOL, BY AMONGST OTHERS, ONE OF MY CO-PRESENTERS, ANDREW BELL SC,THAT DEALS COMPREHENSIVELY WITH THE ISSUES[24]. IT ALSO RAISES THE IMAGINATIVE SOLUTIONS THAT HAVE BEEN DEVELOPED WITHIN NSW AT THE INITIATIVE OF THE CHIEF JUSTICE OF NSW TO ASSIST IN THIS PROCESS BY ENTERING INTO AGREEMENTS WITH SOME FOREIGN COURTS AND JUDGES TO ACT AS REFEREES.

MY CLASSIC EXAMPLE OF THE PROBLEMS IS THE TRANSCRIPT OF A FEDERAL COURT HEARING IN NEW YORK BEFORE LEARNED HAND J, A HIGHLY EXPERIENCED COMMERCIAL JUDGE. HIS ATTEMPTS AT

[20] Australia has a number of umbrella clauses in treaties e.g. Article 11 Australia -Chile BIT 1996; Article 11 Australia -China BIT 1988; Article 2(2) Australia-Hong Kong BIT 1993; Article 11 Australia-Papua New Guinea BIT 1990; Article 10 Australia-Poland BIT 1991.

[21] ICSID. Case (No. ARB/97/3).

[22] NYGH'S CH 17

[23] IBID NOTE 27

[24] The Future of Private International Law in Australia, 16 May 2011.

UNVELING THE MYSTERIES OF FRENCH LAW ON A TIME CLAUSE COULD HAVE BEEN SCRIPTED BY MONTY PYTHON[25].

[25] Wood & Selick Inc v Compagnie Generale Transatlantique (1909) 43 F 2d 941

BILLS OF EXCHANGE ACT 1909 - SECT 77

Rules where laws conflict

Where a bill drawn in one country is negotiated, accepted, or payable in another, the rights, duties, and liabilities of the parties thereto are determined as follows:

(a) The validity of a bill as regards requisites in form is determined by the law of the place of issue, and the validity as regards requisites in form of the supervening contracts, such as acceptance, or indorsement, or acceptance supra protest, is determined by the law of the place where such contract was made:

Provided that:

(i) where a bill is issued out of Australia, it is not invalid by reason only that it is not stamped in accordance with the law of the place of issue;

(ii) where a bill, issued out of Australia, conforms, as regards requisites in form, to the law of Australia, it may, for the purpose of enforcing payment thereof, be treated as valid as between all persons who negotiate, hold, or become parties to it in Australia.

(b) Subject to the provisions of this Act, the interpretation of the drawing, indorsement, acceptance, or acceptance supra protest of a bill, is determined by the law of the place where such contract is made.

Provided that, where an inland bill is indorsed in a foreign country, the indorsement shall as regards the payer be interpreted according to the law of Australia.

(c) The duties of the holder with respect to presentment for acceptance or payment, and the necessity for or sufficiency of a protest or notice of dishonour, or otherwise, are determined by the law of the place where the act is done or the bill is dishonoured.

(d) Where a bill is drawn out of but payable in Australia and the sum payable is not expressed in the currency of Australia, the amount shall, in the absence of some express stipulation, be calculated according to the rate of exchange for sight drafts at the place of payment on the day the bill is payable.

(e) Where a bill is drawn in one country and is payable in another, the due date thereof is determined according to the law of the place where it is payable.

CARRIAGE OF GOODS BY SEA ACT 1991 - SECT 11

Construction and jurisdiction

(1) All parties to:

(a) a sea carriage document relating to the carriage of goods from any place in Australia to any place outside Australia; or

(b) a non-negotiable document of a kind mentioned in subparagraph 10(1)(b)(iii), relating to such a carriage of goods;

are taken to have intended to contract according to the laws in force at the place of shipment.

(2) An agreement (whether made in Australia or elsewhere) has no effect so far as it purports to:

(a) preclude or limit the effect of subsection (1) in respect of a bill of lading or a document mentioned in that subsection; or

(b) preclude or limit the jurisdiction of a court of the Commonwealth or of a State or Territory in respect of a bill of lading or a document mentioned in subsection (1); or

(c) preclude or limit the jurisdiction of a court of the Commonwealth or of a State or Territory in respect of:

(i) a sea carriage document relating to the carriage of goods from any place outside Australia to any place in Australia; or

(ii) a non-negotiable document of a kind mentioned in subparagraph 10(1)(b)(iii) relating to such a carriage of goods.

(3) An agreement, or a provision of an agreement, that provides for the resolution of a dispute by arbitration is not made ineffective by subsection (2) (despite the fact that it may preclude or limit the jurisdiction of a court) if, under the agreement or provision, the arbitration must be conducted in Australia.

CHEQUES ACT 1986 - SECT 117

Conflict of laws

(1) Where a cheque drawn in one country is:

(a) payable in another country; or

(b) transferred by negotiation in another country;

the rights, duties and liabilities of the drawer, indorsers and holder shall be ascertained in accordance with this section.

(2) Subject to subsections (4), (5) and (6), the validity, as regards requisites in form, of a cheque shall be determined in accordance with the law of the place of issue.

(3) Without limiting the generality of subsection (2), the question whether a particular instrument is a cheque shall be determined in accordance with the law of the place of issue.

(4) A cheque issued outside Australia is not invalid by reason only that it is not stamped or properly stamped in accordance with the law of the place of issue or any other law.

(5) A cheque issued in Australia and payable outside Australia that is not stamped or properly stamped in accordance with the law of the place of issue or any other law:

(a) is not invalid by reason only that it is not so stamped; and

(b) may be received in evidence if the proper duty and penalty (if any) is paid.

(6) A cheque issued outside Australia that conforms, as regards requisites in form, to the law of Australia is, for the purpose of enforcing payment of the cheque, valid as between all persons who, in Australia, transfer the cheque by negotiation or hold or become indorsers of the cheque.

(7) The validity as regards requisites in form, of a supervening contract on a cheque shall be determined in accordance with the law of the place where the contract is made.

(8) Subject to subsection (10), the effects of a transfer of a cheque by negotiation shall be determined in accordance with the law of the place where the cheque is transferred by negotiation.

(9) The capacity of a person to incur liability on a contract on a cheque shall be determined in accordance with the law of the place where the contract is made.

(10) Subject to subsections (12), (13) and (14), a contract on a cheque shall be interpreted and have effect in accordance with the law of the place where the contract is to be performed.

(11) Without limiting the generality of subsection (10), where a cheque is dishonoured, the amount (if any) recoverable as damages in respect of a contract on the cheque shall be determined in accordance with the law of the place where the contract is to be performed.

(12) The necessity for presentment for payment, and the sufficiency of a presentment for payment, in relation to a cheque shall be determined in accordance with the law of the place where the cheque is payable.

(13) Where a cheque is dishonoured the necessity for, and the sufficiency of, a notice of dishonour, and any other act, in relation to the dishonour shall be determined in accordance with the law of the place where the cheque is payable.

(14) Where a cheque drawn in one country is payable in another country, the date on and after which the cheque may be paid by the drawee institution shall be determined in accordance with the law of the place where the cheque is payable.

(15) In this section:

"contract" , in relation to a cheque, includes:

(a) a contract or warranty arising out of the drawing; and

(b) a supervening contract in relation to the cheque.

"supervening contract" , in relation to a cheque, includes a contract or warranty arising out of:

(a) an indorsement; or

(b) a transfer by negotiation.

AUSTRALIAN CONSUMER LAW (SCHEDULE 2 OF COMPETITION AND CONSUMER LAW)

67 Conflict of laws

If:

(a) the proper law of a contract for the supply of goods or services to a consumer would be the law of any part of Australia but for a term of the contract that provides otherwise; or

(b) a contract for the supply of goods or services to a consumer contains a term that purports to substitute, or has the effect of substituting, the following provisions for all or any of the provisions of this Division:

(i) the provisions of the law of a country other than Australia;

(ii) the provisions of the law of a State or a Territory;

the provisions of this Division apply in relation to the supply under the contract despite that term.

68 Convention on Contracts for the International Sale of Goods

The provisions of the United Nations Convention on Contracts for the International Sale of Goods, done at Vienna on 11 April 1980, as amended and in force for Australia from time to time, prevail over the provisions of this Division to the extent of any inconsistency.

INSURANCE CONTRACTS ACT 1984 - SECT 8

Application of Act

(1) Subject to section 9, the application of this Act extends to contracts of insurance and proposed contracts of insurance the proper law of which is or would be the law of a State or the law of a Territory in which this Act applies or to which this Act extends.

(2) For the purposes of subsection (1), where the proper law of a contract or proposed contract would, but for an express provision to the contrary included or to be included in the contract or in some other contract, be the law of a State or of a Territory in which this Act applies or to which this Act extends, then, notwithstanding that provision, the proper law of the contract is the law of that State or Territory.

All asset security interests revisited

Alan Maclean
Partner, HWL Ebsworth Lawyers

Key Issues

- Changing attachment rules and resulting priority consequences
- Is PMSI “super priority” available under an ALLPAP?
- New concepts - circulating and non-circulating assets

Attachment and priority – 3 Stages of enquiry:

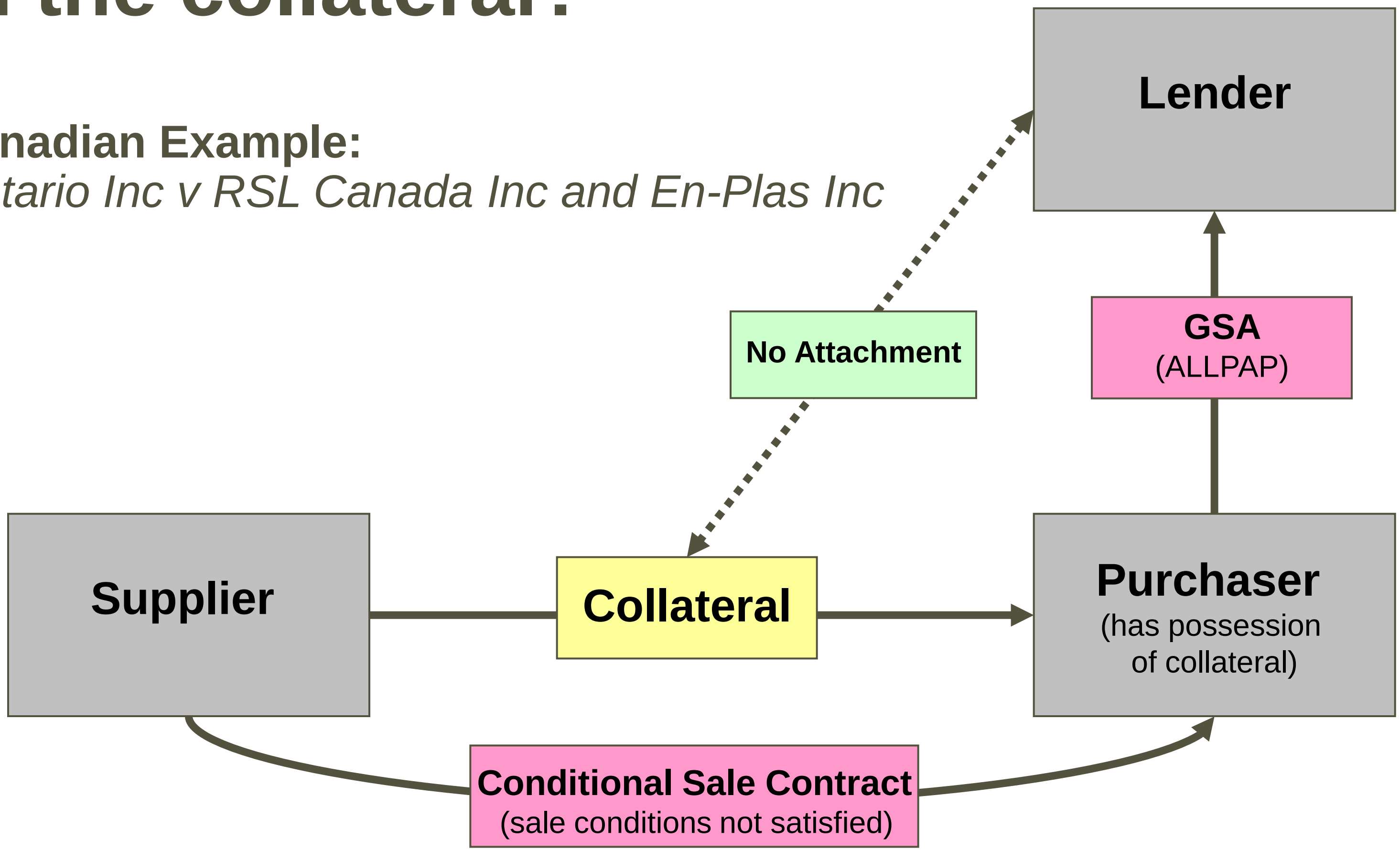
Stage 1
Does the grantor have any rights in the collateral?

Stage 2
What is the nature of the grantor's rights?

Stage 3
What are the competing interests for priority purposes? Are they both PPSA security interests?

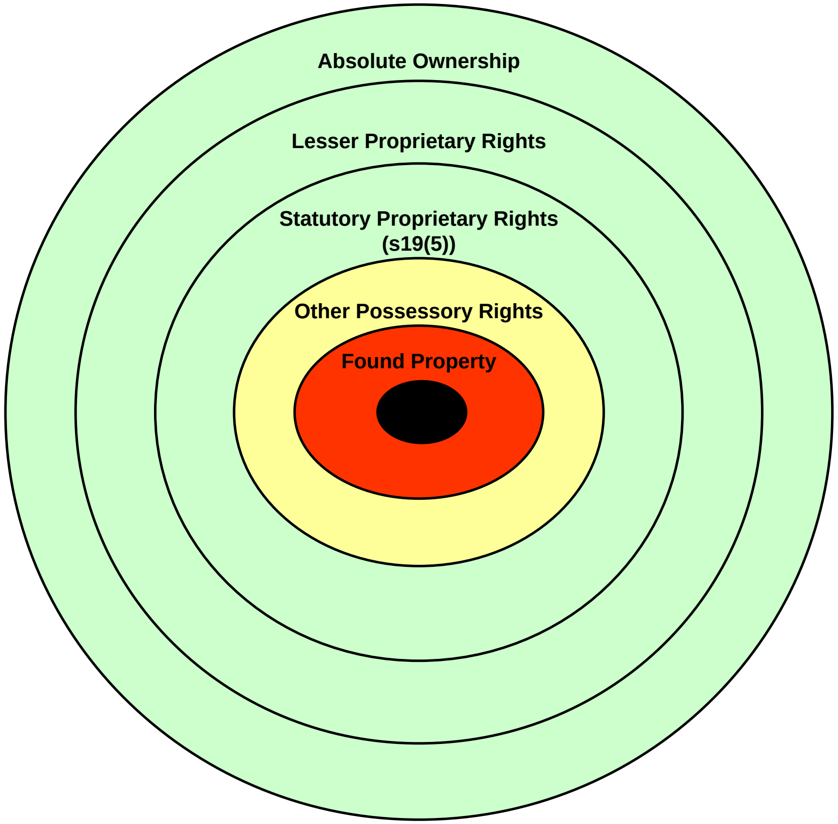
Stage 1: Does the grantor have any right in the collateral?

Canadian Example:
Ontario Inc v RSL Canada Inc and En-Plas Inc



- *Nemo dat quod non habet* can still apply

Stage 2: Assessing nature of grantor rights



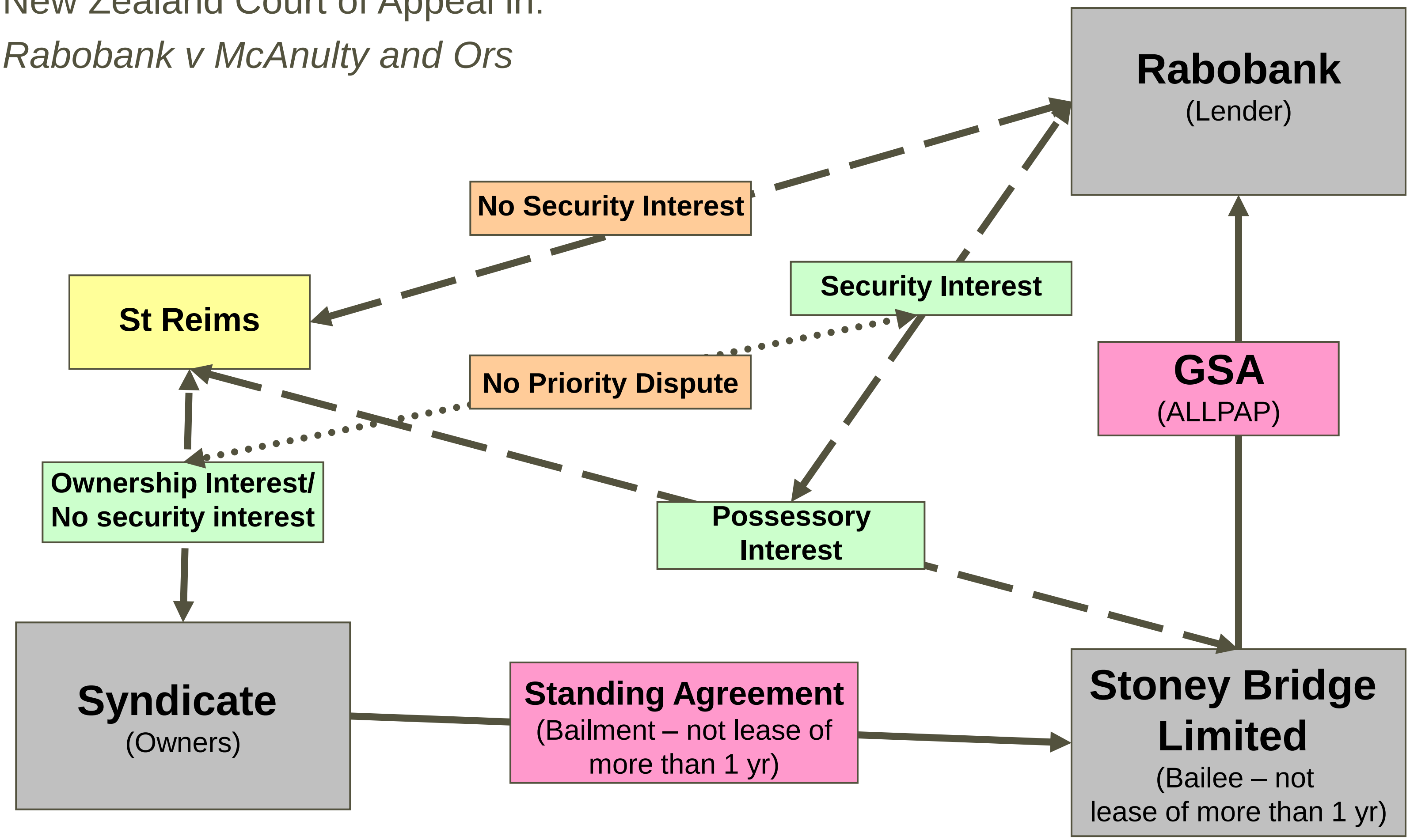
- What rights are sufficient to support attachment to the whole collateral?

Stage 3: Priority Disputes

Is there a competition between two security interests?

New Zealand Court of Appeal in:

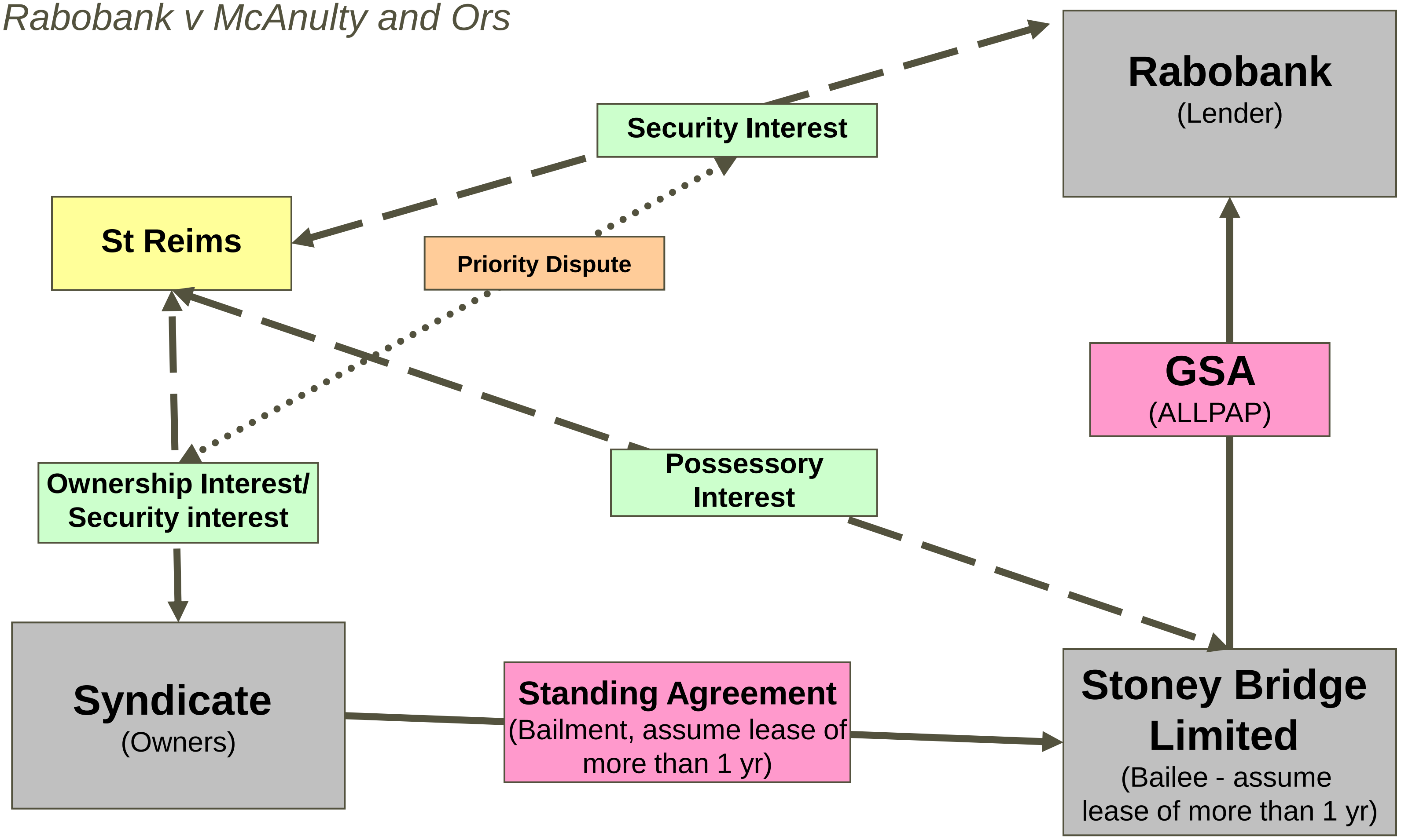
Rabobank v McAnulty and Ors



Stage 3: Priority Dispute

What if there was a lease of more than 1 year?

Rabobank v McAnulty and Ors



Is PMSI priority available under an ALLPAP?

Requirements	Issues to consider
1. Giving value to enable the grantor to acquire rights in the collateral	▪ Undertaking to apply loan proceeds to acquire collateral
2. Value is actually applied to acquire collateral	▪ Evidence that loan proceeds have in fact been applied ▪ What if the customer doesn't? ▪ Loss of PMSI status and defective registration
3. Financing statement lodged claiming PMSI over collateral within time limits	▪ Cannot claim PMSI in ALLPAP registration ▪ Separate financing statement claiming PMSI ▪ Time limits

- Previously the PPS Regulations prohibited claiming PMSI in respect of an ALLPAP security interest
- Priority of PMSIs already recognised in Australian law

Circulating and non-circulating assets

- Policy decision to maintain status quo
- New definition of circulating security interest:

“a security interest that is:

(a) a PPSA security interest, if:

(i) the security interest has attached to a circulating asset within the meaning of the Personal Property Securities Act 2009; and

(ii) the grantor (with the meaning of that Act) has title to the asset; or

(b) a floating charge”

- Relevance of distinction:
  - “Charges” in Commonwealth and State legislation
  - Post PPS security agreements

Circulating Assets

- Statutory codification of existing case law on floating charges
- Applies to all security interests not just all asset security interests

Presumed circulating assets	Catch-all
1. Book debts which do not arise from sale of property 2. Book debts that are the proceeds of sale of inventory 3. ADI accounts which are not term deposits 4. Currency 5. Inventory (given ordinary meaning) 6. Negotiable Instruments	Express or implied authority to dispose in the ordinary course of business

Non-circulating Assets

1. Security interests in goods perfected by possessed
2. Deemed security interests arising from a transfer of account or chattel paper
3. Control of presumed circulating assets and registration claiming control
   - Control test does not apply to other non presumed circulating assets
4. Property to which the grantor does not have title
   - Conditional sale agreements
   - Commercial consignments
   - PPS leases

Corporations Act – floating charge

- Priority of employee entitlements and other preferred claims in receivership (s 433)
- Presumption of insolvency by reason of appointment of a receiver (s 459C(2)(c))
- Administrator's right to deal with property (s 442)
- Priority of administrator's rights of indemnity and lien (s 443E & 443F)
- Priority of employee entitlements and other preferred claims in winding up (s 561)
- Voidable security interests created within 6 months of insolvency (s 588FJ)

Corporations Act – Circulating Security Interest

- Is the status quo maintained?
  - Definition of "**floating charge**" negates crystallisation affecting preferential creditors
  - Definition of "**circulating security interest**" does not negate conversion to non-circulating asset
  - Is conversion of a circulating asset to a non-circulating asset possible?
  - Can this conversion by control be registered?

Time for attachment to circulating assets

- There are two possible times:
    1. Time when security interest first attaches to circulating assets
    2. Time when receiver or administrator appointed or when winding up commences
- First interpretation accords with legislative intent to maintain status quo
- Second interpretation is a black letter interpretation and may result in preferential creditors being defeated
    - High Court decision in *Stein v Saywell*

The Concept of a Security Interest: The Canadian Experience

Roderick J. Wood*

1. Introduction

The enactment of the *Personal Property Securities Act 2009* (Cth) ("PPSA")[1] brings into play a series of fundamental changes to secured transactions law in Australia. Perhaps the most significant of these changes is the adoption of a unitary concept of a security interest. This represents a radical departure from the past in which several different species and subspecies of security interests[2] and quasi-security interests[3] co-existed. The PPSA draws heavily from personal property security legislation in Canada[4] and the United States.[5] The architects of these systems recognized that although there were a variety of different types of security devices governed by their own separate rules, they shared a common feature. They were designed to secure payment or performance of an obligation. The critical move was to recognize that they should be assimilated and governed by the same set of principles. The unitary concept of a security interest was the lynchpin that made it possible to implement many of the other fundamental changes to personal property security law.[6]

The recognition of a unitary concept of a security interest did not simply mean that the various consensual security interests and quasi-security interests – the pledge, contractual lien, mortgage,

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[1] Unless otherwise provided, references to the PPSA are to the Australian legislation.

[2] The traditional forms of non-consensual security were the pledge, contractual lien, mortgage and charge. See Beale, Bridge, Gullifer & Lomnicka, *The Law of Personal Property Security* (Oxford: OUP, 2007) at 8.

[3] Quasi-security interests are usually created by retention of title and include conditional sales agreements, hire purchase agreements and finance leases. See *ibid.*, at 9-10.

[4] Each province and territory in Canada has enacted a PPSA, with the exception of the civil law jurisdiction of Quebec, which has adopted a hybrid of civil law and PPSA inspired concepts. There are two basic models in use – the model adopted in Ontario and the model in use in the other common law provinces. Although there is little prospect of a uniform statute in the foreseeable future, there are currently some efforts to achieve a convergence on matters where the two models differ. See R.C.C. Cuming, C. Walsh & R. Wood, "Secured Transactions Law in Canada – Significant Achievements, Unfinished Business and Ongoing Challenges" (2011), 50 C.B.L.J. 156 at 174-78.

[5] Uniform Commercial Code, Article 9.

[6] These include the creation of a single unified registry system, a comprehensive set of priority rules based upon the time of registration, a single set of enforcement rules that provide remedies on default.

charge, conditional sales, hire purchase and finance lease – were to be husbanded together for the purposes of the registration, priorities and enforcement regime of the PPSA, but would retain their separate character and identity for other purposes. In Canada, courts at the highest level have recognized that the transformation has been more profound. The concept of a unitary security interest is not one that applies only within the context of the PPSA; the juridical nature of a security interest has been pervasively altered. The old dichotomies that characterized security interests as fixed or floating, legal or equitable were swept away, as was the division between true security interests and quasi-security interests.

2. A Brief History

Canadian, New Zealand and Australian personal property security legislation all share a similar structure and methodology with Article 9 of the Uniform Commercial Code of the United States.[7] The drafters of Article 9 set out to reform secured transactions law through the adoption of a unitary concept of a security interest. This represented a fundamental break with the past. Grant Gilmore, one of the principal architects of Article 9, recounts that:[8]

> The idea which the draftsmen started with was that the system of independent security interests had served its time; that the formal differences which separated one device from another should be scrapped and replaced with the simple concept of a security interest in personal property; that all types of personal property, whether held for use of sale, should be available for security.

The adoption of a unitary concept of a security interest has a number of different consequences. First and foremost, it means that the former differences among the various types of financing devices no longer have any significance. The distinct legal rules and principles that pertained to the pledge, the mortgage, the floating charge, and the assignment of receivables no longer have

[7] For a discussion of some of the background to the reform efforts in Australia and New Zealand, see A. Duggan & M. Gedye, "Personal Property Security Law Reform in Australia and New Zealand: The Impetus for Change" (2009), 27 Penn State International Law Review 655.
[8] Grant Gilmore, *Security Interests in Personal Property*, vol. 1, (Boston: Little, Brown & Co:, 1965) at 290.

any role to play. In their place, there is a single concept and a single source of law that governs security interests in personal property.[9]

A second aspect of this unification and reform of secured transactions law is that transactions that were not technically regarded as secured transactions were brought within the scope of the legislation. Historically, the pledge, lien, mortgage and charge were transactions by way of security – transactions by which the debtor created an interest in the debtor's assets in order to secure payment or performance of an obligation. Conditional sales contracts and other title retention devices did not qualify, since the debtor did not obtain title to the property in question until the full purchase price and credit charges had been satisfied. Nevertheless, they served a like function and were often characterized as "quasi-security." These devices were also brought within the scope of the Act.[10] They should no longer be considered quasi-security interests as they create security interests with exactly the same nature and characteristics as any other security interest governed by the Act.

The PPSA concept of a security interest entails a second idea that is closely associated with the unitary concept of a security interest. It is the idea that the definition of a security interest covers any transaction that in substance creates a security interest, regardless of its formal attributes or the identity of the person who holds title to the property.[11] This is sometimes referred to as the "substance" test. Not only does the definition cover the traditional types of security interests, it will also cover any new financing devices that are created if they are designed to secure payment or performance of an obligation.

This, too, is a radical departure from the past. The pre-reform law adopted a formal approach which drew distinctions on the basis of the legal category of interest that was created. Indeed, this contributed to the proliferation of independent security devices. The parties were able to develop new types of financing devices, and often did so in order to evade registration or other onerous requirements. The PPSA does not permit the creation of new forms of security devices that fall outside the scope of the Act. The PPSA "is all-embracing, all devouring; it covers

[9] PPSA, s.12(1).
[10] PPSA, s.12(2).
[11] PPSA, s.12(1).

everything."[12] New financing devices can be created, but they will be governed by the PPSA if their function is to secure payment or performance of an obligation. In determining if a transaction in substance secures payment or performance of an obligation, one must look at the economic effect of the transaction rather than its legal form. The test therefore captures disguised security interests – transactions that take the form of a non-security transaction but which have the effect of securing payment or performance of an obligation.[13] Transactions such as leases and consignments are therefore brought within the definition if the economic reality is that they operate to secure an obligation.

This paper will examine the Canadian experience with these two foundational concepts. The courts have, with one exception, given full reign to these concepts, and have recognized that they have fundamentally altered the structure of secured transactions law.

3. The Unitary Concept of a Security Interest

The adoption of a unitary concept has meant that the old forms of security interests no longer hold any special significance. Each can be used to create a security interest, but the nature and characteristics of the security interest is the same regardless of its form. There were several false starts in Canada in the early years when some courts instinctively clung to the old terminology and concepts and tried to replicate them within the context of the PPSA. For example, courts attempted to recreate the idea of crystallization of a floating charge by manipulating the PPSA concept of attachment. The courts have since rejected this approach, and have recognized that the PPSA has completely transformed the nature of some pre-PPSA devices such as the floating charge. The courts have been somewhat less successful with a similar transformation of the conditional sales agreement. This problem often arises when other statutes continue to use of the older terminology and concepts, and it has, on occasion, caused courts to depart from the notion of a unitary security interest.

[12] Gilmore, *supra* note 8 at 295.

[13] See R.C.C. Cuming, C. Walsh & R.J. Wood, *Personal Property Security Law* (Toronto: Irwin Law, 2005) at 67-80.

a) The Transformation of the Floating Charge

The juridical nature of the floating charge is a topic that has attracted much attention and debate.[14] The charge is said to be an existing but non-specific charge on the debtor's assets that permits the debtor to deal with those assets.[15] Upon crystallization, the charge specifically attaches to the individual assets and the debtor no longer has the ability to deal with them.[16] In Australia, there is greater support for the view that a floating charge did not give rise to any proprietary interest until its crystallization.[17]

The unitary concept of a security interest under the PPSA does not allow for the idea of a present but non-specific charge. Nor does it allow for the idea of a present but non-proprietary security right. A security agreement that purports to create a floating charge creates a security interest and is governed by the same rules that govern any other security interest. Canadian cases have worked out the consequences of this reconceptualization of the floating charge.

i) Time of Attachment

Although the floating charge was abolished as an autonomous legal concept under the PPSA, this did not mean that floating charge debentures or security agreements that created floating charges could no longer be used. These agreements clearly manifest an intention to create a security interest. But the security interest that is created is no different from any other security interest. The rules that govern when the interest arises (attachment of the security interest) and the rules governing its priority are no different from those that govern agreements in the form of a pledge, mortgage, charge or title retention device, or newer agreements that simply grant a security interest in the collateral.

[14] L. Gullifer & J. Payne, "The Characterization of Fixed and Floating Charges" in J. Getzler & J. Payne (eds.) *Company Charges: Spectrum and Beyond* (Oxford: OUP, 2006) 64; P. Watts, "Alternative Types of Charge over Co Businesses and the Effect of Winding up on Them – Recent Developments in Australia and New Zealand" (1989) 12 U.N.S.W.L.J. 179; S. Worthington, *Proprietary Interests in Commercial Transactions* (Oxford,: Clarendon Press, 2006) at 74-77; R. Nolan, "Property in a Fund" (2004), 120 L.Q.R. 108.
[15] *Evans v. Rival Granite Quarries Ltd.*, [1910] 2 K.B. 979.
[16] *Ibid.*
[17] W.J. Gough, *Company Charges*, 2nd ed., (London: Butterworths, 1996) at 97-101; D. Everett, *The Nature of Fixed and Floating Charges as Security Devices*, (Monash Law Press, 1988) at 21-26. And see *Tricontinental Corporation Ltd. v. Federal Commissioner of Taxation* (1987), 73 A.L.R. 433; *Lyford v. Commonwealth Bank of Australia* (1995), 17 A.C.S.R. 211.

Despite the adoption in the PPSA of a unitary concept of a security interest, some earlier Canadian decisions attempted to replicate some of the unique features of the floating charge within the context of the PPSA. Some courts took the view that the use of the older floating charge form of agreement showed an intention to delay attachment of the security interest until the charge had crystallized.[18] This line of thinking would have resulted in a partial resurrection of the floating charge and all the complexities associated with the crystallization concept. This approach has withered on the vine. Courts have decisively rejected the idea that the concept of crystallization continues to apply under the PPSA.[19] Later versions of the statute reinforced this position by expressly stating that that the rules for attachment apply to a security interest including a security interest in the nature of a floating charge.[20]

ii) Authorization and the Reigning-In of the Licence Theory

The juridical nature of the floating charge has never been satisfactorily resolved. This search for an underlying theory is no longer useful, as the floating charge has ceased to be an autonomous security device under the PPSA. A PPSA security interest is a fixed security interest that comes into existence when the requirements for attachment of the security interest have been satisfied. This is the case even when the collateral is in the form of circulating assets, such as inventory or accounts. Although the assets are subject to the security interest, the debtor is able to deal with the assets if the secured party has authorized the dealing.[21] There are two consequences of this. First, the debtor is obviously not in breach of the security agreement if the debtor deals with the asset within the authority to deal granted by the secured party. Secondly, the party who acquires the interest in the asset as a result of the dealing takes free of the security interest.[22]

The PPSA does not rely solely upon the authorization idea in protecting parties who deal with the debtor. The secured party may have restricted the debtor's ability to deal with circulating

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[18] See, *e.g.*, *Access Advertising Management Inc. v. Servex Computers Inc.* (1993), 15 O.R. (3d) 635 (Gen. Div.).
[19] *G.M. Homes Ltd., Re* (1984), 10 D.L.R. (4th) 439 (Sask. C.A.); *Irving A. Burton Ltd. v. Canadian Imperial Bank of Commerce* (1982), 134 D.L.R. (3d) 369 (Ont. C.A.); *Roynat Inc. v. United Rescue Services Ltd.*, [1982] 3 W.W.R. 512 (Man. C.A.). And see J.S. Ziegel, "Floating Charges and the OPPSA: A Basic Misunderstanding" (1994), 23 C.B.L.J. 470.
[20] PPSA, s.19(4).
[21] PPSA, s.32(1)(a).
[22] See *Lanson v. Saskatchewan Valley Credit Union Ltd.* (1998), 14 P.P.S.A.C. (2d) 71 (Sask. C.A.).

assets from the outset, or the secured party may have withdrawn the authorization upon the occurrence of some event, such as an event of default. The PPSA provides a set of priority rules that protect parties who acquire inventory in the ordinary course of the debtor's business,[23] or who receive payment of their claims.[24] These priority rules operate whether or not the secured party has authorized the transaction.

The PPSA contemplates that the authorization may be express or implied. The possibility remained that courts might use a wide implied authorization idea to breathe new life into the floating charge idea within the context of the PPSA. For example, it might be argued that the use of a floating charge debenture indicates that the grantor was authorized to create a wide range of competing interests in priority to the security interest created by the floating charge debenture. Some courts adopted the view that a secured party who authorizes the sale of inventory impliedly agrees to the subjection of its security interest to other claims that may arise in the ordinary course of business, such as the creation of non-consensual security interests in favour of the Crown in respect of taxes that ought to have collected in connection with the sales.[25]

Although for a time it seemed that this argument had some traction, it was ultimately rejected by the Supreme Court of Canada in *Royal Bank of Canada v. Sparrow Electric*.[26] The Court rejected a wide conception of the authorization (the licence to sell the inventory) and held that "what a security agreement with a licence to sell creates is a defeasible interest; but the event of defeasance is the <u>actual</u> sale of the inventory and the <u>actual</u> application of the proceeds against an obligation to a third party."[27] Many security agreements in use in PPSA jurisdictions give the secured party a security interest in all present and after-acquired personal property, and authorize the sale of inventory in the ordinary course of business and the collection of accounts. This gives buyers and creditors who were paid from the proceeds the accounts priority, but it does not replicate the wide latitude that was given to the debtor to deal with the assets prior to crystallization of a floating charge.

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[23] PPSA, s.46.
[24] PPSA, ss. 48, 59.
[25] See *G.M. Homes, Re*, *supra* note 19. And see R.J. Wood, "Revenue Canada's Deemed Trust Extends its Tentacles: *Royal Bank of Canada v Sparrow Electric Corp."* (1995) 10 B.F.L.R. 429.
[26] [1997] 1 SCR 411.
[27] *Ibid.*, at para. 94.

iii) Permissive Provisions and Subordination

Although secured parties may continue to use older forms of security documents, the security interest that is thereby created does not depend on the form of agreement. The security agreement creates a security interest, and its attributes and priority are governed by the PPSA. There is at least one situation where use of the older forms of agreement may prove to be detrimental. The issue concerns the inclusion of restrictive and permissive provisions in security agreements.

Under the pre-reform law, it was common to include restrictive provisions (often referred to as "negative pledge covenants" in Canada and the United States) that limited the debtor's authority to grant a security interest in the collateral subject to the charge. The restrictive provision was often modified by a permissive provision that carved out certain permitted transactions – typically involving the creation of purchase money security interests.[28]

The controversy arises when the holder of the purchase money security interest fails to register within the time frames necessary to obtain the higher ranking priority afforded by the PPSA over prior registered security interests.[29] As the special priority rule in favour of purchase money security interests is inapplicable, the priority competition will be resolved through the application of the ordinary priority rule with the result that the first party to register will prevail.[30] However, if the holder of the purchase money security interest can show that the earlier secured party agreed to subordinate its security interest, the agreement will be given effect. The PPSA contains an express provision that validates the use of subordination agreements between or among the creditors (inter-creditor agreements) as well as subordination provisions contained in the security agreement between the secured party and the debtor.[31] The holder of the purchase money security interest will therefore argue that the inclusion of a permissive provision in the security agreement amounts to a subordination to a person who enters into a permitted transaction.

[28] See K. Morlock, "Floating Charges, Negative Pledges, the PPSA and Subordination: *Chiips v. Skyview Hotels Limited*" (1995) 10 B.F.L.R. 405.
[29] PPSA, s.62.
[30] PPSA, s.55.
[31] *Sperry Inc. v. Canadian Imperial Bank of Commerce* (1985), 17 D.L.R. (4th) 236 (Ont. C.A.); *Bank of Nova Scotia v. Royal Bank* (1987), 8 P.P.S.A.C. 17 (Sask. C.A.).

Canadian courts have held that a permissive provision by itself is not sufficient to constitute a subordination provision. A covenant that the debtor shall keep the collateral free of all security interests or encumbrances other than permitted encumbrances does not result in a subordination of the security interest to the permitted encumbrance. Rather, it means that the creation of a permitted encumbrance will not constitute a breach of the contractual provision, which would constitute an event of default and permit the secured party to enforce the security interest. But if the provision goes further and refers to the priority ranking of permitted encumbrances, the provision will constitute a subordination provision.[32]

The distinction is a subtle one. A provision under which the debtor agrees to keep the collateral free of all encumbrances *ranking in priority to or pari passu with the security interest* other than permitted encumbrances subordinates the security interest to the permitted encumbrance. If the italicized wording is removed, the provision merely excepts the transaction from the scope of the negative covenant but does not in itself effect a subordination.

iv) Abandonment of the Floating Charge Debenture

Although Canadian judicial decisions have now confirmed that the use of a floating charge does not produce a different kind of security interest or different priorities, the drafters in the early years following adoption of the PPSA operated under a real apprehension that the use of the floating charge might result in an inferior priority status. As a result, the floating charge form of agreement has been almost completely abandoned in favour of modernized forms of security agreements that adopted PPSA terminology. In its place, drafters produced a "general security agreement" (or "GSA") under which the debtor grants to the secured party as security interest in all of its present and after-acquired personal property. If the security agreement contains a permissive provision, the drafter will generally ensure that the language will not constitute a subordination unless so intended by the parties.

[32] *Asklepeion Restaurants Ltd. v. 791259 Ontario Ltd.* (1996), 11 P.P.S.A.C. (2d) 320 (Ont. Ct. Gen. Div.), aff'd (1998) 13 P.P.S.A.C. (2d) 295 (Ont. C.A.); *Re DCD Industries (1999) Ltd*. (2005), 11 C.B.R. (4th) 246 (Alta. C.A.).

v) Competitions with non-PPSA Interests

Although the PPSA contains a set of priority rules that govern many kinds competitions that can arise, these rules are not exhaustive. There are simply too many different types of proprietary rights, and it is simply not realistic to expect that the statute can provide a specific rule for every possible priority competition. The matter therefore falls to be determined through the application of ordinary property law principles. At this juncture, a critical issue arises. How is a PPSA security interest to be characterized? Do we revert to the older categories (pledge, mortgage, charge, title retention) and characteristics (fixed v. floating) when the PPSA does not provide a specific priority rule. Or do we regard the PPSA as having a more pervasive effect such that the old categories are banished throughout the realm?

The Supreme Court of Canada has ruled unequivocally in favour of the latter approach in *Bank of Montreal v. Innovation Credit Union.*[33] The priority competition was between a PPSA security interest and a federal *Bank Act*[34] security. The *Bank Act* security is not a security interest covered by the PPSA, and the federal provisions that governed it do not create a comprehensive set of priority rules.[35] The matter therefore fell to be determined through the application of conventional property law principles. In applying these principles, the court stated:[36]

> It is true that the internal priority rules of the *PPSA* cannot be invoked to resolve the dispute. However, it does not follow that the provincial security interest created under the *PPSA* does not exist outside these priority rules. Nor can the fundamental changes brought about by the *PPSA* be ignored in determining the nature of the prior competing interest.

[33] 2010 SCC 47.
[34] S.C. 1991, c. 46.
[35] The co-existence of two security regimes – one based on traditional property law concepts and the other that ranks priority according to the time of registration has generated much litigation. See R.C.C. Cuming, "PPSA — Section 178 *Bank Act* Overlap — No Closer to Solutions" (1991) 18 Can. Bus. L.J. 135 and J.S. Ziegel, "The Interaction of Section 178 Security Interests and Provincial PPSA Security Interests: Once More into the Black Hole" (1991) 6 B.F.L.R. 323; R.J. Wood, "The Nature and Definition of Federal Security Interests" (2000) 34 Can. Bus. L.J. 65. Although the Law Commission of Canada recommended repeal of the Bank Act security provisions, there has been no progress on this front. See *Modernizing Canada's Secured Transactions Law: The* Bank Act *Security Provisions* (Ottawa: Law Commission of Canada, 2004).
[36] *Supra* note 33 at para. 30.

The Court went on to observe that although some of the pre-PPSA security devices created equitable rather than legal interests, the PPSA treats them all equally as security interests.[37] Because the PPSA security interest is recognized and regulated by statute, it is to be regarded as a legal interest that operates by way of security.

A PPSA security interest is different from the historical concept of the floating charge in two essential respects. First, the secured party obtains a legal rather than an equitable interest.[38] Secondly, the legal interest is fixed rather than floating and arises as soon as the conditions for attachment have been satisfied. The transformation has had the effect of elevating the priority status of a PPSA security interest over that formerly obtained by a floating charge under pre-reform law.

vi) Legislative Superpriority Provisions

The vast majority of income tax revenue in Canada is collected through a system of source deduction that requires employers to deduct amounts from the pay of their employees and remit it to the taxation authority. Although an employer is required to hold these amounts in trust, an insolvent employer will often fail to do so with the result that the common law requirements for the creation of a trust will not have been satisfied. In order to give the taxation authority a proprietary interest in the debtor's assets, the taxation legislation imposes a statutory deemed trust on the assets of the debtor.[39] Upon the insolvency of the employer, priority competitions frequently arise between prior secured parties and the statutory deemed trusts in respect of source deductions.

Prior to the PPSA, Canadian courts resolved these priority competitions through the application of conventional property law principles. A prior fixed charge had priority over a subsequent statutory deemed trust, since the latter only operated in respect of the debtor's interest in the asset.[40] The situation was different if the security interest took the form of a floating charge.

[37] *Ibid.*, at para. 42.
[38] See also *i Trade Finance Inc. v. Bank of Montreal*, 2011 SCC 26 at para. 61 in which the court characterized a PPSA security interest as a legal interest since the interest is recognized by statute.
[39] *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), s.227(4).
[40] *Board of Industrial Relations v. Avco Financial Services Realty Ltd*, [1979] 2 S.C.R. 699.

Canadian courts held that the statutory deemed trust was entitled to priority if it arose before crystallization of the floating charge.[41] As a result, the statutory deemed trust was typically subordinate to a fixed charge, but usually had priority over a floating charge.

The implementation of the PPSA disturbed this equilibrium and provided a nasty shock to the taxation authority. Secured creditors were able to take security interests in all the assets of the debtor and these security interests were no longer regarded as floating charges. They were fixed legal interests that attached to new assets the moment that the debtor acquired rights in the property. Since the PPSA security interest attached to the asset before the statutory deemed trust arose, the security interest was entitled to priority over the statutory deemed trust.[42]

The victory was only temporary. Parliament soon passed amendments to ensure that the statutory deemed trust was given priority.[43] The legislation, however, did not simply attempt a return to the status quo. The statutory deemed trust was afforded a priority over almost all prior or subsequent security interests of any nature.[44]

There are many other types of non-consensual security interests in Canada. In many cases they secure claims owed to the Crown, but some are in favour of other claimants such as unpaid employees.[45] Often the non-consensual security interest is afforded a superpriority over other security interests, but sometime there is an exception made for specified kinds of interests such as purchase-money security interests.[46] In some instances, the priority is capped by a monetary limit, or imposed only against certain types of assets.[47] The trend in drafting these provisions has been to use PPSA concepts and terminology, and when this is done there are generally few

[41] *Dauphin Plains Credit Union Ltd. v. Xyloid Industries Ltd.*, [1980] 1 S.C.R. 1182.
[42] *Royal Bank of Canada v. Sparrow Electric Corp.*, [1997] 1 S.C.R. 411.
[43] *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), s.227(4.1).
[44] The one exception is a registered mortgage on land, but only in respect of amounts that are due before the deemed trust arises.
[45] See *Bankruptcy and Insolvency Act*, R.S.C. 1985, c B-3, s.81.3.
[46] See, *e.g.*, *Employment Standards Code*, R.S.A. 2000, c E-9, s.109(3)-(4) which provides that a claim for unpaid wages has priority over a security interest other than a prior registered purchase money security interest.
[47] The statutory security in respect of unpaid wages created by the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c B-3, s.81.3 is capped at $2000 for each employee and covers only cash, cash equivalents, inventory, accounts, and proceeds from any dealing with those assets.

problems of interpretation.[48] As will be seen, difficulties are more likely to arise when the statute adheres to older concepts and terminology of pre-PPSA law.

b) The Characterization of Title Retention Devices

The application of the PPSA to title retention devices was relatively uncontroversial in Canada. Conditional sales agreements were subject to a registration requirement under pre-PPSA law.[49] In this respect, Canadian law shared a greater affinity with the pre-reform law of the United States. Accordingly, it was not a large conceptual leap to assimilate them with other security devices. Canadian courts had greater difficulty with the idea that leases were to be brought within the scope of the Act, but resistance to this idea has largely passed.[50]

Problems have arisen when the issue is not expressly governed by the PPSA. It might become necessary to characterize the interest of the conditional seller for the purposes of sales law or some other body of law. Do we consider the conditional seller to be the owner who holds legal title to the goods? Or is the buyer the owner?

The Uniform Commercial Code of the United States was unequivocal on this issue. It provided that a retention of title was limited in effect to a reservation of a security.[51] The property in the goods would pass immediately to the buyer according to ordinary sales law principles and the seller would have nothing more than a security interest in the debtor's newly acquired asset in order to secure the unpaid purchase price and credit charges. Unfortunately, the drafters of the Canadian legislation thought in unnecessary to include a similar provision, and Canadian courts have not adopted a consistent approach when confronted with this issue.

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[48] See, *e.g., Workers Compensation Act*, R.S.A. 2000, c W-15, s.129(3) which provides that the assessment has priority over all security interests as defined in the PPSA.
[49] See J.S. Ziegel, "Canadian Chattel Security Law: Past Experience and Current Developments" in J.G. Sauveplanne, ed. *Security over Corporeal Moveables* (Lieden:A.W. Sijthoff, 1971) 71.
[50] Judicial resistance to the idea was finally laid to rest by the Supreme Court of Canada in *Giffen, Re,* [1998] 1 S.C.R. 91. Prior to this, some courts were troubled by the idea that an unregistered lease should be rendered ineffective against a trustee in bankruptcy, and employed a number of different techniques to avoid this outcome.
[51] Uniform Commercial Code, 2-401(1).

i) Competitions with non-PPSA Interests

The courts were again called upon to resolve a priority competition between a statutory deemed trust and a PPSA security interest – this time in the form of a conditional sales agreement or finance lease.[52] The federal legislation gives the deemed trust priority over any security interest.[53] Although title retention devices are clearly security interests for the purposes of the PPSA, the issue was whether they should also be characterized as such for the purposes of the federal legislation. The legislation defines a security interest as "any interest that secures payment or performance of an obligation..."[54] This portion closely tracks the PPSA definition, and one would be forgiven for thinking that the courts would give them the same construction.

This did not happen. The courts seized upon the concluding portion of the definition, which indicated that it included an interest that arose out of a mortgage, pledge, lien or charge. The failure to include title retention devices among this enumeration was thought to show an intention to exclude such security interests from the scope of the provision. The result was that a title retention device enjoyed priority over the statutory deemed trust.

These decisions were perhaps motivated by a wish to curtail the long reach of the statutory deemed trust. The difficulty is that Canadian insolvency statutes also define a security interest as a mortgage, charge, lien or pledge. The decisions therefore have the potential to undermine several key insolvency policies by excluding title retention devices from the scope of the insolvency definition.[55]

ii) Passage of Property under Title Retention Agreements

The use of a conditional sales agreement brings both sales law and secured transactions law into play. The contract involves a credit sale of the goods from the seller to the buyer. It also involves the creation of a security interest to secure the obligation to pay. Canadian courts have had little

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[52] *DaimlerChrysler Financial Services (Debis) Canada Inc. v. Mega Pets Ltd.* (2002), 212 D.L.R. (4th) 41 (B.C.C.A.); *Minister of National Revenue v. Schwab Construction Ltd*. (2002), 31 C.B.R. (4th) 75 (Sask. C.A.); *Bank of Nova Scotia v. Turyders Trucking Ltd.* (2001), 32 C.B.R. (4th) 14 (Ont. S.C.J.).
[53] *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), s.224(4.1).
[54] *Ibid.*, s.224(1.3).
[55] See R.J. Wood, "The Definition of Secured Creditor in Insolvency Law" (2010), 25 B.F.L.R. 341.

difficulty with the latter aspect. The transaction creates a security interest, and its priority will be governed by the PPSA. But sometimes it is the sales aspect that is relevant, and it is here that there is greater controversy.

Consider the case where a business has given a security interest in all of its property to a lender. The grantor then sells some of its goods to a buyer under a conditional sales contract. This does not involve a competition between secured parties. It is essentially a competition between the secured party (the lender) and the buyer. The PPSA provides rules that govern competitions between secured parties and buyers. Canadian courts have not been in agreement on precisely when they can be invoked. The Saskatchewan Court of Appeal has taken the view that these rules will not apply unless the buyer has acquired property in the goods.[56] The Ontario Court of Appeal refused to adopt this approach and took the view that the priority rules could operate even if title did not pass so long as it was possible to identify the goods to the contract.[57] The Ontario decision involved a buyer who had purchased an expensive boat under a conditional sales agreement and had paid 90 per cent of the purchase price. The concern was that the sales agreement delayed the passage of property until the full purchase price was paid. As this had not yet occurred, the conditional buyer would be unable to invoke the ordinary course buyer rule that would otherwise allow a buyer to take free of a security interest given by the seller.

The problem would be greatly lessened had the Ontario Court of Appeal had recharacterized the nature and effect of a title retention clause.[58] If the clause had been viewed as creating a security interest and having no other effect, it would not have delayed the passage of property to the buyer. This matter would be determined through the application of sales law without regard to the title retention clause. In the vast majority of cases that involve the sale of specific goods, this occurs the moment when the contract is entered into.[59]

[56] *Royal Bank v. 216200 Alberta Ltd.*, [1987] 1 W.W.R. 545 (Sask C.A.).
[57] *Spittlehouse v. Northshore Marine Inc.* (1994), 18 O.R. (3d) 60.
[58] See Jacob Ziegal, Commentary, “To what types of sale does section 28(1) of the OPPSA apply?” (1994–95) 24 Can. Bus. L.J. 457.
[59] See *Sale of Goods Act*, R.S.S. 1978, s. S-1, s.20 Rule 1.

4. The Substance Test of a Security Interest

The second aspect of the PPSA concept of a security interest involves the idea that the characterization of a transaction as a security interest should depend upon its function rather than the form of the transaction or the location of title. The emphasis is now on the economic realities. If the effect of the transaction is such that a debtor has given a creditor a proprietary right in the debtor's assets such that the creditor may have recourse to the assets in the event of a default, it is to be regarded as a security interest. The fact that the parties may have set it up as a lease, consignment, bailment, trust or other transaction is not relevant if the transaction functions as a security interest.

The application of the substance test is illustrated in three different situations. The first shows how an inquiry into the economic realities may result in the characterization of a lease as a security interest even if the lessee is not expected to acquire title to the goods at the end of the lease term or enjoy possession of the goods for their full useful life. The second deals with the application of the test to new forms of security arrangement, and illustrates the point that there can be no new forms of security arrangements that fall outside the scope of the Act. The third is the most controversial in Canada and concerns the characterization of an arrangement as a security interest despite the fact that under pre-reform law the transaction would be regarded as giving rise only to personal rather than proprietary rights. It therefore represents the outside limits of the substance test.

a) Open End Leases

Canadian courts were often called upon to distinguish between true leases and leases that in substance created a security interest (a "security lease").[60] The courts often found it useful to draw an analogy between a security lease and a secured installment purchase agreement (a

[60] Canadian case law from Ontario and Manitoba are particularly rich in decisions dealing with the characterization of leases. The PPSA of these provinces did not originally bring true long term leases within the scope of the Act as deemed security interests. As a result, registration was required for security leases, but was not required in respect of true leases. Most of these cases involved priority competitions with a trustee in bankruptcy of the lessee or with a secured party whose security interest covered the leased goods. Both provinces have since amended their legislation by bringing leases for a term of more than one year within the scope of the PPSA as deemed security interests. Not surprisingly, this has resulted in a sharp drop in the number of cases litigated on the characterization issue since registration is now required to obtain priority for both security leases and true leases.

conditional sale under the former law).[61] Upon paying the full purchase price and credit charges, the buyer under a secured installment purchase agreement ends up with unencumbered title to the goods. If the lease were structured such that title to the goods automatically vested in the lessee[62], or if a lease option was structured so that a rational lessee would exercise an option to purchase (because the option price was substantially less than the expected residual value of the goods at the end of the lease term), one could say that there was functionally no real difference between the two devices. In both instances, the party winds up as the owner of the asset.

Although Canadian courts sometimes tested the transaction by inquiring whether the lessee was expected to end up as owner,[63] this was simply an application of the more general "substance test" to the particular facts. The intent was never to substitute an ownership test for the substance test.

This point is confirmed in the Canadian cases dealing with open end leases. Open end leases set a termination value. At the end of the lease term, the goods are returned to the lessor and sold. If the sale proceeds exceed the termination value, the surplus is paid to the lessee. If the sale proceeds are less than the termination value, the lessee is responsible for paying the deficiency. Under this arrangement, the lessee is not expected to become the owner of the goods as the goods as sold to a third party buyer. An insistence that the lessee acquire ownership or enjoy possession of the goods for their full useful life would mean that an open end lease would not be characterized as a security interest.

The courts did not take so narrow an approach, but instead gave full effect to the substance test.[64] The fact that the lessee did not acquire ownership was not the *sine qua non*. The essential consideration was that the lessee occupied the economic position of an owner. The lessee had the benefits and disadvantages of ownership – the risk of gain or loss. From an economic

[61] See *Federal Business Development Bank v. Bramalea Ltd*. (1983), 144 D.L.R. (3d) 410 (Ont. H.C.J.), aff'd 150 D.L.R. (3d) 768 (Ont. C.A.).
[62] *DaimlerChrysler Services Canada Inc. v. Cameron*, (2007, 279 D.L.R. (4th) 629 (B.C.C.A.).
[63] See, *e.g.*, *Stark Coaxial Systems Inc., Re*, (1985), 55 C.B.R. (N.S.) 308 (Ont. S.C.)
[64] See *Crop & Soil Service Inc. v. Oxford Leaseway Ltd*. (2000), 186 D.L.R. (4th) 85 (Ont. C.A.); *HOJ Franchise Systems Inc. v. Municipal Savings & Loan Corp.* (1994), 6 P.P.S.A.C. (2d) 302 (Ont. Ct. Gen. Div.).

perspective, there was no difference between a transfer of title to the lessee and a forced sale of the goods for the account of the lessee.[65]

b) New Forms of Security – Feeder Association Agreements

The application of the PPSA to feeder association agreements provides a good illustration of the all encompassing nature of the substance test and the idea that there can be no new secured transactions that fall outside the scope of the PPSA. Feeder associations are organizations that provide feed to livestock producers. A feeder association acquires cattle and brands them (or identifies them with an ear tag) in the name of the feeder association. The feeder association then enters into an agreement with a member of the feeder association who takes possession of the livestock and raises them. The agreement provides that the legal title to the livestock remains with the feeder association. The member is responsible for maintaining the health of the livestock, must provide them with veterinary services and must insure them. The feeder association provides credit to the member to permit the purchase of feed. When the cattle are sold, the charges payable to the feeder association are paid and the balance is paid to the producer.

The use of feeder association agreements is a relatively new phenomenon. Canadian courts were called upon to determine if these agreements in substance created security interests.[66] From an economic perspective, the matter is clear cut. Despite the fact that the feeder association holds legal title to the livestock, the producer is in the economic position of an owner. The producer has the benefit of gain and the risk of loss, while the feeder association is assured that the credit it supplies will be recovered. In many respects, the analysis is similar to that applied in respect of open end leases. It makes no difference that the producer never acquires legal title at any time. The focus is upon substance not form, on the economic realities and not the location of legal title.

[65] *Re Cronin Fire Equipment Ltd.* (1993), 21 C.B.R. (3d) 127 (Ont. Ct. Gen. Div.).
[66] *Farm Credit Corp. v. Valley Beef Producers Co-operative Ltd.* (2002) 36 C.B.R. (4th) 121 (Sask. C.A.); *Toronto Dominion Bank v. East Central Feeder Co-operative Ltd.*, (2001), 2 P.P.S.A.C. (3d) 283 (Ont. S.C.J.).

c) Set-Off and Flawed Asset Arrangements

The Canadian personal property security statutes, unlike the statutes in Australia and New Zealand, do not contain a provision that brings flawed asset arrangements with their scope.[67] This is perhaps not as surprising as it may seem. Until recently, there was a large gap in the Canadian case law. First, there was no guidance on the question whether it was even possible for a party to be granted a security interest in an obligation that was owed by the secured party to the grantor.[68] Secondly, there was absolutely no guidance on the nature or character of a "flawed asset" arrangement. Indeed, the term could not be found in any Canadian decision. All this changed with the release of the Supreme Court of Canada's decision in *Caisse populaire de Drummond v. Canada*.[69]

i) The Decision of the Supreme Court of Canada

The controversy again concerned the federal statutory deemed trust that secures source deductions. A financial institution had extended an operating line of credit to the debtor. The parties entered into two agreements. The first was a term savings agreement under which the debtor deposited $200,000 with the financial institution. The term was for five years and the funds could not be redeemed before that date. The agreement also provided that the deposit was not transferrable and could only be given as security to the financial institution.

The second agreement contained three elements. First, it provided that the debtor consented to the withholding of the $200,000 term deposit until all the amounts due under the credit agreements were fully repaid. Secondly, it provided that in the event of default the financial institution could claim compensation (the civil law counterpart to set-off in common law systems) between the term deposit and the amount due under the credit contracts. Thirdly, the debtor pledged and hypothecated the term deposit as security for the loans. The debtor had failed to remit source deductions both before and after the agreements had been entered into. The financial institution did not immediately enforce its claim against the term deposit. Shortly after the insolvency proceedings were instituted against the debtor, the financial institution purported

[67] PPSA, s.12(2)(l).
[68] See R.J. Wood, Journey to the Outer Limits of Secured Transactions Law: *Caisse populaire Desjardin de l'Est de Drummond*" (2010) 48 C.B.L.J. 482 at 491.
[69] [2009] 2 S.C.R. 94.

to close out the account in realization of its security and the Crown claimed that the term deposit was subject to its statutory deemed trust.

The legislation that created the statutory deemed trust provided that it ranked ahead of any security interest in the assets. Clearly, any attempt to assert the security interest against the Crown was doomed to failure. For this reason, the financial institution did not elect to assert its security interest against the term deposit. Instead, it claimed that its agreement gave it the contractual right to withhold the term deposit until the amounts owing to it were paid. The issue was whether these other contractual provisions constituted a security interest within the meaning of the federal provision.[70] If so, the statutory deemed trust would be entitled to priority. If not, the statutory deemed trust would only be effective in respect of unremitted source deductions that were due at the time the term deposit was created and would be ineffective in respect of any unremitted amounts that arose after the creation of the contractual rights in favour of the financial institution.

The majority judgment found that the contractual provisions satisfied the definition of a security interest. Rothstein, J. held that arrangement will constitute a security interest if the substance of the transaction was that the creditor acquired an interest in the debtor's property so as to ensure that the right of set-off or compensation would provide an effective remedy on default in payment of an obligation. He held that the five year term, the contractual right to withhold payment and the restrictions on transfer created a security interest. The provisions were designed to "encumber" the term deposit to ensure that it would be available on a default in repaying the loans.[71]

The dissenting judgment took the view that the contractual provisions only gave rise to personal rights, and did not create proprietary rights in the term deposit. The length of the term merely defined the timing of the repayment obligation. A negative pledge covenant merely gives the contracting a right to sue for damages for breach. The right to withhold merely imposed a

[70] The issue was not whether the arrangement fell within the definition of a security interest in the PPSA. However, the federal definition of a security interest did not vary materially from the definition contained in the PPSA in this respect, and therefore the case is generally regarded as authoritative on the scope of the PPSA as well. However, differences in the wording of the provisions have been held to be significant in other contexts. These will be discussed in the next section dealing with the characterization of conditional sales agreements.
[71] *Supra*, note 69 at para. 30.

condition that was required to be satisfied in order to obtain payment of the term deposit. None of these rights individually or in tandem created a security interest.[72]

ii) The Application of the Substance Test

The decision is important in that it demonstrates the astonishing breadth of the substance test. When a lease, trust, bailment or consignment is used to provide a creditor with security for payment of an obligation, there is no question that the creditor has some kind of proprietary right in the asset, if only possession.[73] The issue is whether this proprietary interest is held as security. But the issue in *Caisse populaire de Drummond v. Canada* was whether a combination of personal rights could constitute a security interest if their effect was to secure payment of an obligation. The court held that if the contractual provisions effectively placed the creditor in the same position as it would have occupied had it been granted a security interest, it would be characterized as such.

Outside of Canada, this aspect of the decision may seem, at first, to be of lesser importance. The decision places Canada in the same camp as New Zealand and Australia, which have expressly included flawed asset arrangements within the scope of their Acts. But on closer reflection, it should be apparent that the decision has a wider significance. The reasoning is not restricted to flawed asset arrangements, but is relevant whenever contractual rights are used to create a set of rights that are functionally equivalent to a security interest.

iii) The Priority Consequences of the Decision

Characterization of the transaction as a security interest was significant in the case because it triggered federal priority provision that gave the statutory deemed trust priority over a security interest. But the decision has a broader implication. If the transaction is characterized as a security interest, then it must be perfected under the PPSA in order obtain priority over other

[72] *Ibid.* at para 122.
[73] PPSA, s.20(5) makes it clear that a lessee or bailee of goods under a PPSA lease or a buyer under a conditional sales agreement has rights in the goods when that person obtains possession of the goods.

secured parties. It must also be perfected in order to be effective in some insolvency proceedings. The degree to which this is viewed as a concern very much depends on the perfection and priority rules that are in place. It is here that there is significant variation across jurisdictions.

Canada and New Zealand do not provide any special perfection or priority rules in respect of a deposit account with a financial institution. This account, like any other account, can only be perfected by registration. In Canada, this perfection requirement has caused concerns in the derivatives industry over cash collateral transactions in which cash is provided as credit support for exposure on derivatives and securities financing transactions. Under these transactions, a party will wire funds to its counterparty. The funds are held in a bank account in the name of the counterparty. If the documentation provides that the counterparty is granted a security interest in the funds that are transferred, the transaction clearly creates a security interest and is governed by the PPSA. This would mean that registration would be required to perfect the security interest.

In order to work around this requirement, the Canadian practice has been to structure the transaction as an absolute transfer of the funds to the counterparty.[74] This creates a debtor-creditor relationship between the parties. The credit support document also provides that the counterparty has the right to set-off the obligations owed by the transferor of the funds against its obligation to repay the transferred funds. The decision of the Supreme Court of Canada has caused consternation because of the potential for this form of transaction to be characterized as a security interest, and thereby give rise to the requirement for registration to perfect it.[75]

The response of the derivatives industry has been to request amendments to the Canadian PPSAs in order to introduce the concept of perfection by control of deposit accounts and the corresponding priority and conflicts rules that are found in the Article 9 of the Uniform Commercial Code.[76] Under Article 9, a security interest in a deposit account can be perfected by control by becoming the bank's customer, or by entering into an agreement under which the bank

[74] See International Swaps and Derivatives Association Inc., "Proposal for Amendments to the Treatment of Deposit Accounts under the PPSA" (June 8, 2009) online: http://www.isda.org/c_and_a/pdf/ISDA-Proposal-for-Amendments-to-Treatment-of-Deposit-Accounts-under-PPSA-8June2009.pdf.
[75] See International Swaps and Derivatives Association Inc., Letter to Alberta and Ontario Governments re Proposal for Amendments to the Treatment of Deposit Accounts under the PPSA (April 13, 2010) online: http://www.isda.org/speeches/pdf/ISDA-Letter-to-Alberta-and-Ontario-Governments.pdf.
[76] *Ibid.*

agrees to comply with the instructions of the secured party directing disposition of the funds without further consent by the debtor.[77] If the secured party is the bank, the security interest is automatically perfected by control.[78] No other method of perfection is effective in respect of deposit accounts under Article 9.[79] Competing security interests in the deposit account is determined in accordance with the following rules:

- A security interest perfected by control has priority over a security interest that is not perfected by control.[80]

- If both security interests are perfected by control, first priority goes to a secured party who obtains control by becoming the bank's customer in respect of the deposit account.[81]

- Second priority goes to a bank which has taken a security interest in the deposit account (the funds that it owes to its depositor).[82]

- Thereafter, priority is given to the secured party who was first to perfect by control.[83]

The proposal to adopt the Article 9 approach has been highly controversial. Although some have argued strongly in its favour, others have argued that it goes too far in its adoption of non-temporal priority rules and that it unduly favours banks over other commercial parties. This is illustrated in the following example:

> SP takes and perfects a purchase money security interest in inventory. The inventory is sold and the proceeds are deposited in a bank account. Thereafter, the bank makes a loan to its customer and takes a security interest in the deposit account to secure the loan. The

[77] It is not necessary for the secured party to have exclusive control over the account pursuant to the agreement. U.C.C. 9-104(b) provides that a secured party has control even if the debtor retains the right to direct the disposition of funds from the deposit account.
[78] U.C.C. 9-104 and 9-314.
[79] U.C.C. 9-312(b)(1).
[80] U.C.C. 9-327(1).
[81] U.C.C. 9-327(4).
[82] U.C.C. 9-327(3).
[83] U.C.C. 9-327(2).

> bank has priority over SP, and this holds true even if the bank knew of SP's security interest in the proceeds.[84]

This has led to the development of a number of reform proposals in Canada. One proposal would adopt the Article 9 perfection by control concept, but exclude operating accounts and accounts maintained primarily for personal, family or household purposes from its operation.[85] Another response is to create a "blocked account security interest" that would require notice to holders of prior registered security interests.[86]

iv) Concurrent Security Interest and the Set-Off Right

The last aspect of the decision concerns the interplay between security interests and set-off rights. The commercial practice has tended towards the creation of multiple devices in the belief that if there is a problem with the operation of one of them, one or the other can be used as a backup. The "triple cocktail" of a security interest, a flawed asset arrangement, and a contractual right of set-off is the classic example of this phenomenon.[87] There no longer seems to be any point in combining a security interest and a flawed asset arrangement under the PPSA. A flawed asset arrangement is regarded as a kind of security interest, and therefore it creates nothing more than that which is already granted by way of a security interest.

The interplay between a security interest and a right of set-off is a little more involved. *Caisse populaire de Drummond v. Canada* was decided on the basis that the requirements for legal compensation (the civil law counterpart to set-off) had not been satisfied. The implication is that

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[84] Comment 5 of the Official Commentary to 9-327 indicates that "[a] secured party who claims the deposit account as proceeds of other collateral can reduce the risk of becoming junior by obtaining the debtor's agreement to deposit proceeds into a specific cash collateral account and obtaining the agreement of that bank to subordinate all its claims to those of secured party." It goes on to note that this arrangement will not be effective if the debtor violates this arrangement and deposits the proceeds into a deposit account instead of the cash collateral account.

[85] R.M. Scavone, "Should the PPSA be amended to Permit Security Interests in Deposit Accounts to be Perfected Through Control?" (November 23, 2010) (on file with author) canvasses some of the options. It is likely that the Personal Property Security Act Subcommittee of the Ontario Bar Association will endorse amendments that permit perfection by control, but exclude personal and operating accounts.

[86] R.C.C. Cuming, "Memorandum on Security Interests in Deposit Accounts" (December 30, 2010) (on file with author).

[87] See P. Wood, *Set-Off and Netting, Derivatives, Clearing Systems*, 2nd ed. (London: Sweet & Maxwell, 2007) at 13.

the secured party is entitled to assert set-off or legal compensation if the conditions for its exercise has been satisfied, and it is not precluded from doing so by virtue of taking a security interest in the account that it owes to the debtor. This point is uncontroversial. There is no reason in principle why the granting of a security interest in the debt should deprive the secured party of its right to legal or equitable set-off. The same should hold true in respect of a contractual right of set-off. A contractual right of set-off is frequently employed to create a right of set-off in circumstances where it would not otherwise be permitted. For example, contractual set-off can be used to permit a party to set-off claims owed to it by the other party as well as claims owed to it by affiliated entities of the other party. Again, there is no reason why the granting of a security interest in the debt should affect the exercise of this right.

The situation is otherwise when the security interest arises from a transaction that creates a contractual right of set-off that comes into operation only on default, and is combined with contractual features that are designed to prevent the debtor from collecting, disposing of, or encumbering the asset. The Supreme Court of Canada held that this type of transaction should be characterized as a security interest. The contractual right of set-off only comes into operation upon a default and is therefore only a mechanism through which the security interest is enforced. This type of contractual set-off right is not capable on being independently enforced, but is an integral part of the security interest.

5. Legislative Differences

Although the Australian PPSA drew heavily from the Canadian Acts for inspiration, it would be a mistake to regard it as merely a variant of the Canadian model. The legislators adhered to the fundamental principles of the PPSA reform, but often developed different designs and strategies for their implementation. The Australian Act exists as a separate branch of the PPSA family – sharing a close resemblance to the Canadian and New Zealand Acts on many matters, but strikingly different on others. These legislative differences must always be carefully considered when determining if the case law of other PPSA jurisdictions might be relevant.

The unitary concept of a security interest and the substance test for a security interest are central features of PPSA reform, and for this reason there are fewer substantive differences in respect of this element amongst the various personal property security statutes. The case law from Canada, the United States and New Zealand can reasonably be expected to have greater influence when the issue concerns the concept of a security interest under the Australian PPSA.

But even here, difference in the legislative framework will greatly affect the kinds of issues that will come before the courts. Australia has had the very good fortune of being able to implement PPSA reform in one fell swoop. There has been a much greater effort to make adjustments to other pieces of legislation to take into account the new PPSA concepts. For example, references to the now obsolete concept of the floating charges contained in the *Corporations Act 2001* are replaced by references to circulating security interests.[88]

This is very different from implementation of the reforms in Canada. The reform took place over the course of three decades as one province after another joined the fold. The federal government was not involved in the reform initiatives, and the federal legislation has never been comprehensively amended to take into account the new concepts and terminology of the PPSA.[89] As a result, there has been more work for the courts in Canada in attempting to reconcile the obsolete pre-reform language of the federal statutes with the newer concepts and terminology of the PPSA. One can therefore anticipate that these sorts of issues are less likely to come before the courts in Australia because the groundwork in harmonizing the provisions has already been accomplished.

On other matters, the effect of legislative differences may be more pronounced. In Canada, the characterization of a flawed asset arrangement as a security interest has led to calls in some quarters for amendments that would permit perfection by control in respect of deposit accounts. The characterization of the transaction is significant for two reasons. First, it means that it must be perfected in order to achieve the highest level of priority over competing third parties. Secondly, it means that the interest was subordinated to the federal statutory deemed trust in respect of source deductions.

[88] In doing so the status quo in terms of priority ranking is maintained. The drawback is that it also preserves the uncertainty in determining what degree of control is sufficient to trigger the operation of the provision. Although the concept of the floating charge has fallen out of the picture, some of the old debates associated with its use continue in the new system in a different guise.

[89] See Cuming, Walsh & Wood, *supra*, note 4 at 169-74.

The characterization of a flawed asset arrangement as a security interest simply does not have the same resonance in Australia. Deposit taking institutions are unlikely to be concerned because the Australia PPSA permits automatic perfection by control of ADI accounts when the secured party is an ADI.[90] There is no worry about registration because none is required. There is no worry about priority because a security interest perfected by control has priority over a security interest not perfected by control,[91] and only the ADI can perfect by control. The Australian derivatives industry is unaffected because their credit support agreements are structured on the basis of the netting of accounts rather than the granting of security in collateral, and the PPSA expressly excludes such transactions from its scope.[92] If there is to be an outcry in Australia, it will not come from these sectors. It might, however, come from other commercial credit grantors who may question why the legislators thought it appropriate to give ADIs the exceptional benefits of automatic perfection and first priority at their expense.[93]

6. Conclusion

Canadian courts have had little difficulty with adapting the floating charge in light of the unitary concept of a security interest. The concept of a floating security interest simply ceases to exist. It is replaced by the concept of a fixed legal security interest that is subject to a licence that permits the debtor to deal with the assets free from the security interest in respect of authorized transactions. The adaptation of the conditional sales has been somewhat more problematic. Courts have sometimes reverted to the older thinking and have failed to fully assimilate them with other security interests. To be fair, the courts in these cases were sometimes dealing with federal statutes that used pre-reform terminology and concepts, and this has made the passage more treacherous. There are two lessons in this. The first is that a clear statement that the

[90] The Australian PPSA is very different from Article 9 in this respect. Perfection by control of an ADI can be achieved if, and only if, the secured party is the ADI. See PPSA, s.25. An extended meaning of control is, however, retained in respect of the definition of a circulating asset security interest.
[91] PPSA, s.57(1).
[92] PPSA, s.8(1)(e). There is no similar exemption in the Canadian Acts. The problem in Canada is that a credit support agreement that is structured as a security interest requires registration to perfect it (because a transfer of funds into a deposit account in the name of the secured party does not perfect it by control). But structuring it as a netting of accounts is also risky as the transaction might be characterized as a security interest on the basis of the Supreme Court of Canada's decision in *Caisse populaire de Drummond v. Canada*, *supra*, note 69.
[93] For a critique of the Article 9 approach, see W. Gibson, "Banks Reign Supreme under Revised Article 9 Deposit Account Rules" (2005), 30 Delaware Journal of Corporate Law 819.

retention of title only operates to create a security interest would have been useful. Secondly, the culling of the pre-PPSA terminology and a replacement with terminology that accords with that found in the PPSA would also have helped to prevent a reversion to pre-PPSA modes of analysis.

Canadian courts have also fully embraced the substance test for determining if a transaction is to be characterized as a security interest, and have made important strides in working out an appropriate methodology for uncovering disguised security interests. There is now an extensive body of case law that has been developed on the characterization of leases, consignments and trusts. As well, Canadian courts have applied the substance test to new forms of commercial transactions and in doing so have confirmed the correctness of Grant Gilmore's view of the "all-embracing, all devouring"[94] character of the PPSA.

Because the unitary concept of a security interest and the substance test are central features of Article 9 and every PPSA, there is less likelihood that differences in drafting or variations in policy will impede the creation of a truly international body of case law on these issues. Legislative differences are more likely to affect the kinds of cases that come before the court. Although issues concerning flawed asset arrangements are highly contentious in Canada, they may be less so in Australia because of the ability of the deposit taking institution to perfect its security interest automatically by control without any need for registration. Implementation of the Canadian PPSA occurred over three decades at the provincial level with the result that many of the statutory provisions continue to adhere to now obsolete concepts and terminology. The "big bang" implementation of the Australian PPSA brings simultaneous reforms of commonwealth, state and territory legislation, and this will also reduce the need for these types of issues to be litigated.

[94] *Supra*, note 12.

The Concept of a Security Interest: The Canadian Experience

Roderick J. Wood*

1. Introduction

The enactment of the *Personal Property Securities Act 2009* (Cth) ("PPSA")[1] brings into play a series of fundamental changes to secured transactions law in Australia. Perhaps the most significant of these changes is the adoption of a unitary concept of a security interest. This represents a radical departure from the past in which several different species and subspecies of security interests[2] and quasi-security interests[3] co-existed. The PPSA draws heavily from personal property security legislation in Canada[4] and the United States.[5] The architects of these systems recognized that although there were a variety of different types of security devices governed by their own separate rules, they shared a common feature. They were designed to secure payment or performance of an obligation. The critical move was to recognize that they should be assimilated and governed by the same set of principles. The unitary concept of a security interest was the lynchpin that made it possible to implement many of the other fundamental changes to personal property security law.[6]

The recognition of a unitary concept of a security interest did not simply mean that the various consensual security interests and quasi-security interests – the pledge, contractual lien, mortgage,

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[1] Unless otherwise provided, references to the PPSA are to the Australian legislation.

[2] The traditional forms of non-consensual security were the pledge, contractual lien, mortgage and charge. See Beale, Bridge, Gullifer & Lomnicka, *The Law of Personal Property Security* (Oxford: OUP, 2007) at 8.

[3] Quasi-security interests are usually created by retention of title and include conditional sales agreements, hire purchase agreements and finance leases. See *ibid.*, at 9-10.

[4] Each province and territory in Canada has enacted a PPSA, with the exception of the civil law jurisdiction of Quebec, which has adopted a hybrid of civil law and PPSA inspired concepts. There are two basic models in use – the model adopted in Ontario and the model in use in the other common law provinces. Although there is little prospect of a uniform statute in the foreseeable future, there are currently some efforts to achieve a convergence on matters where the two models differ. See R.C.C. Cuming, C. Walsh & R. Wood, "Secured Transactions Law in Canada – Significant Achievements, Unfinished Business and Ongoing Challenges" (2011), 50 C.B.L.J. 156 at 174-78.

[5] Uniform Commercial Code, Article 9.

[6] These include the creation of a single unified registry system, a comprehensive set of priority rules based upon the time of registration, a single set of enforcement rules that provide remedies on default.

charge, conditional sales, hire purchase and finance lease – were to be husbanded together for the purposes of the registration, priorities and enforcement regime of the PPSA, but would retain their separate character and identity for other purposes. In Canada, courts at the highest level have recognized that the transformation has been more profound. The concept of a unitary security interest is not one that applies only within the context of the PPSA; the juridical nature of a security interest has been pervasively altered. The old dichotomies that characterized security interests as fixed or floating, legal or equitable were swept away, as was the division between true security interests and quasi-security interests.

2. A Brief History

Canadian, New Zealand and Australian personal property security legislation all share a similar structure and methodology with Article 9 of the Uniform Commercial Code of the United States.[7] The drafters of Article 9 set out to reform secured transactions law through the adoption of a unitary concept of a security interest. This represented a fundamental break with the past. Grant Gilmore, one of the principal architects of Article 9, recounts that:[8]

> The idea which the draftsmen started with was that the system of independent security interests had served its time; that the formal differences which separated one device from another should be scrapped and replaced with the simple concept of a security interest in personal property; that all types of personal property, whether held for use of sale, should be available for security.

The adoption of a unitary concept of a security interest has a number of different consequences. First and foremost, it means that the former differences among the various types of financing devices no longer have any significance. The distinct legal rules and principles that pertained to the pledge, the mortgage, the floating charge, and the assignment of receivables no longer have

[7] For a discussion of some of the background to the reform efforts in Australia and New Zealand, see A. Duggan & M. Gedye, "Personal Property Security Law Reform in Australia and New Zealand: The Impetus for Change" (2009), 27 Penn State International Law Review 655.
[8] Grant Gilmore, *Security Interests in Personal Property*, vol. 1, (Boston: Little, Brown & Co:, 1965) at 290.

any role to play. In their place, there is a single concept and a single source of law that governs security interests in personal property.[9]

A second aspect of this unification and reform of secured transactions law is that transactions that were not technically regarded as secured transactions were brought within the scope of the legislation. Historically, the pledge, lien, mortgage and charge were transactions by way of security – transactions by which the debtor created an interest in the debtor's assets in order to secure payment or performance of an obligation. Conditional sales contracts and other title retention devices did not qualify, since the debtor did not obtain title to the property in question until the full purchase price and credit charges had been satisfied. Nevertheless, they served a like function and were often characterized as "quasi-security." These devices were also brought within the scope of the Act.[10] They should no longer be considered quasi-security interests as they create security interests with exactly the same nature and characteristics as any other security interest governed by the Act.

The PPSA concept of a security interest entails a second idea that is closely associated with the unitary concept of a security interest. It is the idea that the definition of a security interest covers any transaction that in substance creates a security interest, regardless of its formal attributes or the identity of the person who holds title to the property.[11] This is sometimes referred to as the "substance" test. Not only does the definition cover the traditional types of security interests, it will also cover any new financing devices that are created if they are designed to secure payment or performance of an obligation.

This, too, is a radical departure from the past. The pre-reform law adopted a formal approach which drew distinctions on the basis of the legal category of interest that was created. Indeed, this contributed to the proliferation of independent security devices. The parties were able to develop new types of financing devices, and often did so in order to evade registration or other onerous requirements. The PPSA does not permit the creation of new forms of security devices that fall outside the scope of the Act. The PPSA "is all-embracing, all devouring; it covers

[9] PPSA, s.12(1).
[10] PPSA, s.12(2).
[11] PPSA, s.12(1).

everything."[12] New financing devices can be created, but they will be governed by the PPSA if their function is to secure payment or performance of an obligation. In determining if a transaction in substance secures payment or performance of an obligation, one must look at the economic effect of the transaction rather than its legal form. The test therefore captures disguised security interests – transactions that take the form of a non-security transaction but which have the effect of securing payment or performance of an obligation.[13] Transactions such as leases and consignments are therefore brought within the definition if the economic reality is that they operate to secure an obligation.

This paper will examine the Canadian experience with these two foundational concepts. The courts have, with one exception, given full reign to these concepts, and have recognized that they have fundamentally altered the structure of secured transactions law.

3. The Unitary Concept of a Security Interest

The adoption of a unitary concept has meant that the old forms of security interests no longer hold any special significance. Each can be used to create a security interest, but the nature and characteristics of the security interest is the same regardless of its form. There were several false starts in Canada in the early years when some courts instinctively clung to the old terminology and concepts and tried to replicate them within the context of the PPSA. For example, courts attempted to recreate the idea of crystallization of a floating charge by manipulating the PPSA concept of attachment. The courts have since rejected this approach, and have recognized that the PPSA has completely transformed the nature of some pre-PPSA devices such as the floating charge. The courts have been somewhat less successful with a similar transformation of the conditional sales agreement. This problem often arises when other statutes continue to use of the older terminology and concepts, and it has, on occasion, caused courts to depart from the notion of a unitary security interest.

[12] Gilmore, *supra* note 8 at 295.
[13] See R.C.C. Cuming, C. Walsh & R.J. Wood, *Personal Property Security Law* (Toronto: Irwin Law, 2005) at 67-80.

a) The Transformation of the Floating Charge

The juridical nature of the floating charge is a topic that has attracted much attention and debate.[14] The charge is said to be an existing but non-specific charge on the debtor's assets that permits the debtor to deal with those assets.[15] Upon crystallization, the charge specifically attaches to the individual assets and the debtor no longer has the ability to deal with them.[16] In Australia, there is greater support for the view that a floating charge did not give rise to any proprietary interest until its crystallization.[17]

The unitary concept of a security interest under the PPSA does not allow for the idea of a present but non-specific charge. Nor does it allow for the idea of a present but non-proprietary security right. A security agreement that purports to create a floating charge creates a security interest and is governed by the same rules that govern any other security interest. Canadian cases have worked out the consequences of this reconceptualization of the floating charge.

i) Time of Attachment

Although the floating charge was abolished as an autonomous legal concept under the PPSA, this did not mean that floating charge debentures or security agreements that created floating charges could no longer be used. These agreements clearly manifest an intention to create a security interest. But the security interest that is created is no different from any other security interest. The rules that govern when the interest arises (attachment of the security interest) and the rules governing its priority are no different from those that govern agreements in the form of a pledge, mortgage, charge or title retention device, or newer agreements that simply grant a security interest in the collateral.

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[14] L. Gullifer & J. Payne, "The Characterization of Fixed and Floating Charges" in J. Getzler & J. Payne (eds.) *Company Charges: Spectrum and Beyond* (Oxford: OUP, 2006) 64; P. Watts, "Alternative Types of Charge over Co Businesses and the Effect of Winding up on Them – Recent Developments in Australia and New Zealand" (1989) 12 U.N.S.W.L.J. 179; S. Worthington, *Proprietary Interests in Commercial Transactions* (Oxford,: Clarendon Press, 2006) at 74-77; R. Nolan, "Property in a Fund" (2004), 120 L.Q.R. 108.
[15] *Evans v. Rival Granite Quarries Ltd.*, [1910] 2 K.B. 979.
[16] *Ibid.*
[17] W.J. Gough, *Company Charges*, 2nd ed., (London: Butterworths, 1996) at 97-101; D. Everett, *The Nature of Fixed and Floating Charges as Security Devices*, (Monash Law Press, 1988) at 21-26. And see *Tricontinental Corporation Ltd. v. Federal Commissioner of Taxation* (1987), 73 A.L.R. 433; *Lyford v. Commonwealth Bank of Australia* (1995), 17 A.C.S.R. 211.

Despite the adoption in the PPSA of a unitary concept of a security interest, some earlier Canadian decisions attempted to replicate some of the unique features of the floating charge within the context of the PPSA. Some courts took the view that the use of the older floating charge form of agreement showed an intention to delay attachment of the security interest until the charge had crystallized.[18] This line of thinking would have resulted in a partial resurrection of the floating charge and all the complexities associated with the crystallization concept. This approach has withered on the vine. Courts have decisively rejected the idea that the concept of crystallization continues to apply under the PPSA.[19] Later versions of the statute reinforced this position by expressly stating that that the rules for attachment apply to a security interest including a security interest in the nature of a floating charge.[20]

ii) Authorization and the Reigning-In of the Licence Theory

The juridical nature of the floating charge has never been satisfactorily resolved. This search for an underlying theory is no longer useful, as the floating charge has ceased to be an autonomous security device under the PPSA. A PPSA security interest is a fixed security interest that comes into existence when the requirements for attachment of the security interest have been satisfied. This is the case even when the collateral is in the form of circulating assets, such as inventory or accounts. Although the assets are subject to the security interest, the debtor is able to deal with the assets if the secured party has authorized the dealing.[21] There are two consequences of this. First, the debtor is obviously not in breach of the security agreement if the debtor deals with the asset within the authority to deal granted by the secured party. Secondly, the party who acquires the interest in the asset as a result of the dealing takes free of the security interest.[22]

The PPSA does not rely solely upon the authorization idea in protecting parties who deal with the debtor. The secured party may have restricted the debtor’s ability to deal with circulating

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[18] See, *e.g.*, *Access Advertising Management Inc. v. Servex Computers Inc.* (1993), 15 O.R. (3d) 635 (Gen. Div.).
[19] *G.M. Homes Ltd., Re* (1984), 10 D.L.R. (4th) 439 (Sask. C.A.); *Irving A. Burton Ltd. v. Canadian Imperial Bank of Commerce* (1982), 134 D.L.R. (3d) 369 (Ont. C.A.); *Roynat Inc. v. United Rescue Services Ltd.*, [1982] 3 W.W.R. 512 (Man. C.A.). And see J.S. Ziegel, “Floating Charges and the OPPSA: A Basic Misunderstanding” (1994), 23 C.B.L.J. 470.
[20] PPSA, s.19(4).
[21] PPSA, s.32(1)(a).
[22] See *Lanson v. Saskatchewan Valley Credit Union Ltd.* (1998), 14 P.P.S.A.C. (2d) 71 (Sask. C.A.).

assets from the outset, or the secured party may have withdrawn the authorization upon the occurrence of some event, such as an event of default. The PPSA provides a set of priority rules that protect parties who acquire inventory in the ordinary course of the debtor's business,[23] or who receive payment of their claims.[24] These priority rules operate whether or not the secured party has authorized the transaction.

The PPSA contemplates that the authorization may be express or implied. The possibility remained that courts might use a wide implied authorization idea to breathe new life into the floating charge idea within the context of the PPSA. For example, it might be argued that the use of a floating charge debenture indicates that the grantor was authorized to create a wide range of competing interests in priority to the security interest created by the floating charge debenture. Some courts adopted the view that a secured party who authorizes the sale of inventory impliedly agrees to the subjection of its security interest to other claims that may arise in the ordinary course of business, such as the creation of non-consensual security interests in favour of the Crown in respect of taxes that ought to have collected in connection with the sales.[25]

Although for a time it seemed that this argument had some traction, it was ultimately rejected by the Supreme Court of Canada in *Royal Bank of Canada v. Sparrow Electric*.[26] The Court rejected a wide conception of the authorization (the licence to sell the inventory) and held that "what a security agreement with a licence to sell creates is a defeasible interest; but the event of defeasance is the <u>actual</u> sale of the inventory and the <u>actual</u> application of the proceeds against an obligation to a third party."[27] Many security agreements in use in PPSA jurisdictions give the secured party a security interest in all present and after-acquired personal property, and authorize the sale of inventory in the ordinary course of business and the collection of accounts. This gives buyers and creditors who were paid from the proceeds the accounts priority, but it does not replicate the wide latitude that was given to the debtor to deal with the assets prior to crystallization of a floating charge.

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[23] PPSA, s.46.
[24] PPSA, ss. 48, 59.
[25] See *G.M. Homes, Re*, *supra* note 19. And see R.J. Wood, "Revenue Canada's Deemed Trust Extends its Tentacles: *Royal Bank of Canada v Sparrow Electric Corp."* (1995) 10 B.F.L.R. 429.
[26] [1997] 1 SCR 411.
[27] *Ibid.*, at para. 94.

iii) Permissive Provisions and Subordination

Although secured parties may continue to use older forms of security documents, the security interest that is thereby created does not depend on the form of agreement. The security agreement creates a security interest, and its attributes and priority are governed by the PPSA. There is at least one situation where use of the older forms of agreement may prove to be detrimental. The issue concerns the inclusion of restrictive and permissive provisions in security agreements.

Under the pre-reform law, it was common to include restrictive provisions (often referred to as "negative pledge covenants" in Canada and the United States) that limited the debtor's authority to grant a security interest in the collateral subject to the charge. The restrictive provision was often modified by a permissive provision that carved out certain permitted transactions – typically involving the creation of purchase money security interests.[28]

The controversy arises when the holder of the purchase money security interest fails to register within the time frames necessary to obtain the higher ranking priority afforded by the PPSA over prior registered security interests.[29] As the special priority rule in favour of purchase money security interests is inapplicable, the priority competition will be resolved through the application of the ordinary priority rule with the result that the first party to register will prevail.[30] However, if the holder of the purchase money security interest can show that the earlier secured party agreed to subordinate its security interest, the agreement will be given effect. The PPSA contains an express provision that validates the use of subordination agreements between or among the creditors (inter-creditor agreements) as well as subordination provisions contained in the security agreement between the secured party and the debtor.[31] The holder of the purchase money security interest will therefore argue that the inclusion of a permissive provision in the security agreement amounts to a subordination to a person who enters into a permitted transaction.

[28] See K. Morlock, "Floating Charges, Negative Pledges, the PPSA and Subordination: *Chiips v. Skyview Hotels Limited*" (1995) 10 B.F.L.R. 405.
[29] PPSA, s.62.
[30] PPSA, s.55.
[31] *Sperry Inc. v. Canadian Imperial Bank of Commerce* (1985), 17 D.L.R. (4th) 236 (Ont. C.A.); *Bank of Nova Scotia v. Royal Bank* (1987), 8 P.P.S.A.C. 17 (Sask. C.A.).

Canadian courts have held that a permissive provision by itself is not sufficient to constitute a subordination provision. A covenant that the debtor shall keep the collateral free of all security interests or encumbrances other than permitted encumbrances does not result in a subordination of the security interest to the permitted encumbrance. Rather, it means that the creation of a permitted encumbrance will not constitute a breach of the contractual provision, which would constitute an event of default and permit the secured party to enforce the security interest. But if the provision goes further and refers to the priority ranking of permitted encumbrances, the provision will constitute a subordination provision.[32]

The distinction is a subtle one. A provision under which the debtor agrees to keep the collateral free of all encumbrances *ranking in priority to or pari passu with the security interest* other than permitted encumbrances subordinates the security interest to the permitted encumbrance. If the italicized wording is removed, the provision merely excepts the transaction from the scope of the negative covenant but does not in itself effect a subordination.

iv) Abandonment of the Floating Charge Debenture

Although Canadian judicial decisions have now confirmed that the use of a floating charge does not produce a different kind of security interest or different priorities, the drafters in the early years following adoption of the PPSA operated under a real apprehension that the use of the floating charge might result in an inferior priority status. As a result, the floating charge form of agreement has been almost completely abandoned in favour of modernized forms of security agreements that adopted PPSA terminology. In its place, drafters produced a "general security agreement" (or "GSA") under which the debtor grants to the secured party as security interest in all of its present and after-acquired personal property. If the security agreement contains a permissive provision, the drafter will generally ensure that the language will not constitute a subordination unless so intended by the parties.

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[32] *Asklepeion Restaurants Ltd. v. 791259 Ontario Ltd.* (1996), 11 P.P.S.A.C. (2d) 320 (Ont. Ct. Gen. Div.), aff'd (1998) 13 P.P.S.A.C. (2d) 295 (Ont. C.A.); *Re DCD Industries (1999) Ltd*. (2005), 11 C.B.R. (4th) 246 (Alta. C.A.).

v) Competitions with non-PPSA Interests

Although the PPSA contains a set of priority rules that govern many kinds competitions that can arise, these rules are not exhaustive. There are simply too many different types of proprietary rights, and it is simply not realistic to expect that the statute can provide a specific rule for every possible priority competition. The matter therefore falls to be determined through the application of ordinary property law principles. At this juncture, a critical issue arises. How is a PPSA security interest to be characterized? Do we revert to the older categories (pledge, mortgage, charge, title retention) and characteristics (fixed v. floating) when the PPSA does not provide a specific priority rule. Or do we regard the PPSA as having a more pervasive effect such that the old categories are banished throughout the realm?

The Supreme Court of Canada has ruled unequivocally in favour of the latter approach in *Bank of Montreal v. Innovation Credit Union.*[33] The priority competition was between a PPSA security interest and a federal *Bank Act*[34] security. The *Bank Act* security is not a security interest covered by the PPSA, and the federal provisions that governed it do not create a comprehensive set of priority rules.[35] The matter therefore fell to be determined through the application of conventional property law principles. In applying these principles, the court stated:[36]

> It is true that the internal priority rules of the *PPSA* cannot be invoked to resolve the dispute. However, it does not follow that the provincial security interest created under the *PPSA* does not exist outside these priority rules. Nor can the fundamental changes brought about by the *PPSA* be ignored in determining the nature of the prior competing interest.

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[33] 2010 SCC 47.
[34] S.C. 1991, c. 46.
[35] The co-existence of two security regimes – one based on traditional property law concepts and the other that ranks priority according to the time of registration has generated much litigation. See R.C.C. Cuming, "PPSA — Section 178 *Bank Act* Overlap — No Closer to Solutions" (1991) 18 Can. Bus. L.J. 135 and J.S. Ziegel, "The Interaction of Section 178 Security Interests and Provincial PPSA Security Interests: Once More into the Black Hole" (1991) 6 B.F.L.R. 323; R.J. Wood, "The Nature and Definition of Federal Security Interests" (2000) 34 Can. Bus. L.J. 65. Although the Law Commission of Canada recommended repeal of the Bank Act security provisions, there has been no progress on this front. See *Modernizing Canada's Secured Transactions Law: The* Bank Act *Security Provisions* (Ottawa: Law Commission of Canada, 2004).
[36] *Supra* note 33 at para. 30.

The Court went on to observe that although some of the pre-PPSA security devices created equitable rather than legal interests, the PPSA treats them all equally as security interests.[37] Because the PPSA security interest is recognized and regulated by statute, it is to be regarded as a legal interest that operates by way of security.

A PPSA security interest is different from the historical concept of the floating charge in two essential respects. First, the secured party obtains a legal rather than an equitable interest.[38] Secondly, the legal interest is fixed rather than floating and arises as soon as the conditions for attachment have been satisfied. The transformation has had the effect of elevating the priority status of a PPSA security interest over that formerly obtained by a floating charge under pre-reform law.

vi) Legislative Superpriority Provisions

The vast majority of income tax revenue in Canada is collected through a system of source deduction that requires employers to deduct amounts from the pay of their employees and remit it to the taxation authority. Although an employer is required to hold these amounts in trust, an insolvent employer will often fail to do so with the result that the common law requirements for the creation of a trust will not have been satisfied. In order to give the taxation authority a proprietary interest in the debtor's assets, the taxation legislation imposes a statutory deemed trust on the assets of the debtor.[39] Upon the insolvency of the employer, priority competitions frequently arise between prior secured parties and the statutory deemed trusts in respect of source deductions.

Prior to the PPSA, Canadian courts resolved these priority competitions through the application of conventional property law principles. A prior fixed charge had priority over a subsequent statutory deemed trust, since the latter only operated in respect of the debtor's interest in the asset.[40] The situation was different if the security interest took the form of a floating charge.

[37] *Ibid.*, at para. 42.
[38] See also *i Trade Finance Inc. v. Bank of Montreal*, 2011 SCC 26 at para. 61 in which the court characterized a PPSA security interest as a legal interest since the interest is recognized by statute.
[39] *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), s.227(4).
[40] *Board of Industrial Relations v. Avco Financial Services Realty Ltd*, [1979] 2 S.C.R. 699.

Canadian courts held that the statutory deemed trust was entitled to priority if it arose before crystallization of the floating charge.[41] As a result, the statutory deemed trust was typically subordinate to a fixed charge, but usually had priority over a floating charge.

The implementation of the PPSA disturbed this equilibrium and provided a nasty shock to the taxation authority. Secured creditors were able to take security interests in all the assets of the debtor and these security interests were no longer regarded as floating charges. They were fixed legal interests that attached to new assets the moment that the debtor acquired rights in the property. Since the PPSA security interest attached to the asset before the statutory deemed trust arose, the security interest was entitled to priority over the statutory deemed trust.[42]

The victory was only temporary. Parliament soon passed amendments to ensure that the statutory deemed trust was given priority.[43] The legislation, however, did not simply attempt a return to the status quo. The statutory deemed trust was afforded a priority over almost all prior or subsequent security interests of any nature.[44]

There are many other types of non-consensual security interests in Canada. In many cases they secure claims owed to the Crown, but some are in favour of other claimants such as unpaid employees.[45] Often the non-consensual security interest is afforded a superpriority over other security interests, but sometime there is an exception made for specified kinds of interests such as purchase-money security interests.[46] In some instances, the priority is capped by a monetary limit, or imposed only against certain types of assets.[47] The trend in drafting these provisions has been to use PPSA concepts and terminology, and when this is done there are generally few

[41] *Dauphin Plains Credit Union Ltd. v. Xyloid Industries Ltd.*, [1980] 1 S.C.R. 1182.
[42] *Royal Bank of Canada v. Sparrow Electric Corp.*, [1997] 1 S.C.R. 411.
[43] *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), s.227(4.1).
[44] The one exception is a registered mortgage on land, but only in respect of amounts that are due before the deemed trust arises.
[45] See *Bankruptcy and Insolvency Act*, R.S.C. 1985, c B-3, s.81.3.
[46] See, *e.g.*, *Employment Standards Code*, R.S.A. 2000, c E-9, s.109(3)-(4) which provides that a claim for unpaid wages has priority over a security interest other than a prior registered purchase money security interest.
[47] The statutory security in respect of unpaid wages created by the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c B-3, s.81.3 is capped at $2000 for each employee and covers only cash, cash equivalents, inventory, accounts, and proceeds from any dealing with those assets.

problems of interpretation.[48] As will be seen, difficulties are more likely to arise when the statute adheres to older concepts and terminology of pre-PPSA law.

b) The Characterization of Title Retention Devices

The application of the PPSA to title retention devices was relatively uncontroversial in Canada. Conditional sales agreements were subject to a registration requirement under pre-PPSA law.[49] In this respect, Canadian law shared a greater affinity with the pre-reform law of the United States. Accordingly, it was not a large conceptual leap to assimilate them with other security devices. Canadian courts had greater difficulty with the idea that leases were to be brought within the scope of the Act, but resistance to this idea has largely passed.[50]

Problems have arisen when the issue is not expressly governed by the PPSA. It might become necessary to characterize the interest of the conditional seller for the purposes of sales law or some other body of law. Do we consider the conditional seller to be the owner who holds legal title to the goods? Or is the buyer the owner?

The Uniform Commercial Code of the United States was unequivocal on this issue. It provided that a retention of title was limited in effect to a reservation of a security.[51] The property in the goods would pass immediately to the buyer according to ordinary sales law principles and the seller would have nothing more than a security interest in the debtor's newly acquired asset in order to secure the unpaid purchase price and credit charges. Unfortunately, the drafters of the Canadian legislation thought in unnecessary to include a similar provision, and Canadian courts have not adopted a consistent approach when confronted with this issue.

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[48] See, *e.g., Workers Compensation Act*, R.S.A. 2000, c W-15, s.129(3) which provides that the assessment has priority over all security interests as defined in the PPSA.
[49] See J.S. Ziegel, "Canadian Chattel Security Law: Past Experience and Current Developments" in J.G. Sauveplanne, ed. *Security over Corporeal Moveables* (Lieden:A.W. Sijthoff, 1971) 71.
[50] Judicial resistance to the idea was finally laid to rest by the Supreme Court of Canada in *Giffen, Re,* [1998] 1 S.C.R. 91. Prior to this, some courts were troubled by the idea that an unregistered lease should be rendered ineffective against a trustee in bankruptcy, and employed a number of different techniques to avoid this outcome.
[51] Uniform Commercial Code, 2-401(1).

i) Competitions with non-PPSA Interests

The courts were again called upon to resolve a priority competition between a statutory deemed trust and a PPSA security interest – this time in the form of a conditional sales agreement or finance lease.[52] The federal legislation gives the deemed trust priority over any security interest.[53] Although title retention devices are clearly security interests for the purposes of the PPSA, the issue was whether they should also be characterized as such for the purposes of the federal legislation. The legislation defines a security interest as "any interest that secures payment or performance of an obligation..."[54] This portion closely tracks the PPSA definition, and one would be forgiven for thinking that the courts would give them the same construction.

This did not happen. The courts seized upon the concluding portion of the definition, which indicated that it included an interest that arose out of a mortgage, pledge, lien or charge. The failure to include title retention devices among this enumeration was thought to show an intention to exclude such security interests from the scope of the provision. The result was that a title retention device enjoyed priority over the statutory deemed trust.

These decisions were perhaps motivated by a wish to curtail the long reach of the statutory deemed trust. The difficulty is that Canadian insolvency statutes also define a security interest as a mortgage, charge, lien or pledge. The decisions therefore have the potential to undermine several key insolvency policies by excluding title retention devices from the scope of the insolvency definition.[55]

ii) Passage of Property under Title Retention Agreements

The use of a conditional sales agreement brings both sales law and secured transactions law into play. The contract involves a credit sale of the goods from the seller to the buyer. It also involves the creation of a security interest to secure the obligation to pay. Canadian courts have had little

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[52] *DaimlerChrysler Financial Services (Debis) Canada Inc. v. Mega Pets Ltd.* (2002), 212 D.L.R. (4th) 41 (B.C.C.A.); *Minister of National Revenue v. Schwab Construction Ltd*. (2002), 31 C.B.R. (4th) 75 (Sask. C.A.); *Bank of Nova Scotia v. Turyders Trucking Ltd.* (2001), 32 C.B.R. (4th) 14 (Ont. S.C.J.).
[53] *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), s.224(4.1).
[54] *Ibid.*, s.224(1.3).
[55] See R.J. Wood, "The Definition of Secured Creditor in Insolvency Law" (2010), 25 B.F.L.R. 341.

difficulty with the latter aspect. The transaction creates a security interest, and its priority will be governed by the PPSA. But sometimes it is the sales aspect that is relevant, and it is here that there is greater controversy.

Consider the case where a business has given a security interest in all of its property to a lender. The grantor then sells some of its goods to a buyer under a conditional sales contract. This does not involve a competition between secured parties. It is essentially a competition between the secured party (the lender) and the buyer. The PPSA provides rules that govern competitions between secured parties and buyers. Canadian courts have not been in agreement on precisely when they can be invoked. The Saskatchewan Court of Appeal has taken the view that these rules will not apply unless the buyer has acquired property in the goods.[56] The Ontario Court of Appeal refused to adopt this approach and took the view that the priority rules could operate even if title did not pass so long as it was possible to identify the goods to the contract.[57] The Ontario decision involved a buyer who had purchased an expensive boat under a conditional sales agreement and had paid 90 per cent of the purchase price. The concern was that the sales agreement delayed the passage of property until the full purchase price was paid. As this had not yet occurred, the conditional buyer would be unable to invoke the ordinary course buyer rule that would otherwise allow a buyer to take free of a security interest given by the seller.

The problem would be greatly lessened had the Ontario Court of Appeal had recharacterized the nature and effect of a title retention clause.[58] If the clause had been viewed as creating a security interest and having no other effect, it would not have delayed the passage of property to the buyer. This matter would be determined through the application of sales law without regard to the title retention clause. In the vast majority of cases that involve the sale of specific goods, this occurs the moment when the contract is entered into.[59]

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[56] *Royal Bank v. 216200 Alberta Ltd.*, [1987] 1 W.W.R. 545 (Sask C.A.).
[57] *Spittlehouse v. Northshore Marine Inc.* (1994), 18 O.R. (3d) 60.
[58] See Jacob Ziegal, Commentary, "To what types of sale does section 28(1) of the OPPSA apply?" (1994–95) 24 Can. Bus. L.J. 457.
[59] See *Sale of Goods Act*, R.S.S. 1978, s. S-1, s.20 Rule 1.

4. The Substance Test of a Security Interest

The second aspect of the PPSA concept of a security interest involves the idea that the characterization of a transaction as a security interest should depend upon its function rather than the form of the transaction or the location of title. The emphasis is now on the economic realities. If the effect of the transaction is such that a debtor has given a creditor a proprietary right in the debtor's assets such that the creditor may have recourse to the assets in the event of a default, it is to be regarded as a security interest. The fact that the parties may have set it up as a lease, consignment, bailment, trust or other transaction is not relevant if the transaction functions as a security interest.

The application of the substance test is illustrated in three different situations. The first shows how an inquiry into the economic realities may result in the characterization of a lease as a security interest even if the lessee is not expected to acquire title to the goods at the end of the lease term or enjoy possession of the goods for their full useful life. The second deals with the application of the test to new forms of security arrangement, and illustrates the point that there can be no new forms of security arrangements that fall outside the scope of the Act. The third is the most controversial in Canada and concerns the characterization of an arrangement as a security interest despite the fact that under pre-reform law the transaction would be regarded as giving rise only to personal rather than proprietary rights. It therefore represents the outside limits of the substance test.

a) Open End Leases

Canadian courts were often called upon to distinguish between true leases and leases that in substance created a security interest (a "security lease").[60] The courts often found it useful to draw an analogy between a security lease and a secured installment purchase agreement (a

[60] Canadian case law from Ontario and Manitoba are particularly rich in decisions dealing with the characterization of leases. The PPSA of these provinces did not originally bring true long term leases within the scope of the Act as deemed security interests. As a result, registration was required for security leases, but was not required in respect of true leases. Most of these cases involved priority competitions with a trustee in bankruptcy of the lessee or with a secured party whose security interest covered the leased goods. Both provinces have since amended their legislation by bringing leases for a term of more than one year within the scope of the PPSA as deemed security interests. Not surprisingly, this has resulted in a sharp drop in the number of cases litigated on the characterization issue since registration is now required to obtain priority for both security leases and true leases.

conditional sale under the former law).[61] Upon paying the full purchase price and credit charges, the buyer under a secured installment purchase agreement ends up with unencumbered title to the goods. If the lease were structured such that title to the goods automatically vested in the lessee[62], or if a lease option was structured so that a rational lessee would exercise an option to purchase (because the option price was substantially less than the expected residual value of the goods at the end of the lease term), one could say that there was functionally no real difference between the two devices. In both instances, the party winds up as the owner of the asset.

Although Canadian courts sometimes tested the transaction by inquiring whether the lessee was expected to end up as owner,[63] this was simply an application of the more general "substance test" to the particular facts. The intent was never to substitute an ownership test for the substance test.

This point is confirmed in the Canadian cases dealing with open end leases. Open end leases set a termination value. At the end of the lease term, the goods are returned to the lessor and sold. If the sale proceeds exceed the termination value, the surplus is paid to the lessee. If the sale proceeds are less than the termination value, the lessee is responsible for paying the deficiency. Under this arrangement, the lessee is not expected to become the owner of the goods as the goods as sold to a third party buyer. An insistence that the lessee acquire ownership or enjoy possession of the goods for their full useful life would mean that an open end lease would not be characterized as a security interest.

The courts did not take so narrow an approach, but instead gave full effect to the substance test.[64] The fact that the lessee did not acquire ownership was not the *sine qua non*. The essential consideration was that the lessee occupied the economic position of an owner. The lessee had the benefits and disadvantages of ownership – the risk of gain or loss. From an economic

[61] See *Federal Business Development Bank v. Bramalea Ltd*. (1983), 144 D.L.R. (3d) 410 (Ont. H.C.J.), aff'd 150 D.L.R. (3d) 768 (Ont. C.A.).
[62] *DaimlerChrysler Services Canada Inc. v. Cameron*, (2007, 279 D.L.R. (4th) 629 (B.C.C.A.).
[63] See, *e.g.*, *Stark Coaxial Systems Inc., Re*, (1985), 55 C.B.R. (N.S.) 308 (Ont. S.C.)
[64] See *Crop & Soil Service Inc. v. Oxford Leaseway Ltd*. (2000), 186 D.L.R. (4th) 85 (Ont. C.A.); *HOJ Franchise Systems Inc. v. Municipal Savings & Loan Corp.* (1994), 6 P.P.S.A.C. (2d) 302 (Ont. Ct. Gen. Div.).

perspective, there was no difference between a transfer of title to the lessee and a forced sale of the goods for the account of the lessee.[65]

b) New Forms of Security – Feeder Association Agreements

The application of the PPSA to feeder association agreements provides a good illustration of the all encompassing nature of the substance test and the idea that there can be no new secured transactions that fall outside the scope of the PPSA. Feeder associations are organizations that provide feed to livestock producers. A feeder association acquires cattle and brands them (or identifies them with an ear tag) in the name of the feeder association. The feeder association then enters into an agreement with a member of the feeder association who takes possession of the livestock and raises them. The agreement provides that the legal title to the livestock remains with the feeder association. The member is responsible for maintaining the health of the livestock, must provide them with veterinary services and must insure them. The feeder association provides credit to the member to permit the purchase of feed. When the cattle are sold, the charges payable to the feeder association are paid and the balance is paid to the producer.

The use of feeder association agreements is a relatively new phenomenon. Canadian courts were called upon to determine if these agreements in substance created security interests.[66] From an economic perspective, the matter is clear cut. Despite the fact that the feeder association holds legal title to the livestock, the producer is in the economic position of an owner. The producer has the benefit of gain and the risk of loss, while the feeder association is assured that the credit it supplies will be recovered. In many respects, the analysis is similar to that applied in respect of open end leases. It makes no difference that the producer never acquires legal title at any time. The focus is upon substance not form, on the economic realities and not the location of legal title.

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[65] *Re Cronin Fire Equipment Ltd.* (1993), 21 C.B.R. (3d) 127 (Ont. Ct. Gen. Div.).

[66] *Farm Credit Corp. v. Valley Beef Producers Co-operative Ltd.* (2002) 36 C.B.R. (4th) 121 (Sask. C.A.); *Toronto Dominion Bank v. East Central Feeder Co-operative Ltd.*, (2001), 2 P.P.S.A.C. (3d) 283 (Ont. S.C.J.).

c) Set-Off and Flawed Asset Arrangements

The Canadian personal property security statutes, unlike the statutes in Australia and New Zealand, do not contain a provision that brings flawed asset arrangements with their scope.[67] This is perhaps not as surprising as it may seem. Until recently, there was a large gap in the Canadian case law. First, there was no guidance on the question whether it was even possible for a party to be granted a security interest in an obligation that was owed by the secured party to the grantor.[68] Secondly, there was absolutely no guidance on the nature or character of a "flawed asset" arrangement. Indeed, the term could not be found in any Canadian decision. All this changed with the release of the Supreme Court of Canada's decision in *Caisse populaire de Drummond v. Canada*.[69]

i) The Decision of the Supreme Court of Canada

The controversy again concerned the federal statutory deemed trust that secures source deductions. A financial institution had extended an operating line of credit to the debtor. The parties entered into two agreements. The first was a term savings agreement under which the debtor deposited $200,000 with the financial institution. The term was for five years and the funds could not be redeemed before that date. The agreement also provided that the deposit was not transferrable and could only be given as security to the financial institution.

The second agreement contained three elements. First, it provided that the debtor consented to the withholding of the $200,000 term deposit until all the amounts due under the credit agreements were fully repaid. Secondly, it provided that in the event of default the financial institution could claim compensation (the civil law counterpart to set-off in common law systems) between the term deposit and the amount due under the credit contracts. Thirdly, the debtor pledged and hypothecated the term deposit as security for the loans. The debtor had failed to remit source deductions both before and after the agreements had been entered into. The financial institution did not immediately enforce its claim against the term deposit. Shortly after the insolvency proceedings were instituted against the debtor, the financial institution purported

[67] PPSA, s.12(2)(l).
[68] See R.J. Wood, Journey to the Outer Limits of Secured Transactions Law: *Caisse populaire Desjardin de l'Est de Drummond*" (2010) 48 C.B.L.J. 482 at 491.
[69] [2009] 2 S.C.R. 94.

to close out the account in realization of its security and the Crown claimed that the term deposit was subject to its statutory deemed trust.

The legislation that created the statutory deemed trust provided that it ranked ahead of any security interest in the assets. Clearly, any attempt to assert the security interest against the Crown was doomed to failure. For this reason, the financial institution did not elect to assert its security interest against the term deposit. Instead, it claimed that its agreement gave it the contractual right to withhold the term deposit until the amounts owing to it were paid. The issue was whether these other contractual provisions constituted a security interest within the meaning of the federal provision.[70] If so, the statutory deemed trust would be entitled to priority. If not, the statutory deemed trust would only be effective in respect of unremitted source deductions that were due at the time the term deposit was created and would be ineffective in respect of any unremitted amounts that arose after the creation of the contractual rights in favour of the financial institution.

The majority judgment found that the contractual provisions satisfied the definition of a security interest. Rothstein, J. held that arrangement will constitute a security interest if the substance of the transaction was that the creditor acquired an interest in the debtor's property so as to ensure that the right of set-off or compensation would provide an effective remedy on default in payment of an obligation. He held that the five year term, the contractual right to withhold payment and the restrictions on transfer created a security interest. The provisions were designed to "encumber" the term deposit to ensure that it would be available on a default in repaying the loans.[71]

The dissenting judgment took the view that the contractual provisions only gave rise to personal rights, and did not create proprietary rights in the term deposit. The length of the term merely defined the timing of the repayment obligation. A negative pledge covenant merely gives the contracting a right to sue for damages for breach. The right to withhold merely imposed a

[70] The issue was not whether the arrangement fell within the definition of a security interest in the PPSA. However, the federal definition of a security interest did not vary materially from the definition contained in the PPSA in this respect, and therefore the case is generally regarded as authoritative on the scope of the PPSA as well. However, differences in the wording of the provisions have been held to be significant in other contexts. These will be discussed in the next section dealing with the characterization of conditional sales agreements.

[71] *Supra*, note 69 at para. 30.

condition that was required to be satisfied in order to obtain payment of the term deposit. None of these rights individually or in tandem created a security interest.[72]

ii) The Application of the Substance Test

The decision is important in that it demonstrates the astonishing breadth of the substance test. When a lease, trust, bailment or consignment is used to provide a creditor with security for payment of an obligation, there is no question that the creditor has some kind of proprietary right in the asset, if only possession.[73] The issue is whether this proprietary interest is held as security. But the issue in *Caisse populaire de Drummond v. Canada* was whether a combination of personal rights could constitute a security interest if their effect was to secure payment of an obligation. The court held that if the contractual provisions effectively placed the creditor in the same position as it would have occupied had it been granted a security interest, it would be characterized as such.

Outside of Canada, this aspect of the decision may seem, at first, to be of lesser importance. The decision places Canada in the same camp as New Zealand and Australia, which have expressly included flawed asset arrangements within the scope of their Acts. But on closer reflection, it should be apparent that the decision has a wider significance. The reasoning is not restricted to flawed asset arrangements, but is relevant whenever contractual rights are used to create a set of rights that are functionally equivalent to a security interest.

iii) The Priority Consequences of the Decision

Characterization of the transaction as a security interest was significant in the case because it triggered federal priority provision that gave the statutory deemed trust priority over a security interest. But the decision has a broader implication. If the transaction is characterized as a security interest, then it must be perfected under the PPSA in order obtain priority over other

[72] *Ibid.* at para 122.
[73] PPSA, s.20(5) makes it clear that a lessee or bailee of goods under a PPSA lease or a buyer under a conditional sales agreement has rights in the goods when that person obtains possession of the goods.

secured parties. It must also be perfected in order to be effective in some insolvency proceedings. The degree to which this is viewed as a concern very much depends on the perfection and priority rules that are in place. It is here that there is significant variation across jurisdictions.

Canada and New Zealand do not provide any special perfection or priority rules in respect of a deposit account with a financial institution. This account, like any other account, can only be perfected by registration. In Canada, this perfection requirement has caused concerns in the derivatives industry over cash collateral transactions in which cash is provided as credit support for exposure on derivatives and securities financing transactions. Under these transactions, a party will wire funds to its counterparty. The funds are held in a bank account in the name of the counterparty. If the documentation provides that the counterparty is granted a security interest in the funds that are transferred, the transaction clearly creates a security interest and is governed by the PPSA. This would mean that registration would be required to perfect the security interest.

In order to work around this requirement, the Canadian practice has been to structure the transaction as an absolute transfer of the funds to the counterparty.[74] This creates a debtor-creditor relationship between the parties. The credit support document also provides that the counterparty has the right to set-off the obligations owed by the transferor of the funds against its obligation to repay the transferred funds. The decision of the Supreme Court of Canada has caused consternation because of the potential for this form of transaction to be characterized as a security interest, and thereby give rise to the requirement for registration to perfect it.[75]

The response of the derivatives industry has been to request amendments to the Canadian PPSAs in order to introduce the concept of perfection by control of deposit accounts and the corresponding priority and conflicts rules that are found in the Article 9 of the Uniform Commercial Code.[76] Under Article 9, a security interest in a deposit account can be perfected by control by becoming the bank's customer, or by entering into an agreement under which the bank

[74] See International Swaps and Derivatives Association Inc., "Proposal for Amendments to the Treatment of Deposit Accounts under the PPSA" (June 8, 2009) online: http://www.isda.org/c_and_a/pdf/ISDA-Proposal-for-Amendments-to-Treatment-of-Deposit-Accounts-under-PPSA-8June2009.pdf.

[75] See International Swaps and Derivatives Association Inc., Letter to Alberta and Ontario Governments re Proposal for Amendments to the Treatment of Deposit Accounts under the PPSA (April 13, 2010) online: http://www.isda.org/speeches/pdf/ISDA-Letter-to-Alberta-and-Ontario-Governments.pdf.

[76] *Ibid.*

agrees to comply with the instructions of the secured party directing disposition of the funds without further consent by the debtor.[77] If the secured party is the bank, the security interest is automatically perfected by control.[78] No other method of perfection is effective in respect of deposit accounts under Article 9.[79] Competing security interests in the deposit account is determined in accordance with the following rules:

- A security interest perfected by control has priority over a security interest that is not perfected by control.[80]

- If both security interests are perfected by control, first priority goes to a secured party who obtains control by becoming the bank's customer in respect of the deposit account.[81]

- Second priority goes to a bank which has taken a security interest in the deposit account (the funds that it owes to its depositor).[82]

- Thereafter, priority is given to the secured party who was first to perfect by control.[83]

The proposal to adopt the Article 9 approach has been highly controversial. Although some have argued strongly in its favour, others have argued that it goes too far in its adoption of non-temporal priority rules and that it unduly favours banks over other commercial parties. This is illustrated in the following example:

> SP takes and perfects a purchase money security interest in inventory. The inventory is sold and the proceeds are deposited in a bank account. Thereafter, the bank makes a loan to its customer and takes a security interest in the deposit account to secure the loan. The

[77] It is not necessary for the secured party to have exclusive control over the account pursuant to the agreement. U.C.C. 9-104(b) provides that a secured party has control even if the debtor retains the right to direct the disposition of funds from the deposit account.
[78] U.C.C. 9-104 and 9-314.
[79] U.C.C. 9-312(b)(1).
[80] U.C.C. 9-327(1).
[81] U.C.C. 9-327(4).
[82] U.C.C. 9-327(3).
[83] U.C.C. 9-327(2).

> bank has priority over SP, and this holds true even if the bank knew of SP's security interest in the proceeds.[84]

This has led to the development of a number of reform proposals in Canada. One proposal would adopt the Article 9 perfection by control concept, but exclude operating accounts and accounts maintained primarily for personal, family or household purposes from its operation.[85] Another response is to create a "blocked account security interest" that would require notice to holders of prior registered security interests.[86]

iv) Concurrent Security Interest and the Set-Off Right

The last aspect of the decision concerns the interplay between security interests and set-off rights. The commercial practice has tended towards the creation of multiple devices in the belief that if there is a problem with the operation of one of them, one or the other can be used as a backup. The "triple cocktail" of a security interest, a flawed asset arrangement, and a contractual right of set-off is the classic example of this phenomenon.[87] There no longer seems to be any point in combining a security interest and a flawed asset arrangement under the PPSA. A flawed asset arrangement is regarded as a kind of security interest, and therefore it creates nothing more than that which is already granted by way of a security interest.

The interplay between a security interest and a right of set-off is a little more involved. *Caisse populaire de Drummond v. Canada* was decided on the basis that the requirements for legal compensation (the civil law counterpart to set-off) had not been satisfied. The implication is that

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[84] Comment 5 of the Official Commentary to 9-327 indicates that "[a] secured party who claims the deposit account as proceeds of other collateral can reduce the risk of becoming junior by obtaining the debtor's agreement to deposit proceeds into a specific cash collateral account and obtaining the agreement of that bank to subordinate all its claims to those of secured party." It goes on to note that this arrangement will not be effective if the debtor violates this arrangement and deposits the proceeds into a deposit account instead of the cash collateral account.

[85] R.M. Scavone, "Should the PPSA be amended to Permit Security Interests in Deposit Accounts to be Perfected Through Control?" (November 23, 2010) (on file with author) canvasses some of the options. It is likely that the Personal Property Security Act Subcommittee of the Ontario Bar Association will endorse amendments that permit perfection by control, but exclude personal and operating accounts.

[86] R.C.C. Cuming, "Memorandum on Security Interests in Deposit Accounts" (December 30, 2010) (on file with author).

[87] See P. Wood, *Set-Off and Netting, Derivatives, Clearing Systems*, 2nd ed. (London: Sweet & Maxwell, 2007) at 13.

the secured party is entitled to assert set-off or legal compensation if the conditions for its exercise has been satisfied, and it is not precluded from doing so by virtue of taking a security interest in the account that it owes to the debtor. This point is uncontroversial. There is no reason in principle why the granting of a security interest in the debt should deprive the secured party of its right to legal or equitable set-off. The same should hold true in respect of a contractual right of set-off. A contractual right of set-off is frequently employed to create a right of set-off in circumstances where it would not otherwise be permitted. For example, contractual set-off can be used to permit a party to set-off claims owed to it by the other party as well as claims owed to it by affiliated entities of the other party. Again, there is no reason why the granting of a security interest in the debt should affect the exercise of this right.

The situation is otherwise when the security interest arises from a transaction that creates a contractual right of set-off that comes into operation only on default, and is combined with contractual features that are designed to prevent the debtor from collecting, disposing of, or encumbering the asset. The Supreme Court of Canada held that this type of transaction should be characterized as a security interest. The contractual right of set-off only comes into operation upon a default and is therefore only a mechanism through which the security interest is enforced. This type of contractual set-off right is not capable on being independently enforced, but is an integral part of the security interest.

5. Legislative Differences

Although the Australian PPSA drew heavily from the Canadian Acts for inspiration, it would be a mistake to regard it as merely a variant of the Canadian model. The legislators adhered to the fundamental principles of the PPSA reform, but often developed different designs and strategies for their implementation. The Australian Act exists as a separate branch of the PPSA family – sharing a close resemblance to the Canadian and New Zealand Acts on many matters, but strikingly different on others. These legislative differences must always be carefully considered when determining if the case law of other PPSA jurisdictions might be relevant.

The unitary concept of a security interest and the substance test for a security interest are central features of PPSA reform, and for this reason there are fewer substantive differences in respect of this element amongst the various personal property security statutes. The case law from Canada, the United States and New Zealand can reasonably be expected to have greater influence when the issue concerns the concept of a security interest under the Australian PPSA.

But even here, difference in the legislative framework will greatly affect the kinds of issues that will come before the courts. Australia has had the very good fortune of being able to implement PPSA reform in one fell swoop. There has been a much greater effort to make adjustments to other pieces of legislation to take into account the new PPSA concepts. For example, references to the now obsolete concept of the floating charges contained in the *Corporations Act 2001* are replaced by references to circulating security interests.[88]

This is very different from implementation of the reforms in Canada. The reform took place over the course of three decades as one province after another joined the fold. The federal government was not involved in the reform initiatives, and the federal legislation has never been comprehensively amended to take into account the new concepts and terminology of the PPSA.[89] As a result, there has been more work for the courts in Canada in attempting to reconcile the obsolete pre-reform language of the federal statutes with the newer concepts and terminology of the PPSA. One can therefore anticipate that these sorts of issues are less likely to come before the courts in Australia because the groundwork in harmonizing the provisions has already been accomplished.

On other matters, the effect of legislative differences may be more pronounced. In Canada, the characterization of a flawed asset arrangement as a security interest has led to calls in some quarters for amendments that would permit perfection by control in respect of deposit accounts. The characterization of the transaction is significant for two reasons. First, it means that it must be perfected in order to achieve the highest level of priority over competing third parties. Secondly, it means that the interest was subordinated to the federal statutory deemed trust in respect of source deductions.

[88] In doing so the status quo in terms of priority ranking is maintained. The drawback is that it also preserves the uncertainty in determining what degree of control is sufficient to trigger the operation of the provision. Although the concept of the floating charge has fallen out of the picture, some of the old debates associated with its use continue in the new system in a different guise.
[89] See Cuming, Walsh & Wood, *supra*, note 4 at 169-74.

The characterization of a flawed asset arrangement as a security interest simply does not have the same resonance in Australia. Deposit taking institutions are unlikely to be concerned because the Australia PPSA permits automatic perfection by control of ADI accounts when the secured party is an ADI.[90] There is no worry about registration because none is required. There is no worry about priority because a security interest perfected by control has priority over a security interest not perfected by control,[91] and only the ADI can perfect by control. The Australian derivatives industry is unaffected because their credit support agreements are structured on the basis of the netting of accounts rather than the granting of security in collateral, and the PPSA expressly excludes such transactions from its scope.[92] If there is to be an outcry in Australia, it will not come from these sectors. It might, however, come from other commercial credit grantors who may question why the legislators thought it appropriate to give ADIs the exceptional benefits of automatic perfection and first priority at their expense.[93]

6. Conclusion

Canadian courts have had little difficulty with adapting the floating charge in light of the unitary concept of a security interest. The concept of a floating security interest simply ceases to exist. It is replaced by the concept of a fixed legal security interest that is subject to a licence that permits the debtor to deal with the assets free from the security interest in respect of authorized transactions. The adaptation of the conditional sales has been somewhat more problematic. Courts have sometimes reverted to the older thinking and have failed to fully assimilate them with other security interests. To be fair, the courts in these cases were sometimes dealing with federal statutes that used pre-reform terminology and concepts, and this has made the passage more treacherous. There are two lessons in this. The first is that a clear statement that the

[90] The Australian PPSA is very different from Article 9 in this respect. Perfection by control of an ADI can be achieved if, and only if, the secured party is the ADI. See PPSA, s.25. An extended meaning of control is, however, retained in respect of the definition of a circulating asset security interest.
[91] PPSA, s.57(1).
[92] PPSA, s.8(1)(e). There is no similar exemption in the Canadian Acts. The problem in Canada is that a credit support agreement that is structured as a security interest requires registration to perfect it (because a transfer of funds into a deposit account in the name of the secured party does not perfect it by control). But structuring it as a netting of accounts is also risky as the transaction might be characterized as a security interest on the basis of the Supreme Court of Canada's decision in *Caisse populaire de Drummond v. Canada*, *supra*, note 69.
[93] For a critique of the Article 9 approach, see W. Gibson, "Banks Reign Supreme under Revised Article 9 Deposit Account Rules" (2005), 30 Delaware Journal of Corporate Law 819.

retention of title only operates to create a security interest would have been useful. Secondly, the culling of the pre-PPSA terminology and a replacement with terminology that accords with that found in the PPSA would also have helped to prevent a reversion to pre-PPSA modes of analysis.

Canadian courts have also fully embraced the substance test for determining if a transaction is to be characterized as a security interest, and have made important strides in working out an appropriate methodology for uncovering disguised security interests. There is now an extensive body of case law that has been developed on the characterization of leases, consignments and trusts. As well, Canadian courts have applied the substance test to new forms of commercial transactions and in doing so have confirmed the correctness of Grant Gilmore's view of the "all-embracing, all devouring"[94] character of the PPSA.

Because the unitary concept of a security interest and the substance test are central features of Article 9 and every PPSA, there is less likelihood that differences in drafting or variations in policy will impede the creation of a truly international body of case law on these issues. Legislative differences are more likely to affect the kinds of cases that come before the court. Although issues concerning flawed asset arrangements are highly contentious in Canada, they may be less so in Australia because of the ability of the deposit taking institution to perfect its security interest automatically by control without any need for registration. Implementation of the Canadian PPSA occurred over three decades at the provincial level with the result that many of the statutory provisions continue to adhere to now obsolete concepts and terminology. The "big bang" implementation of the Australian PPSA brings simultaneous reforms of commonwealth, state and territory legislation, and this will also reduce the need for these types of issues to be litigated.

[94] *Supra*, note 12.

Blake Dawson

Funding the Golden Fleece
Some PPSA considerations

Bruce Whittaker
PARTNER

6 August 2011

214168184

Topics covered

- Import transactions
- Inventory financing

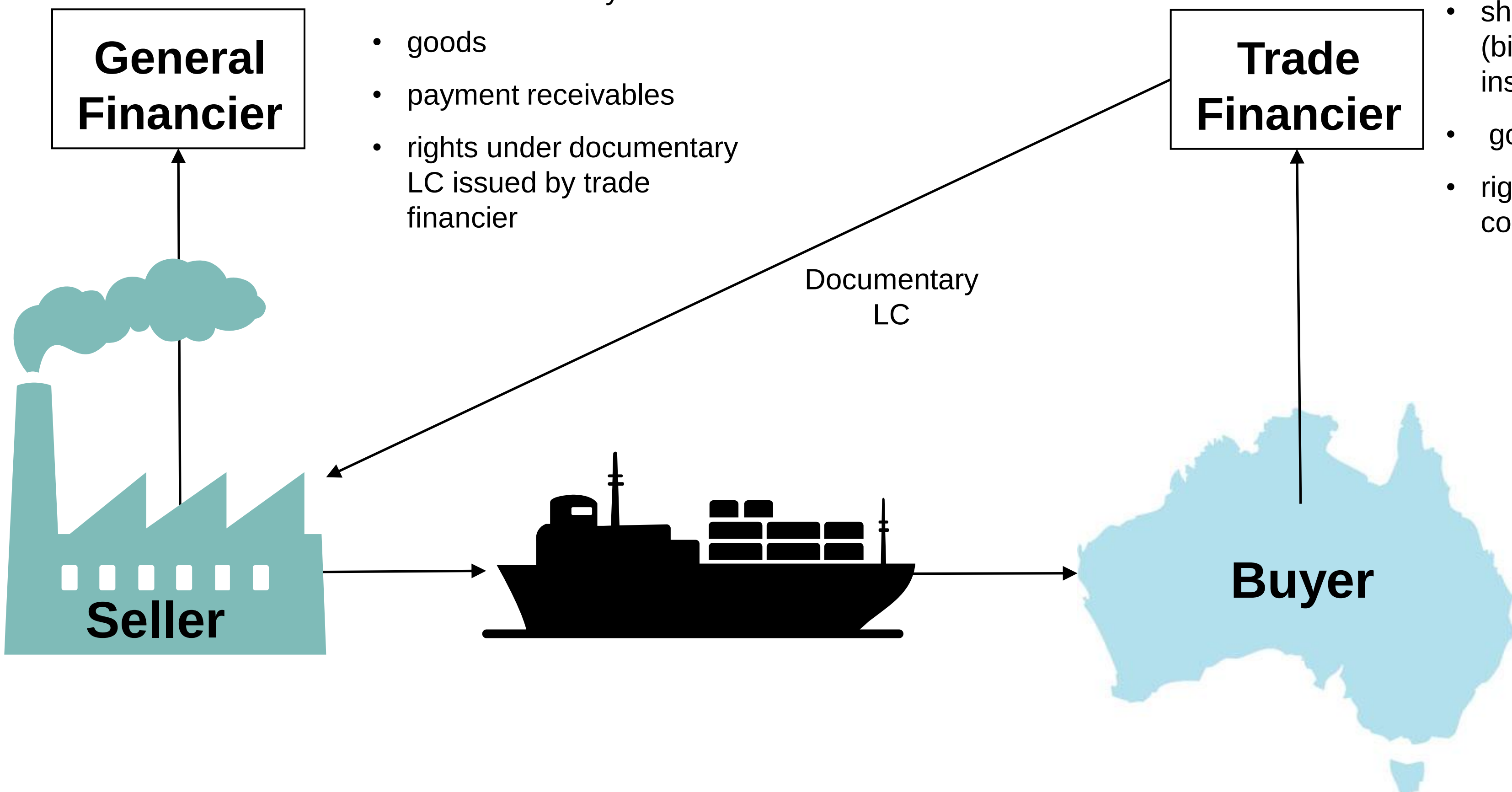
Import transactions

Could take security over:

- goods
- payment receivables
- rights under documentary LC issued by trade financier

Could take security over:

- shipping documents (bill of lading and insurances)
- goods
- rights under the sale contract



Import transactions (cont'd)

Nexus tests – does the PPSA apply?

- section 6 – depends on factors such as:
  - nature of the property
  - location of the property
  - whether the grantor is an "Australian entity"
  - place of performance
- nexus test will always be satisfied if the grantor is an Australian entity

Import transactions (cont'd)

Governing law

- Even if the PPSA applies, the choice of law rules in Part 7.2 may still direct you to apply non-Australian law
- Choice of law rules only apply to "validity, perfection and effect of perfection or non-perfection of the security interest"
    - don't affect the law that governs the contractual obligations

Import transactions (cont'd)

Governing law rules				
	Bill of lading ("financial property")	Insurances ("intangible property")	Goods ("goods")	Purchase contract ("intangible property")
Validity	Location of grantor (s240(1)) Unless bill is "non-negotiable", in which case – location of goods at time of attachment (s 240(6))	Location of grantor at time of attachment (s 239(1))	Location of goods at time of attachment (s 238(1)) Unless reasonable to believe at time of attachment that goods would be moved to another jurisdiction, in which case – that jurisdiction (s 238(2))	Location of grantor at time of attachment (s 239(1))

Import transactions (cont'd)

Governing law rules				
	Bill of lading ("financial property")	Insurances ("intangible property")	Goods ("goods")	Purchase contract ("intangible property")
Perfection	Location of grantor (s 240(4)) Unless bill is "non-negotiable", in which case – location of goods at time of attachment (s 240(6))	Location of grantor (s 239(2))	Location of goods at the time (s 238(1A)) Unless reasonable to believe at time of attachment that goods would be moved to another jurisdiction, in which case – that jurisdiction (s 238(2))	Location of grantor (s 239(2))

Import transactions (cont'd)

Perfection options

Bill of lading	Insurances	Goods	Purchase contract
Possession	Registration	Registration or Possession of the bill of lading, if it's negotiable (s 22)	Registration

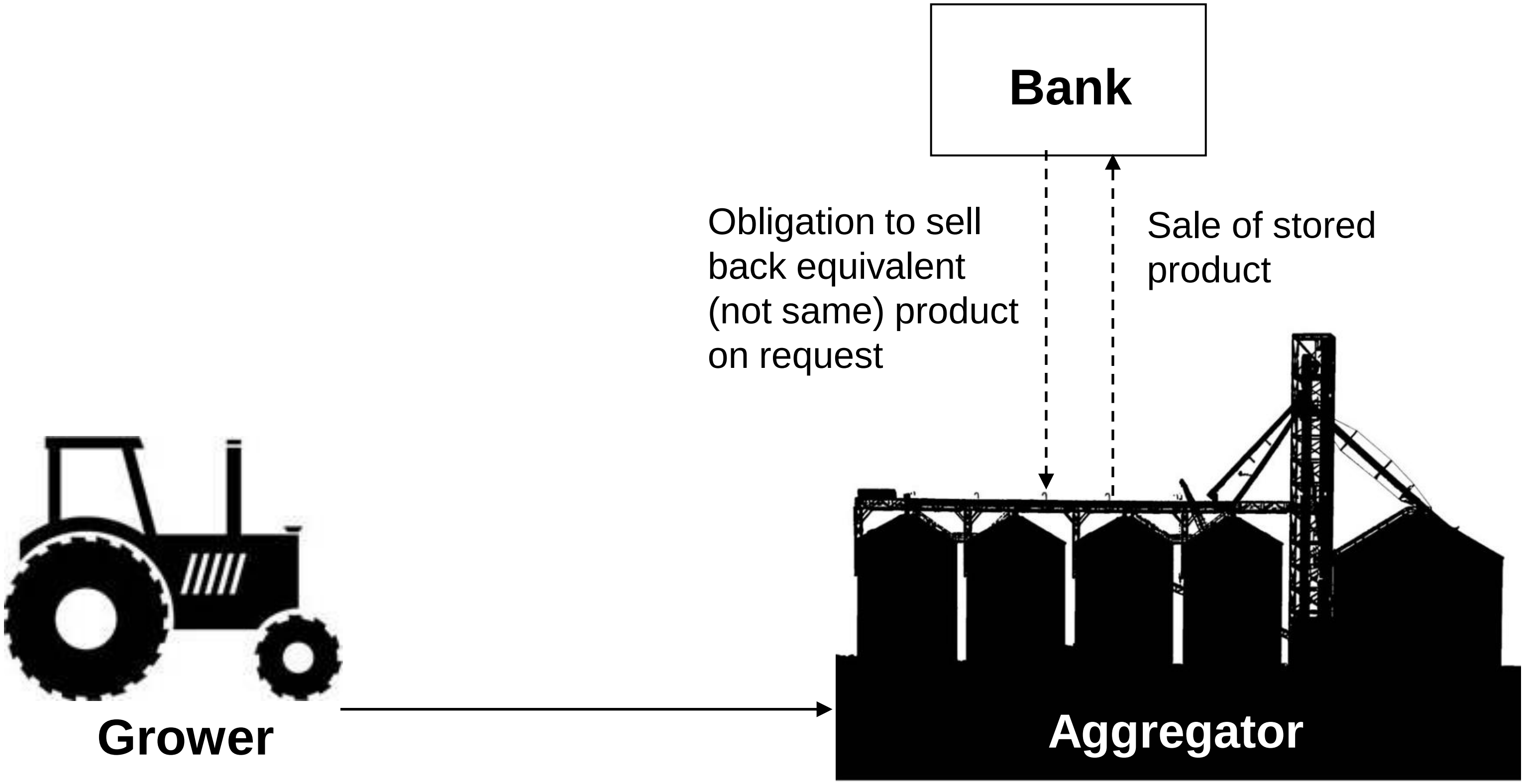
Financier may have a registered GSA anyway, in which case that registration will perfect these security interests too.

Import transactions (cont'd)

What happens if the security interest of the seller's financier continues in the goods?

- perhaps unlikely to arise often in practice
- section 32 – seller's financier may have authorised the sale
- section 39 – if collateral is relocated to Australia, pre-existing security interest is temporarily perfected for up to 56 days
- section 52 – buyer of goods for new value takes free of temporarily-perfected security interests

Inventory financing



Import financing (cont'd)

Does the bank have a security interest?

- Arguments against
  - transfer of the product to the bank doesn't secure any obligation – rather, it causes the obligation to arise
  - bank's right to deal with the product make it hard to see what any security interest could be said to be attached to
- Arguments in favour
  - commercial intent is to provide finance, with ownership of the product as "security"
  - s 12(2)(k) says a security interest can be by way of "transfer of title"
  - would otherwise be a triumph of form over substance?

Import financing (cont'd)

If the bank does have a security interest

- it should be perfected by possession
- it will however be subject to prior-ranking security interests

Funding the Golden Fleece:
An A to Z of commodity financing

Colin George
Director

Trade, Commodity and Agribusiness Finance

BFSLA Conference

6 August 2011

Australian Government

EFIC
Export Finance
& Insurance Corporation

Overcoming financial barriers for exporters

About EFIC

- Australia's export credit agency (ECA)
- Purpose is to support growth of Australian business internationally
- Provides financial and insurance solutions for Australian exporters and offshore investors
- Fills 'market gap' when commercial finance unavailable/insufficient
- Role complementary to commercial lenders
- 100% owned by the Commonwealth of Australia
- EFIC debt securities rated AAA (S&P)
- Over 50 year's experience

EFIC financial solutions

Pre-shipment

- Working capital guarantees
- Advance payment and performance bonds
- Inventory finance
- Producer Offset loans
- Foreign Exchange
- Project Finance

Post-shipment

- Working capital guarantees
- Risk participation in overseas receivables
- Inventory Finance
- Documentary credit guarantees
- Finance to overseas buyers
- Project finance

Offshore investment

- Working capital guarantees
- Export finance guarantees
- Political risk insurance

Case Study

AgCo

- Agricultural trading business specialising in supplying agricultural product to China, South-East Asia, the Middle East and Russia.

- AgCo needs short-term pre-shipment finance to fulfil contracts (circa $10m each) to ship product.

- AgCo needs to pay suppliers and accumulate product prior to bulk shipment. Typical financing period 90 days. Once goods are shipped documents are presented to their bank for presentation under a confirmed sight L/C.

- Their bank is only willing to provide finance with a third party guarantee for repayment.

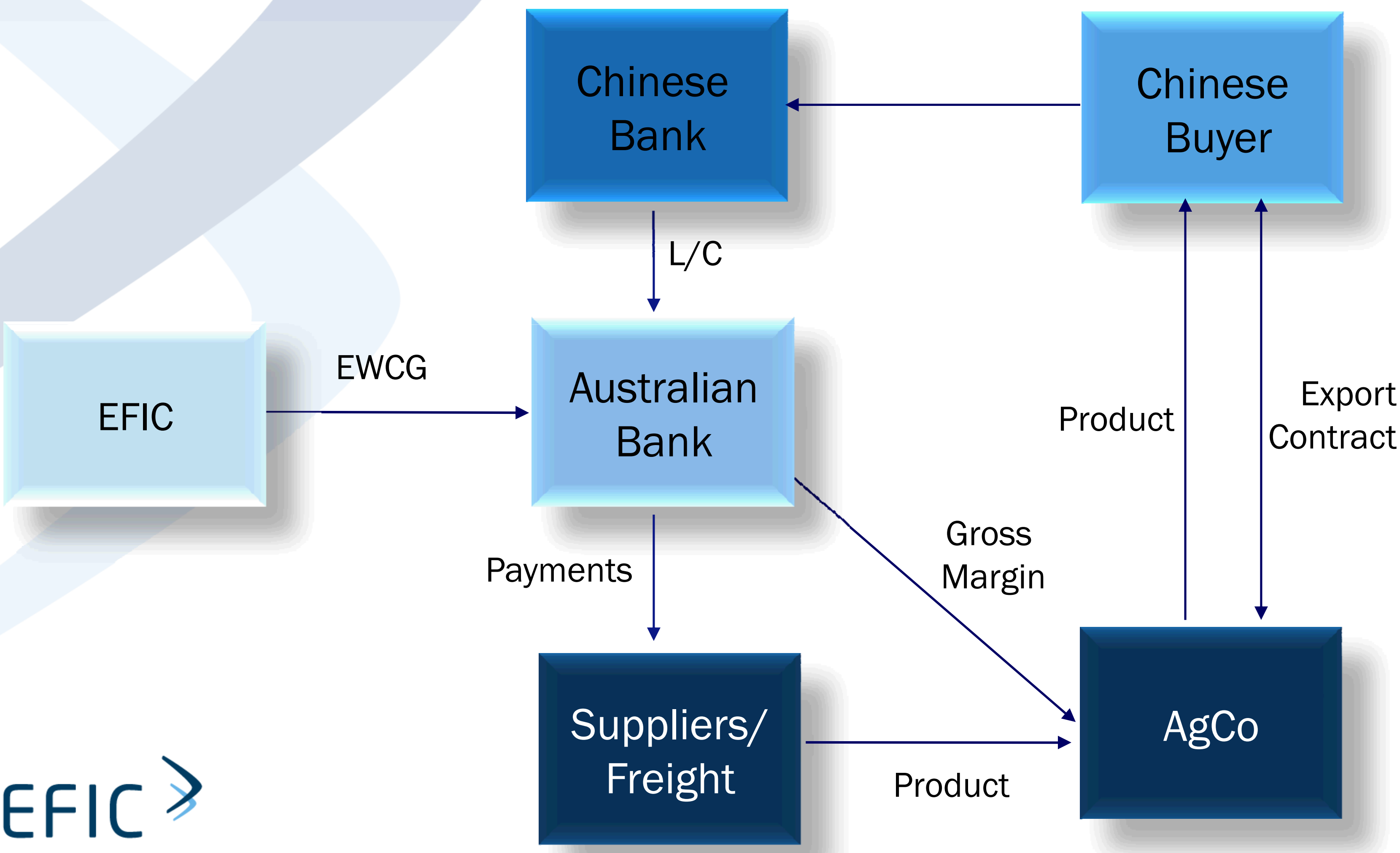
AgCo

- Under a Master Export Working Capital Guarantee, EFIC provides the bank with a three month guarantee for each of AgCo's shipments.

- Repayment of the EFIC guarantee comes from proceeds of the L/C.

- Fully self-liquidating pre-shipment finance facility where EFIC bears the entire credit risk on the exporter. EFIC has first ranking fixed and floating charge over AgCo. The bank takes second ranking security.

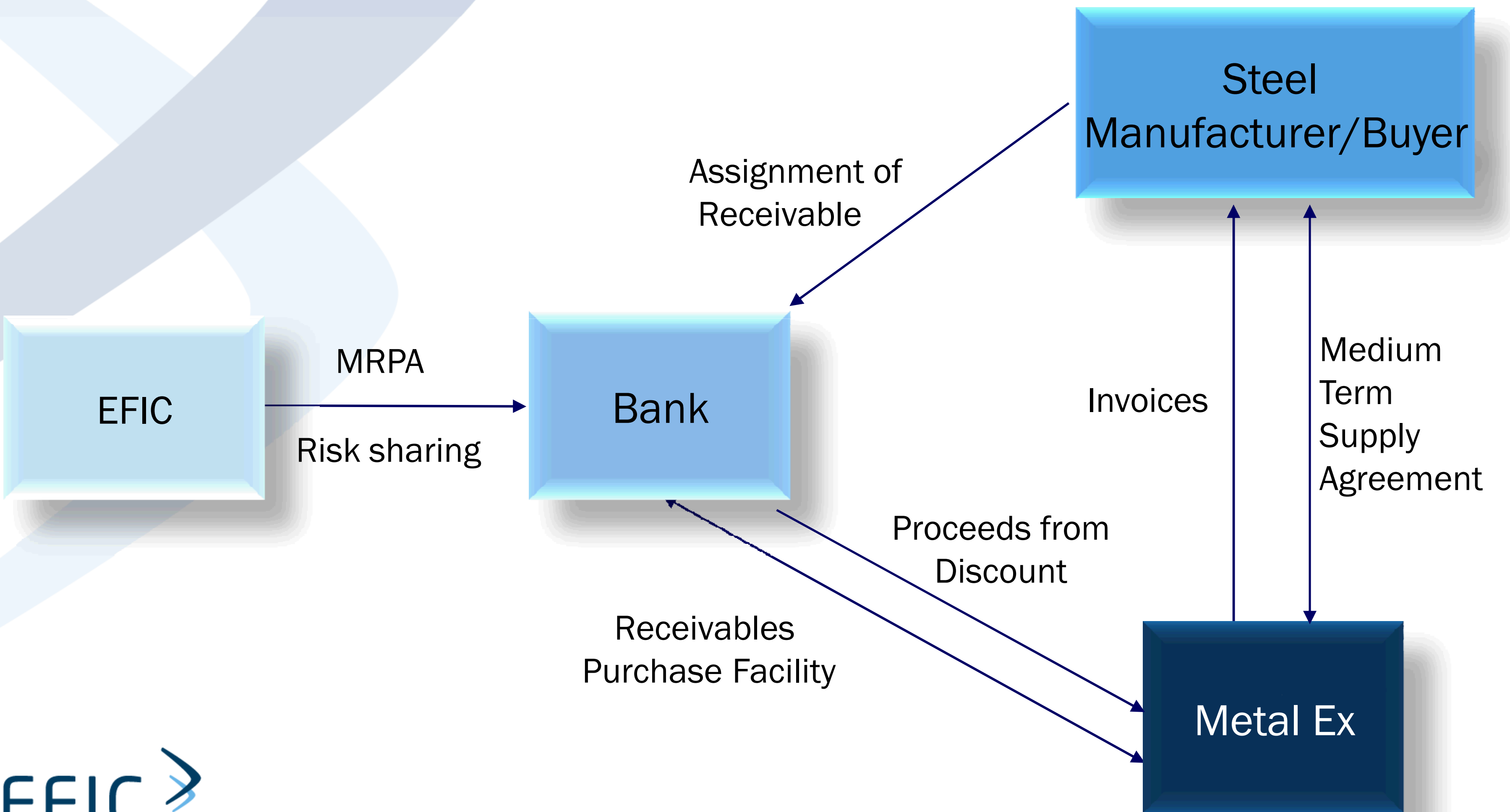
AgCo Structure



MetalEx

- Large coal mining company with multiple operations in QLD and NSW. Output exported globally to large and small buyers.
- Increasing coal prices and tonnages resulted in the company requiring a larger receivable finance facility against receivables due from a large steel manufacturer.
- MetalEx's bank has reached its internal counterparty ceiling on the buyer.
- EFIC enters into a Master Risk Participation Agreement with the company's bank. This enables the bank to increase the receivable finance facility with EFIC taking 25% of the facility risk on a pari passu basis.
- Each receivable is due 180 days after the bill of lading date. MetalEx sends bills of lading, commercial invoice and analysis certificates to the Buyer. MetalEx assigns the receivable to their bank. The buyer issues a letter to MetalEx's bank confirming the invoice value is correct, consent to the assignment and an irrevocable undertaking to pay the amount on the due date to the bank.
- There is no right of recourse to MetalEx.

MetalEx Structure

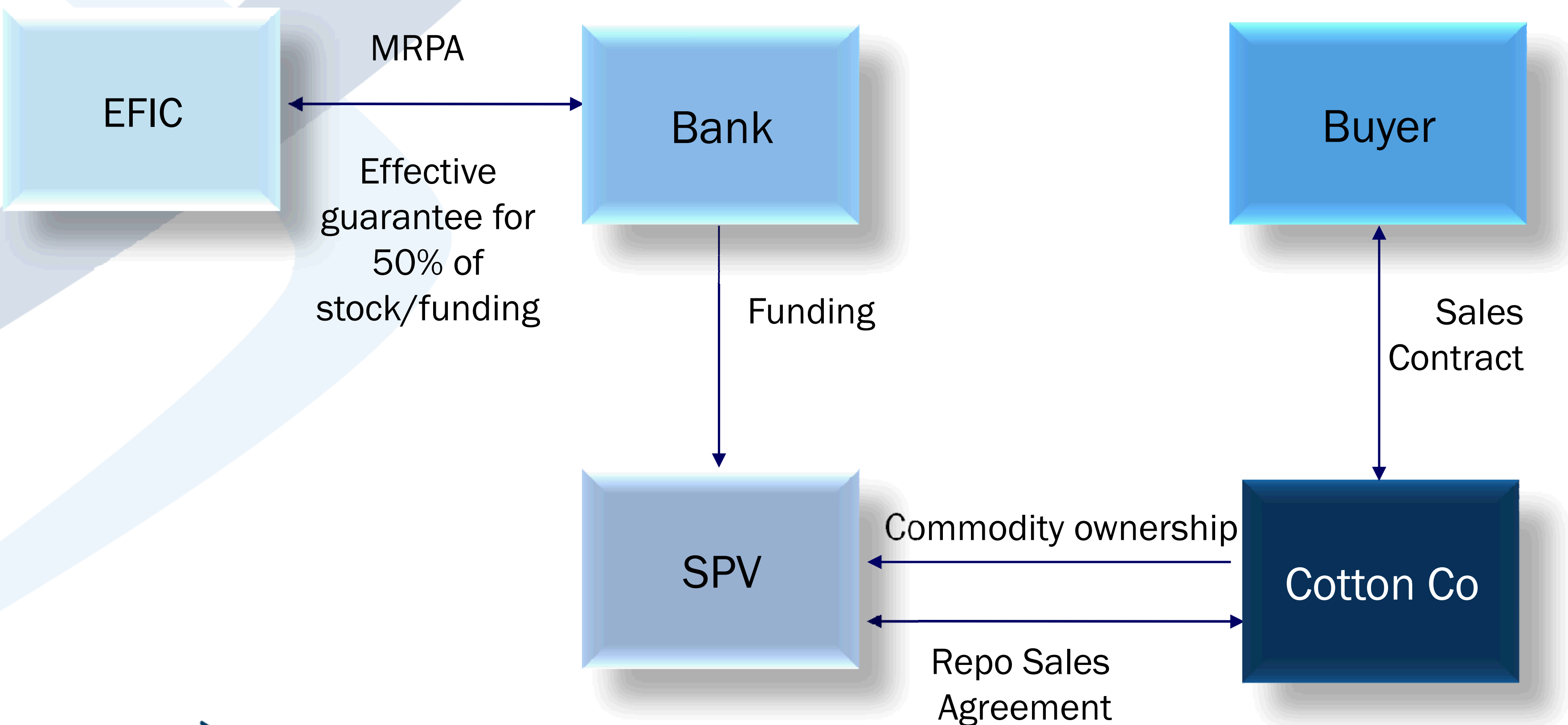


EFIC
Export Finance & Insurance Corporation

CottonCo

- Cotton exporter who purchases cotton from Australian farmers, processes it and then sells to overseas buyers.
- CottonCo wish to store cotton in China for just in time delivery to their buyers.
- Bank not fully comfortable with storage and legal risks in China, therefore seeking EFIC participation in the facility in order to risk share.
- EFIC and the bank use a Master Risk Participation Agreement to document EFIC's participation into an inventory finance repurchase agreement.
- Under the repo agreement, a SPV wholly owned and funded by the bank agrees to purchase agreed quantities of cotton in warehouse in China. The SPV agrees to sell back the same quantities of cotton each fortnight and at the same price.
- The cotton is marked to market each day and margin calls may be made on CottonCo should the market price of the cotton fall below a certain percentage of the purchase price.

CottonCo Structure



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FINANCIAL INSTITUTIONS ● ENERGY ● INFRASTRUCTURE AND COMMODITIES ● TRANSPORT ● TECHNOLOGY

FUNDING THE GOLDEN FLEECE

Structured Trade and Commodity Finance – Legal and Commercial Issues

Gillad Dalal
Partner
Norton Rose Australia

BFSLA Conference
6 August 2011

Introduction

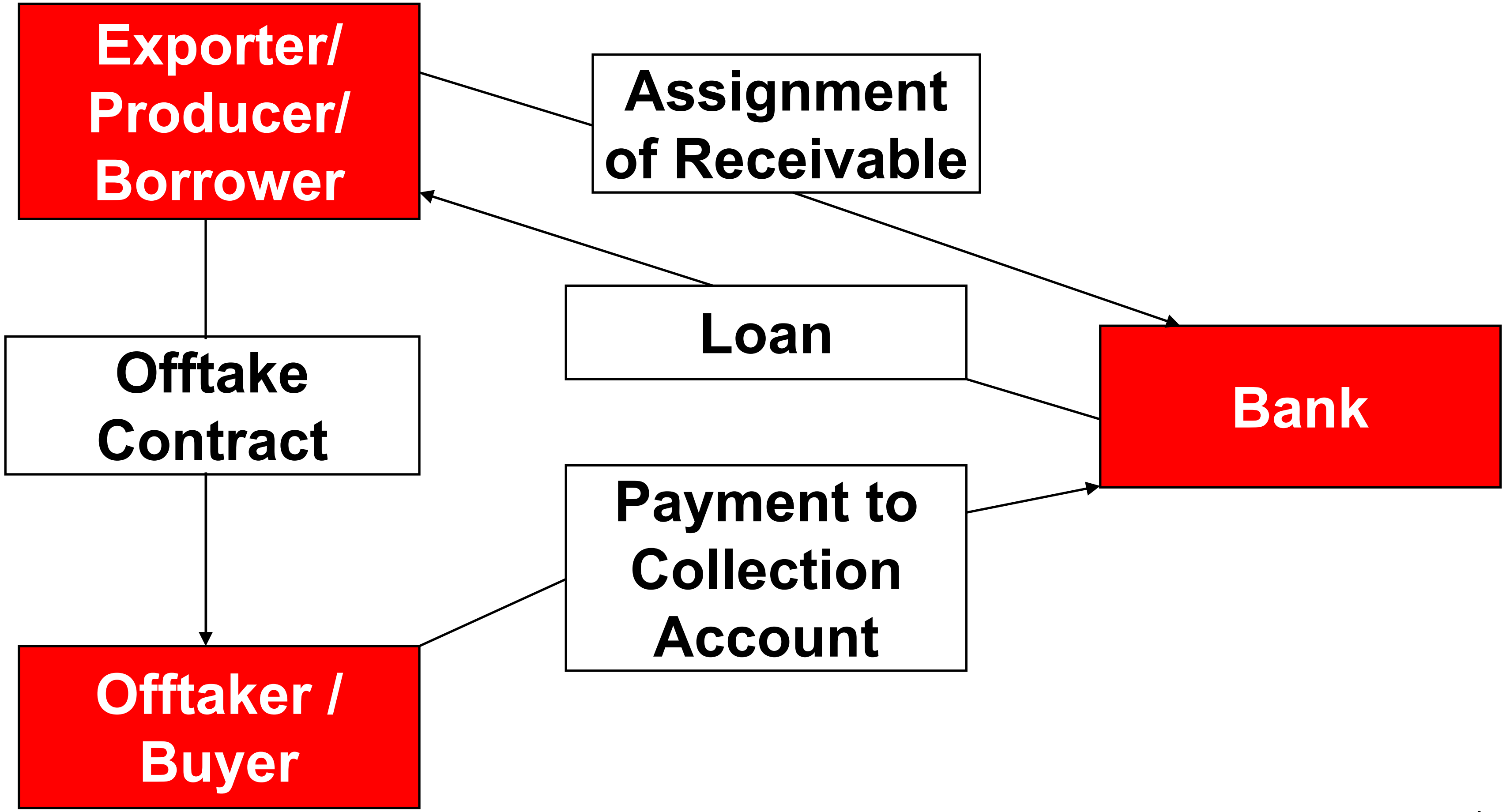
What is Structured Trade Finance?

- Structured around a particular commodity / customer need
- Usually larger amounts of debt / funding required
- Usually longer tenor than typical trade transactions
- More complex structures used
- Due diligence usually required on offtakes and other relevant contracts
- Usually (not always) used with tradeable commodities (e.g. grain, oil, iron ore, etc.)
- Usually these are quite capital efficient structures for Banks, however Basel II and III may impact capital cost of these structures

Common Structured Trade and Commodity Finance Structures

- Pre-export finance
- Pre-payment finance
- Borrowing base lending
- Sale and repurchase financing (Repos)

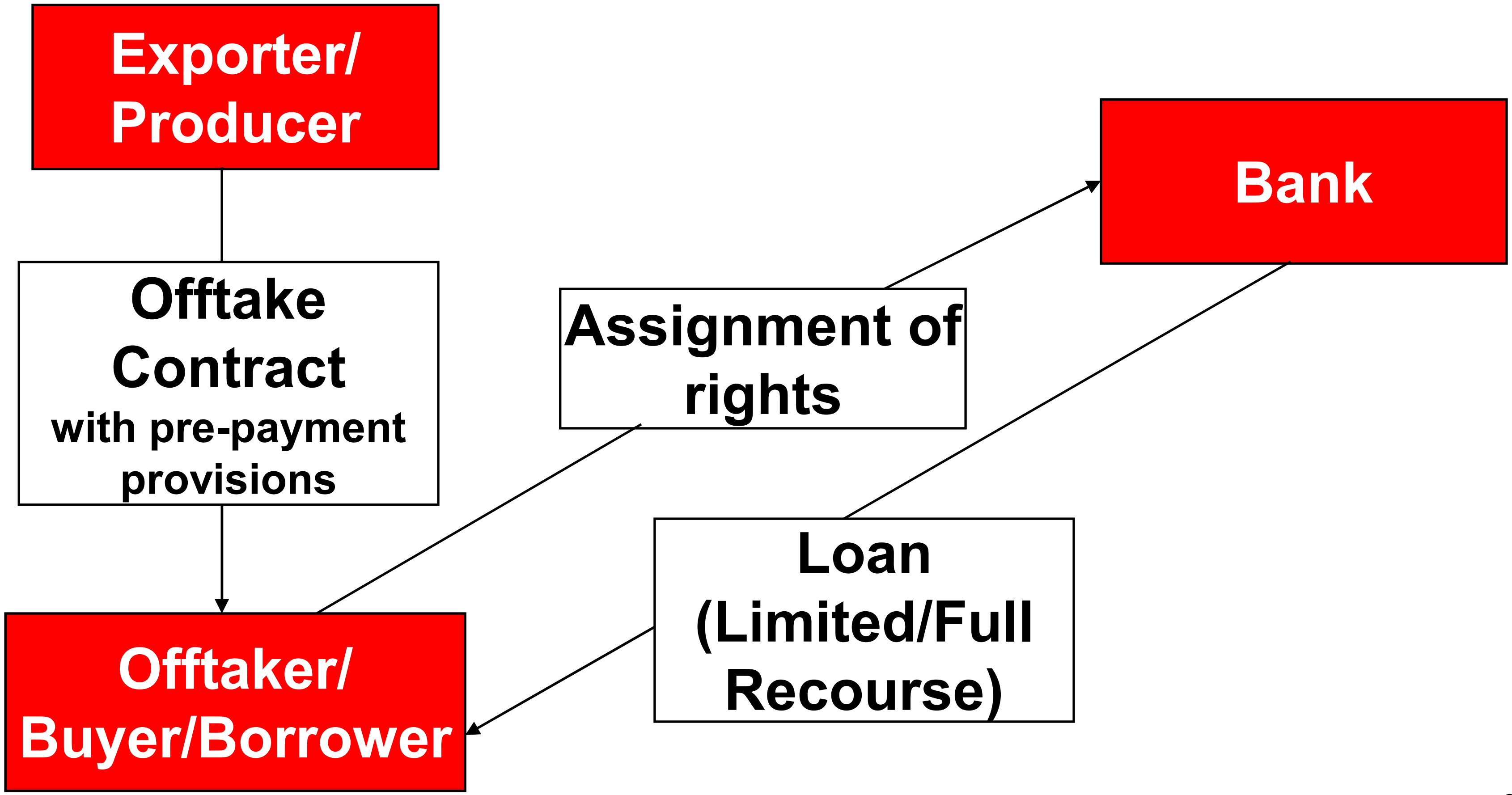
Pre-export finance



Pre-export finance - Legal issues

- Normal short term loan issues
- Review of offtake / Assignment of offtake / Foreign law issue
- Security/collection account - issues around security over deposit
- Commercial disputes between buyer and seller - Bank deals in documents not goods

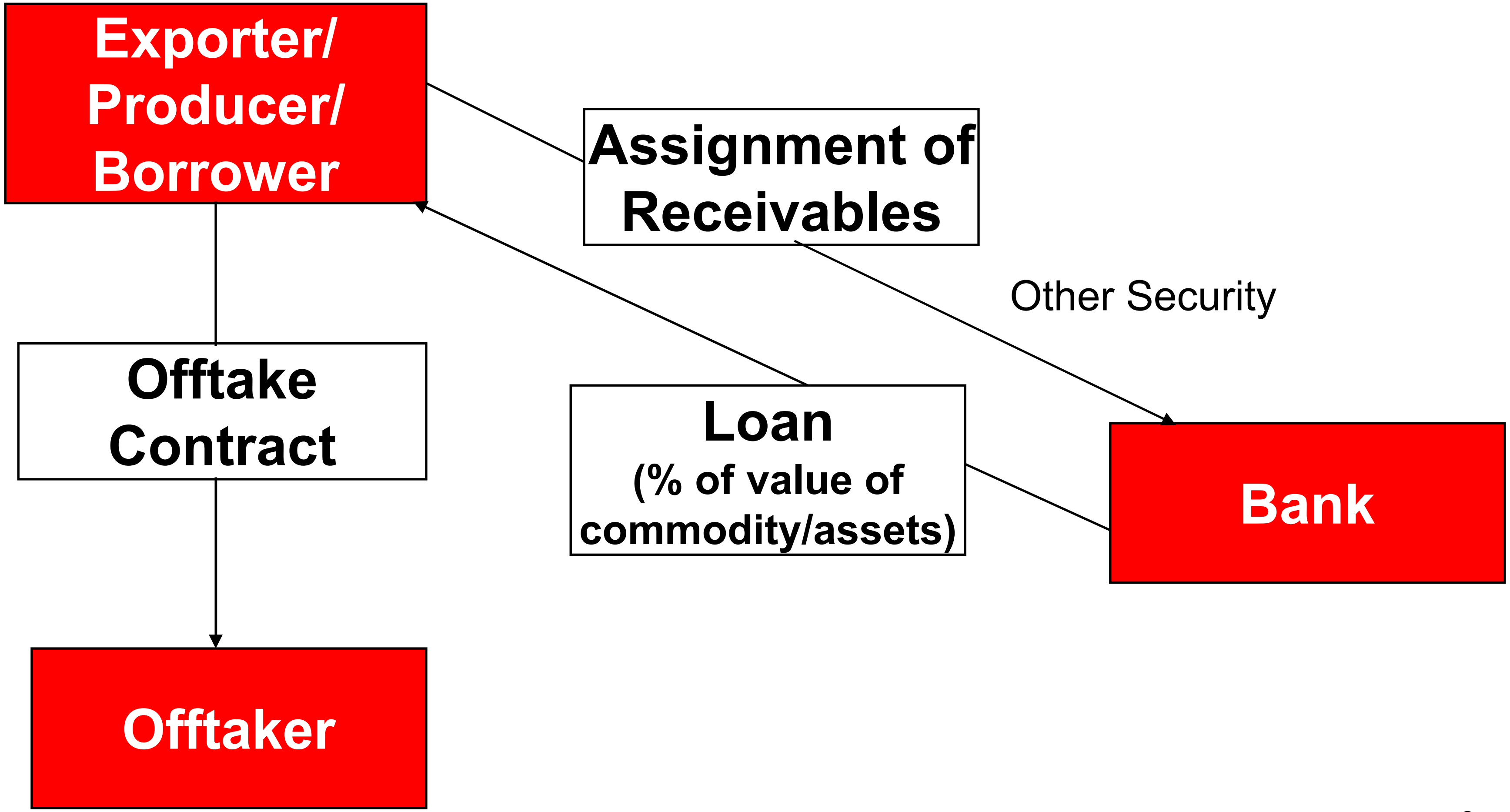
Pre-payment finance



Pre-payment finance - Legal issues

- Facility documentation / full recourse / limited recourse
- Assignment over the Exporter’s rights to receive payment from the Buyer
- Payment Guarantees

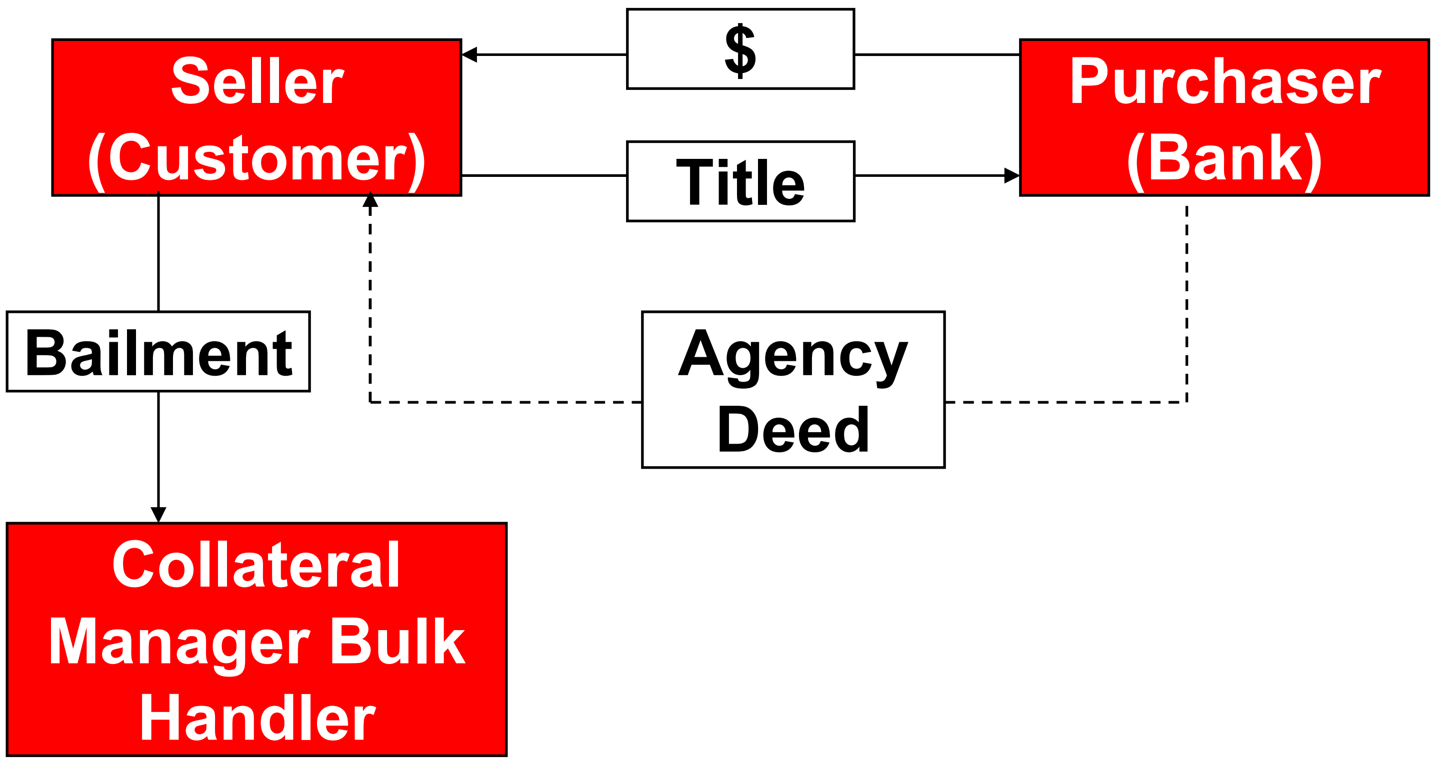
Borrowing base lending



Borrowing base lending – Legal issues

- Drafting appropriate Borrowing Base trigger for top ups, etc
- Issues around security over receivables

Sale and repurchase (Repos)



Sale and repurchase (Repos) - Legal issues

- True sale vs Assignment by way of security
- GST complications
- How to control the commodities: agency issues / bulk handling agreements
- Fungible nature of commodities – who owns them and how does it work when they are co-mingled

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Funding the Golden Fleece:

- an A to Z of commodity financing

Phil Cubbin
Segment Head
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BFSLA Conference
6th August 2011

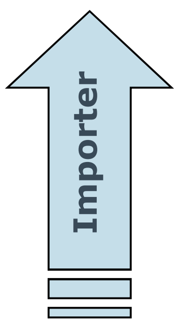
ANZ

Trading internationally has many Risks:

- Sovereign/Country risk
- Foreign exchange & interest rate risk
- Commodity price risk
- Sanctions risks
- Cultural and regulatory differences
- Unknown standing of the Supplier / Buyer
- Willingness verses Ability to pay
- Language & time zone differences
- Dispute Resolution can be costly
- Distance between buyer and seller

… which can be managed using various Trade Finance products:

LEAST RISK

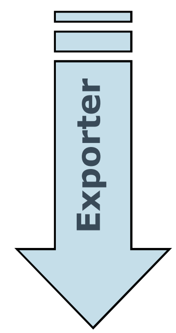


HIGHEST RISK

- Open Account / TT
- Supply Chain & Structured Trade*
- Documentary Trade Products
- Prepayment / Advance Payment

**Structure dependant*

HIGHEST RISK



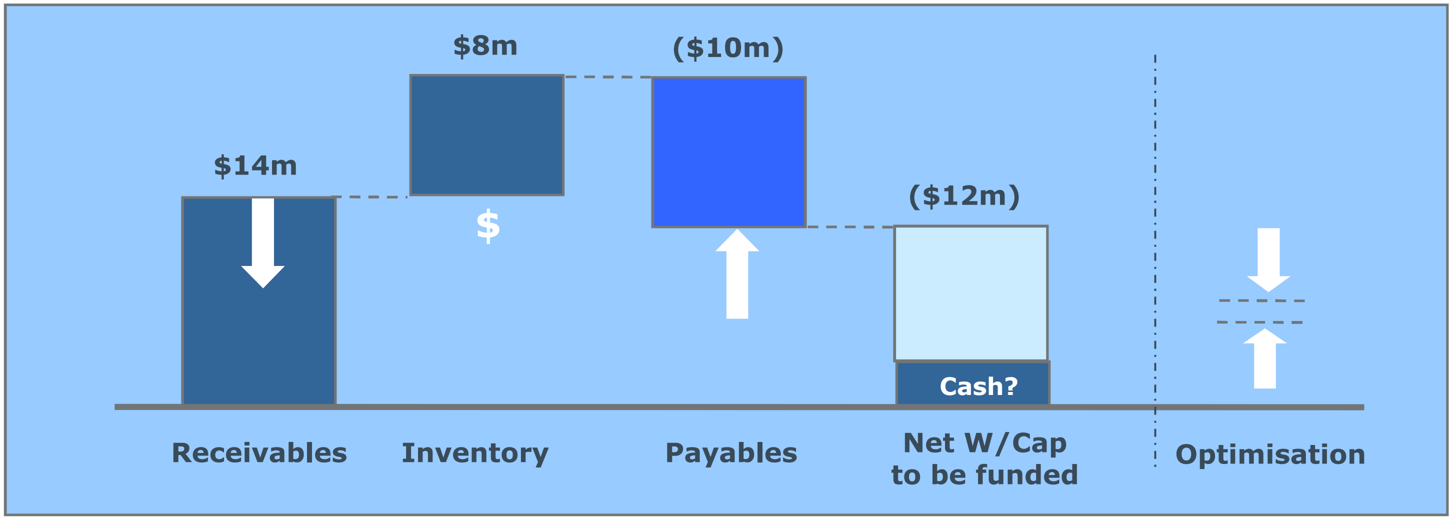
LEAST RISK

Trading internationally also requires substantial Working Capital:

Current Assets	Receivables	***plus***	***(monetise)***
	Inventories		***(monetise)***

Current Liabilities	Payables	***less***	***(extend)***

	Net Working Capital		***(optimise)***



(NB: Capital always has a Cost !!!)

TRADE FINANCE PRODUCTS DELIVER - RISK MGMT, WORKING CAPITAL LIQUIDITY (& OPERATIONAL SUPPORT)

CUSTOMER NEEDS

Risk Management

- Enhance counterparty payment risk
- Reduce concentration risk
- Mitigate performance risk

Liquidity

- Extend payment terms
- Accelerate payment collection, improve cash cycles
- Increase funding capacity
- Improve metrics

Operational Support (Customer Service)

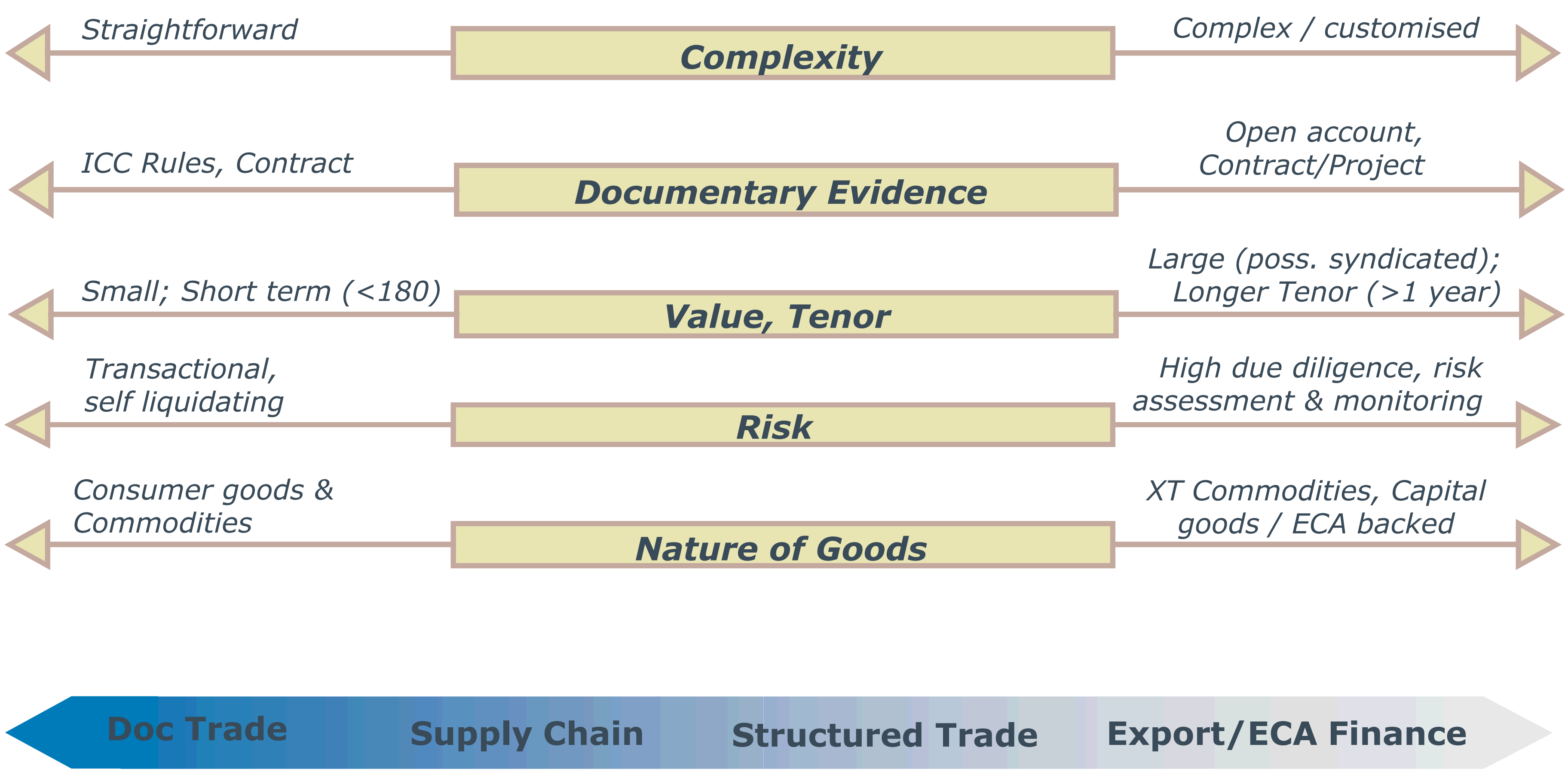
- End-to-end transaction execution
- Local processing, operational support
- Globally consistent
- Technology supported

TRADE FINANCE SOLUTIONS

- Documentary Credits (DC's) – issuance, advising, neg's, etc
- Documentary Collections (DA/DP)
- DC Confirmations & Finance
- Bid/Performance Bonds
- Trade Finance Loans
- Payment Guarantee's
- Receivables Finance
- Payables Finance
- Pre-export Finance
- Pre-payment Finance
- Warehouse Finance

Transactionally based; Flows of Goods; Alignment with cash cycles

Simplistically, Trade Finance 'products' can be defined by:



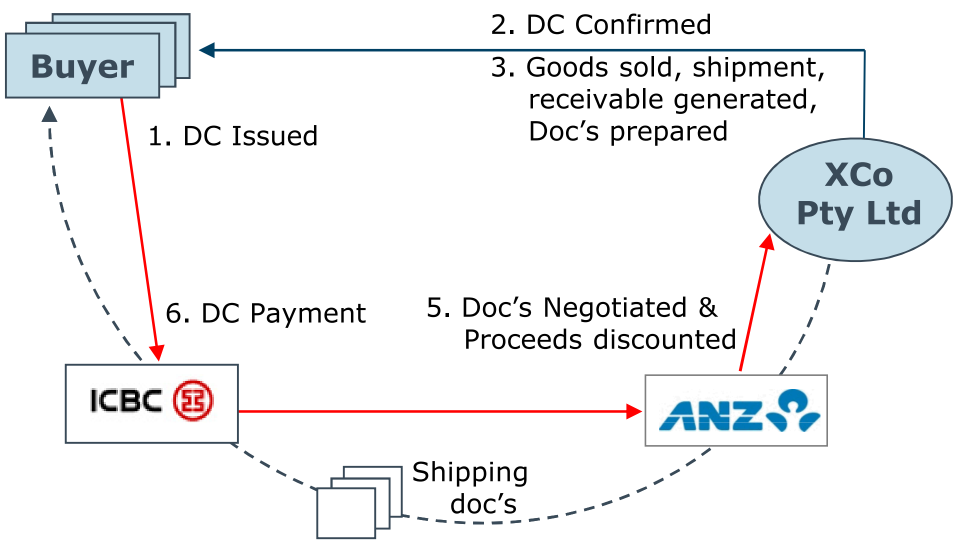
HOW TRADE PRODUCTS ARE APPLIED

Risk Management, Working Capital liquidity… supporting Commercial terms

Commercial activity	**Buyer & Seller negotiate Commercial contracts**	**Goods sourced, produced and/or stored**	**Goods Shipped**	**Goods arrive, are converted and/or stored**	**Payment settlement Goods are on-sold**
Commercial needs	>Establish supply >Assess Risks >Agree payment method >Establish financing	>Access working capital >Issue Bonds, DC's >Secure risk coverage >Manage production	>Pay transport, insurance, shipment costs >Prepare shipping doc's, compliance, handling, etc	>Obtain doc's >Clear & store goods >Access working capital >Pay clearance & storage costs	>Goods payment (payment / receipt) >Establish supply
Trade Finance solutions	**>Bid Bonds** **>Pre-payment finance** **>Advance Payment Guarantee** **>DC Issuance** **>EFIC/ECA**	**>Performance Bonds** **>Pre-shipment / Pre-export finance** **>DC Financing** **>DC Confirmation** **>Trade Finance Loan** **>Warehouse Finance**	**>DC Negotiation, Discounting** **>DA/DP Collections** **>Trade Finance Loan** **>Receivables Finance** **>Payment G'tee** **>EFIC/ECA**	**>Shipping Guarantee** **>DC Doc processing** **>Trade Finance Loan** **>Buyer Finance** **>Payables Finance** **>Warehouse Finance**	**>Payments & Cash Management** **>SWIFT & Corro bank Network** **>Bid Bonds…** **>…** **>…**

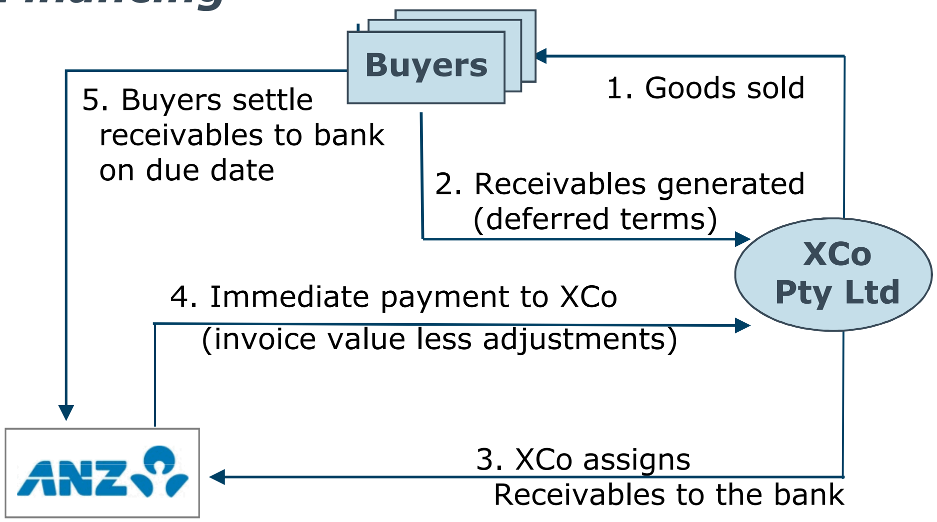
Assumes a continuing cycle; FX and IR management throughout

Confirmation & Discounting of Documentary Credits (DCs)



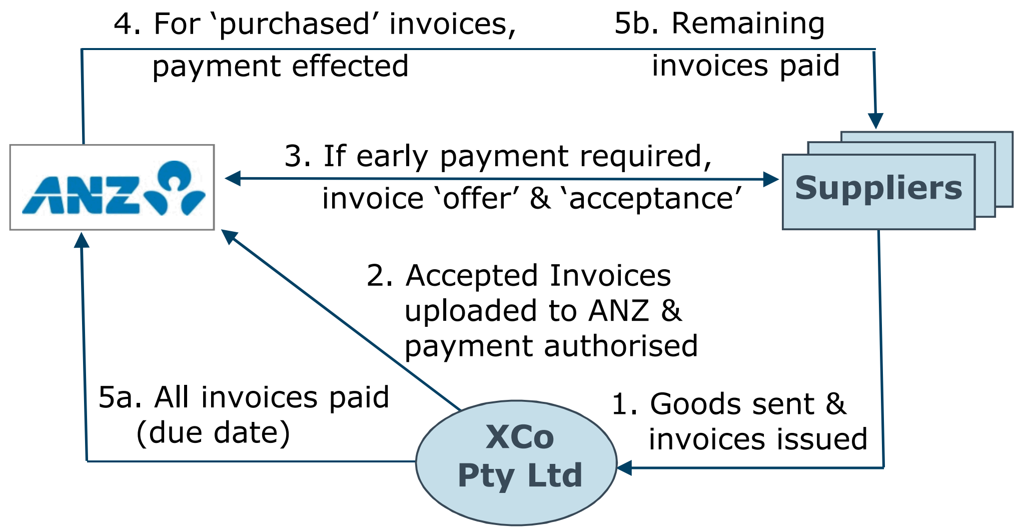
- XCo's Buyers seeks deferred payment terms (Eg 90 days), via Doc Credit issued by an acceptable bank
- XCo holds Documentary Credit Bank & Sovereign payment risk, needs to fund deferred payment terms (200bp)
- Bank agrees to confirm Doc Credit – B&C limits permitting
- Bank negotiates compliant DC documents, pay's XCo discounted FV 'up front' (Libor + 75bp)
- Buyer's bank pays XCo's bank on DC payment due date (90 days after shipment)
- XCo:
  - ✓ Mitigates Bank, Country (& Counterparty) payment risk, & accesses Working Capital liquidity
  - ✓ Improves cash position, Reduces funding costs, & preserves existing Funding lines
  - ✓ Can offer Buyers longer terms, and/or increase shipment volumes, frequency
  - ✓ Preserves BS metrics

Receivables Financing



- XCo's Buyers seek deferred payment terms (Eg 90 days)
- XCo holds counterparty payment risk, needs to fund deferred payment terms (Eg 200bp)
- Bank agrees to purchase Trade Receivables
- Bank pays XCo discounted FV 'up front' (Eg Libor + 100bp)
- Buyers pay Bank on due dates
- XCo:
  - ✓ Covers payment risk, accesses Working Capital liquidity
  - ✓ Improves cash position, Reduces funding costs & preserves existing Funding lines
  - ✓ Can offer Buyers longer terms, and/or increase shipment volumes, frequency
  - ✓ Preserves BS metrics

Payables Financing



- XCo receives deferred payment terms (Eg 90 days)
- Suppliers hold payment risk, need to fund deferred payment terms (200bp)
- Bank is willing to potentially purchase Supplier's Receivables (XCo Payables), if/when required by Suppliers
- If requested, Bank pays Suppliers discounted FV, when required (Eg Libor + 100bp)
- XCo pays Bank for total invoice value on due date, Bank settles balance to Suppliers
  - ✓ XCo retains Payables terms (and/or extends?)
  - ✓ Suppliers can receive Payment risk coverage
  - ✓ Suppliers can also access Working Capital liquidity, if and when required
  - ✓ XCo and Suppliers preserve other Finance lines, and optimise Financing costs
  - ✓ BS metrics preserved

Trade Finance – removing the wool from over our eyes

- *Is fundamentally about 'Trade' related Risk Management & access to Working Capital*
- *Is reflected in a range of Trade 'Products' and 'Solutions'*
- *Can be simple or complex, 'vanilla' or highly structured*
- *Is often dependant upon current or future rights to Goods*
- *If applied properly, can significantly enhance Risk, and Commercial terms to deliver substantial benefits*
- *Is highly relevant to both Buyers and Suppliers (and also other Stakeholders)*
- *Should be a fundamental part of every Company's financing considerations*

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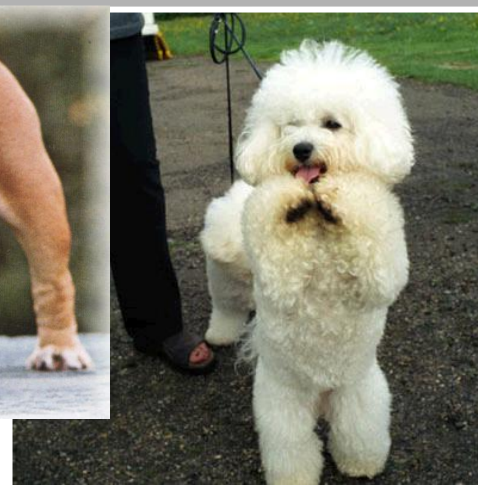
Allens Arthur Robinson

The changed role of the agent in syndicated financings – sheepdog, bulldog, poodle, or lead husky?

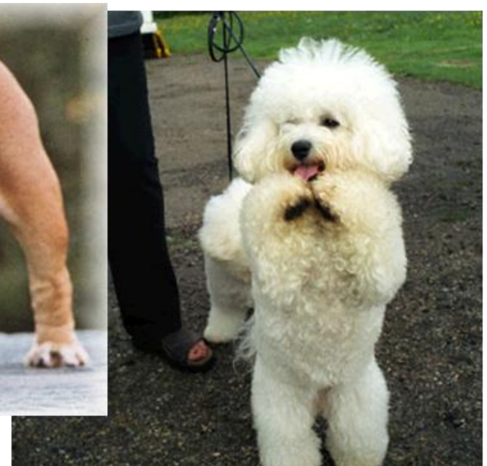


Allens Arthur Robinson

Outline

- The historical understanding
- The current experience
- Legal analysis of the Agent's role and position
- The issues
- Voting in syndicates






The historical understanding

- Agent a major relationship bank
- Agent has "skin in the game" – retains strong hold
- Agent may also be the lead arranger – natural succession
- Syndicate composed of banks with similar interests and outlooks (though they did not always agree)
- Syndicate composition fairly static
- As a consequence in documents the Agent's role was "loose-tight" – significant discretion but little responsibility, and a lot of protection

The historical practice – Agent as sheepdog or lead husky

- Agency staff closely aligned with wider bank staff – no separation
- In times of consent, waiver and enforcement, relationship and other staff involved
- Agent bank had significant exposure to protect
- Agents would see it as their role to be "proactive" – formulate, negotiate and drive through proposals
- Fees normally a fixed annual sum – recompense for extra effort in other ways
  - New arranged deal
  - Reduction in losses

The current position – the rolling maul syndicate and the brawling maul syndicate

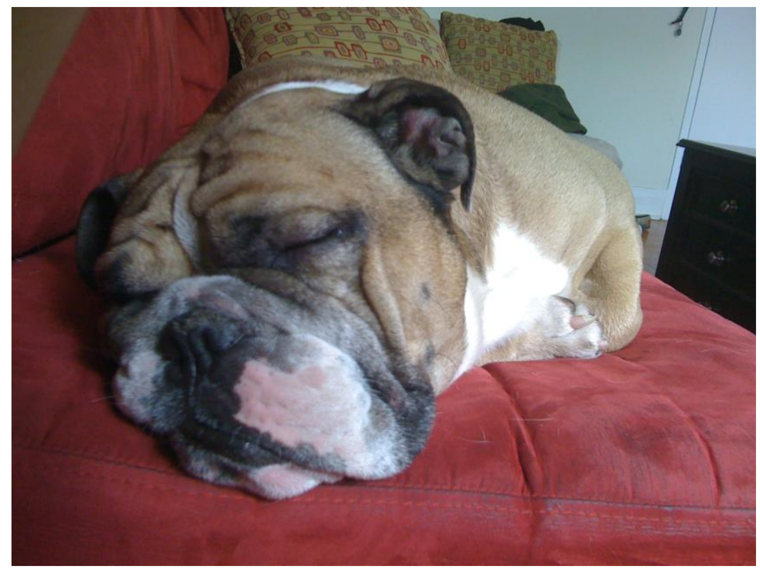
- Participations actively traded
  - Sometimes large shifting syndicates
  - Old banks sell out on distress to be replaced by funds
- Funds as participants often aggressive protectors of their position, often have own advisers
  - No relationship with borrower or others
- No community of interest or approach
  - can be different exposures eg hedge, working capital
  - can be other agendas
- Active leaking of information and proposals

The current position – the Agent

- Agent bank itself may sell down and have little exposure
- Often separation between agency and other relevant parts of bank – less involvement of other bank staff
- Fees often cover other activity but are not always charged, sometimes transfer fees a significant earner
- Agents sometimes take a more passive role

Why more passive?

- Structural separation of agency team from other bank staff
- Some suspicion by other participants of conflicts
- Concern about conflicts internally, the rise of the compliance function and risk aversion
- Less reward
  - May not have stake
  - Don’t want unpaid arranger role
- Participants sometimes have their own proposals and advisers or “bad bank” team
- Formal or informal lead group
  - sometimes undocumented



The agent's role – analysis

Introduction

Title "Agent" is unfortunate

Three propositions:

1. The Agent is an agent but not in all respects
2. The Agent should be a fiduciary but not in all respects, and probably is not one if agreement says it isn't, and doesn't behave as one
3. Any fiduciary and other duties it owes are very limited (both because of limited role and express limitations)

It would be better to give it another name like:

THE GRAND PANJANDRUM

The Agent's role – analysis

What the Agent does but <u>not</u> as agent

- Fix rates
- Calculate amounts
- Keep accounts and register of participations
- (in the APLMA doc) receive and pass on utilisation notices
- (in the APLMA doc) receive and pass on payments
- (Under APLMA practice) instruct lawyers and consultants

The Agent's role – analysis

What the Agent does <u>as agent</u>

Under the documents

- Review and bless CP documents
- Receive and pass on documents, other notices (including of default) and correspondence
- Sign transfer certificates (as agent of all other parties)
- Sign amendment and waiver docs on behalf of participants
- Give consents and approvals
- Declare a default and accelerate debt

It is a party to the facility agreement and agrees to provide agency services as principal

Is the Agent a fiduciary?

- High authority that an agent is not necessarily a fiduciary but not general view
- In any event extent and existence of duties depends on its role and is subject to contract
- Agent has little material discretion except acceleration and (in some cases) acceptance of CPs
  - In most cases subject to majority direction
- Some documents (including APLMA) say it is not (though they say it must act in 'best interests")

What would be its duties absent contractual limitations?

- Fiduciary Duties
  - Not to place itself in a position of conflict
  - Not to profit
  - Disclosure of information relevant for decision on above duties
- Other duties
  - (implied or express contractual)
    - Reasonable care and skill (maybe also equitable)
    - Good faith
    - Pass on relevant info obtained in course of agency
    - Possibly, implied duties to monitor obligors and ensure
  - (tort)
    - Reasonable care
  - (statutory duties)
    - Not to mislead or deceive

Can these duties be limited by contract?

- Contract can define role, and function, and fiduciary and other duties flow from role
- Fiduciary relationship “must accommodate itself to the terms of the contract “ (Mason J in *Hospital Products*)
- Contract can limit or remove duties (but maybe not entirely allow fiduciary to fraudulently or willfully disregard interests of principal) (see *ASIC v Citigroup, also NZI v BNZ*)
- Contract can define and limit contractual obligations and limit tort exposure (but not statutory)

What the agreement says

Duties and role

- Expressly appointed agent (except for certain tasks)
- Authorised to exercise express powers plus incidentals
- “Solely mechanical and administrative in nature”
- No duties other than expressly given
- “Not a trustee or fiduciary”
- Notify if given express notice of Default as being a Default
- Notify of payment default
- Act as instructed (except if not secured for costs and liabilities), absent instructions can act as it sees fit in best interests of Participants
- Need not breach law, fiduciary and other duties and confidence

What the agreement says

Powers and exclusions

- May delegate
- May rely on:
  - advice
  - what Obligors say
- May assume no non-payment Default
- May disclose info received as Agent
- Can act separately through agency and other divisions
  - Can treat as confidential info received through other division
- Not responsible for information, effectiveness of docs, Obligors' credit
- Liability excluded except gross negligence, willful default
- Can resign if there is a replacement

Some particular issues – conflicts of interest

- Agent bank may be a participant
- May have other facilities, hedge arrangements, mezzanine debt
- Should not prevent it voting in that capacity
- Pure view would stymie any activity
- May well prevent Agent initiating material action without instructions
- Need to have robust authorisations in facility agreement
- May need robust approach and depend on instructions
- Should, in any event, disclose interest
- One possible solution is to delegate

Some particular issues – insider trading under Australian law

- Under Corpse Act, loans to holding companies and treasury subs who on-lend are “*debentures*” and therefore “*securities*” and therefore “*Division 3 financial products”*
- s1043A(2) ban on providing material price-sensitive inside info in relation to Division 3 FP’s “able to be traded on a financial market operated in this jurisdiction”
- Is there a “*financial market*”, requires a *“facility”* (s767A)
- If participations can be so traded Agent who gives info to fund who may trade would be in breach
- Issue also arises if info relates to secured shares and fund may be buyer or may be advising buyer

Some particular issues - information and knowledge

- General law, Agent obliged to pass on info received in the course of agency (but not other info)
  - If strictly applied makes negotiation difficult
- Syndicate deemed to have info given to Agent (*Bell Group)*
- BUT syndicates leak like sieves
- Participants use info to trade

What to do about leaks? Strategies:

- Separation (see below)
- By-pass agent and set up working party, lead bank
  - BUT they can be agent for knowledge (*Bell Group*)
  - And no protection or mandate without new doc
- Use financial adviser
- Impose obligation of confidence (depends on doc)
- Alter docs to allow withholding
- Rely on possible illegality

Information barriers and separation, why have them?

- Clarifies which info should be given to the syndicate
- Commercially addresses conflict
  - <u>But NOT legally (except for confidentiality issues)</u>
- If Agent bank is a trader, assists "chinese wall" defence for insider trading (s1043F)

Some things that may be considered

- Separate entity?
  - A number of difficulties – eg credit, confidentiality, greater separation, “trustee company” attitude
- Providing for lead bank role?
  - Shifts issue sideways
- Adding to Agent protection in the document?
  - Eg allowing restriction of information
  - Strengthening ability to act in conflict
- Restricting discretion?

The “locked-in” Agent syndrome

- Agent can’t resign unless there is a replacement
- If no replacement stuck with role and issues
- LMA leveraged document deals with the “Impaired Agent” (one who is broke)

Voting issues – the changing syndicate

What happens if:

- Participants change their mind before majority formed
- Participants in majority change their mind after majority is formed but before instructed action?
- A participant transfers to a buyer with opposite views in either of the above situations?
- Need clauses binding transferees, locking in majority
- “Record date” concept, or freeze transfers?

The changing syndicate - a case study

Strategic Value Master Fund Ltd v Ideal Standard International Acquisition S.A.R.L.

- LBO
- Borrower breached ratio and assets < liabilities
- Agent on majority instructions called event of default and placed loan on demand
- Sponsor bought from 2 largest participants – now had majority
- Reversed instructions, instructed agent to waive default, revoke notice, place loan on normal maturity
- “Stuffee” minority banks sued, and lost.

Other voting issues

- Can a Participant split its vote?
  - Should it be able to do so?
- Can a Participant abstain?
- Should we always have “snooze you lose” clauses?
- What about “yank the bank”?
- Should sponsors and other borrower mates be disenfranchised?
- Should defaulting participants be disenfranchised?

FINANCING TRANSACTIONS AND THE RELENTLESS INTRUSION OF STATUTORY REGULATION

John G H Stumbles*

Part A Introduction

The impact of statute on commercial transactions is so pervasive today that it barely calls for comment. In a survey conducted in 2008, the Institute of Public Affairs noted that the average number of pages in Commonwealth legislation had increased from less than 2000 thousand pages in the 1970s to over 6000 pages in 2006.[1] The increase in the statutory regulation of financing transactions is but one example of this phenomenon. Although it would be fair to say that statute has always had some part to play in regulating financing transactions and in their documentation, the extent of statutory intervention has increased significantly over the last 40 years, and in many areas statute is now the main factor in determining the manner in which risk is allocated between a financier and a borrower.

This paper provides a brief survey of this phenomenon since the 1970's,[2] by reference to some of the main legal considerations which financiers need to address for the purposes of ensuring the enforceability of contractual rights in a financing transaction. In order to provide a context for these legislative changes and a framework for assessing their significance, there will be a brief discussion in Part B of the legal considerations arising at general law including equity. Examples of statutory intervention will be then be considered in Part C.

The historical analysis reveals a trend of increasing layers of statutory intervention. Whilst some of the interventions may have been in response to perceived gaps in the law, others may have been unnecessary. It will be argued that the law, as it stood prior to the legislative change, may have already adequately addressed part of the mischief sought to be further regulated. In some instances, the law was amended with scant attention to the existing regulatory regime. Because of the sheer bulk of the statutory changes, the survey is selective and focuses on the more significant developments.[3] The law regulating financial transactions is now a complex overlapping web of the common law, contract and statute and presents significant challenges for even the most experienced legal practitioner specialising in the area. Apart from compliance costs[4], the law also poses significant operational risks for any financier who fails in any attempt to comply in good faith with its provisions. Part D of the paper

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1 Chris Berg, 'The Growth of Australia's Regulatory State Ideology, Accountability and the Mega-regulators', Institute of Public Affairs, 2008 at 9.

2 This date has been selected to enable identification of potential claims prior to the introduction of the *Trade Practices Act 1974* (Cth) and in particular s52 of that Act enabling claims to be made in respect of conduct that is misleading or deceptive or is likely to mislead or deceive.

3 Reference will not be made to mirror provisions in the Australian State and Territory fair trading legislation. As at 2011 and notwithstanding the introduction of the *Australian Consumer Law*, the State and Territory legislation is still not identical. This paper will not address the regulation of credit card transactions nor licensing requirements and only brief reference will be made to the *Contracts Review Act 1980* (NSW).

4 In implementing the *Consumer Credit Code* in 1994, financiers incurred a one-off implementation cost of $200 million with an ongoing recurring cost of $50 million. See 'Rethinking Regulation Report of the Taskforce on Reducing Regulatory Burdens on Business' at page ii quoting from a submission of the Australian Bankers Association.

considers briefly the policy implications arising from increased statutory intervention and suggests that the law in this area needs to be simplified and rationalised.

Part B General Law risk considerations for financiers

(a) **Common law claims**

Even prior to the 1970's and leaving aside any statutory rights, a financier seeking to recover a loan still had to contend with a significant array of possible cross claims by a borrower, the effect of which, if successful, was to either reduce the borrower's liability to the financier or to relieve the borrower from that liability in its entirety. A bank seeking to recover a loan in this period may have found itself subject to a cross claim for breach of an implied term in the banker/customer contract where, for example, the bank offered a new risky product to an inexperienced customer without providing proper warning or advice as to the risks involved. More recently, these claims could also have been based on a breach of the Code of Banking Practice which is incorporated as a matter of contract into loan agreements between a bank and its customer, which for these purposes would also include a small business[5]. Alternatively, the financier may have been exposed to a cross claim in tort on the basis of fraudulent[6] or negligent advice.

In *Woods v Martins Bank Ltd*[7], for example, a young man of no business experience sued the bank for negligent advice associated with his investments in a company whose account with the bank at the relevant time was overdrawn in circumstances where the financier was pressing the company to reduce its indebtedness. The young man lost £16,000 and sued the bank for fraud and negligence. Although fraud was not established, it was found that the bank manager had been grossly negligent. After considering the advertising material and booklets produced by the bank, the court rejected the defence that the advice given by the bank manager was outside the scope of the financier's business. The court awarded damages based on negligence. However, in what has been described as a "shabby subterfuge to overcome the authorities which in 1959 appeared clearly to mean that there was no duty of care in those circumstances",[8] the Court found that there was a fiduciary relationship between the bank and the plaintiff.

In *Hedley Byrne & Co Ltd v Heller & Partners Ltd*,[9] it was held that a bank may be liable for negligent misstatement associated with credit enquiries that demonstrated reliance on the bank's skill or judgment. If the bank provided such advice without a clear disclaimer of responsibility (which was found to be effective in the instant case), it accepted a legal duty to

5 Code of Banking Practice clause 40 (definition of 'you' and 'your' when read with the definition of 'small business' defined to mean a manufacturing business having less than 100 full time people or in any other case less than 20 full time people).

6 *Deery v Peek* (1889) 14 Ap Cas 337. In practice fraud was difficult to establish because of a need to prove an actual intent to deceive or reckless indifference as to the truth or falsity of any statement.

7 [1959] 1 QB 55.

8 Meagher Gummow and Lehane's, *Equity Doctrines and Remedies* (4th ed) at [2-280]. One such authority was *Banbury v Bank of Montreal* [1918] AC 626 where a financier was found not liable for investment advice, because it was outside the scope of its business. Salmon J was forced to distinguish this case in his judgment. See *Woods v Martins Bank Ltd* [1959] 1 QB 55 70.

9 [1964] AC 465.

exercise proper care, even if it was not under any contractual or fiduciary duty to the enquirer.[10]

Defaults under foreign currency loans extended by banks largely to farmers in the second half of the 1980's presented the courts with an opportunity to explore further the application of principles relating to negligent misstatement in the context of financing transactions. In response to demands by banks for loan repayments, borrowers would often plead negligent misstatement by way of cross claim (where the bank had provided advice to the borrower in connection with the taking out of the loan).[11] To establish a claim, it was necessary for borrowers to establish evidence of forseeability and evidence of reliance or assumption of responsibility or both[12] and that the loss was caused by the breach. Some of these claims succeeded[13] whilst others failed[14].

(b) **Breach of fiduciary duty**

A financier is not within one of the traditional categories of fiduciary relationship, such as principal and agent or solicitor and client. A fiduciary relationship will only arise between a financier and a customer where the financier:

(i) has an obligation to act for or on behalf or in the interests of the customer in exercising a power or discretion which will affect the interest of the customer in a legal or practical sense;

(ii) is given a special opportunity by the customer to exercise a power which may operate to the detriment to the customer; or

(iii) acts in a representative capacity in exercising responsibilities.[15]

However, one finds in the law reports a reluctance to treat the banker/customer relationship as fiduciary in nature.[16] This attitude may be seen in *Lloyds Bank v Bundy*[17] where an old farmer

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10 See also *Box v Midland Bank Ltd* [1979] 2 Lloyd's Rep 391 on app [1981] 1 Lloyd's Rep 434. The financier was found liable for statement that obtaining of finance was a mere formality where finance rejected. Compare *Mutual Life and Citizens Assurance v Evatt* [1971] AC 793, holding that the principle in *Hedley Byrne* did not extend to negligent advice given by one whose business did not include the giving of advice and had not held himself out as an expert.

11 See, eg, *Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390. (Bank liable for investment advice given by financier manager relating to the purchase of a hotel in a small country town from another customer of the financier. Business performed poorly and customer sought and obtained relief against the financier.)

12 *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 93 ALR 271 (reversed on other grounds in *David Securities v Commonwealth Bank of Australia* (1992) 175 CLR 353). These principles have developed further in the context of expert reports and whether the author of the report is liable to third parties who relied on them. See eg *Esanda Finance Corp Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241 and *Ingot Capital Investments v Macquarie Equity Capital Markets (No 6)* (2007) 63 ACSR 1. Currently, the principles are being further tested in actions commenced by local councils against rating agencies for ratings associated with products marketed in Australia by a member of the Lehmann group of companies.

13 See eg *Foti v Banque Nationale de Paris (No 1)* (1989) 54 SASR 354.

14 See eg *Copping v ANZ McCaughan Ltd* (1997) 67 SASR 525.

15 *Hospital Products v United States Surgical Corporation* (1984) 156 CLR 41.

provided a guarantee and charge to support his son's indebtedness to the bank. Following the son's bankruptcy and the bank's attempt to enforce the guarantee and charge, the Court set them aside. Lord Denning based his judgment on both an inequality of bargaining power between the bank and Mr Bundy and undue influence. In contrast, Lord Justice Sachs based his decision on undue influence and the "confidentiality" which is an essential ingredient of the special relationship upon which undue influence is grounded. In substance Sachs LJ found that a fiduciary relationship existed. In contrast, Cairns LJ said that he had doubts as to the existence of a fiduciary duty in the case "but in the end … for the reasons given by Sir Eric Sachs … I have reached the conclusion that in the very unusual circumstances of the case there was such a duty".[18] Even today, the Courts are wary of finding fiduciary relationships in commercial dealings.[19]

(c) **Unconscionability and Undue Influence in Equity**

The equitable principles associated with relief from transactions on the basis of unconscionability have an impeccable pedigree dating back at least as far as the seminal decision in *Earl of Chesterfield v Janssen*.[20] In modern parlance, the case may be seen as an example of a debt restructuring which was set aside on the basis of unconscionability.

In *Chesterfield*, an heir borrowed money secured over an expectancy from his grandmother's estate. Variations were made to the loan contract the ultimate effect of which was that the principal sum doubled in size if the borrower failed to repay the debt on the new repayment date. The borrower failed to repay the debt on the amended repayment date with the result that the outstanding principal doubled in size. The borrower's estate (the borrower had died in the meantime) was granted relief on the basis that the loan arrangements constituted a 'catching' bargain involving an heir "against which relief always extended".

The jurisdiction is engaged "whenever one party to a transaction is at a special disadvantage in dealing with the other party because of illness, ignorance, inexperience, impaired faculties, financial need or other circumstances affect his ability to conserve his own interests and the other party unconscientiously takes advantage of the opportunity thus placed in his hands".[21] A transaction may also be set aside because of other factors such as age, sex, lack of proper explanation and lack of education.

Although these principles have been applied in a wide variety of circumstances, and not just where a financier attempted to recover a loan, they have been relied upon from time to time by

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16 In this respect, the comments of Salmon J in *Woods v Martins Bank Ltd* [1959] 1 QB 55 constitute a notable exception.

17 [1975] QB 326.

18 Ibid, 340.

19 See eg the dismissal by Eintein J of a fiduciary claim by investors in the Great Southern managed investment schemes in *Bendigo and Adelaide Bank in Bendigo and Adelaide Bank Limited v Cairncross* [2011] NSWSC 610 (22 June 2011).

20 (1751) 2 Ves Sen 125; 28 ER 82. In this case Lord Hardwicke outlined the various categories of equitable fraud of which unconscionability is one manifestation and which are still applicable today.

21 *Blomley v Ryan* (1956) 99 CLR 362 415.

borrowers in response to a demand by a financier for repayment of financial indebtedness.[22] Financiers were reminded of the extent of this equitable jurisdiction in the 1986 decision in *Commercial Bank of Australia Ltd v Amadio*,[23] where an elderly lowly educated migrant couple with poor English signed guarantees and mortgages over their home to support an overdraft facility provided by the financier to their son, a builder. At the relevant time, the son's building business was in financial difficulties. On the evidence, the parents did not fully understand the extent of the liability covered by their guarantee and mortgage. In addition, Mr and Mrs Amadio were given no opportunity to obtain independent advice in respect of their liabilities. Not surprisingly, they were relieved from the obligations under the documentation.

In addition or in the alternative, a borrower or security provider was also able to set aside its obligations on the grounds of undue influence. [24]

Part C - Statute law risk considerations for financiers

The above overview illustrates that in many cases, the general law was able to provide a remedy where financiers had acted improperly. However, even prior to the 1970's, the legislature recognised the need for at least some form of statutory regulation in relation to certain types of loans. For example, up until 1981, the provisions of the *Money Lenders and Infants Loans Act* 1941 (NSW) required moneylenders to be licensed and permitted the court to re-open loan contracts which were harsh or unconscionable.[25] However the Act did not apply to banks and only applied to a certain category of loans above a designated interest rate.

Many of the more recent statutory innovations discussed below relating specifically to financing transactions were introduced to make up for what were perceived to be deficiencies in the existing law (often with little or no analysis of the existing law) and were in response to particular problems or abuses experienced by individual borrowers. However, other statutory changes were more generic in nature and applied to commercial transactions generally, including financing transactions, even though financing transactions may have been already subject to a specific existing regulatory regime. As a consequence, financing transactions became subject to ever increasing layers of statutory regulation, much of which was directed at the same type of conduct.

(a) **Misleading and Deceptive Conduct (section 12 DA of the *Australian Securities and Investments Commission Act 2001*)**

Section 12DA of the *Australian Securities and Investments Commission Act 2001* ('*ASIC Act*') states that a 'person must not, in trade or commerce, engage in conduct in relation to financial services that it misleading or deceptive or is likely to mislead or deceive'. This

[22] See for example *Harrison v National Bank of Australasia Limited* (1928) 23 Tax LR 1.

[23] (1983) 151 CLR 447. The New Zealand case of *Archer v Cutler* [1980] 1 NZLR 386 in some respects anticipated the reasoning in *Amadio*. Compare the position in England where reliance on undue influence is the norm.

[24] See eg *Bank of NSW v Rogers* (1941) 65 CLR 42. In England, the related equitable doctrine permitting transactions to be set aside on the basis of undue influence is preferred. See eg *National Westminster Bank plc v Morgan* [1985] AC 685.

[25] *Money Lenders and Infants Loans Act 1941* (NSW), s30.

provision is the mirror provision of section 18 of the *Australian Consumer Law ('ACL')* which relates to conduct other than financial services.[26] Each of these provisions is derived from section 52 of the *Trade Practices Act 1974 (Cth).* However, in their latest manifestation they have been expanded by deleting the reference to 'corporation' and inserting the word 'person' in its place.

The Explanatory Memorandum to the *Trade Practices Bill 1974* (Cth) merely described the provision[27] and lacked any real analysis of the deficiencies in the then existing general law as a justification for introduction of the new provision. Indeed, as seen above, the general law continues to have relevance. It was simply asserted that:

The untrained consumer is no match for the businessman who attempts to persuade the consumer to buy goods or services on terms and conditions suitable to the vendor. The consumer needs protection by the law and the Bill will provide such protection'.[28]

At the time, there was some appreciation of the impact of the new law on existing State legislation[29] but no appreciation of its ultimate reach.

A breach of section 12DA of the *ASIC Act* occurs where there is misleading or deceptive conduct or conduct that is likely to mislead or deceive where the recipient of such conduct relies on such representation and as a consequence suffers loss.[30] The conduct alleged to be misleading or deceptive need not be the sole *cause* of the loss but must be a *cause* as determined by the court. Although section 12DA does not give rise to a general duty of disclosure, in some instances silence may, on the particular facts, constitute misleading or deceptive conduct.[31] In determining the second element namely reliance, the court may take into account the skill of the party making the claim to test whether reliance had in fact occurred.[32] In financing transactions, the issue usually arises where the financier's representative proffers deficient advice prior to the borrower entering into the transaction. In many instances, this claim is pleaded in addition or as an alternative to a claim for negligent misstatement to address conduct which may have been misleading or deceptive but not negligent.

In *Westpac Banking Corporation v Spice*,[33] a bank manager advised a Mr Spice in relation to a foreign currency loan that "there is no catch" and that the taking out of the loan "… is very much the thing to do". Although the manager advised Mr Spice that "the exchange risk is

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26 *Competition and Consumer Act 2010* (Cth) s131A.

27 Explanatory Memorandum, Trade Practices Bill 1974 (Cth) paragraph 60.

28 Commonwealth, *Parliamentary Debates*, House of Representatives, 16 July 1974, 226 (Kep Enderby, Minister for Manufacturing Industries).

29 Ibid 573 (Robert Ellicott QC).

30 Requirements pertaining to *Trade Practices Act 1974* (Cth*)* s52 as outlined in *Gould v Vaggelas* (1985) 157 CLR 215. These principles are equally applicable in construing section 12DA of the *ASIC Act* and the mirror provisions in s18 of the *ACL*.

31 *Henjo Investments Pty Ltd v Collins Marrickville Pty Ltd (No 1)* (1988) 39 FCR 546 commenting on the equivalent provision in the *Trade Practices Act 1974* (Cth).

32 *Lam v Austotel Investments Australia Pty Ltd* [1990] ATPR 50, 866.

33 [1990] ATPR 51386.

yours", there was no further explanation or disclosure as to the particular type of risk or its magnitude. The Full Federal Court confirmed the findings of the trial judge that the conduct of the financier induced Mr Spice to enter into the foreign currency loan and consequently suffer loss.[34] The current edition of the leading Australian text which considers these provisions[35] identifies 9 reported cases where financiers and financial advisers have been found liable for misleading or deceptive conduct, including 2 further foreign currency loan cases where the financier was found to have been liable.[36]

(b) **Unconscionability under statute - (sections 12CB and 12CC of the *ASIC Act*)[37]**

Section 12CB of the ASIC Act states that a 'person must not, in trade or commerce, in connection with the supply or possible supply of financial services to a person, engage in conduct that is, in all the circumstances, unconscionable'.

The provision was originally enacted in 1986 as section 51AB of the *Trade Practices Act* 1974 (Cth) following a recommendation of the Swanson Committee in 1976. According to the Explanatory Memorandum accompanying the amendment, its aim was to provide a 'greater ability to deal with the general disparity of bargaining power between buyers and sellers.'[38] The provision "introduce[d], in effect, a general duty to trade fairly in relation to consumers by establishing a norm of conduct prohibiting unconscionable conduct in connection with the supply of goods or services".[39] The provision only applied to goods and services of a kind ordinarily acquired for personal, domestic or household use or consumption and which were not goods supplied for the purposes of resupply or for the purposes of transforming them in trade or commerce.[40] Again, it is notable that the Explanatory Memorandum contains little analysis of the existing law or its deficiencies as a justification for the changes.

For the first time, the legislature introduced a series of factors to be weighed by the court in determining whether the provision had been breached.[41] The reference to the strength of the

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34 Compare the decision in *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 93 ALR 271 where the full court of the Federal Court upheld the decision at trial that there had been no reliance by the borrower on any statement made by the financier officer. In that case, the court held that there was nothing inherently dangerous about a foreign borrowing "merely because opportunities for profit, or loss may exist" [at 34].

35 *Miller's Australian Competition and Consumer Law* annotated (33rd edition 2011) (Thomson Reuters) at page 1579

36 *Chiarabaglio v Westpac Banking Corporation* (1989) ATPR 40-971 and *Commonwealth Bank of Australia v Mehta* (1991) 23 NSWLR 84. *Compare Kullack v ANZ Banking Corporation Ltd* (1988) ATPR 40-853. (Bank found not found to have engaged in misleading or deceptive conduct).

37 The mirror provisions are found in ss 21 and 22 of the *ACL*.

38 Explanatory Memorandum, *Trade Practices Revision Bill 1986* (Cth) paragraph 79.

39 *Miller* above, footnote 35 at 1660.

40 *Trade Practices Act* 1974 (Cth) s51AB(5) and (6).

41 The factors included:

- the relative strengths of the bargaining positions of the parties;
- whether the consumer is required to comply with conditions not reasonably necessary for the protection of the legitimate interests of the supplier;
- the ability of the consumer to understand the documentation;
- whether any undue influence had been exercised or unfair tactics used;

bargaining positions of the parties[42] is reminiscent of the reference to Lord Denning's allusion to inequality of bargaining power in *Lloyds Bank v Bundy*.[43] The references to the inability of the consumer to understand the documentation, to the exercise of undue influence or pressure and to unfair tactics raise factors similar to those which an equity court considers in deciding whether or not to set aside a transaction on the basis of undue influence or unconscionability, as illustrated by the *Amadio* decision. However, the statutory provision introduced two innovations. First, the provision applied without the court having to find a recognised category of disadvantage. Secondly, and in contrast to the position in equity, the court was now also able to consider an additional range of factors.[44]

In the period between 1990 and 2010, there were three further significant developments. First, the norm of unconscionability was widened to incorporate "conduct that is unconscionable within the meaning of the unwritten law …".[45] Secondly, the specific statutory norms of unconscionable conduct were extended to business transactions involving unlisted corporations.[46] For these purposes, the Court was directed to consider a set of factors similar but not identical to those applicable when determining whether dealings with individuals were unconscionable, including any industry code which for these purposes would include the Code of Banking Practice in so far as it applied to small business. Thirdly, the responsibility for administering the unconscionability provisions of the statute, in so far as they related to financial products and financial services was vested in the Australian Securities and Investments Commission.[47]

Of these changes, the extension of statutory unconscionability to business transactions was perhaps the most significant development. In relation to financial products and services, this provision is currently found in section 12CC of the *ASIC Act*. Financiers and their advisers tend to confine considerations concerning unconscionability and its statutory manifestations to dealings with individuals; they are apt to overlook the significance of the extension of these principles to unlisted businesses. The matters which a court is asked to consider in relation to a claim on the basis of unconscionability when made by an individual, are also relevant in the context of a an claim of unconscionability in a business transaction.

Some of these matters (for example, scope for negotiation, the right to unilateral variation and good faith) are also factors for determining whether the statutory provisions discussed below relating to unfair contract terms are engaged. They constitute a good example of overlapping regulation.

- consideration for equivalent or identical services.

42 See now *ASIC Act* s 12CB (1)(a) and 12CC (1)(a).

43 [1975] 1QB 326.

44 See now *ASIC Act* s 12CB (2)(a) s12CC (2)(b) and s 12CC (3)(b).

45 *Trade Practices Act* 1974 (Cth) s51AA. The applicable provision is now to be found in section 20(1) of the *ACL* and s12CA of the *ASIC Act*.

46 *Trade Practices Act* 1974 (Cth) s51AC. The provision is now to be found in s22 of the *ACL* and s12CC of the *ASIC Act*.

47 Pursuant to s131A of the *Competition and Consumer Act* 2010 (Cth), the *ACL* contained in schedule 2 of that Act does not apply to "the supply, or possible supply, of services that are financial services, or of financial products".

Examples where such claims have been made include the following:

- the calling up of performance bonds and letters of credit;[48]
- the demand for the provision of security where a company gets into financial difficulties;[49]
- margin calls under margin loans;[50]
- ambiguous loan approvals subject to valuation where the loan amount is later reduced due to an unsatisfactory valuation;[51]

To date, most of the claims based on unconscionability have been unsuccessful, but financiers are likely to see more of these claims in the future.

Further important changes in the law relating to statutory unconscionability will be made by the *Competition and Consumer Legislation Bill 2011* which, at the time of writing, is before the Commonwealth Parliament. Section 12CB and section 12CC of the *ASIC Act* will be repealed. New section 12CB of the *ASIC Act* will apply the same unconscionabilty test for both consumer transactions and to transactions with entities which are not listed public companies[52]. For the purpose of determining whether conduct is unconscionable, new section 12CC lists a set of common factors which the Court is required to consider in relation to dealings involving both consumers and unlisted public companies. More significantly, a court will now also be able to consider the actual terms of the contract and the 'manner in which and the extent to which the contract is carried out'.[53] Accordingly, even though the unfair contract terms provisions discussed below apply only to consumer contracts, it is conceivable that in the future an unlisted public company may be able to challenge a term in a non-consumer contract on the basis of unconscionability.

(c) **Unfair Terms in Consumer Contracts**

With effect from 1 July 2010, a term of a standard form consumer contract relating to a financial service or a financial product is void if it is unfair where the contract is a standard form contract.

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48 *Clough Engineering Ltd v Oil & Natural Gas Corporation Ltd* [2008] FCA 191; *Clough Engineering Ltd v Oil & Natural Gas Corporation Ltd [No 2]* [2007] FCA 927 and *Clough Engineering Ltd v Oil & Natural Gas Corporation Ltd* [2007] FCA 881.

49 *Bell Corporation Ltd (in liq) v Westpac Banking Corporation* [2008] WASC 239.

50 *Imobilari Pty Ltd v Opes Prime Stockbroking Ltd* [2008] FCA 1920; *Storm Financial v CBA* [2008] FCA 191.

51 *Ines v CBA* (2008) FCA 1608.

52 The relevant definition is found in *Income Tax Assessment Act 1997* s 995-1 which defines a listed public company as 'a company shares in which…are listed for quotation in the official list of an approved stock exchange'. However, a company is not a listed public company if, amongst other matters, a person controls or is able to control or up to 20 persons between them control, 75% of the voting power of the company.

53 S 12CB(4)(c) of the *ASIC Act* and s 21(4)(c) of the *ACL* after amendment by the *Competition and Consumer Legislation Amendment Bill 2011*. Similar amendments will also be made to the mirror provisions in the *ACL*.

For these purposes, a consumer contract exists when the supply of the product or service is "wholly or predominantly … for personal, domestic or household use or consumption". In contrast to the other provisions applicable to consumers, where the test for consumers is objective[54], the test refers to the subjective intention of the person acquiring the product or service[55]. The provisions do not apply to loans to corporations and may not apply to loans to individuals to fund a personal investment.

A contract is presumed to be standard form unless the other party to the proceedings proves to the contrary[56]. For these purposes, the court is to consider such matters as it thinks fit. As was said in *Director of Consumer Affairs Victoria v Craig Langley Pty Ltd & Matrix Pilates and Yoga Pty Ltd (Civil Claims)* in relation to similar provisions in Part 2B of the *Fair Trading Act 1999* (Vic):

> *"[T]erms of a consumer contract which have been the subject of genuine negotiation should not be lightly declared unfair. This legislation is designed to protect consumers from unfair contracts, not to allow a party to contract who has genuinely reflected on its terms and negotiated them, to be released from a contract term from which he or she later wishes to resile."*[57]

The unfair contract terms provisions are inapplicable to the terms referable to the main subject matter of the contract, the upfront price or any terms expressly permitted by Commonwealth, State or Territory law[58].

The main subject matter of the contract refers to both terms relating to the subject matter (material conditions) and such terms which give effect to the main subject matter terms and would include delivery or payment conditions (that is, all terms ancillary to the supply or grant of the main subject matter of the contract). The upfront price refers to a price payable which was disclosed before the contract was entered into. For financial products and financial services, the upfront price includes the principal amount borrowed together with interest payable. The upfront price would also include fees disclosed at the time of contracting but not include contingent fees such as default fees.[59]

All other contractual terms, except for those expressly permitted by Commonwealth, State and Territory law, are subject to the test of unfairness. For these purposes the court is directed to consider the following factors:

- *Significant Imbalance* - that is whether a term of the consumer contract causes a significant imbalance in the parties' rights and obligations *under* the contract.

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54 *ASIC Act* s12BC.

55 *ASIC Act* s12BF(3).

56 *ASIC Act* s12BK.

57 [2008] VCAT 482 at 66 per Harbison J.

58 *ASIC Act* s12BI.

59 *ASIC Act* s12BI(2). However, an upfront price could include future payments or a series of future payments, provided such payments are disclosed in a way that is transparent, before the contract was entered into.

- *Whether reasonably necessary* **-** that is whether a term is reasonably necessary to reflect what was freely negotiated between the contracting parties. The party advantaged by the term must provide evidence to the court to demonstrate why it is necessary for the contract to include the term.

- *Detriment* -whether a term would cause detriment to a party if it were to be applied or relied upon[60].

The court must also consider:

(a) the extent to which the term is transparent; and

(b) the contract as a whole.[61]

A term is transparent if it is:

(a) expressed in reasonably plain language;

(b) legible;

(c) presented clearly; and

(d) readily available to any party affected by the term.

Section 12BH of the *ASIC Act* contains illustrations of unfair terms[62]. The provisions tend to be classed into 3 categories: anti-unilateral provisions without relevant disclosure and transparency to the consumer, anti-assignment provisions where the rights of the consumer are adversely affected and anti-enforcement provisions whereby businesses try to restrict the enforcement measures of the consumers. Some of these factors (for example, the bargaining power of the parties and whether or not the terms of the contract were negotiable) overlap with the matters which a court may consider when determining whether a party has engaged in statutory unconscionability. The impetus is on equalising the bargaining power between the parties.

Although intended to operate in relation to consumer contracts generally, such as standard form gym contracts, the provisions have added another layer of compliance and complexity for banking and financial institutions. Similar legislation has been in force for some years in Victoria and England[63] and case law in those jurisdictions[64] will assist in construing the new

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60 *ASIC Act* s12BG(1).

61 *ASIC Act* s12BG(2)(b), s12BG(2)(c) and s12BG(3).

62 Examples include: terms permitting one party to avoid or limit performance; unilateral clauses regulating termination, variation and the contractual renewal; unilateral clauses limiting liability or clauses imposing an evidential burden on a party (for example a clause in an agreement stating that a certificate from a financier is prima facie evidence of the amount owing by the borrower). Penal clauses are also captured.

63 For England see the *Unfair Terms in Consumer Contracts Regulations 1999* (UK); for Victoria see Part 2B of the *Fair Trading Act 1999* (Vic).

64 For England, see *Director-General of Fair Trading v First National Bank plc* [2002] 1 AC 481;*The Office of Fair Trading v Foxtons* [2009] EWHC1681; for Victoria, see *Director of Consumer Affairs Victoria v Craig Langley Pty Ltd & Matrix Pilates and Yoga Pty Ltd* [2008] VCAT 482.

Commonwealth provisions. When combined with the provisions of the *National Consumer Credit Protection Act 2009* (Cth) and *National Credit Code*, which do regulate the main subject matter of the contract and its enforcement (as to which, see further below), significant parts of financing contracts relating to consumer loans are now regulated by statute and very little is left unregulated.

In the Explanatory Memorandum accompanying the Bill[65] which originally introduced the unfair contracts terms provisions into the *Trade Practices Act 1974* (Cth), it was stated that there was ‘limited evidence’[66] that unfair contract terms were causing detriment to consumers. It appears that the more significant driver for the introduction of these provisions was to render national law consistent with the unfair contracts provisions in Victoria and to avoid differences in consumer legislation throughout Australia.

(d) **Responsible Lending**

The collapse of share prices following the Global Financial Crisis occasioned significant social and financial difficulties for individuals who had entered into margin lending facilities through investment advisers such as Storm Finance Limited. It was argued that such facilities were regulated inadequately under Australian law[67]. The *Green Paper on Consumer Credit and Financial Services Reform* identified the absence of specific regulation of margin lending as a significant gap in the regulation in Australia of financial services.[68] The gaps included inadequate pre-contractual disclosures, absence of any licensing requirement, inconsistent application of Chapter 7 of the *Corporations Act* and the absence of any requirements to give notification of margin calls.[69] As a matter of contract, clause 25.1 of the Code of Banking Practice already required banks to ‘exercise the care and skill of a diligent and prudent banker in selecting and applying [the bank’s] credit assessment methods and in forming [its] opinion on the [borrower’s] ability to repay it’. However, the Code did not apply to non-bank financial institutions.

Following the passing of the *Corporations Legislation Amendment (Financial Services Modernisation) Act 2009*[70], a margin lending facility is now included in the definition of financial product under section 764A(1)(l) of the *Corporations Act* and as a consequence is regulated by Chapter 7 of that Act. These provisions do not apply to margin lending

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65 *Trade Practices Amendment (Australia Consumer Law) Bill No2 2010* (Cth).

66 Ibid, 110.

67 Many retirees entered into such transactions without necessarily appreciating the implications. Many borrowers were unable to meet margin calls and in many cases lost their homes.

68 The current litigation instituted by the Australian Securities and Investments Commission against Storm Finance Limited and associated financiers will test this conclusion. According to the ASIC website (accessed July 7 2011), the action against the financiers is based upon breach of contract (presumably, amongst other matters, on the basis of a breach of the prudent banker obligation in clause 25.1 of the Code of Banking Practice), unconscionable conduct and liability as a linked credit provider under s73 of the *Trade Practices Act 1974* (Cth). Relief is also being sought on grounds that the arrangements between the borrowers, the financiers and Storm Finance Limited constituted an unregistered managed investment scheme.

69 Explanatory Memorandum, *Corporations Legislation Amendment (Financial Services Modernisation) Bill* 2009 *(Cth)* 15.

70 Act No 108 of 2009.

facilities[71] provided to individuals in amounts equal to or greater than $500,000.[72] For these purposes, a margin lending facility may be either a standard margin lending facility (where the securities are mortgaged or charged to the financier)[73] or a non standard margin lending facility (where the securities are transferred absolutely to the financier).[74] The provisions applied to some lenders from July 2010 and applied to all lenders from January 1 2011.

If a financier wishes to provide a margin lending facility to a retail client or increase that facility, section 985E of the *Corporations Act* triggers two obligations. First, prior to providing the facility the financier must:

(a) make reasonable inquiries as to the retail client's financial situation;[75]and

(b) take reasonable steps to verify the retail client's financial situation.

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71 By way of exception, the provisions do not apply to limited recourse margin lending facilities. See *Corporations Regulations* 7.8.08B.

72 That is the provisions only apply in dealings with 'retail clients'. See *Corporations Act* s761G(7)(a) when read with *Corporations Act* s761G(10) and Regulation 7.1.19 of the *Corporations Regulations*. A borrower will not subsequently become a retail client if its loan amount falls below $500,000. See *Corporations Regulations* 7.1.27.

73 *Corporations Act* ss761EA(2)(a)-(e) and 761EA(4). A standard margin lending facility has the following elements:

(a) the provision of credit to a natural person;

(b) provision of credit for the purpose either of the acquisition of a financial product (for example a share or a unit in a managed investment scheme) or to refinance a prior acquisition of such a product;

(c) the credit is secured over property consisting of marketable securities; and

(d) the facility is subject to a term requiring compliance with a loan to value ratio computed by reference to the amount of the debt owing by the client and the value of the secured property in circumstances where upon non compliance with the LVR ratio the borrower (the client) or the provider become required or entitled respectively to initiate action.

74 *Corporations Act* section 761EA(5). The Act defines a non standard margin facility to include the following elements:

(a) the *transfer* by a natural person of marketable securities to the provider of the facility;

(b) the transfer by the provider of the facility of property to the client;

(c) the transferred property is to be applied wholly or partly to acquire a financial product;

(d) the vesting in the client of a right to receive in the future marketable securities equivalent but not identical to the securities originally transferred by the client to the provider; and

(e) the incorporation as a term of the facility of a loan to value ratio computed by reference to the value of any property transferred by the provider to the client, and any other amount owing by the client to the provider and the value of the securities originally transferred by the client to the provider, non-compliance with which requires the client to take action or the provider being entitled to take action.[emphasis added]

75 Regulation 7.8.09 of the *Corporations Regulations* imposes the following additional inquiries:

(a) whether the client has taken out a loan to fund the secured property or transferred securities contributed by the client for establishing the margin lending facility;

(b) if an existing loan has been made to fund the secured property or transferred securities whether that loan extends to the client's primary residential property;

(c) if there is a guarantor reasonable inquiries as to whether the guarantor has been warned of the risks associated with the provision of a guarantee;

(d) reasonable inquiries as to the amount of any other debt incurred by the client;

(e) any other matter specified by ASIC in a legislative instrument.

Secondly, the financier must assess "whether the margin lending facility will be unsuitable for the retail client if the facility is issued or the limit is increased".[76] A facility is regarded as unsuitable if the retail client:

(i) would be unable to comply with the retail client's financial obligations under the terms of the facility; or

(ii) could only comply with substantial hardship.

In order to determine suitability, a financier is required to make wide ranging inquiries with respect to the potential borrower's financial circumstances. The complexity of the decision is increased by the need also to take into account significant movements in markets and the consequential operation of any loan to value ratio. A financier is required to form a positive opinion that it is unlikely either of the above consequences will occur. A conservative loan to value ratio will assist a financier in reaching this conclusion.

The provisions prompt certain questions. What other factors go into the determination of likelihood in these circumstances? Is the enquiry at large or may it be confined just to the personal circumstances of the retail client? To what extent must the financier take into account external macro-economic factors beyond the control of the borrower? How far ahead is the financier meant to look? The Australian Securities and Investments Commission ('ASIC') has indicated that it will not issue any guidance notes as to the nature of reasonable inquiries which are to be made in the context of margin lending facilities. However, ASIC has issued guidance notes for the mirror responsible lending provisions in relation to consumer loans subject to the *National Consumer Protection Act 2009* (Cth) which will be of assistance in applying the same requirement for margin loans.[77]

A financier would breach the provisions if it:

- provides or increases the limit of a margin lending facility without making an assessment[78];
- fails to assess a margin lending facility is unsuitable[79];
- issues or increases the limit of a margin lending facility if it forms a view that margin lending is unsuitable for the client,

(e) **Consumer Credit legislation**

Any survey addressing the increasing trend of statutory intervention into financial transactions would be incomplete if reference were not made to consumer credit regulation. Historically, the money lending legislation of the States and Territories permitted the court to open unjust

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76 *Corporations Act* s985F.

77 Compare the extensive "scalable" inquiry requirements outlined in ASIC Guidance Note No. 209 (March 2011) in relation to consumer lending.

78 *Corporations Act* s985E(1).

79 S985H(1).

loan contracts.[80] In the 1980's[81], each State and Territory of Australia enacted new legislation regulating consumer credit, the current version of which is found in the *National Consumer Credit Protection Act 2009* (Cth) and the *National Credit Code* which is schedule 1 to that Act. The *National Credit Code* applies to credit contracts with natural persons or strata corporations for personal, domestic or household purposes.[82] It also applies to credit contracts for the purchase of investment properties or for their renovation or improvement.[83] However, the Code does not apply to margin loans.[84] The statutory intrusion into regulated credit contract is now all pervasive. Some key aspects are summarised below.

(i) changes to credit contracts on the basis of hardship and unjust transactions

Section 72 of the *National Credit Code* enables a debtor to request an alteration to their credit contract where the debtor "is unable reasonably, because of illness, unemployment or other reasonable cause, to meet the debtor's obligations under a credit contract …"[85] and where the debtor would otherwise be able to discharge that obligation if the contract were changed in the manner requested. This provision does not apply if the amount of credit exceeds $500,000. If the credit provider does not make a change following the debtor's application so to do, the debtor may apply to the court which on hearing the applications from the respective parties, "may, if it thinks it appropriate … stay any enforcement proceedings under the credit contract and make such other orders as it thinks fit …".[86]

(ii) *Reopening Unjust Transactions*

Section 76(1) of the *National Credit Code* enables the court, on application of a debtor, mortgagor or guarantor, to reopen a credit contract if the Court concludes that the contract was 'unjust' as at the time of its creation. Similar wording may be found in the *Contracts Review Act 1980* (NSW). Before forming a view that the contract is unjust, the court is required to consider a list of factors which is similar but not identical to those which a court is directed to consider for the purposes of determining whether conduct is unconscionable or whether a contract contains an unjust contractual term.[87]

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80 See eg s30 of the *Money-Lenders and Infants Loans Act 1941* (NSW).

81 See eg *Credit Act 1984* (NSW).

82 National Credit Code s5(1).

83 Ibid s5(1)(b)(ii).

84 Ibid s6(12).

85 Ibid, s72(1).

86 Ibid, s74.(2).

87 *National Credit Code* s 76(2). The list is similar but not identical to the list of factors which a court may consider under s12BH, s12CB and s12CC of the *ASIC Act* when determining whether a term of a contract is unfair or whether conduct is unconscionable. However, the list in the *National Credit Code* contains significant differences. For example, s76(2)(l) enables the court to consider whether or not at the time of entering into the relevant contract, "the credit provider knew, or could have ascertained by reasonable enquiry at the time that the debtor could not pay in accordance with this terms or not without substantial hardship". The latter provision appears to overlap with the responsible lending provisions in the *National Consumer Credit Protection Act 2009* (Cth*).*

(iii) *Unconscionable interest and other charges*

By separate provision, the court is also authorised to review and make orders in respect of any interest charge which it perceives to be unconscionable. In determining unconscionability for these purposes, the court considers whether the credit fee or charge "is equal to the credit provider's reasonable costs of administering an application for credit and the administrative cost of providing credit or is equal to the credit provider's average reasonable costs of those things in respect of that class of contract".[88] In this respect, the provision goes beyond the protection given by the unfair contract terms provisions where an interest is part of the main subject matter and not susceptible to review.[89]

(iv) *Responsible lending*

In relation to credit contracts subject to the *National Credit Code*, the *National Consumer Credit Protection Act 2009* (Cth) also imposes responsible lending obligations on credit providers, credit assisters such as investment advisers and brokers as well as lessors. These provisions applied to some institutions with effect from July 1 2010; they applied to all other financial institutions, including authorised deposit taking institutions, from January 1 2011. The substance of the provisions are largely the same as those applicable to lenders providing margin loans to retail clients regulated by the *Corporations Act*.

First, a credit provider regulated by the *National Consumer Credit Protection Act 2003* (Cth) is required to make reasonable enquiries concerning the consumer's objectives and requirements.

Secondly, the credit provider must ascertain the financial circumstances of the proposed borrower. In particular, enquiries are to be made as to the borrower's ability to meet all repayments and other liabilities under the proposed borrowing and whether or not these can all be met from income or other assets of the borrower or consumer.

Thirdly, the credit provider must verify the consumer's financial circumstances by, amongst other things, undertaking the enquiries ordinarily taken by a prudent lender in these circumstances. For these purposes, the lender should obtain information from other sources such as accountants.

Finally, the credit provider must determine whether the proposed contract is unsuitable. Relevantly, if it is likely that the consumer will be unable to repay the proposed loan as at its repayment date or will only be able do so with substantial hardship, then the loan will be regarded as being unsuitable. Substantial hardship is presumed to occur if the borrower is only able to meet the obligation by selling his

88 Ibid, s78(3).

89 See *ASIC Act*, s12BL.

principal place of residence.[90] Otherwise, the matter is left for resolution by the general law and is likely to be given a wide interpretation.[91]

In addition, unsuitability would also be established if the proposed loan contract does not meet the consumer's requirements or objectives. The latter requirement is not contained in the provisions in the *Corporations Act* regulating margin lending. However, its absence may not be significant in practice given the nature of the enquiries which a prudent financier would ordinarily make in any event in deciding whether or not to provide that type of facility to a borrower. ASIC has published guidelines indicating the nature of enquiries which are to be made by credit providers regulated by the *National Consumer Credit Protection Act 2009* (Cth) and notes that such enquiries are scalable, that is, adjustable having regard to the personal circumstances of the particular borrower.[92]

The responsible lending provisions are not uniquely Australian. Statutory provisions in England and the United States also impose obligations on lenders to assess the borrower's ability to pay.[93]

(iv) Recent and Proposed Regulatory Changes for Consumer Loans

Some commentators and politicians are of the view that the current statutory provisions are still inadequate. For any loans secured over residential property entered into after July 1 2011, credit providers are now prohibited from charging a credit fee or charge such as a break fee or a discharge fee[94]. Why, it may be asked, were the unfair contracts term provisions inadequate in addressing this issue? As with the other changes discussed in this paper, there appears to have been little analysis as to why the existing statutory provisions failed to regulate this conduct adequately.

Finally, reference should also be made to the amendments contained in the *Consumer Credit Protection Amendment (Fees) Bill 2011* (Cth). As currently drafted, this Bill will require that credit providers must only charge a reasonable credit fee or charge[95]. If this provision is breached, ASIC may apply to the Court to annul or vary the fee. There is also a consequential amendment to the *Banking Act 1959* (Cth) which prohibits an authorised deposit taking institution having a market share of more than 10 % from imposing an early termination fee for any loan agreement or mortgage contract entered into after the commencement of the

90 *National Consumer Credit Protection Act 1999 (Cth)* ss118(3), 119(3), 131(3), 141(3), 142(3), 146(3).

91 Compare cases on hardship under the Uniform Credit Code. See eg *Permanent Custodians Ltd v Upton* [2007] NSWSC 223 at [155], [156].

92 See Credit licensing: Responsible lending conduct, ASIC Regulatory Guide 209 (March 2011).

93 *Consumer Credit Act* 1974 (UK), section 25(2B); *Consumer Credit Code Act* 1974 (UK), s55B; *FSA MCOB* 11.3.1; 11.3.2R; *Truth in Lending Act* 1968 USA, s129B including amendments made by the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010, s1411.

94 *National Consumer Credit Protection Amendment Regulations 2011 (No2)* (Cth) and *National Consumer Credit Protection Amendment Regulations 2011 (No3)* (Cth).

95 The change will be made by the insertion of a new s30B into the *National Credit Code.*

section.[96] Again, in what respect is the current legislation deficient in regulating excessive credit fees or charges? On what basis will the criterion of 'reasonableness' be assessed? Will it require an inquiry into a financier's own funding arrangements? How will the cost of those funding arrangements be applied to a specific loan agreement? Anyone who has attempted to enforce an increased costs clause in a loan agreement will appreciate the practical limitations in administering the proposed provisions.

Part D Assessment

A financier considering providing a loan facility to a corporate or individual borrower is now subject to a vast array of potential risks prior to the execution of the loan contract and during its administration and enforcement. These risks are associated with the potential application of the common law principles and the potential application of the statutory provisions relating to misleading or deceptive conduct and unconscionability. If the borrower is an individual, additional risks may arise because of the potential application of unfair contracts terms legislation and responsible lending obligations. If the facility is a consumer loan, the *National Consumer Credit Protection Act 1999* (Cth) imposes yet another layer of risk. When dealing with an individual potential borrower, a financier's freedom to require certain terms to be inserted into a loan contract is now significantly constrained. Many of the statutory changes outlined above were made without any serious consideration having been given to the impact of this change on the existing law and the extent to which the existing law already dealt adequately with the problem sought to be further regulated. The result is a complex cumulative matrix of overlapping statutory provisions.

In December 2005, the Business Council of Australia[97] noted that documentation totalling some 227 pages was required before a customer was able to open a cheque account with an overdraft limit with an accompanying home loan, approximately 5 times the amount of documentation required in 1985. Some recognition that statutory provisions requiring such prolix documentation are not achieving their purpose may be seen in yet another amendment to the *National Consumer Credit Protection Act 1999* (Cth) to be made by the *National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Bill 2011* (Cth) requiring financiers of home loans to make available by website and on request a Key Facts Sheet.

In contrast to New Zealand, Australian policy makers appear to have little appreciation of the compliance costs[98] associated with increased statutory regulation. of financing transactions. As the Task Force On Reducing Regulatory Burdens on Business wrote in 2006:

> *"Regulation has come to be seen as a panacea for many of society's ills and as a means of protecting people from inherent risks of daily life. Any adverse event - especially where it involves loss of life, possessions immunity or money - is laid at the government's door for a*

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96 The Bill will insert new s9AF into the *Banking Act 1959* (Cth). Compliance with these provision will also be made a condition of the authority of held by the ADI.

97 Business Council of Australia, submission to the Task Force on Reducing the Regulatory Burden on Business.

98 In an address to the Israel Chamber of Commerce on July 5 2011, Sir Ralph Norris, CEO of the Commonwealth Bank of Australia, stated that the new banking regulations were costing the CBA $100 million a year 'with the financial sector as a whole facing a $500 million bill'. Quoted in Mark Ludlow, 'Norris Warns About Regulation', *The Australian Financial Review* (Sydney), July 6 2011.

regulatory fix. The pressure on government to 'do something' is heightened by intense, if short lived media attention … in responding to such pressures, governments themselves are often attracted to regulatory solutions, both as a tangible demonstration of government concern and because the costs are typically 'off budget' diffuse and hard to measure …

In this climate, a 'regulate first, ask questions later' culture appears to have developed. Even where regulatory action is clearly justified, options and design principle which could lessen compliance costs or side-effects appear to be given little consideration."[99]

In relation to the regulation of financing transactions, these comments apply equally today if not more so. It is not suggested that all statutory controls should be removed. Indeed, there are many instances where regulation is justified and reasonable of which the regulation of margin loans is a good example. However, it is also likely finance will cease to be available to many potential borrower and costs for existing borrowers will increase. In relation to the new responsible lending requirements, a mortgage broker has described those who are now missing out on finance as :

… older borrowers aged 40 and upwards who were taking out loans that would need to be repaid after retirement and couples moving to a single income due to circumstances such as maternity leave.[100]

It is legitimate to now ask whether the correct balance has been struck between lenders and borrowers and whether this vast array of statutory regulation is really achieving its stated purpose.

Furthermore, little attention appears to have been given to another important issue, namely the extent to which the various statutory changes have added an additional layer to the operational risks faced by financiers, and if they are authorised deposit taking institutions, whether additional capital should be set aside to meet these risks. Many of the statutory changes are potentially fertile grounds for the emergence of such risks, especially when combined with the obligation imposed on financiers to remit disputes with borrowers to external dispute resolution[101]. It also prompts the question whether the practical difficulties in complying with this raft of statutory regulation is setting banks and other financial institutions up for failure.

In relation to responsible lending, the same mortgage broker made the following observations:

Smart solicitors will just claim under the responsible lending obligations [as there is no clear guidance of what this constitutes] and there is no question there will be opportunistic claims …[102]

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99 Rethinking regulation report of the Task Force on Reducing Regulatory Burdens on Business, January 2006 at I-II.

100 Quoted in Jane Searle, 'Credit Code Creates Confusion', *The Australian Financial Review (*Sydney), July 4 2011.

101 The obligation is sourced in clause 36 of the Code of Banking Conduct; the *National Consumer Credit Protection Act 2009 (Cth)* ss 47(1)(h) and (i) and s64(4) and (5) (as licence conditions). For margin loans to retail clients, the obligation is sourced in s912A(1)(g) and s912A(2) of the *Corporations Act.* ASIC has also issued a Regulatory Guide (RIG 139) on external dispute resolution schemes.

102 Ibid.

The extent of the operational risk is illustrated by the summary of the available remedies in schedules 1 and 2 of this paper if a financier breaches the provisions regulating misleading or deceptive conduct, unconscionability, unfair contract terms in the *ASIC Act*, or responsible lending provisions for margin loans in the *Corporations Act*. For example, a finding that a term used by a financier in a standard form agreement with a consumer is unfair, would mean that a bank would henceforth be unable to rely upon such a term in similar contracts with other parties and thereby arguably decrease the book value of that type of facility. More significantly, if a financier was found to have breached a provision, any remedial monetary orders made by a court may generate set-offs or cross claims by borrowers against financiers and thereby reduce the amount ultimately recoverable by the financier from the borrower. The potential diminution in the value of a loan book arising from these provisions poses challenges not only for the financier but also for the regulators.

This discussion of the more significant, but by no means complete, statutory provisions impacting on a financing transactions also raises the question as to whether the statutory intrusion is justified by the mischief that the statutory response was intended to address. In times past, case law would have provided a response even if such a response may have been selective and slow to emerge given the delays and expense associated with litigation. The writer is not suggesting a return to the past. Over the last 40 years, there have been many instances of financiers "behaving badly". In some instances, this behaviour was the result of deliberate deceit, self-interest and greed accompanied by a free-wheeling attitude with respect to the provision of financial accommodation. On many occasions, the principal concern of a financier was the adequacy of the security. A loan would often be provided so long as the security was adequate, even if such a devil may care attitude may result in the loss of a borrower's family home. As against that, a case can be made that the balance may have tipped too far in favour of borrowers who appear to require a risk free environment. Even if it felt that the correct balance has now been struck between lender and borrower, the law in this area is now too prescriptive and made excessively complex by overlapping and cumulative layers of regulation. At the very least, the law should be shortened and rationalised.

SCHEDULE 1

Remedies

If there is a breach of the misleading or deceptive conduct provisions of the *ASIC Act* or the unconscionability provisions, the following remedies are available:

- fine - *ASIC Act* s 12GB;
- pecuniary penalties - up to $1.1 million for breaches by companies and $220,000 for breaches by individuals. *ASIC Act* s12GBA. (Note that this provision does not apply however with respect to misleading or deceptive conduct under s 12DA);
- injunctive relief - *ASIC Act* s12GD;
- damages for persons suffering loss - *ASIC Act* s12GF;
- non punitive orders such as community service orders or probation orders -*ASIC Act* s 12GLA;
- punitive orders including adverse publicity orders - *ASIC Act* s12GLB;
- public warning notices - *ASIC Act* s12GLC;
- disqualification from managing a corporation - *ASIC Act* s12GLD;
- such other orders as the court thinks fit - *ASIC Act* s12GM;
- redress orders for losses suffered by non party consumers - *ASIC Act* s12GNB and s12GNC;
- declaratory relief- ASIC Act s 12GND
- infringement notices - ss 12GX-12GXG;
- substantiation notices - *ASIC Act* ss12GY-12GYB.

SCHEDULE 2

Remedies for breach of unfair contract terms provisions

A party to a consumer contract or ASIC may seek a declaration that a term in a standard form consumer contract is unfair- *ASIC Act* section 12GND.

It is then a breach for the other party to the contract to rely upon or purport to rely upon the unfair contract term - *ASIC Act* section 12GM(10). If a party does purport to rely upon such a term in breach of the Act then the following remedies would be available:

- injunction - *ASIC Act* s12GD;
- such other orders as the court thinks fit including specific performance or damages - *ASIC Act* s12GM.;
- orders prohibiting the payment or transfer of money - *ASIC Act* s12GN;
- orders requiring redress to be paid to non party consumers (other than an award of damages) as the court considers appropriate - *ASIC Act* s12GNB and s12GNC;

FINANCIAL MARKETS REGULATION: THE ROLE OF THE STATE

Victoria Heine, Chapman Tripp[1]

"Should governments lean towards libertarianism, freeing us to act as we wish [or]...tilt towards paternalism, constraining the choice of adults to protect themselves, others, and the rest of us from them". Statman[2]

The financial crises of the late 2000s reignited the age old debate about the roles of government and markets in promoting trust and confidence. Relatedly, it also generated debate about the role of government *in* markets, and the role of government in protecting investors from themselves and from one another.

New Zealand, in common with most other OCED countries, has experienced a vast increase in the scope and breadth of the regulation governing financial services. These changes occurred at both the institutional level, in the form of significant reform to a core financial regulator, and at the functional level of regulating the relationship between financial provider and consumer.

Regulation is largely a socio-political question. It reflects a particular view of the appropriate balance between the market system and the collectivist system at any given point in time. The market system is based on a belief that individuals should be left free to pursue their own goals, subject to certain basic requirements underpinned by private law. The collectivist system has the state seeking to direct or encourage particular behaviours which would not otherwise occur owing to actual or perceived shortcomings in the market system.[3] These behaviours are mandated through regulation.

The balance between these two systems of economic organisation fluctuates over time and is driven by a variety of different factors. The regulatory changes which were introduced in response to the Global Financial Crisis, in New Zealand and internationally, reflect a move away from the market system, towards the collectivist system.

This paper explores a number of themes arising from some of the New Zealand reforms. Part I creates a framework for that analysis by examining the conventional justifications for the regulation of financial services, together with some newer and more controversial justifications. Part II reviews recent New Zealand reforms against the framework in Part I and identifies the motivations for those reforms. It is argued that an increasing (but largely unarticulated) motivation for recent financial services reform initiatives has been an erosion of the belief that consumers can, and should, make decisions for themselves.

Part III identifies the downstream commercial and policy consequences which result from that change. A full analysis of the normative question of whether financial services regulation *ought* to assume that individual consumers are rational is outside the scope of this paper. Rather, to the extent that the inability of consumers to behave rationally *is* a motivator for regulation, then its importance lies in identifying what remedies might meet that concern. As Breyer notes: "regulatory failure sometimes means a failure to correctly match the tool to the problem at hand".[4]

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1 This paper is a work in progress, for the purposes of discussion.

2 Meir Statman "*Regulating Financial Markets"* .

3 Ogus *Regulation: Legal Form and Economic Theory,* Hart Publishing, 2004, page 2.

4 Breyer Regulation and its Reform, Harvard 1982 page 191.

PART I: TRADITIONAL AND NOT SO TRADITIONAL JUSTIFICATIONS FOR REGULATION

To date, much of the focus in regulatory debate has been on regulatory methods for dealing with monopolies and natural monopolies and had revolved around the terms and price for access to essential facilities. Very different issues arise in the context of financial services.

Markets for banking and financial services have a number of unique characteristics which make them more complex from a regulatory perspective. Most obviously such markets are (or can be assumed to be) competitive.[5] The markets are heavily integrated – both vertically and horizontally. The range of services and products is wider and more complex than in traditional commoditised markets. Technology has fuelled that development – as shown by the "loan by text" promotion run recently by a Finland-based company, Ferratum.[6]

Traditional justifications

Traditional justifications about the value of markets (and consequential reliance on the market to achieve optimal consumer outcomes) are based around neoclassical concepts of economics (as exemplified by the Chicago School). These rest on two key assumptions:

- that consumers have adequate information about the choices available to them, including the consequences of those choices; and

- that consumers are capable of processing information and of behaving rationally in a way which maximises their utility.

The absence of either of those two assumptions can form the basis for regulation of some sort, although neo-classical economists have generally been reluctant to abandon concepts of individual capacity and choice, instead preferring to deal with problems by improving information flows.[7] For that reason, regulation in banking and financial services markets has tended to focus on information disclosure. This presupposes that consumers are capable of making, and will make, rational decisions provided they have sufficient information of the right type.

Information disclosure regulation seeks to prescribe the form and content of disclosures and to impose penalties for the conveyance of false or misleading information.

Are humans rational? Less traditional justifications

There is a growing body of material which supports an approach to regulation that is at once more paternalistic and more corrosive of choice. This approach challenges the assumption that humans are rational and asserts that, even if full and adequate information is available, consumers will nevertheless make irrational decisions.

The concept has struck some resistance, as shown the following statement from Breyer:

> "this justification is pure paternalism: the government supposedly knows better than individuals what they want or what is good for them. Such distrust of the ability of

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5 This is despite efforts by the New Zealand Commerce Commission to establish otherwise in the context of the multiple party interchange litigation, which alleged price fixing between the major banks.

6 http://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=10733481.

7 Ogus page 51.

the purchaser to choose may be based on the alleged inability of the lay person to evaluate the information, as in the case of purchasing professional services, or the belief that, although the information could be accurately evaluated by the lay person, irrational human tendencies prevent this".[8]

The challenge to the assumption of perfect rationality is identified with the work of the behavioural law and economics movement at Chicago Law School in the mid 1990s. The behavioural law and economics scholars worked with social psychologists to demonstrate empirically that humans are in fact subject to a number of rules and biases. What we know about human behaviour and choice should therefore dictate our legal interventions.[9]

Scholars (and in particular Sunstein) identify a number of human traits which they argue support their position, including that:

- humans systematically undervalue the costs and risks arising from the choices which they make;
- humans tend to value the status quo;
- short term consequences tend unduly to influence decision-making relative to longer term consequences;
- choices in purchasing and other activities are highly imitative of those made by others.

These justifications to regulation have been controversial. Many take issue with the robustness of the empirical work. It is clear that, even if human beings are not as rational as they might be, neither are they as irrational as the behavioural law and economic scholars would have us believe. There have been many challenges to the quality of the data relied on by both camps.[10]

Such regulatory interventions create a problem of moral and cognitive hazard in the long term. If consumers are protected from the consequences of their own decisions, they are denied the opportunity to learn from their mistakes and become more and more dependent on government through a vicious cycle of dependency.

Finally, from a policy perspective, interventions which are applied universally also capture, and deny choice to, those individuals who are capable of making decisions in their own best interest.[11]

PART II Recent New Zealand Financial Markets Reforms

This part of the paper examines the application of the principles outlined above to three recent financial services reforms in New Zealand:

- the Consumer Law Reform project;

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8 Breyer page 33.

9 Cass R Sunstein *Behavioural Law & Economics, Cambridge University Press, 2000.*

10 George Gregory Mitchell "Why law and economics is perfect rationality should not be traded for behavioural law and economics is equal incompetence", 91GOLJ67.

11 Ogus page 53.

- the credit reforms; and
- the Financial Markets Authority, and the extensive new legislation it administers.

Consumer Law Reform Bill
The objectives of the Consumer Law Reform Bill, now before Parliament, are to:

- have in place principles-based consumer law that:
  - enables consumers to transact with confidence and protects reputable suppliers and consumers from inappropriate market conduct;
  - is up to date and relevant now and into the future;
  - is easily accessible to those who are affected by it;
  - is in line with international best practice;
  - is appropriate; and
  - is effective and enforceable;
- achieve simplification and consolidation of the existing law;
- achieve harmonisation with the Australian Consumer Law in accordance with the government's Single Economic Market objective.[12]

Officials in the Ministry of Consumer Affairs had participated in the development of the Australian Consumer Law and advocated strenuously that New Zealand should follow Australia's lead and introduce both unfair contract terms and unconscionability provisions.

The relevant Cabinet papers make an interesting read. In relation to the principles which underpin consumer law, they state:

> "The policy underpinning consumer law is essentially that consumers individually and the economy as a whole benefit from consumers making effective purchasing choices from a range of competing offerings. In order to make effective choices, consumers need to have access to both good and accurate information and to be able to make their decisions without undue pressure or duress."[13]

This passage reflects a relatively standard approach to regulation, based around information disclosure.

By contrast:

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[12] The SEM outcomes were agreed by the Australian and New Zealand Prime Ministers in August 2009 with the purpose of advancing a single economic market. The intention is to promote a Trans Tasman economy or market based on the objective that deeper economic linkages provide bigger markets in which to buy and sell goods and services, allow access to a larger and more varied pool of capital and labour, and open a New Zealand economy to new ideas and technology.

[13] Para 38 Office of the Minister of Consumer Affairs dated 1 December 2010.

> "Consumer law provisions covering unfair contract terms concern pre-written terms in standard form contracts which usually cannot be negotiated by a consumer or small business. Types of consumer contracts which are typically standard form contracts include: rental car agreements, electricity and gas agreements, telephone line agreements, gym memberships and retirement home contracts. An unfair term in a standard form contract is considered to be one that causes a party to a contract (usually the consumer) to be at a disadvantage while the term is not really necessary for the protection of the interests of the other party (usually a business)."[14]

So even if consumers have adequate information, there are some contracts which are apparently so "unfair" that they should be prevented from entering into them, or being held to their terms. The implied contradiction between the overt reasons for consumer law reform (properly informed consumers making good purchasing decisions) and the reasons for introducing unfair contract terms (even properly informed consumers should be protected from entering into arrangements which some may view as objectively unfair) is interesting. Does this carry shades of paternalism? Does it implicitly assume that consumers cannot be left to form rational and sensible decisions? Arguably so.

Happily, the Ministry's arguments were not accepted by the Minister. He was concerned that unfair contract terms would cause uncertainty and expense to businesses and that these transaction costs would be passed onto consumers. Neither was he prepared at this time to add unconscionability provisions to the Fair Trading Act.[15] But he indicated that this decision may be subject to subsequent review, saying:

> "...it may be appropriate to consider adding unfair contract terms to our law in the future after observing the application in Australia over the next few years".[16]

Credit Contract and Consumer Finance
The Credit Contracts and Consumer Finance Act 2003 (*CCCFA*) regulates all forms of consumer credit including personal loans, credit sales, hire purchase, credit cards, long-term leases, mortgages and housing buyback schemes. In September 2009, the Ministry of Consumer Affairs commenced a review of the legislation with a view to improving its operation.[17]

The introduction to the policy paper records that "a fundamental principle in the Act is that decisions to borrow will be made by individuals in a rational manner fully taking into account available information". When first promulgated, the purpose statement was:

- to protect the interests of consumers in connection with credit contracts, consumer leases and buyback transactions of land; and

- to provide for the disclosure of adequate information to consumers under consumer credit contracts and consumer leases:

  - to enable consumers to distinguish between competing credit arrangements or competing lease arrangements; and

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[14] Ibid para 40.

[15] Ibid para 55.

[16] Ibid para 48.

[17] Review of the operation of the Credit Contracts and Consumer Finance Act 2003, Ministry of Consumer Affairs, September 2009.

- to enable consumers to become informed of the terms of consumer credit contracts or consumer leases before they become irrevocably committed to them; and

- to enable consumers to monitor the performance of consumer credit contracts or consumer leases; and

- to provide rules about interest charges, fees, and payments in relation to consumer credit contracts; and

- to enable consumers to seek reasonable changes to consumer credit contracts on the grounds of unforeseen hardship; and

- to provide for the disclosure of adequate information to consumers under buyback transactions of land and for the provision of independent legal advice to those consumers;

• to provide rules about fees in relation to buyback transactions of land; and

• to prevent:

  - oppressive credit contracts, consumer leases and buyback transactions of land; and

  - oppressive conduct by creditors under credit contracts, lessors under consumer leases, and transferees under buyback transactions of land.

This suggests that, as originally promulgated, the Act was largely based around information disclosure with some fallback paternalistic interventions in particular circumstances.

By contrast, the new Ministry policy paper notes that the effectiveness of disclosure, on which the CCCFA is predicated, will always be linked to the individual consumer's ability and willingness to use the information provided. Where it is not used or cannot be used then its effectiveness is limited.[18]

In the context of considering unsolicited credit, the Ministry notes: "behavioural economics indicates that people tend not to opt out when given a choice that something will occur unless you expressly indicate otherwise. Unsolicited "selling" takes advantage of this inertia".[19]

The discussion paper also asks whether particular regulatory reform is needed in respect of fringe lending practices and whether the disclosure regime in the legislation adequately addresses undesirable lending practices operating in lower socioeconomic communities.

> "The CCCFA is based on the premise that well informed consumers are best placed to make borrowing decisions that are optimum given their own particular circumstances. This is reflected in the disclosure based character of the CCCFA. The CCCFA implicitly assumes that consumers should be responsible for the decisions that they make, for good or for bad.

[18] At page 14.

[19] Ibid at page 42.

> "Despite the availability of information, in some situations, consumers make what would generally be regarded as poor financial decisions, resulting in excessive debt and/or excessive costs (interest repayments and penalty charges). Of particular concern are those credit providers who exploit poor decision-making, resulting in consumers being much worse off than if they had not had access to credit."[20]

Comment was invited on regulatory initiatives to deal with lending to marginalised groups, on the basis of the behavioural economics assumption that rationality cannot be assumed.

The policy response has yet to be released. Key areas will be how far the Ministry chooses to take these reforms and how it chooses to grapple with boundary issues between consumers who are perceived as competent and those who are perceived as not.

Financial Markets Authority

One of the most significant events in regulatory terms for some years in New Zealand has been the emergence of the Financial Markets Authority (FMA), which opened for business on 1 May 2011. Compared to its predecessor agencies, the FMA has extensive enforcement powers and capabilities, with the ultimate aim of promoting and facilitating the development of fair, efficient and transparent financial markets.

This reform is interesting, not because it contains overt notions of paternalism (which it does not in the sense used in relation to the consumer and credit reforms), but because it reflects such an enhanced role for government in a different way – and thus is reflective of a more general trend.

New Zealand's financial institutions (with the notable exception of the finance companies) in fact survived the GFC rather well. However, of the many views expressed in the aftermath there was one (largely) unifying factor – relevant regulators were letting misconduct slip through the gaps and wholesale changes to the regulatory environment were a 'must' if investor confidence in New Zealand's financial markets was to be restored.

This regulatory underperformance was, at least in the minds of the government, the fault of the regulatory framework and the limitations and complications it placed on any one regulatory agency seeking to exercise powers of enforcement. The blame being levelled at the broader regulatory framework was the topic of a March 2010 article in the New Zealand Herald, the headline to which was: Unify regulatory framework and confidence will grow.

The Herald article was written by Jane Diplock, then head of the Securities Commission, who observed that current regulatory arrangements were not fit for purpose. They did not give "domestic and international investors the confidence to invest in the local securities that provide capital for our local businesses to grow". The solution:

> ...we need a single comprehensive regulatory agency with extended powers to offer real confidence to both domestic and foreign investors...[the] urgent first step to economic growth should be to consolidate New Zealand's regulators...
>
> Those who point their fingers at the Securities Commission and the other New Zealand regulators for doing too little to prevent [the finance company collapses], should look instead at the regulatory framework in which we operate – a patchwork quilt of add-ons and Bandaids cobbled together over the past eight years, none of which helped protect finance company investors.

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[20] At page 54.

> The regulatory vacuum attracted opportunistic operators and the result was market failure of an entire industry and tragically the loss of retail investor confidence in the New Zealand capital markets once again.
>
> Despite warnings by the commission, it could do nothing to prevent this failure. A government agency can only act within its warrant. Time has come to extend the warrant of New Zealand's regulators.

Similar concerns were expressed in submissions to the Capital Market Development Taskforce, the Prada and Walter review of the Securities Commission, and in comments by the Registrar of Companies to the Commerce Select Committee inquiry into finance company failures. All expressed concerns about:

- the fragmentation of market regulators, leading to concerns about gaps and overlaps;
- the regulators' willingness actively and visibly to prosecute wrongdoers, and to take cases in order to clarify the boundaries of the law; and
- the adequacy of regulators' powers.

This idea of "restoring public confidence" resonated throughout the legislative process. This reflected public sentiment that an increased role for government was necessary and desirable. Will that legitimise further interventions? Possibly. Does it reflect a public desire for safe investment at the expense of individual choice? Perhaps.

Why the change in emphasis?

This paper argues that the three regulatory interventions under discussion reflect a mix of regulatory motivations. It is hard to be definitive about whether the paternalistic impulse is more or less dominant than historically. There are a few factors which could suggest that if it is more dominant, or will become so.

First, there appears to be a stronger public desire for (and acceptance of) government intervention in the markets than might have existed prior to the GFC. The New Zealand government recently bailed out South Canterbury Finance for around NZ $1.8 billion (extending the requirements of the Retail Deposit Guarantee Scheme to non eligible deposit holders), and has guaranteed AMI Insurance in the wake of the Canterbury Earthquake.

Secondly, consumer groups are becoming more vocal with the rise of social media. Greater media coverage has put governments under pressure to adopt policies which appeal to broad sectors of the population and to respond quickly to problems when they emerge in acute form.

Thirdly, it seems clear that advances in technology make retail consumers of banking and financial services more vulnerable than they might otherwise have been (e.g. the "borrow by text" promotion), so that the case for intervention becomes stronger.

Finally, the influence of international academic opinion is also relevant – and appears to be more disposed to paternalistic intervention.

PART III: POLICY AND COMMERCIAL CONSEQUENCES

This paper has explored some themes arising from current and recent policy debates in New Zealand. It suggests that under the apparently unobjectionable goal of "consumer protection" lies a more controversial view on the extent to which consumers can be taken to be capable of looking after themselves.

In this part of the paper, a series of propositions are put forward as to the likely policy and commercial consequences which could follow.

The first proposition is that financial services regulation will only increase in scope and depth, and that this cycle will perpetuate for some years. As Richard Epstein has noted[21] "the complete regulator is like the boy and the dam – except he never runs out of fingers". In other words once the process of regulation starts, it tends to increase – a process known as regulatory creep. Indeed, the difficult policy decisions are usually about whether to regulate at all. Once that decision is made, increasing regulation is easier to justify and tends not to be subject to the same degree of political scrutiny.

Furthermore, history suggests that fundamental changes of regulatory direction occur only every few decades (not every few years). Triggered by a constitutional and foreign exchange crisis in July 1984, New Zealand launched into a series of reforms which were described at the time as: "one of the most notable episodes of liberalisation that history has to offer".[22] Retrenchment followed, and New Zealand is now more tentatively entering another round of liberalisation of state assets. Financial services are unlikely to be "deregulated" for many years.

Any further regulation is likely to be accelerated by a change in government. It is clear from the policy papers referred to that current Ministerial opposition to the introduction of an unfair contract terms standard is finely balanced.

The second proposition is that policy makers, with the encouragement of the industry, need to be clearer (or perhaps more honest) about the motivations for reform. While not often overtly invoked in policy discussions, paternalism is a power motivation for policy change. It is not necessarily a wrong motivation, but it is important that the downstream policy implications of particular choices are confronted. In particular, the costs and benefits of "paternalistic" interventions must be properly identified.

Ogus put it this way[23]:

> "Let us assume that, with the aid of the psychological evidence described above we can identify situations in which many, perhaps most, individual decision–makers select options which would not reflect their individual preferences if they had been responding rationally to the information available. The benefit of a legal intervention forcing an individual to adopt the rational choice may then be expressed as the difference between the utility she has gained from complying with the legal requirement and the utility she would have gained from her own preferred option. The social

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21 Epstein as many will know is a Professor of Law at the University of Chicago. The comment was made in a lecture attended by the writer in the 1990s.

22 David Henderson, quoted in Evans et al " New Zealand's Economic Reforms: 1984-95" Victoria Economic Commentaries, Number 1, 1986.

23 Anthony Ogus, Costs and Cautionary Tales – Economic Insights for the Law, Hard Publishing, Oxford 2006, at page 238.

> benefit of the measure would then be the aggregate of such increases in utility for all those subject to the requirement..."

There is a need for a more nuanced assessment of proposed regulation whereby the problem is clearly identified, the suite of policy options exposed to a cost benefit analysis, and an appropriate solution crafted.

If, for example, the proposition is that financially and educationally disadvantaged groups should be prevented from borrowing money (which may well be a perfectly laudable and desirable outcome), a more targeted approach is required than a universal tightening of credit criteria. In other words, the fact that some sectors of society may need to be protected from themselves does not mean we all need to be protected from ourselves, and a regulatory intervention which does the latter so as to achieve the former is flawed.

If paternalistic interventions apply uniform controls on certain activities, then those individuals who are more sophisticated and better informed will be deprived of choice. This creates a cost to them in the achievement of a 'benefit' which they do not require and which is irrelevant to them. The regulatory intervention should be crafted so as create some form of default rule whereby those who can demonstrate rationality or likely rationality (however that could be identified) can opt out. Absent very obvious distinctions (retails vs wholesale, for example) this is likely to be difficult ex ante and will, of course, significantly increase compliance costs. This is the type of analysis which the Ministry of Consumer Affairs (and others) needs to undertake.

Thirdly, the (New Zealand) financial markets sector needs to be better equipped to engage in the policy debate. Generally, the larger retail banks (the majority of whom are Australian owned) are held in good regard by government. They are seen as responsible and responsive. That platform can and should be used to increase the quality of the policy dialogue.

The banking and financial services sector has an important role to play here. The challenge is proactively to initiate change rather than responding to policy papers as they emerge and to no longer simply oppose proposed interventions but to propose alternatives. The development of empirical data would assist greatly in elevating the debate beyond the "is/isn't" level of argument, as would sponsoring high quality academic literature and discourse.[24]

[24] On that note, the Institute for the Study of Competition and Regulation at Victoria University of Wellington (www.iscr.org.nz) has done an extremely effective job in some areas of regulation.

TRANSNATIONAL COMMERCE, CERTAINTY AND THE CONFLICT OF LAWS

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Introduction

1. Australia's economic future will be closely tied to Australian companies' ability to do business globally. Australian companies and, therefore, Australian commercial lawyers are increasingly involved in transnational commercial transactions.

2. As with any commercial transaction, a transnational transaction carries with it risk for the parties involved. That risk may or may not be insured against, and careful drafting of the commercial terms will be designed to minimise risk or at least uncertainty in the event of disputes arising. At one level, there will be greater scope for disputes to arise in a *transnational* contractual setting because often at least one party will be doing business in a country with which it may not be familiar including in terms of its legal and regulatory frameworks as well as in terms of its business culture and ethos.

3. Two of the particular and most fundamental risks which may arise in the context of a transnational commercial transaction are the risks of exposure to:
   i. an unfamiliar body of law; and or
   ii. an unfamiliar legal system or, alternatively, a legal system in which an Australian company may lack confidence because of real or perceived corruption, bias, inexperience, incompetence or dilatoriness.

4. In this paper, I focus upon the ways in which these two particular risks can be minimised through the careful drafting of choice of law and dispute resolution clauses (by which I include both jurisdiction or choice of court clauses, and arbitration clauses). The inclusion of such clauses in a transnational commercial contract or transnational financing documents is designed to inject certainty on the twin questions as to where, and by reference to what law, any disputes will be resolved. The degree of certainty injected, however, will be a function of the care taken in the drafting of such clauses.

5. In what follows, I highlight, by reference to a number of recent Australian decisions, some of the issues can arise where such clauses are not well drafted, and also some of the issues which, in my opinion, can be regarded as unsettled. I begin with choice of law clauses.

Choice of law clauses

6. Assume that a contract contains a choice of law clause in the following terms:

> *"This contract shall be interpreted [and/or construed] in accordance with German law."*

Such a clause, on its face, is confined to the *interpretation* and *construction* of the contract. It is far from self-evident that a clause drafted in this way will be effective to require that the contract in question be *governed by* German law. For example, the question of whether or not a party is entitled to terminate the contract is not typically regarded as a question of interpretation or construction. A party to a contract containing such a clause could be met with an argument to the effect that, whilst German law may govern the interpretation of the contract, another body or system of law has a claim to govern substantive contractual questions arising in a contractual dispute. Ultimately, this will turn on a question of the proper interpretation of the choice of law clause, but if the competing governing law may yield a different substantive answer to that which German law would provide, a "wildcard" is introduced into the dispute resolution process which may be wielded to provide leverage where the other contracting party may have thought that the matter was clear.

7. It should be noted, parenthetically, that where there are multiple language versions of a particular contract, a word such as "*interpreted*" or "*construed*" may, upon translation, have or be given a different meaning, e.g. "*governed by*". Where multiple language versions of the contract are in existence, it is important for there to be a clause identifying which language version of the contract is authoritative or to prevail in the case of the inconsistency.

8. A superior form of drafting of the first example would be to provide that:

> *"This contract shall be governed by German law."*

This form of drafting eliminates the potential argument arising in relation to the first example, namely that the reference to German law and its applicability was intended to be limited to questions of interpretation and construction, and that some other body of law had a role to play in the resolution of the parties' dispute.

9. On the other hand, a clause which simply provides that "*This contract shall be governed by German law*" leaves an uncertain question as to whether or not the reference to German law is a reference to *German domestic law* or to German law including its own principles of private international law. Depending on the content of those principles, if the choice of German law was interpreted to include a reference to the entire body of German law including its principles of private international law, the operation of German law may require reference to another system of law to be applied to resolve the dispute, e.g. if the contract was being performed in a third country, the law of that country may be referred. This is the problem of *renvoi* which has long been the bane of academics and law students and has

tended to be treated as theoretical conundrum unlikely to be encountered in practice.

10. The issue has, however, been the subject of a relatively recent decision of the High Court in *Neilson v Overseas Development Corporation* (2005) 223 CLR 331 where it was held that, in a case being litigated in the Supreme Court of Western Australia, although the law governing what was in that case a tort, was the law of the place of the tort, namely China, Chinese law referred the matter, in a case (as *Neilson* was) involving nationals from the one (foreign) country, to the law of *that country* to resolve any disputes. On the facts of *Neilson*, this was not simply academic point-taking but was crucially important to the outcome of the case. Mrs Neilson was living in China with her husband who had been posted there by his Australian employer, the Defendant. The Defendant had provided the Neilsons with a form of housing for the period of Mr Neilson's employment in China. Mrs Neilson suffered serious injuries when a balustrade in the house in which they were living gave way. The tort undoubtedly occurred in China but, if Chinese domestic law were to apply, Mrs Neilson's claim was out of time under the Chinese limitation law. If, however, Australian law was to apply by reason of the fact that Chinese law "referred" the matter on to Australian law, the matter was not out of time because of the difference in the limitation periods under Chinese law and Australian law.

11. Returning to the question of drafting, the potential scope for *renvoi* can be eliminated by drafting a clause along the following lines:

> *"This contract shall be governed by German law excluding the principles of German private international law".*

I describe such clauses as an "anti-renvoi" clause. It is obvious that such a clause minimises the risk for debate as to the applicable law and adds certainty to dispute resolution. You may consider that this represents an excessive caution but, where the stakes are sufficiently high, any competent transnational litigator should be alive to this argument and will explore the question to ascertain whether or not (i) the nominated law may or would, in the circumstances, refer the matter to another legal system, and (ii) if it did, whether such a reference would provide his or her client with some strategic benefit because of, for example, a difference in the substantive law of the legal system to which the dispute were referred.

12. But even a clause of the kind I have referred to in the previous paragraph does not, at least on its face, cover a situation whereby disputes arise between parties to a contract governed by, say, German law but where those disputes are not or may not be characterized as contractual in nature even though they may arise in the context of and/or in relation to the contract. The most obvious example is a claim in tort. Conceivably, one party may have a claim in contract to be governed by German law and a claim in tort which may fall to be governed by some other country's law, depending on the choice of law rules of the forum in which the dispute is litigated, regardless of the fact that there may be a very close overlap indeed between any contract claim and any tort claim. For example, assume a joint venture between an Australian and a German company to perform work in Indonesia with a German governing law clause. If the relevant tort occurred in Indonesia, Australian law would dictate that Indonesian law governed this claim, but the identical facts may give rise to a contractual claim which would fall to be determined by German law.

13. There is obvious merit from the perspective of certainty and indeed consistency in a single system of law being applied to govern all aspects of commercial disputes, in whatever form the various causes of action are dressed or may be characterized. The question is: can this be achieved by contractual drafting?

14. An example of a clause seeking to achieve this outcome was contained in the contract between Oil & Natural Gas Corporation of India ("**ONGC**") and Clough Engineering Ltd which was the subject of litigation ultimately concluded in the Full Court of the Federal Court: *Clough Engineering Limited v Oil and Natural Gas Corporation Limited* (2008) 249 ALR 458.

15. The relevant clause provided:

> *All questions, disputes or differences <u>arising under, out of or in connection with</u> this Contract shall be settled in accordance with laws of India (both procedural and substantive) from time to time in force and to the exclusive jurisdiction of the Courts in India, subject to the provisions of clause 1.3.2.* (emphasis added)

The draftsman could have added after the word Contract, to be abundantly cautious, words such as (whether contractual, tortious, restitutionary or statutory).

16. But even a clause such as this may not be fully effective to identify an exclusive body of law to govern the outcome of a dispute, as the facts of the litigation between Clough and ONGC serves to demonstrate. Australian Banks had furnished to ONGC performance bonds on the application of, and to guarantee the performance of Clough in the performance of large scale off shore construction work in India. The circumstances in which ONGC was entitled to call on the bonds were governed by the construction contract containing the choice of law clause as set out above. ONGC sought to call on the bonds but, prior to this call being honoured, Clough got wind of the call and moved *ex parte* in the Federal Court seeking to restrain the call on the bonds on the basis that to do so was unconscionable in contravention of s.51AA of the *Trade Practices Act*: see *Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd* (2007) 29 ATPR 42-166.

17. The case involved many issues and was ultimately resolved, in the context of a successful challenge to the jurisdiction by reference to the absence of a prima facie case, based upon the proper construction of the construction contract and an analysis of whether or not the contract required there to be an actual breach of contract as opposed to bona fide claimed breach in order to call on the bond. One argument which the Court did not need to resolve, however, was whether or not the Trade Practices Act in fact applied, given the widely drawn choice of law clause and whether or the choice of law

clause as set out above in fact meant that, by virtue of their agreement, the parties could not invoke a law other than a law of India to resolve any dispute between them.

18. Another case involving a clash between a contractually chosen governing law (and jurisdiction) clause, on the one hand, and an arguably mandatory law of the forum (mandatory in the sense of being a law which, on its proper construction, is intended to apply irrespective of the operation of common law choice of law principles) was the recently settled litigation between Qantas Airways Ltd and Rolls-Royce plc in relation to the A380 engine incident over Indonesia. Qantas commenced its proceedings in the Federal Court of Australia, raising claims for misleading and deceptive conduct under the Trade Practices Act and secured an ex parte anti-anti-suit injunction restraining Rolls-Royce from commencing proceedings in England seeking to enforce its express English choice of law and exclusive jurisdiction clauses on the footing that to do so would be to oust or run the risk of ousting or excluding a hearing of the Trade Practices Act claim on its merits (for the reason that the English choice of law rules would not "pick up" the Trade Practices Act cf. *Reinsurance Australia Corp Ltd v HIH Casualty and General Insurance Ltd (in liq)* (2003) 254 ALR 29.)

19. There are obviously competing policy considerations in play. On the one hand, practitioners will be familiar with statements in the cases to the effect that parties cannot "contract out of" the Trade Practices Act (albeit that these statements are usually found in the context of exclusion clauses although note *Green v Australian Industrial Investment Ltd* (1989) 25 FCR 532 and *Pty Limited v Kiukiang Maritime Carriers* (1998) 90 FCR 1). That legislation, and cognate provisions in the *ASIC Act* and Fair Trading Acts, is undoubtedly underpinned by normative policy considerations in relation to commercial dealing.

20. On the other hand, at least in the context of a transnational contract which is to be performed outside of Australia (as was the case in *Clough* but not

Qantas), the question may be posed as to why it would be contrary to policy to permit sophisticated commercial parties to agree on one governing law, even if not Australian and even though the effect of that choice may be that the operation of the Trade Practices Act is excluded. After all, as Kirby J. observed in *Pan Foods Company Importers and Distributors Pty Ltd v Australia and New Zealand Banking Group Limited* (2000) 170 ALR 579; (2000) 74 ALJR 791 at [24]:

> Business is entitled to look to the law to keep people to their commercial promises. In a world of global finances and transborder capital markets, those jurisdictions flourish which do so. Those jurisdictions which do not soon become known. They pay a price in terms of the availability and costs of capital necessary as a consequence of the uncertainties of the enforcement of agreements in their courts.

21. In a related context, in *Comandate Marine v Pan Australia Shipping Pty Limited* (2006) 157 FCR 45, Finn J. observed:

> I would merely add that, whatever advantage or disadvantage accrued to Pan from having both the relevant legal effects of its pre-contractual conduct and its Trade Practices Act claims determined in London according to English law (including relevant principles of conflict of laws), this is what has been agreed to by the parties as international commercial contractors. There is no legal principle of, nor is there any policy immanent in, Australian law that denies them what they have agreed.

22. As a matter of principle, there would seem to be a great deal to be said for permitting parties to make provision for the law which will govern any non-contractual as well as contractual claims arising *inter se*. Such an approach has two principal virtues. It ensures consistency in the sense that it eliminates the prospect of a claim in tort being governed by the law of country "X" whilst the claim in contract is governed by the law of country "Y", being the parties' agreed governing law, the example given in paragraph 12 above. The second virtue is that it could eliminate the notoriously difficult question which arises from time to time in transnational cases, namely identifying the place or "locus" of the tort. This is particularly important since *John Pfeiffer Pty Ltd v Rogerson* (2000) 2003 CLR 503 and *Renault v Zhang* (2002) 2010 CLR 491 which cases established, on a domestic and international level respectively, that the

Australian choice of law rule for torts is the *lex loci delecti* or law of the place of the tort.

23. Parenthetically, it may be noted that the simplicity of that formula masks the very real difficulty that can sometimes arise where it becomes necessary to identify the place where the tort occurred. That difficulty is at its most acute in cases which can be characterised as ones involving a negligent omission. Where does the negligent omission occur in a transnational context? Equally complex may be tortious claims involving conspiracy (where conspirators may be located in more than one jurisdiction) or claims involving the use communications via the internet. The issue of "locating" the tort was of importance in the High Court's decision in *Voth v Manildra Flour Mills Pty Limited* (1991) 171 CLR 538.

24. It is somewhat surprising that the prospect of a tort claim being the subject of a "choice of law agreement" does not appear to have attracted much if any attention in the academic writing. The principal exception to this is the outstanding monograph by Professor Briggs in the OUP Private International Law series entitled *Agreements on Jurisdiction and Choice of Law*.

25. If liability in tort can be excluded by virtue of a sufficiently clearly expressed contractual exclusion clause, it is difficult to understand why, as a matter of principle, parties should not be able to identify, *ex ante*, the law that is to govern any tortious (or statutory or otherwise non-contractual) claims arising as between the parties in a choice of law clause. And although the argument is probably more delicately balanced in the context of statutory causes of action, there is much to be said for an approach which encourages parties to choose in advance the legal system (and ideally one legal system) which is to govern their claims. (Of course, in *true* cases of consumer contracts, the Courts may be more reluctant to permit this, and the problem in Australia is that the *Australian Competition and Consumer Act* (formerly the *Trade Practices Act*) and cognate provisions in the ASIC and

Fair Trading Acts are, of course, not for the most part, so confined, and statutory unconscionability has been left somewhat and regrettably in limbo by reason of the High Court's decision in *ACCC v CG Berbatis Holdings Pty Ltd* (2003) 214 CLR 51.)

26. One final point to be made in the context of express choice of law clauses is that one must be careful in selecting any particular forum's law as the governing law as the Commonwealth Bank probably discovered in the context of its margin lending arrangements with former clients of Storm Financial. Even though the vast majority of individuals affected and who entered into borrowing facilities with the Commonwealth Bank were residents of Queensland, the standard form loan documentation contained an express choice of law clause nominating New South Wales law as the governing law. This had the fortunate consequence for the Queensland-based clients that the provisions of the New South Wales *Contracts Review Act 1980* (and the liberal jurisprudence relating to lending contracts that has developed around the interpretation of that Act) was arguably engaged, thus greatly improving their leverage in commercial negotiations. No similar legislative regime exists under the law of Queensland.

Jurisdiction clauses

27. Turning to the drafting of choice of court or jurisdiction agreements, it is extraordinary how often sloppy or shorthand drafting has led to expensive and extensive litigation in relation to the construction of such clauses. Sometimes such disputes are described by judges as "arid" and it is no doubt correct to say that semantic submissions in relation to the difference between, for example, the expression "arising under" and the expression "arising out of" are aptly so described. On the other hand, such disputes do not occur without good reason. There will invariably be perceived, a major tactical, strategic or substantive advantage in winning such a dispute. In that sense, such disputes are far from "arid".

28. On the question of the scope of jurisdiction (or arbitration) agreements, that is to say, questions as to the width or ambit of such clauses, recent decisions of the Full Court of the Federal Court of Australia (*Comandate Marine Corp. v Pan Australia Shipping* (2006) 157 FCR 45), the House of Lords (*Premium Nafta Products Limited v. Fili Shipping Company Limited* [2008] 1 Lloyd's Rep 254 (in which the Full Court's decision was cited) and the NSW Court of Appeal (*Global Partners Fund Ltd v Babcock & Brown Ltd (in liq)* (2010) 79 ACSR 383) have done much to eliminate the scope for such disputes.

29. In the Australian context, an earlier Full Court decision, that of *Hi-Fert Pty Limited v Kiukiang Maritime Carriers* (1998) 90 FCR 1 had appeared to endorse a somewhat semantic approach to the construction of such clauses. Thus, in that case, an arbitration clause provided that:

> *Any dispute arising from this charter or any Bill of Lading issued hereunder shall be settled in accordance with the provisions of the Arbitration Act, 1950, and any subsequent Acts, in London, each party appointing an Arbitrator, and the two Arbitrators in the event of disagreement appointing an Umpire whose decision shall be final and binding upon both parties hereto.*
>
> *This Charter Party shall be governed by and construed in accordance with English Law.*

This clause was construed by the Full Court as excluding a claim brought under the *Trade Practices Act*. That decision went very much against the thrust of an earlier decision by the New South Wales Court of Appeal in *Francis Travel Marketing Pty Limited v Virgin Atlantic Airways* (1996) 39 NSWLR 60 in which Gleeson CJ had endorsed what in England had been described as a presumption of "one stop" adjudication, namely an approach to the interpretation of the scope of jurisdiction and arbitration clauses which attributed to commercial parties an intention that there be only one forum, or jurisdiction or mode of dispute resolution for all of the parties' disputes, whether tortious, contractual or statutory.

30. The decision in *Hi-Fert* was expressly disapproved in *Comandate Marine Corp. v Pan Australia Shipping* (2006) 157 FCR 45. In that case, *Pan* had commenced proceedings in Australia seeking to rely on the *Trade Practices Act* in order to extricate itself from a charterparty. The charterparty provided for arbitration in London, with English law to apply. *Pan* perceived that, one way or another, English maritime arbitrators were unlikely to apply the *Trade Practices Act* or, even if purporting to do so, would be unlikely to do so in a manner which correctly and fully gave effect to that Act's remedial operation.

31. Plainly enough, the earlier decision in *Hi-Fert* gave some encouragement to Pan in this forensic endeavour. At first instance, *Pan* succeeded in resisting a stay of the *Trade Practices Act* claim. On appeal, however, the Full Court said that the *Trade Practices Act* claim plainly fell within the scope of the arbitration clause which was to be broadly construed. The leading judgment was delivered by Allsop J. (as he then was). Important passages from his Honour's reasons included the following:

> This liberal approach is underpinned by the sensible commercial presumption that the parties did not intend the inconvenience of having possible disputes from their transaction being heard in two places. This may be seen to be especially so in circumstances where disputes can be given different labels, or placed into different juridical categories, possibly by reference to the approaches of different legal systems. The benevolent and encouraging approach to consensual alternative non-curial dispute resolution assists in the conclusion that words capable of broad and flexible meaning will be given liberal construction and content. This approach conforms with a common-sense approach to commercial agreements, in particular when the parties are operating in a truly international market and come from different countries and legal systems and it provides appropriate respect for party autonomy.

His Honour went on (at [175]) to observe, after an extensive reference to authority, that

> If, subject of course to the context and circumstances of any particular contract, the meaning of the phrase "arising out of a contract" can be equated with "arising in connection with" (as Hirst J and Gleeson CJ say) it seems to me clear that the words "arise out of the contract" are apt, or at least sufficiently flexible, to encompass a sufficiently close connection with the making, the terms, and the performance of the contract as permit the words "arise out of" aptly or appropriately to describe the connection

> with the contract. These words encompass more than merely arising as a contractually classified complaint from one party's rights or another party's obligations under, or in, a bilateral juridical relationship. The width of the phrase "arising out of" in this context and its synonymity with the expression "in connection with" reflect the practical, rather than theoretical, meaning to be given to the word "contract" out of which the disputes may arise. The notion of a contract can involve practical commercial considerations of formation, extent and scope, and performance of the juridical bonds between the parties, out of which disputes may arise.

32. As noted above, the Full Court's decision was cited with approval by the House of Lords in *Fiona Trust Holdings sub nom: Premium Nafta Products Limited v. Fili Shipping Company Limited* [2008] 1 Lloyd's Rep 254. In that case, Lord Hoffmann observed:

> Arbitration is consensual. It depends upon the intention of the parties as expressed in their agreement. Only the agreement can tell you what kind of disputes they intended to submit to arbitration. But the meaning which parties intended to express by the words which they used will be affected by the commercial background and the reader's understanding of the purpose for which the agreement was made. Businessmen in particular are assumed to have entered into agreements to achieve some rational commercial purpose and an understanding of this purpose will influence the way in which one interprets their language.
>
> In approaching the question of construction, it is therefore necessary to inquire into the purpose of the arbitration clause. As to this, I think there can be no doubt. The parties have entered into a relationship, an agreement or what is alleged to be an agreement or what appears on its face to be an agreement, which may give rise to disputes. They want those disputes decided by a tribunal which they have chosen, commonly on the grounds of such matters as its neutrality, expertise and privacy, the availability of legal services at the seat of the arbitration and the unobtrusive efficiency of its supervisory law. Particularly in the case of international contracts, they want a quick and efficient adjudication and do not want to take the risks of delay and, in too many cases, partiality, in proceedings before a national jurisdiction.
>
> If one accepts that this is the purpose of an arbitration clause, its construction must be influenced by whether the parties, as rational businessmen, were likely to have intended that only some of the questions arising out of their relationship were to be submitted to arbitration and others were to be decided by national courts. Could they have intended that the question of whether the contract was repudiated should be decided by arbitration but the question of whether it was induced by misrepresentation should be decided by a court? If, as appears to be generally accepted, there is no rational basis upon which businessmen would be likely to wish to have questions of the validity or enforceability of the contract decided by one tribunal and questions about its

> performance decided by another, one would need to find very clear language before deciding that they must have had such an intention.
>
> A proper approach to construction therefore requires the court to give effect, so far as the language used by the parties will permit, to the commercial purpose of the arbitration clause. But the same policy of giving effect to the commercial purpose also drives the approach of the courts (and the legislature) to the second question raised in this appeal, namely, whether there is any conceptual reason why parties who have agreed to submit the question of the validity of the contract to arbitration should not be allowed to do so.

33. Whereas the decisions in *Comandate Marine* and *Fiona Trust* have signalled a clear approach towards the construction of the *scope* of jurisdiction agreements, no similar, broadbrush approach has been articulated in cases where the issue concerns *not the scope* of such clauses *but their nature*, i.e. whether the jurisdiction clause is exclusive or non-exclusive. This is a potentially vital distinction. Where a jurisdiction agreement is exclusive, a stay of proceedings commenced in the face of such a clause is far more likely to be granted as the strong presumption is that parties should be held to their bargain. Similarly, proceedings commenced in a foreign jurisdiction in breach of an exclusive jurisdiction clause may be restrained by the grant of an anti-suit injunction: see, for example, *CSR Limited v Cigna Insurance Australia Limited* (1997) 189 CLR 345; *The Angelic Grace* [1995] 1 Lloyds Rep. 87.

34. The context of this aspect of the discussion may be set by identifying some typical and potentially ambiguous forms of jurisdiction clause:

- Jurisdiction: England.
- This contract is subject to the jurisdiction of Australian courts.
- The parties submit to the jurisdiction of the courts of New Zealand.

Each of these clauses could be construed as exclusive or non-exclusive jurisdiction clauses. They might be contrasted with the following examples:

- (From *Safe Effect Technologies Limited (ACN 099 107 623) v Hood Group Holdings Ltd (ACN 097 778 375)* [2006] FCA 758):

    (a) This agreement is governed by the laws of New South Wales.

(b) Each of the parties irrevocably submits to the exclusive jurisdiction of the Courts of New South Wales.

- (From *Slater & Gordon v Porteous* [2005] VSC 398):

  This deed will be governed by and construed in accordance with the laws in force in the State of Victoria and each party submits to the exclusive jurisdiction of the courts of that State.

- (From *Wholesome Bake Pty Ltd v Sweetoz Pty Ltd* [2001] NSWSC 248):

  "This Agreement is governed by the laws of the State of Victoria, the Courts at which State shall have exclusive jurisdiction."

35. A useful summary of the principles applicable to the construction of such clauses was provided by Giles J. (as he then was) in *FAI Insurance Limited v Ocean Mutual Marine Insurance* (1997) 41 NSWLR 117:

(a) Whether a jurisdiction clause is an exclusive jurisdiction clause is a question of construction of the particular contract, with such regard to the circumstances surrounding the entry into the contract as is permissible.

(b) The word "exclusive" is not determinative, and a clause may be held to be an exclusive jurisdiction clause notwithstanding the absence of that or a similar word or phrase: as was said in *Continental Bank NA v Aeakos Compania Naviera SA* (at 594), it would be a surrender to formalism to require a jurisdiction clause to provide in express terms that the chosen court is to be the exclusive forum.

(c) Although mutuality, in the sense that both parties agree to the relevant jurisdiction, has been thought to point to exclusive jurisdiction, I have some difficulty seeing why that should be so. Lack of mutuality is likely to tell against exclusive jurisdiction (*Continental Bank NA v Aeakos Compania Naviera SA*), but mutuality is consistent with no more than submission to the jurisdiction. However, when taken with other matters mutuality may assist in finding a contractual intention that disputes shall be submitted only to the courts of the relevant jurisdiction: *British Aerospace Plc v Dee Howard Co*; *Austrian Lloyd Steamship Co v Gresham Life Assurance Society Ltd*.

(d) Other language in the clause or the nature of the contract may point towards that contractual intention, for example "under the jurisdiction of the English courts" and the assumed desire for certainty in *Sohio Supply Co v Gatoil (USA) Inc*; or the use of transitive language as in *Austrian Lloyd Steamship Co v Gresham Life Assurance Society, Ltd*, *British Aerospace Plc v Dee Howard Co* and *Continental Bank NA v Aeakos Compania Naviera SA*.

(e) If the courts of the relevant jurisdiction would have jurisdiction in the absence of the clause, that may indicate that the clause was intended to confer exclusive jurisdiction: *Sohio Supply Co v Gatoil (USA) Inc*; *Gem Plastics Pty Ltd v Satrex Maritime (Pty) Ltd*. It will not always be so, as the clause may have been intended only to put beyond doubt the existing jurisdiction (*S & W Berisford Plc v New Hampshire Insurance Co*), or be an unthinking inclusion.

36. Drafters of choice of court clauses sometimes fail to appreciate the technical distinction between a submission to suit and a jurisdiction clause. In *Autotrop SDN BHD v Powercrank Batteries Pty Limited* [2006] VSC 401, the clause relevantly provided:

> *This agreement shall be governed by and construed in accordance with the laws that are applicable in Sarawak, Malaysia.*
>
> *In relation to any legal action or proceedings arising out of or in connection with this agreement ('proceedings'), the Manufacturer and the Purchaser hereby irrevocably submit to the jurisdiction of the High Court in Sabah and Sarawak (in particular at Kuching) and waives any objection to proceedings in any such courts within the jurisdiction of the High Court in Sabah and Sarawak on the grounds of venue or on the grounds that the proceedings have been brought in an inconvenient forum or any similar grounds and the Purchaser agrees that any writ, summons, order, Judgment or other document shall be deemed duly and sufficiently served if addressed to the Purchaser and left at or sent by post to the address of the Purchaser last known to the Manufacturer.*

Whelan J of the Supreme Court of Victoria held that "*It seems to me that the clause here is an irrevocable submission to the jurisdiction of the courts of Malaysia. The words used do not relevantly go beyond that. It is not an exclusive jurisdiction clause*"

37. The decision of Jacobson J. of the Federal Court in *Armacel Pty Limited v Smurfit Stone Corporation* (2008) 248 ALR 573 provides an instructive illustration of the pitfalls that can follow poor drafting. In that case, the contract contained the following clauses:

> *21.3.1 This Agreement must be read and construed according to the laws of the State of New South Wales, Australia and the parties submit to the jurisdiction of that State. If any dispute arises between the Licensor and the Licensee in connection with this*

> *Agreement or the Technology, the parties will attempt to mediate the dispute in Sydney, Australia.*
>
> *21.3.2* *In the event that there is a conflict between the laws of the State of New South Wales, Australia and the jurisdiction in which the Equipment is located, then the parties agree that the laws of the State of New South Wales shall prevail.*
>
> *21.3.3* *If the licensee is in breach of this Agreement, the Licensee must pay to the Licensor on demand the amount of any legal costs and expenses incurred by the Licensor for the enforcement of its rights under this Agreement and this provision shall prevail despite any order for costs made by any Court.*

38. A dispute arose between the parties. Armacel contended that Smurfit had acted in breach of contract. Smurfit denied this and commenced proceedings in the United States seeking a declaration that it was not liable to Armacel. Armacel countered by commencing its own proceedings in the Federal Court of Australia some three weeks later. It did not, however, immediately seek an anti-suit injunction to restrain Smurfit from continuing with its proceedings in the United States. This was a mistake. Rather, Armacel sought a stay of the American proceedings on the basis, inter alia, of the jurisdiction clause contained in the contract. Smurfit sought a stay of the Federal Court proceedings in Australia on the basis that they were duplicative, commenced second in time and that the centre of gravity of the dispute was the United States.

39. Armacel's stay application came on for resolution first. In accordance with the American practice, that motion was decided on the basis of written arguments without oral hearing. The United States court interpreted clause 21.3.1 as simply a submission and not an exclusive jurisdiction clause, and applied United States law to reach this conclusion notwithstanding the parties' choice of New South Wales law. Accordingly, when Jacobson J. came to consider Smurfit's stay application, he was confronted with a decision of the United States' court which had already construed the jurisdiction clause.

40. Unlike the United States' court, Jacobson J. inclined to the view that the clause was intended to confer exclusive jurisdiction on Australian courts, as a matter of construction.

41. Notwithstanding this view, he considered, consistent with the authority of the House of Lords in *The Sennar (No 2)* [1985] 1 WLR 490 that the decision of the United States' court on the question of the construction of the jurisdiction clause, notwithstanding its interlocutory nature and that it had not applied principles of Australian law to govern this question, nevertheless gave rise to an issue estoppel such that he was bound to proceed on the footing that the clause was, in fact, non-exclusive in nature. In these circumstances, the basis for declining to stay the Australian proceedings became far less compelling. His Honour's reasoning on this issue is worth setting out because it is the first time that I am aware of that this matter – which once again highlights the importance of the race even to interlocutory judgments - has been decided in Australia:

> 66 Having approached the present matter with what, I hope, is the requisite degree of caution, I have come to the view that the present case is indistinguishable from *The Sennar* and that, accordingly, Armacel is barred by an issue estoppel from contending that cl 21.3.1 is an exclusive jurisdiction clause. In coming to this view, I have considered the decisions of the House of Lords, and the Court of Appeal in that case. The Court of Appeal decision is cited as *"The Sennar" (No 2)* [1984] 2 Lloyd's Rep 142.
>
> 67 It seems to me that the reasons for judgment of Kerr LJ and Sir Denys Buckley (Cumming-Bruce LJ concurring) make it clear that it is not possible to avoid the consequence of issue estoppel by simply re-characterising the issue as one which is sought to be litigated in accordance with the law of a different jurisdiction.
>
> 68 As Kerr LJ said at 149, it was not open to the plaintiffs to say, simply:
>
> *What we seek to litigate here are issues under English law, and it does not matter that we litigated precisely the same issues under other systems of law in Holland.*
>
> 69 The facts of *The Sennar* are of some importance. The plaintiffs, who were the holders of a bill of lading, invoked the jurisdiction of a Dutch Court by arresting a sister ship of *The Sennar* in Rotterdam. They brought an action for damages in the Dutch Court which held that their only cause of action lay in contract and that the Dutch court was bound to decline jurisdiction because the contract contained a clause under which the parties submitted to the exclusive jurisdiction of the Court of Sudan.

70 The plaintiffs then began an action in the Admiralty Court of England. However, although they succeeded on the jurisdictional question at first instance, the Court of Appeal held that they were barred from suing in the English Court by reason of an issue estoppel arising from the determination of the Dutch Court as to the construction and effect of the exclusive jurisdiction clause.

71 Kerr LJ observed at 148 that the classification of the plaintiffs' claim, as a matter of private international law, fell to be decided by Sudanese law as the proper law of the bill of lading. He said at 149 that by applying Sudanese law, the Dutch Court of Appeal had adopted the correct approach under the English rules of private international law.

72 However, as I have said, Kerr LJ at 149 also rejected the proposition that it was open to the plaintiffs to seek to re-litigate under English law the same issue that had been litigated under other systems of law in Holland.

73 His Lordship observed at 150 that to accept this proposition would altogether remove the possibility of an issue estoppel arising "from any decision by any Court" on the jurisdiction clause. It would permit uncontrolled forum shopping and run directly counter to the policy behind the doctrine of issue estoppel.

74 Sir Denys Buckley's analysis was to the same effect. He said at 159 that the Dutch Court answered the question by reference to Dutch law, except insofar as it paid attention to Sudanese law; an English court must answer the question by reference to English law except insofar as Sudanese law would be applied. He continued:

This does not, however, mean that the question for decision is not the same in each jurisdiction.

42. A further example worthy of note is the decision of Einstein J. in *HIH Casualty & General Insurance Limited (in liq.) v R J Wallace* (2006) 68 NSWLR 603. This was a case where, for reasons that were wholly unclear, the parties not only included an exclusive jurisdiction clause but also provided for arbitration, thereby generating uncertainty as to how the two clauses related to each other and interacted. The relevant provisions were as follows:

"ARTICLE XVIII SERVICE OF SUIT

The Reinsurer hereon agrees that:

1. In the event of a dispute arising under this Agreement, the Reinsurers at the request of the Company will submit to the jurisdiction of any competent Court in the Commonwealth of Australia. Such dispute shall be determined in accordance with the law and practice applicable in such Court.

2. *Any summons notices or process to be served upon the Reinsurer may be served upon*
MESSRS. FREEHILL, HOLLINGDALE & PAGE
M.L.C. CENTRE,
MARTIN PLACE, SYDNEY,
N.S.W. 2000 AUSTRALIA
who has authority to accept service and to enter an appearance on the Reinsurer's behalf, and who is directed, at the request of the Company to give a written undertaking to the Company that he will enter an appearance on the Reinsurer's behalf.

3. *If a suit is instituted against any one of the Reinsurers all Reinsurers hereon will abide by the final decision of such Court or any competent Appellate Court.*

ARTICLE XIX ARBITRATION:

Disputes arising out of this Agreement or concerning its validity shall be submitted to the decision of a Court of Arbitration, consisting of three members, which shall meet in Australia.

The members of the Court of Arbitration shall be active or retired executives of Insurance or Reinsurance Companies.

Each party shall nominate one arbitrator. In the event of one party failing to appoint its arbitrator within four weeks after having been required by the other party to do so, the second arbitrator shall be appointed by the President of the Chamber of Commerce in Australia. Before entering upon the reference, the arbitrators shall nominate an umpire. If the arbitrators fail to agree upon an umpire within four weeks of their own appointment, the umpire shall be nominated by the President of the Chamber of Commerce in Australia.

The Arbitrators shall reach their decision primarily in accordance with the usages and customs of Reinsurance practice and shall be relieved of all legal formalities. They shall reach their decision within four months of the appointment of the umpire.

The decision of the Court of Arbitration shall not be subject to appeal.
The costs of Arbitration shall be paid as the Court of Arbitration directs.
Actions for the payment of confirmed balances shall come under the jurisdiction of the ordinary Courts."

43. One issue in the case was whether proceedings should have been stayed in favour of arbitration. In the result, Einstein J refused to do so on the basis that, on the proper construction of the relevant clauses, the reinsured (HIH) was given the option either to choose judicial determination in an Australian court or arbitration. This decision had important ramifications for the

manner in which, and the law or principles by reference to which, the ultimate dispute would be resolved.

44. Article XVIII(i) of the reinsurance policy in the *HIH* case was interpreted as permitting proceedings to be commenced "*in a competent court in the Commonwealth of Australia*". It then provided that "*such disputes should be determined in accordance with the law and practice applicable in such court*". In other words, in this case, the parties agreed to what was in effect a "floating" choice of law clause. The law to be applied to the resolution of the parties' dispute would depend upon the choice of forum made by the reinsured. In this context, it should be noted that the law, at least as contained in statutes, differs between the Australian states such that depending on the nature of the case, the choice may be strategically significant.

45. One critical point to note in relation to the *HIH* case was the interaction between the mode of dispute resolution and the governing law. As already noted, were proceedings to be instituted in the particular Australian State, the law of that State would apply. On the facts of that case, it was in HIH's interest to commence proceedings in New South Wales in order to take advantage of certain provisions of the New South Wales *Insurance Act*.

46. Furthermore, and perhaps more critically, had HIH not commenced proceedings but, rather, elected to arbitrate, as it was entitled to do under the reinsurance policy, the arbitrators were directed, by clause XIX to "*reach their decision primarily in accordance with the usages and customs of reinsurance practice and shall be relieved of all legal formalities*". The application of this standard may well have led to a different result on the particular question under consideration in that case, namely the construction of the "*paid to be paid*" clause in the policy, than a decision reached by a New South Wales court applying New South Wales law.

47. HIH not only wanted the benefits of the *Insurance Act*, as noted above, but also wished what was a very important but strictly legal question to be decided by a court of law applying a well recognised body of principles relating to contractual interpretation, and with a right of appeal from the decision in the first instance, to a decision loosely based on custom and practice with the minimum of legal formalities.

48. It might also be noted, in this context, that what HIH saw as an advantage to it in litigating rather than arbitrating was seen as a corresponding disadvantage by the defendant who sought to stay the proceedings in favour of arbitration. Whether or not this was because the defendant thought that the application of the "custom and usage" standard would advantage it is not known although it is highly likely, certainly the application of that standard would have injected a degree of uncertainty (and therefore would have created an appetite for settlement) which may not have existed in that event or simply to be resolved as a question of legal construction.

49. An even more recent case, *Global Partners Fund Ltd v Babcock & Brown Ltd (in liq)* (2010) 79 ACSR 383, represents what is arguably a very significant development in the law where a number of closely related parties are involved in a transaction (and then a dispute) but not all parties are bound contractually to each other. In that case, Global Partners Fund Pty Ltd ("**GPF**") commenced proceedings in the Supreme Court of New South Wales against four Babcock entities, BBL, BBI, BBUS and BBMGP. Only BBMGP was party to a Limited Partnership Agreement ("**LPA**") with GPF with the agreement expressly providing for English law accompanied by a widely drawn exclusive jurisdiction clause for England. GPF sought to justify its commencement of proceedings in NSW on the basis that, whilst BBMGP had the benefit of these two clauses, as a matter of contract, BBL, BBI and BBUS did not, and taking the matter "in the round", as it were, it was more convenient for the matter to be tried in New South Wales rather than England. The Court of Appeal would have none of this with Spigelman CJ saying:

[71] With respect to the proposition that cl 18.11 [the exclusive English jurisdiction clause] does not respond to claims made against non parties to the agreement, there are judgments which have interpreted an exclusive jurisdiction clause to bind a party with respect to proceedings against a non party. (See *Donohue v Armco Inc* [2002] 1 Lloyd's Rep 425 ; [2001] UKHL 64 at [60]–[61] (*Donohue*) per Lord Scott of Foscote (although the issue was not argued in the House of Lords. See [14] per Lord Bingham).) Lord Scott's approach was applied to the clause construed in *Winnetka Trading Corp v Julius Baer International Ltd* [2009] 2 All ER (Comm) 735 ; [2008] EWHC 3146 (Ch) at [28]–[29]. On the other hand, other exclusive jurisdiction clauses have been interpreted as applying only to proceedings between the parties. (See, for example, *Credit Suisse First Boston (Europe) Ltd v MLC (Bermuda) Ltd* [1999] 1 Lloyd's Rep 767 at 777–8; *Morgan Stanley & Co International plc v China Haisheng Juice Holdings Co Ltd* [2010] 1 Lloyd's L Rep 265 at [21]–[30] noting the observations with respect to Lord Scott's judgment in *Donohue* above at [30].)

[72] Each contract must be interpreted in its context. Similar, even identical, words do not necessarily have the same meaning in different contexts.

[73] In the present case, it hardly needs saying that BBL, BBI and BBUS do not have contractual rights with respect to the exclusive jurisdiction clause, because they are not parties to the LPA. BBMGP does have such rights which, in my opinion, it is entitled to assert both with respect to the claims against itself, and with respect to the closely related, indeed, relevantly identical, claims against BBL, BBI and BBUS. The focus of such an assertion is the fact that GPF, which is a party to the contract, has agreed to conduct litigation "arising out of or in connection with" the LPA in England. However, BBL, BBI and BBUS are also entitled to approach the court, in their own right, to request that the court exercise its discretion to grant a stay. This is so because of their involvement in the affairs of the partnership, as envisaged by the LPA itself, and the rights conferred upon them as indemnified persons under the LPA.

[74] GPF sought to categorise the first three respondents as "non parties". However, there are non parties and non parties. These respondents are not strangers to the LPA.

[75] I have set out at [29]–[32] above the provisions of the LPA that directly refer to the involvement of the members of the BB Group in the decision making processes of the partnership. These proceedings concern the internal decision making processes of the BB Group that determined how the funds of the partnership were to be invested, particularly the decision-making process that led to the Coinmach transaction being completed. The obligation imposed upon GPF by cl 18.11 should be interpreted to extend, at least, to the participants in the decision making processes envisaged by the LPA.

[76] The proceedings in this court arise, and arise only, from the internal decision making processes for which the LPA provides, namely the making of investments. By reason of the structure of the BB Group, the functions of BBMGP, as the managing general partner under the LPA, were subject to the assistance and direction of other members of the group in the manner alleged in the commercial list statement. Indeed, that participation is the very foundation of the causes of action which GPF seeks to agitate in this court.

[77] An important clue to resolving this issue is found in the indemnity provisions in the LPA which I have set out at [32] above. Each of the respondents is entitled to the benefit of those provisions. Dr A Bell SC, who appeared for BBI, BBUS and BBMGP, informed the court that his clients intended to rely on these provisions as a contractual defence to the applicant's claims. GPF did not suggest that such issues do not legitimately arise.

[78] Notwithstanding the fact that BBL, BBI and BBUS are not parties to the LPA, they cannot be categorised as members of an undifferentiated group of "non parties". It may well be that cl 18.11 will not apply to other non parties. However, the respondents in the present case are in a quite distinct category.

[79] In a context where the very contract confers rights on identified non parties, the choice of law and exclusive jurisdiction clauses should be construed as binding the parties with respect to proceedings in which such an indemnity may arise. Furthermore, the principles underlying the conclusion that such a clause should not be narrowly construed set out at [61]–[69] above, apply, at least, to include claims against non parties who are so closely connected with the implementation of the contract as are BBL, BBI and BBUS.

[80] In my opinion the GPF's contention that, as a matter of construction, cl 18.11 does not apply to proceedings against BBL, BBI and BBUS

50. What is most interesting about this passage is that it, on one view, creates an exception to the orthodox doctrine of privity of contract cf. *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107. Spigelman CJ's reasoning went some way beyond the argument presented which was one by BBMGP to the effect that the claims against BBL, BBI and BBUS were claims "in relation to" or "arising out of" the LPA (even though those entities were not party to it) and GPF had promised it, BBMGP, that it would not bring such claims otherwise than in England. The argument was that this promise was one made to BBMGP and was one that is could enforce including and even in respect of claims not brought against BBMGP itself.

Conclusion

51. The apparently simple topic of choice of law clauses and choice of court clauses, so often considered by commercial lawyers as "boilerplate" provisions to be copied from a precedents database, can raise some difficult and complex questions of private international law, including renvoi, the

interaction of tort and contract, and public policy questions relating to parties' ability to stipulate and override statutory provisions of a legal system other than that chosen or preferred by the parties.

52. An understanding of these issues, and the potential for complexity, is essential for a commercial lawyer anxious to minimize the scope for adjectival litigation in relation to venue and applicable law. Poor drafting may lead to one party leveraging the uncertainty, and potentially different substantive outcomes that may arise through either the application of different laws to the parties' dispute, or the resolution of that dispute in different forums, or a combination of both.

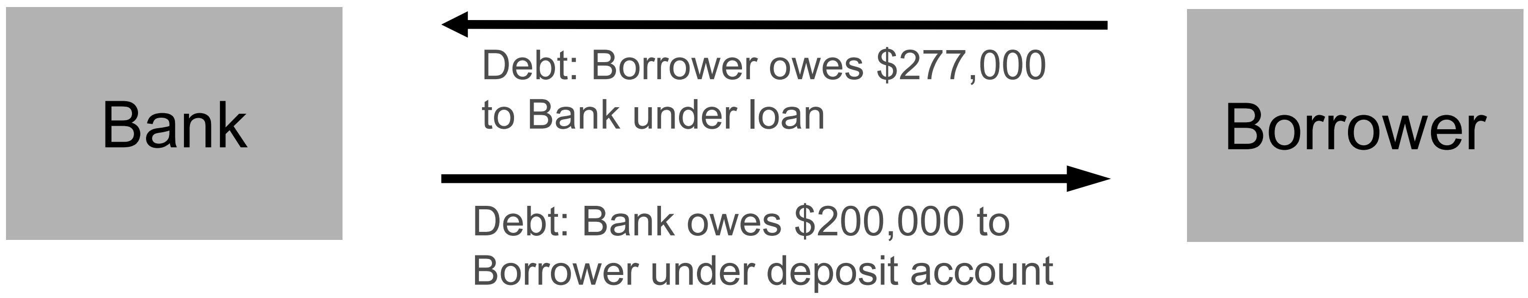
Double and triple cocktails under the PPSA: shaken but not stirred?

Banking & Financial Services Law Association 28th Annual Conference 2011
6 August 2011
Helena Busljeta, Special Counsel

What this presentation is about

- impact of the PPSA on double cocktails and triple cocktails

Double cocktail



Flaw

Bank need not repay deposit until Borrower repays loan

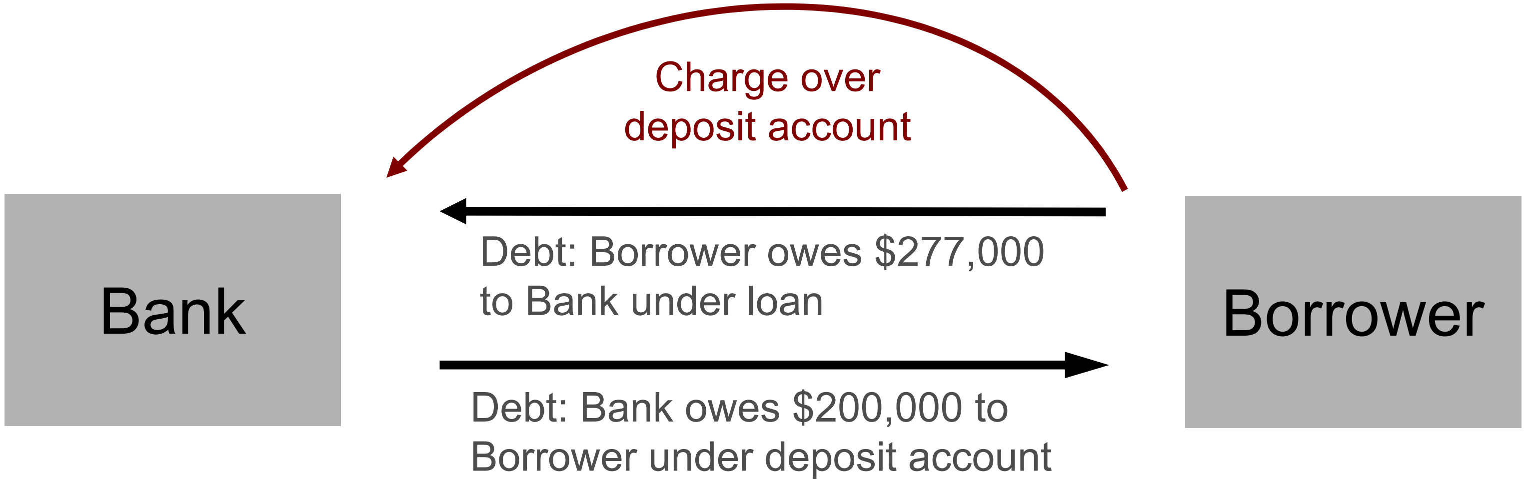
Set-Off

If Borrower defaults in repayment, Bank may set-off deposit against amount owed by Borrower

Restriction on transfer

Borrower may not transfer interest in deposit account without Bank's consent

Triple cocktail



Flaw

Bank need not repay deposit until Borrower repays loan

Set-Off

If Borrower defaults in repayment, Bank may set-off deposit against amount owed by Borrower

Charge-back

If Borrower defaults in repayment, Bank may set-off deposit against amount owed by Borrower

Restriction on transfer

Borrower may not transfer interest in deposit account without Bank's consent

Elements of double and triple cocktail - analysis

Element	Current law	PPSA
Flaw	Not a security interest	Security interest: s12(2)(l)
Set-off	Not a security interest	PPSA does not apply: s8(1)(d)
Charge-back	Conceptually impossible	Expressly permitted: s12(3A) and 12(4)(b)
Restriction on transfer	Effective	Ineffective: s79

What is a security interest under the PPSA?

A ***security interest*** means an interest in 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): s12(1).

For example, a ***security interest*** includes an interest in personal property provided by any of the following transactions, if the transaction, in substance, secures payment or performance of an obligation:…

a flawed asset arrangement: s12(2)(l)

A little background….

There is no creditable explanation for the random arrangement… From time to time someone would think of a new point and a new sentence would be thrown into the hopper. Fortunately, no real harm seems to have been done; except for its untidy appearance and the bewilderment it may cause the unfamiliar reader, the ramshackle structure holds together reasonably well.

Grant Gilmore

Flawed asset arrangement

- can it be argued that a flawed asset arrangement can never satisfy the definition of a security interest because it only gives the financier contractual rights and does not create a proprietary interest in the deposit account?

Arguments that a flawed asset arrangement is a security interest

- unclear what “interest” means
- expressly included as example of a security interest
- using pre-PPSA principles in a post-PPSA world
- compare to charge-back
- compare to set-off
- Canadian Supreme Court decision in *Drummond* case

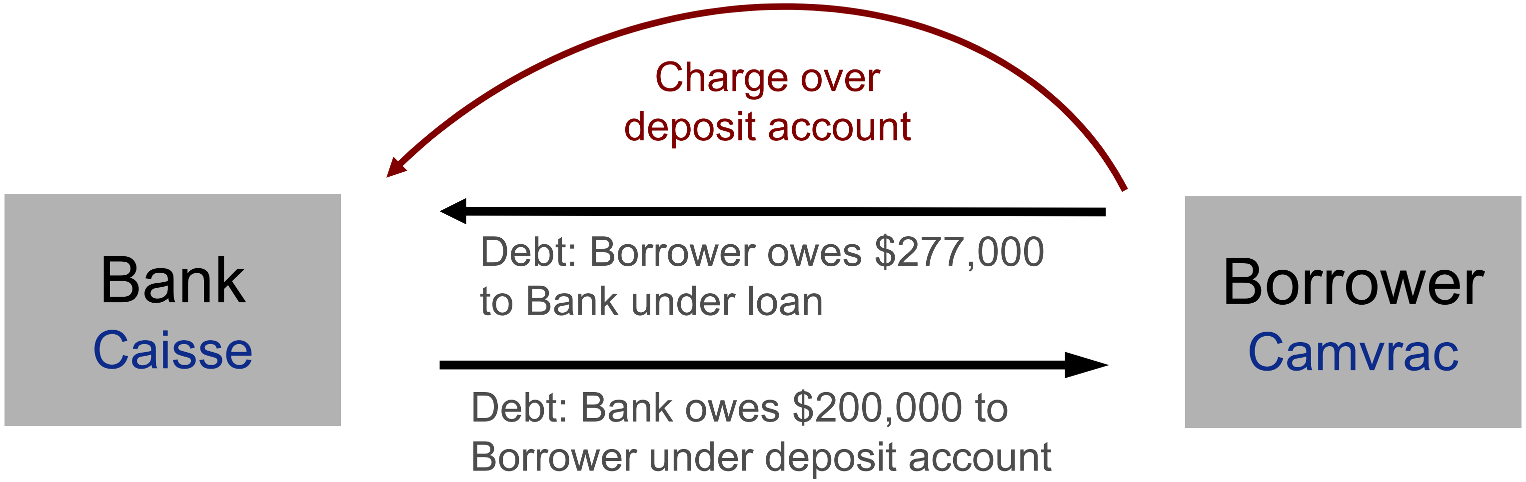
Caisse populaire Desjardins de l'Est de Drummond v Canada [2009] 2 SCR 94 ("***Drummond case"***)

Supreme Court of Canada held that a double cocktail gave rise to a "security interest" within the meaning of a federal tax act

Why is this a big deal?

- tax act definition is in substance the same as the definition of security interest under Canadian (and NZ and Australian) PPS legislation
- the tax act did not include any express reference to a flawed asset arrangement

Drummond case – the facts



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Drummond case – how did it happen?

- considered all the relevant terms of the agreement
- question is not whether set-off alone is a security interest
- must assess whether the agreement functions as a security interest

Drummond case – what the majority said

Rothstein J

- the flaw and restriction on transfer (and the obligation to maintain deposit account) created rights and obligations to ensure the bank would remain liable to the borrower if the bank had to resort to set-off as a remedy
- these rights were "encumbrances" that created an interest in the borrower's property
- the agreement secured the bank's right to effective set-off by conferring on the bank an interest in the property

Drummond case – what the minority said

Deschamps J

- security interest requires bank has a proprietary interest in the deposit account
- combination of personal rights (flaw plus set-off) does not create a proprietary interest

Consequences of double cocktail being a PPSA security interest

- perfection
- impact on insolvency set-off

Perfection

- secured party is not required to register (or otherwise perfect) a security interest but failure to do so exposes it to priority, "taking free" and insolvency risk
- if financier decides that it does want to perfect its security interest in the deposit account, how it should do so depends on:
  - ⇒ nature of the deposit account
  - ⇒ identity of borrower
  - ⇒ whether double cocktail entered into before ("**pre-PPSA double cocktails**") or after PPSA registration commencement time ("**post-PPSA double cocktails**")

Perfection

If financier is ADI and deposit account is an ADI account:

- automatically perfected with control super-priority
- but, if corporate borrower, may need to perfect to ensure priority over Corporations Act preferred creditors

Note that pre-PPSA double cocktails will be automatically perfected by control from RCT and no need to register to ensure priority over Corporations Act preferred creditors

Threat to insolvency set-off

- PPSA permits the borrower to deal with its interest in the deposit: s79
- if borrower assigns its interest in deposit account before insolvency, may destroy mutuality
- financier may not be able to exercise its rights of set-off
- for post-PPSA double cocktails, the financier can rely on fall-back remedies in PPSA which achieve outcome similar to set-off (for example, seize or retain)
- for pre-PPSA double cocktails, no such fall-back PPSA remedies (because enforcement provisions do not apply:s314) but flaw remains intact if otherwise perfected

Arguments that set-off should remain effective

- inability to set-off prejudices financier: s79(2)
- set-off integral part of security interest
- set-off is not a method of enforcement of flaw
- set-off excluded from PPSA

Where do we end up?

- double cocktail is likely to be a PPSA security interest
- triple cocktail is a PPSA security interest
- flawed asset will still be as effective under PPSA as it is under current law provided that it is perfected
- if financier is an ADI and the deposit account is an ADI account, flawed asset arrangement automatically perfected and has control "super-priority" (but registration may be needed to defeat preferred creditors)
- financier may not be able to exercise its set-off rights

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