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General Editor's note

Karen Lee *LEGAL KNOW-HOW*

In my last General Editor's note, I mentioned that drafting is a key skill that all lawyers need to master, and this skill comes with practice and experience. On that note, in the last issue of the bulletin, we looked at drafting definitions and interpretation clauses in security documents.[1] This month, we start the bulletin with an article about the recent decision of *Re Carter Holt Harvey Woodproducts (Australia) Pty Ltd (No 1)*[2] on equitable charges. The facts involved a trade creditor's charging clause in a guarantee that was faced with a challenge by the liquidator — by reason of its breadth and ambiguity. Is near enough good enough? Readers will find out by reading **Benjamin Shaw** and **Morgan Stack**'s (DibbsBarker) article. I am sure you will find that this article serves as a very good refresher on equitable charges.

"PPSA — what difference does it make?" This is the title of **Scott Guthrie**'s (DibbsBarker) article. This is a very good question. Do you think the Personal Property Securities Act 2009 (Cth) (PPSA) recasts the law of personal property in Australia? Do you think the older common law concepts have lost favour? In Scott's article, he considers *Kaizen Global Investments Ltd v Australia New Agribusiness & Chemical Group Ltd (in liq)*[3] and *Knauf Plasterboard Pty Ltd v Plasterboard West Pty Ltd (in liq) (recs and mgrs apptd)*,[4] and looks at what has changed in this area of law and what has remained. My thanks to Scott for sharing his expert knowledge and insights.

Next, in their first article for the bulletin, new contributors **Nicholas Saady** and **Angus Moore** (Supreme Court of New South Wales) analyse recent decisions involving the Boart Longyear Ltd restructuring schemes and how they have affected the way courts facilitate schemes of arrangement under s 411 of the Corporations Act 2001 (Cth). Banking and finance lawyers who advise on matters relating to corporate restructuring will find the main issues that are addressed relevant and interesting. I would like to extend a warm welcome to Nicholas and Angus to our author community, and I look forward to the publication of more of their articles in the near future.

A sincere thank you to editorial board member **Nicholas Mirzai** (Level 22 Chambers) who introduced me to **Alan Parnell**. Alan is currently completing his honours thesis at the University of Technology, Sydney. Alan's article is titled "Understanding s 75 of the PPSA: the inventory financier vs the accounts financier" and is about the effect of priorities under the PPSA between an inventory financier and an accounts financier. This is typically a difficult topic! Alan's paper achieved the highest mark awarded in the subject of Finance Law, and Nicholas recommended it for publication with the bulletin. Would an accounts financier defeat an inventory financier in a priority dispute? Is the outcome fair? Find out by reading Alan's in-depth analysis.

I hope you enjoy reading this issue of the bulletin, and I welcome your thoughts.

Karen Lee
Principal and Consultant
Legal Know-How
karen.lee@LegalKnowHow.com.au
www.legalknowhow.com.au

Karen Lee is the General Editor of the Australian Banking & Finance Law Bulletin and the Financial Services Newsletter. She also partners LexisNexis in other capacities, including as Specialist Editor for precedents in banking and finance, mortgages and options, and as contributing author of a number of other publications, including Australian Corporate Finance Law, Halsbury's Laws of Australia and Practice Guidance for General Counsel. Karen established her legal consulting practice, Legal Know-How, in 2012. She provides expert advice to firms and businesses on risk management, legal and business process improvement, legal documentation, regulatory compliance and knowledge management. Prior to this, Karen worked extensively in-house, including as Head of Legal for a leading Australasian non-bank lender, as well as in top-tier private practice, including as Counsel at Allen & Overy and Clayton Utz.

Footnotes

1. See A Flannery "Take care when drafting: the lesson from *Springsure*" (2017) 33(8) *BLB* 135 regarding *Credit Suisse AG, Sydney Branch v Springsure Property Holdings Pty Ltd (in liq) (recs and mgrs apptd)* [2017] QSC 142; BC201705356.
2. *Re Carter Holt Harvey Woodproducts (Australia) Pty Ltd (No 1)* [2017] VSC 499; BC201707042.
3. *Kaizen Global Investments Ltd v Australia New Agribusiness & Chemical Group Ltd (in liq)* (2017) 120 ACSR 220; [2017] FCA 431; BC201703032.
4. *Knauf Plasterboard Pty Ltd v Plasterboard West Pty Ltd (in liq) (recs and mgrs apptd)* [2017] FCA 866; BC201705852.

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Charging clauses: is near enough still good enough?

Benjamin Shaw *and* ***Morgan Stack*** *DIBBSBARKER*

The incorporation of charging clauses in commercial agreements (and particularly supply agreements) is commonplace. Notwithstanding the frequency with which such clauses are encountered in practice, and that the legal principles applicable to their construction are settled, the Supreme Court of Victoria's decision in *Re Carter Holt Harvey Woodproducts (Australia) Pty Ltd (No 1)*[1] (*Re Carter*) was the second recent case[2] involving a challenge to a charging clause.

In this article, we explore the court's reasoning in *Re Carter*, which confirmed (among other things) that charging clauses will generally be construed liberally, even when incorporated in a guarantee. Robson J's reasons surveyed the principles applicable to charging clauses, which we review.

Background

Carter Holt Harvey Woodproducts Australia Pty Ltd (CHH) sold goods and services to Amerind Pty Ltd (recs and mgrs apptd) (in liq) (Amerind) pursuant to a supply agreement. Mr Naja David, the sole director of Amerind, guaranteed the trade debt by a written guarantee and indemnity which contained the following term:

> [Clause 2.6A]
> The Guarantor will charge in favor of CHH all estates and interest in any land and any other assets whether tangible in [sic] intangible in which they now have any legal or beneficial interest or in which they later acquire any such interest, with payment of all monies owed by the customer and agree upon request, to execute a registrable instrument transferring to CHH the Guarantors estate and interest by way of security.[3]

After executing the guarantee, Mr David acquired three (further) real properties. Amerind's debt to CHH grew to $4,927,452.19.

The effectiveness of the charging clause was a critical issue in three separate proceedings, namely:

- CHH's debt recovery proceedings seeking approximately $6 million and the sale of certain properties held by Mr David;
- unfair preference proceedings by the liquidator of Amerind against CHH, which CHH sought to defend on the basis that amounts paid to it (totalling $10,048,637.19) were secured; and
- proceedings by CHH against the receivers of Amerind, by which CHH sought payment of a receivership surplus arising from the receivers' sale of properties CHH claimed secured (by reason of the charge) Amerind's debt to CHH.

While Mr David defended CHH's claim, at the hearing the liquidators were the only party actively challenging the effectiveness of the charge. The liquidators (consistently with Mr David's pleaded position) did so on the following two bases:

- the charging clause did not create a present charge, rather it was an agreement to create a charge by a future act, and therefore consideration was required (and was absent); and
- the wording of the charging clause was so uncertain and ambiguous that it was rendered void and unenforceable.

As explored below, the liquidator's arguments focused on the meaning of the words "will charge" in the charging clause.

Principles applicable to charging clauses

Robson J confirmed the following principles applicable to the creation of an equitable charge:[4]

- an "equitable charge" does not require any specific wording, rather it is sufficient that the grantor of the charge manifest a present intention to charge the land specified as security. It may also apply to after-acquired property so long as the property was identifiable at the time of enforcement of the charge;
- the requirement that there be a present intention to charge land does not require the property over which the charge is to be created to be owned by the charger at the time agreement is entered into. The temporal requirement indicated by the word "present" is of the "intention" to create a charge, not the property subject to the charge;
- in addition to the requirement that the charge be over land, and recorded in writing, where consideration is necessary, it must be executed consideration. That is, the money must have been actually

advanced and a promise to enter into a transaction could not itself constitute valuable consideration;

- there will be a valid charge where there is an intention that property, be it existing or future, be used as security, even if that security is enforceable in the future with the assistance of the court; and
- it is sufficient that the court can ascertain the parties' intention that the relevant property will amount to security.

Did the charging clause create a present charge?

The liquidator argued that an intention to create an immediate charge is not created by the word "will", as that word connotes an agreement to do something in the future (in this case, an obligation to charge the relevant assets later acquired). Accordingly, such an agreement does not create a present charge and does not evidence a clear intention to create a charge.

The court rejected that argument, finding that the words "will charge" manifested the necessary present intention to create a charge. The fact that the charge would not come into being until credit was extended did not affect this conclusion.

The liquidator further argued that the word "will" referred to the promise to "execute a registrable interest" and do so "upon request". This, it was argued, amounted merely to an agreement to enter into future documents. The fact that further acts were contemplated was important for two reasons.

First, the agreement to create a further security by the execution of further documents was inconsistent with a present intention to create a charge. This contention was rejected, Robson J finding that the promise to execute a registrable instrument of transfer is a separate and distinct promise made under the clause creating a charge.[5]

Second, the liquidator argued that even if the requisite intention was present, the agreement should fail for lack of valuable consideration. As the supply agreement contained a retention of title clause, the supply of goods could not be valuable consideration.[6]

Again, the court rejected this argument, finding that as the guarantee and indemnity was by deed, consideration was not required, and in any event, the provision of goods on credit to Amerind at Mr David's request amounted to valuable consideration. The retention of title clause was found to merely provide another means of securing repayment.

Was the charging clause uncertain and ambiguous?

The liquidator asserted that the clause was uncertain in that it purported to operate in respect of property that is undefined and unascertainable at the time of the execution of the charge. This argument was disposed of on the basis that a valid charge may be engaged by the acquisition of property in the future.

The liquidator argued further that the charging clause was ambiguous in the following respects, and therefore unenforceable:[7]

- first, the word "will" creates a future obligation, but the agreement neither stated when or in what circumstances that obligation would arise, nor was it clear what the charge is securing;
- second, it was not clear whether the charge related to moneys owed but not yet payable, moneys due and payable, or moneys that might become owed;
- third, the circumstances in which Mr David was to execute a registrable instrument other than upon request were unclear;
- fourth, the system of registration referred to by the registrable interest was unclear;
- fifth, the registrable instrument referred to contemplated a transfer, which goes beyond a charge;
- sixth, the term "estate and interest" is vague, and inconsistent with the broad reference to assets found elsewhere in the clause; and
- finally, the transferring of Mr David's estate and interest was purportedly by way of security, without reference to what was being secured.

As the charging clause was contained in a guarantee, the liquidators urged the court to view the asserted ambiguities through the prism of the principle in *Ankar Pty Ltd v National Westminster Finance Australia Ltd*[8] (*Ankar*), with the effect that any ambiguity in the guarantee should be construed in favour of the surety.[9]

Rejecting all of the asserted ambiguities, Robson J held that there was no room for the application of *Ankar*.

Conclusion

In light of the courts' historical deference to substance over form in giving effect to charging clauses, the result in *Re Carter* is unsurprising, even having regard to the opportunity the presence of the clause in a guarantee created to invoke *Ankar*. Although the charging clause under consideration was not a shining example of draftsmanship, the outcome confirms that in construing and giving effect to charging clauses, near enough will usually be good enough.

The recent decision of the Supreme Court of New South Wales in *Coleman v Hart-Hughes*[10] (*Coleman*) underscores this conclusion. That case confronted a similarly ambiguous charging clause, and produced a similar result. The relevant clause was contained in a joint venture deed, and merely provided that the land-owner "will consent" to the registration of a caveat, rather than specifically referring to the grant of an equitable charge. The court found that despite no reference being made to the grant of an equitable charge, the reference to a caveat implied an intention to create equitable charge to secure repayments of the moneys advanced.[11]

The decisions in *Re Carter* and *Coleman* will not provide encouragement to parties seeking to avoid the operation of charging clauses that might be considered ambiguous. The decisions also serve as a useful reminder to the drafters of such clauses of the importance of ensuring the intention to create a charge is clearly articulated.

Benjamin Shaw
Partner
DibbsBarker
ben.shaw@dibbsbarker.com
www.dibbsbarker.com

About the author

Benjamin Shaw's practice focuses on dispute resolution in the banking, insolvency and financial services industries. He is also experienced in general commercial litigation.

Morgan Stack
Lawyer
DibbsBarker
morgan.stack@dibbsbarker.com
www.dibbsbarker.com

About the author

Morgan Stack practices in the areas of insolvency and commercial dispute resolution. She has acted for liquidators and administrators in complex matters throughout Australia.

Footnotes

1. *Re Carter Holt Harvey Woodproducts (Australia) Pty Ltd (No 1)* [2017] VSC 499; BC201707042.
2. The first being *Coleman v Hart-Hughes* [2017] NSWSC 656; BC201703866.
3. Above n 1, at [37]–[39].
4. Above n 1, at [40]–[46].
5. Above n 1, at [63].
6. Above n 1, at [67].
7. Above n 1, at [75]–[91].
8. *Ankar Pty Ltd & Arnick Holdings Ltd v National Westminster Finance (Aust) Ltd* (1987) 162 CLR 549; [1987] HCA 15; BC8701770.
9. Above n 1, at [78].
10. Above n 2.
11. Above n 2.

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PPSA — what difference does it make?

Scott Guthrie *DIBBSBARKER*

The commencement of the Personal Property Securities Act 2009 (Cth) (PPSA) in 2012 was met with considerable fanfare. In part, this was because it was meant to herald the simplification of the law pertaining to the taking of security interests in personal property in Australia. Prior to its enactment, there existed a disparate set of registers and state-based laws concerning the taking and registration of security in personal property. Now there is, of course, a national register of interests and one set of "rules" that apply to security in personal property.

These rules are, of course, largely embodied in the PPSA and consequential amendments to the Corporations Act 2001 (Cth). However, how these rules are to be applied, and the extent to which they represent a departure from the previous law, is (obviously) a matter for interpretation by the courts.

A number of clear trends have already emerged concerning the application of the PPSA, including that:

- registration of a retention of title interest in collateral should occur at the date of execution of the first terms of credit, and subsequent deliveries (with fresh invoice terms) do not "restart" the time for doing so;[1] and
- once collateral has vested, it is too late to register a security interest and thereafter seek an extension of time for registration.[2]

On the whole, it seems that the PPSA is recasting the law of personal property in Australia and that older common law concepts have lost favour. However, as three recent cases have demonstrated, the extent to which the old law relating to personal property security continues to apply depends very much on the issues at hand and an interpretation of the precise terminology of the PPSA and the consequent amendments to the Corporations Act.

This article will explore two of those cases, *Kaizen Global Investments Ltd v Australia New Agribusiness & Chemical Group Ltd (in liq)*[3] (*Kaizen*) and *Knauf Plasterboard Pty Ltd v Plasterboard West Pty Ltd (in liq) (recs and mgrs apptd)*[4] (*Knauf*), both of which were considered by the Federal Court of Australia. A further article to follow this one will explore the third case, *Hamersley Iron Pty Ltd v Forge Group Power Pty Ltd (in liq) (recs and mgrs apptd)*[5] (*Hamersley*), which was considered by the Supreme Court of Western Australia.

Kaizen — what is the relevant prejudice to consider in applications to extend time to register security interests?

As was the case under the old law concerning charges, there remain insolvency risks for borrowers who fail to register interests within mandated time periods under the PPSA if within 6 months of the creation of the interest in collateral, the borrower becomes subject to external administration (excluding receivership).

Kaizen concerned an application by an overseas lender to extend time to register (and thereby perfect) its security interest in an insolvent borrower's shares (or in PPSA jargon, "the collateral") in a phosphate mining company as security for a loan of $5 million.

Although the transaction occurred in December 2015, the lender did not register its interest in the collateral within 20 business days (as it was unaware of the requirement to do so). Three months later, the lender was informed that its share mortgage was required to be registered, otherwise its interest would remain unperfected. However, the lender did not register its interest for a further 33 days after becoming aware of this requirement. A little over a week later, the borrower was placed into administration, and subsequently liquidation.

Absent the assistance of the court (via s 588FM of the Corporations Act), the security would have been ineffective and the collateral would vest in the borrowing company's insolvent estate.[6] The authorities concerning applications for an extension of time to register a security interest (in conjunction with the terms of s 588FM) demonstrate that there are two broad matters for the court to consider:

- The first (and threshold issue) is that the creditor's failure to register its interest within time was accidental or due to inadvertence.
- Assuming that threshold issue is satisfied (and it usually is), the court then considers whether it is just and equitable to accede to the creditor's request.

As above, the secured creditor (which was an overseas entity) did not immediately appreciate the need to register its interest on the Personal Property Securities Register (PPS Register). The court considered, on the facts, that the threshold issue of inadvertence had been established.

As to whether time should have been extended to permit the valid registration of the security interest, an issue of some importance was the potential prejudice to unsecured creditors of the now insolvent borrower.

Do the old authorities apply?

In the earlier case of a *Re Appleyard Capital Pty Ltd; 123 Sweden AB v Appleyard Capital Pty Ltd*,[7] Brereton J of the New South Wales Supreme Court had this to say:

> Thus, although I accept, as the authorities make clear, that the presence or absence of prejudice to unsecured creditors is a relevant discretionary consideration, relevant prejudice is not necessarily established merely by showing that the dividend to unsecured creditors will be less if the security interest does not vest in the company; the unsecured creditors may well have been in no different a position had the security interest been timely registered. *The type of prejudice that is of particular relevance is prejudice attributable to the delay in registration, rather than prejudice from making the order (which is inevitable)*.[8] [Emphasis added.]

Those comments were subsequently referred to approvingly in the decision of *Re Carpenter Int Pty Ltd*.[9] On their face, they arguably represented a contrast from the position adopted in the older cases under the law of charges where, broadly, the courts had taken a view that an extension of time would only be permitted where the company was or was likely to become insolvent in “exceptional circumstances”.

However, in *Kaizen*, the court noted that any seeming divergence between the two views was probably illusory and that the law as it applied under the old regime continued to be relevant. Accordingly, the court confirmed that, broadly, as it related to the exercise of discretion in circumstances where the borrower was insolvent, or likely to become so:

- there was no constraint on the court’s discretion when considering whether exceptional circumstances existed permitting the making of an extension order;
- > A determination that it is appropriate to grant relief in such circumstances will require the identification of factors of sufficient significance to outweigh the adverse impact on unsecured creditors of the grant of relief[;][10]

  and
- an order extending time in terms of an insolvent entity will not be lightly made and only on conditions that will minimise the impact on unsecured creditors.

As the court noted, the older “charge” authorities are:

> … of continuing relevance in relation to the current provisions, as there is no indication that the current provisions were intended to change the principles applicable to the exercise of the discretion.[11]

Taking into account these discretionary considerations, the court refused to exercise its discretion to extend time within which the security interest could be registered, given the conduct of the borrower and the time that had elapsed prior to registration of its interest. Although the creditor could demonstrate that the failure to register was due to inadvertence, their overseas lawyers had recommended that they enquire as to any registration requirements in Australia and that their failure to do so earlier was “careless”.[12]

Knauf — do common law concepts of possession survive the PPSA and are perfection by “taking” a valid act of perfection if the taking of possession was consensual?

Knauf was another case involving delay in registering a security interest, though the issues considered were different to those traversed in *Kaizen*.

Knauf was a secured creditor that had potentially fallen foul of s 588FL of the Corporations Act due to its failure to register its security interest on the PPS Register within the time stipulated by the PPSA.

Knauf registered its interest a week before appointing receivers. Following that appointment, the directors of the debtor company purported to appoint liquidators. The court determined that, on the facts, the appointment of liquidators was invalid and therefore s 588FL had no application.

The court nevertheless went on to consider Knauf’s alternative argument which was that despite the potential registration issue, it had nevertheless perfected its interest in the debtor’s collateral by possession, by either:

- the act of appointing receivers; or
- the subsequent act of the receivers taking possession of the collateral.

Knauf argued that either of those acts did not constitute seizure or repossession (which are not methods by which perfection can be achieved).[13]

Knauf was compelled to argue perfection by possession due to its (ultimately unfounded) risk that its security interest had vested in the debtor company in liquidation.

What does the PPSA say about perfection?

Section 21 of the PPSA provides for how an interest in collateral is perfected. It relevantly states:

> **Perfection — main rule**
> (1) A security interest in particular collateral is *perfected* if:
> (a) the security interest is temporarily perfected, or otherwise perfected, by force of this Act; or
> (b) all of the following apply:
> (i) the security interest is attached to the collateral;
> (ii) the security interest is enforceable against a third party;
> (iii) subsection (2) applies.
> (2) This subsection applies if:
> (a) for any collateral, a registration is effective with respect to the collateral; or
> (b) for any collateral, the secured party has possession of the collateral (other than possession as a result of seizure or repossession) …

As can be seen above, perfection can be achieved by either registration or possession (other than possession by seizure or repossession).

In support of its argument that it was in possession of the debtor company's collateral other than by seizure or repossession, Knauf asserted that "the common law concept of possession may be equated with de facto possession, legal possession and/or *the right* to possess or to have legal possession"[14] (emphasis added).

Possession under the PPSA

The court considered that the answer to what is meant by the term "possession" under the PPSA should principally be determined by the way it was addressed in the legislation.

As to that, s 10 of the PPSA defines possession as follows: "*Possession* has a meaning affected by section 24."

The court observed that in *Vanstone v Clark*,[15] the Full Court of the Federal Court has previously noted that the term "has a meaning affected by" is a common drafting device and that "if the words 'affected by' are to be given any sensible interpretation, they must contemplate the expansion or contraction of the meaning that would otherwise be applicable".[16] Accordingly, the meaning of possession was either expanded or contracted under the PPSA.

Turning to s 24 of the PPSA, it relevantly defines possession as follows:

> *Possession by one party exclusive of possession by others*
> (1) A secured party cannot have *possession* of personal property if the property is in the actual or apparent possession of the grantor or debtor, or another person on behalf of the grantor or debtor.
> (2) A grantor or debtor cannot have *possession* of personal property if the property is in the actual or apparent possession of the secured party, or another person on behalf of the secured party.

The court considered that the meaning of the term "possession" had been contracted by the PPSA because:

> … subss 24(1) and (2) limit the meaning of "possession" by reference to the party who has the "actual or apparent possession" of the personal property. That is, as between a secured party and a grantor or debtor, a secured party cannot have "possession" if the grantor or debtor, or someone on their behalf, has actual or apparent possession: s 24(1). Similarly, a grantor or debtor cannot have "possession" of personal property if the secured party, or someone on their behalf, has actual or apparent possession: s 24(2).[17]

Accordingly, in terms of whether the mere appointment of a receiver was sufficient to constitute possession, the court determined it was not, because:

> Without more, the exclusionary modification to the definition of possession in s 24(1) of the PPS Act prevents the appointment from constituting possession. It cannot be said that, merely by the appointment of a receiver, a secured party has possession of personal property if at that point the personal property remains in the actual or apparent possession of the grantor or debtor. That was so in this case. Upon their appointment the Receivers had the authority to deal with the assets the subject of the Security Deed and, in relation to those assets, could exercise the powers conferred on them by the Security Deed and s 420 of the Corporations Act. But actual or apparent possession remained with the grantor …[18]

Were steps by a receiver to take possession effective perfection or merely seizure or repossession?

Alternatively, Knauf submitted that in addition to the appointment of a receiver, its steps in implementing the exercise of rights (by the receiver demanding possession and changing the locks to the trading premises) constituted perfection by way of possession. Knauf argued that as the terms of the facility agreement with the grantor permitted the *consensual* taking of possession upon default, there could not be seizure as that term is understood, because seizure involves a form of enforcement. Accordingly, Knauf argued that taking possession in that context was not seizure.

The court agreed that the actions of the receiver amounted to actual or apparent possession of the collateral. However, the court found (I would submit correctly) that regardless of whether or not possession is able to be taken consensually is not really to the point:

> … the meaning of "seizure" in s 21(2)(b) is informed by the significant purpose of the PPS Act to give notice of security interests to third parties. The appointment and conduct of a receiver in taking possession of collateral falls short of satisfying that purpose. The appointment and grant of powers to a receiver is consensual as between parties to a security agreement but, because that arrangement does not

concern third parties, they are not notified of the existence of a security interest until after the grantor defaults under the security agreement and the secured party exercises its rights under that agreement. A third party is not put on notice of the security interest until after the grantor has experienced financial difficulty and, as a result, cannot make informed commercial decisions in its dealings with the grantor. It follows that there are sound policy reasons to understand "seizure" as including actions taken by a receiver pursuant to a security agreement.[19]

Accordingly, the court held that the appointment of a receiver and their taking of possession of collateral was clearly seizure under the PPSA and therefore could not constitute perfection (as per s 123(4) of the PPSA).

Conclusion

As with any significant legislative change, there will likely be changes to the law as it existed before. In the case of the PPSA, it can be seen that some remnants of the old charges regime remain (as demonstrated by *Kaizen*); but that in other areas, the law has been fundamentally altered.

The outcome in *Knauf*, while unsurprising, clearly demonstrates that in terms of the concept of possession, the older, broader common law definitions no longer apply. This is particularly in circumstances where creditors seek to retrospectively perfect interests by taking collateral instead of properly registering their interest on the PPS Register.

In the subsequent article concerning these issues, I will consider the decision of the Supreme Court of Western Australia in *Hamersley* whereby that court confirmed that the introduction of the PPSA materially altered the prior law concerning the distinction between fixed and floating charges.

Scott Guthrie
Partner
DibbsBarker
scott.guthrie@dibbsbarker.com
www.dibbsbarker.com

About the author
Scott Guthrie is a partner in DibbsBarker's Banking, Insolvency & Disputes group, and leads the Restructuring & Insolvency team. Scott draws on his 22 years of expertise to advise clients in the finance, insolvency and property industries. He acts for banks, receivers, liquidators and administrators in enforcement and priority disputes, and provides advice on personal property security issues that often arise in insolvency matters.

Footnotes

1. *Central Cleaning Supplies (Australia) Pty Ltd v Elkerton (in his capacity as joint and several liquidator of Swan Services Pty Ltd) (in liq))* (2015) 321 ALR 181; [2015] VSCA 92; BC201503669; *Re Carpenter Int Pty Ltd (Carpenter)* (2016) 111 ACSR 477; [2016] VSC 118; BC201602013; *Amerind Pty Ltd (recs and mgrs apptd) (in liq)* (2017) 121 ACSR 206; [2017] VSC 127; BC201701878.
2. *Re OneSteel Manufacturing Pty Ltd (admin apptd)* (2017) 344 ALR 657; [2017] NSWSC 21; BC201700308.
3. *Kaizen Global Investments Ltd v Australia New Agribusiness & Chemical Group Ltd (in liq)* (2017) 120 ACSR 220; [2017] FCA 431; BC201703032. DibbsBarker acted for the liquidators in the proceedings. An appeal will be heard on 1 November 2017.
4. *Knauf Plasterboard Pty Ltd v Plasterboard West Pty Ltd (in liq) (recs and mgrs apptd)* [2017] FCA 866; BC201705852.
5. *Hamersley Iron Pty Ltd v Forge Group Power Pty Ltd (in liq) (recs and mgrs apptd)* (2017) 320 FLR 259; [2017] WASC 152; BC201704639.
6. Corporations Act, s 588FL.
7. *Re Appleyard Capital Pty Ltd; 123 Sweden AB v Appleyard Capital Pty Ltd* (2014) 101 ACSR 629; [2014] NSWSC 782; BC201404636.
8. Above n 7, at [30].
9. *Carpenter*, above n 1.
10. Above n 3, at [87].
11. Above n 3, at [85].
12. Above n 3, at [92].
13. PPSA, s 123(4).
14. Above n 4, at [118]. An example of such a right is one under a facility agreement with a borrower.
15. *Vanstone v Clark* (2005) 147 FCR 299; [2005] FCAFC 189; BC200507054.
16. Above n 15, at [135].
17. Above n 4, at [127].
18. Above n 4, at [145].
19. Above n 4, at [175].

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Breaking down Boart: an analysis of the Boart Longyear litigation and its ramification for schemes of arrangement

Nicholas Saady *and* ***Angus Moore*** *SUPREME COURT OF NEW SOUTH WALES*

Introduction

This article will analyse recent decisions involving the Boart Longyear Ltd (BLY) restructuring schemes and how they have affected the way courts facilitate schemes of arrangement under s 411 of the Corporations Act 2001 (Cth). In turn, this article will address issues of relevance for banking and finance lawyers advising on matters relating to corporate restructuring.

Main issues addressed

- What is the courts' approach in determining voting classes under s 411(1) of the Act?
- What conditions must be satisfied before a court approves a scheme under s 411(4) of the Act?
- What is the scope of the power conferred upon courts by s 411(6) of the Act?
- What is the general approach of the courts in facilitating schemes of arrangement?

The factual background

BLY is a Utah-based, Australian Securities Exchange (ASX) listed company. It is part of the Boart Longyear group of companies, which sells drilling products and provides drilling services and equipment for companies globally.[1] BLY fell into a "parlous financial position"[2] and was unlikely to be able to repay over US$760 million in debt.[3] Debt restructuring was proposed to prevent its impending insolvency, through the following two schemes of arrangement:

- An unsecured creditors scheme (unsecured scheme)[4] relating to US$294 million in senior unsecured notes (SUNs) with an interest rate of 7%. This scheme provided for:
  - — the cancellation of approximately US$196 million of SUNs in exchange for the issue of ordinary equity in BLY to the SUN holders (totalling approximately 42% of BLY's equity);
  - — an extension of the maturity dates of the SUNs to December 2022;
  - — the subordination of SUN holders' priority to unsecured interest accrued on certain facilities held by secured creditors;
  - — the reinstatement of the remaining US$88 million of SUNs at 1.5%; and
  - — the release of certain "subordinate"[5] claims.
- A secured creditors scheme relating to US$204 million in senior secured notes (SSNs) held by various entities with an interest rate of 10%, and US$250 million in two instruments named term loan A and term loan B (TLABs) held by entities associated with Centerbridge Partners LP,[6] with interest rates of 12% (secured scheme).[7] This scheme provided for:
  - — the reinstatement of the SSNs at 12% interest payable in kind until December 2018;
  - — an extension of the maturity dates of SSNs and TLABs to December 2022;
  - — the waiver of SSN and TLAB holders' rights to call on debts arising from a change of control event;
  - — a reduction in the interest rate on TLABs to 10% in exchange for TLAB holders being issued shares in BLY amounting to 56% of BLY's post-restructuring equity; and
  - — the introduction of new asset-based facilities (ABLs) to Centerbridge to replace other previous facilities it held.

On 24 April 2017, BLY and several associated companies commenced Supreme Court proceedings for the approval of these two schemes.[8] On 10 May 2017, after the first court hearing, Black J made orders under s 411(1) convening creditors' meetings for the consideration and potential approval of the two schemes.[9]

One of BLY's creditors, First Pacific Advisors LLC (holding 29.07% of the SSNs), appealed Black J's decision — arguing that separate class meetings of secured creditors under the secured scheme should have been ordered. The Court of Appeal (Bathurst CJ, Beazley P and Leeming JA agreeing) dismissed that appeal and examined the law regarding the composition of classes for Pt 5.1 scheme meetings,[10] which will be explained below.

In July and August 2017, the second court hearing took place to determine the fate of the schemes. However, after 4 days, the hearing was adjourned as Black J ordered the parties to mediate — an unusual step for scheme litigation, taken because of the "interests other than those of the entities before the Court"[11] which could be "adversely affected if the schemes were ultimately not approved".[12]

After mediation, the parties agreed on alterations to be made to the schemes.[13] The "substantive and material"[14] alterations proposed included:

- that paid-in-kind interest on SSNs accrues from 1 October 2016 rather than 1 January 2017 at 12%;[15]
- the introduction of a call schedule which granted BLY optional redemption of its SSNs at increasing premiums of outstanding principal amounts until maturity on 31 December 2022;[16]
- that if repayment of the SSNs was accelerated due to default, they would be repayable at par plus accrued interest, but without a premium;[17]
- the reallocation of the ordinary shares to be issued, such that 4% would be issued to SSN holders rather than Centerbridge and its associated entities;[18] and
- that First Pacific would fund 50% of Ares's (an entity associated with Centerbridge) existing commitment under a new ABL for BLY.[19]

Most voting secured creditors (representing 99.63% of debt under the secured scheme) and voting unsecured creditors (representing 96.19% of debt under the unsecured scheme) supported the altered scheme, apart from one minor creditor whose attitude was not known.[20] While appearing as *amicus curiae* and making submissions as to the applicable law, the Australian Securities and Investments Commission "did not express a view as to whether the schemes should be approved".[21]

The Snowside companies,[22] shareholders of BLY, were granted leave to be heard in their capacity as contributories of BLY under r 2.13 of the Supreme Court (Corporations) Rules 1999 (NSW). Together, these companies held 2.82% of BLY's shares — being the third largest shareholding group in BLY.[23] The implementation of the schemes would have reduced the Snowside companies' collective shareholding to approximately 0.1%.[24] They opposed the schemes in their original and altered forms.[25]

NSW Supreme Court decision

On 22 August 2017, Black J approved the two amended schemes under s 411(4).[26] His Honour also held that the proposed amendments accorded with s 411(6) because:

- they had been agreed to by substantially all secured and unsecured creditors;[27]
- the alterations to the secured scheme advantaged secured creditors,[28] caused no "prejudice and disadvantage"[29] to creditors, did not change the secured scheme's essential features,[30] did not alter class composition[31] and did not make the explanatory statements "falsified or … irrelevant";[32]
- his Honour was "comfortably … satisfied" that the creditors would have likely voted in favour of the altered schemes at the scheme meetings;[33]
- the schemes provided a proper mechanism to implement the complex arrangements;[34]
- the parties did not have the "luxury" of restarting the process because of BLY's near insolvency;[35] and
- there was no utility in ordering further creditors' meetings where substantially all voting creditors supported the alterations.[36]

The Snowside companies appealed this decision.

NSW Court of Appeal decision

The Court of Appeal (Bathurst CJ, Beazley P and Leeming JA) unanimously dismissed the Snowside companies' two grounds of appeal. Both grounds were "confined to questions of the limits of the discretionary power to approve conferred on the Court",[37] specifically being that:

1) section 411(6) was not available to a court in relation to a scheme which had substantial or material amendments from that upon which creditors voted;[38] and
2) the terms of the resolution by which the creditors supported the schemes precluded the court from exercising its s 411(6) power.[39]

Ground 1: availability of s 411(6)

Referring to various authorities, the Snowside companies submitted that the court's s 411(6) power did not extend to amendments which were "material or substantial or significant".[40] While noting that a court had never approved a scheme with such substantial amendments, the court rejected the Snowside companies' approach as conflating "what is sufficient with what is necessary",[41] as there was:

> … no reason in the text, or context, or purpose of the section to confine the power to approve of "such alterations

or conditions as it thinks just" to alterations or conditions which fall short of being material.[42]

Nevertheless, the court held that s 411(6) "is not without limitation",[43] being "circumscribed by the requirement that the Court thinks the alteration is one that is just".[44]

Ground 2: the effect of the terms of the creditors' approval on s 411(6)

This ground related to the following term of the creditors' resolution, approving of the original schemes:

> … with or without alterations or conditions approved by the Court, provided that such alterations or conditions do not change the substance of the Scheme, including the Steps, in any material respect.[45]

The court rejected this ground because "all voting secured creditors"[46] and "all save one"[47] of the voting unsecured creditors expressed their approval of the altered schemes. Therefore, it held that to limit this approval due to the above term would be to take an "extremely narrow view"[48] of the court's power, because the term had now been subsumed by the creditors' later substantial approval of the altered scheme.

Further, the court reasoned that the terms of members' or creditors' approval of a scheme do not prevent the s 411(4) and (6) powers from being enlivened. Rather, such terms may only inform the exercise of the courts' discretion under s 411(4) and (6).

Accordingly, the Court of Appeal held there were only two requirements for a binding scheme. First, that the scheme was agreed to by the requisite majorities of members or creditors.[49] Second, that it was approved by the court.[50] Both had occurred and therefore the schemes were binding.

Practical implications of the Boart decisions

Composition of classes — first Court of Appeal decision

The Court of Appeal characterised the task of identifying classes of members or shareholders as grouping together "those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest",[51] quoting the oft-cited remarks of Bowen LJ in *Sovereign Life Assurance Co v Dodd*[52] (*Sovereign Life*).

However, the Court of Appeal refined the approach to undertaking this task — proposing three fundamental questions for determining share classes:[53]

- What are the rights which existing creditors (or members) have against the company and to what extent are they different?
- To what extent are those rights differently affected by the scheme?
- Does the difference in rights or different treatment of rights make it impossible for the creditors (or members) in question to consider the scheme as one class?

The court also emphasised that the context in which the scheme is presented must be considered when assessing members' or creditors' rights and determining the suitability of constituting separate classes[54] — with BLY's "imminent prospect of insolvency"[55] being one such contextual consideration, heavily relied on by the Court of Appeal in its reasoning. Further, it was suggested that courts must adopt a "practical business-like approach" to the determination of classes and avoid being overly "assiduous in identifying classes".[56]

The first Court of Appeal decision has been flagged as pushing the boundaries of the differential rights that may be conferred on discrete creditor groups without warranting the creation of separate classes and as encouraging uncertainty in the formation of such classes.[57] It has also been suggested that the court's application of *Sovereign Life* "was too narrow or literal", placing too great an emphasis on context (BLY's impending insolvency) to determine the similarity of the creditors' rights.[58]

Beazley P recently responded to this by explaining extra-curially:

> The decision reflects an intensely pragmatic approach where, on the evidence, the only alternative was liquidation. Rather than introducing uncertainty into class constitution, I would suggest that the Court has recognised that classes cannot be narrowly confined. In brief, the metes and bounds of a class should not be restricted in a commercial world where debt and equity can take a myriad of forms.[59]

Putting debate about the application of s 411(1) in *Re Boart Longyear Ltd*[60] (*Boart*) aside, the decision has drawn together precedent relating to the determination of s 411(1) classes and clarified the approach courts should adopt when determining them. While this approach seems to confer a large degree of discretion upon courts to determine scheme classes and sanction the favouring of a practical business-like method of exercising this discretion, it must be considered alongside s 411(4).

The promotion of commercial efficiency and reluctance to prevent a scheme from progressing on "technical class grounds"[61] in exercising this discretion appears appropriate because courts retain another broad discretion under s 411(4)(b) (which will be analysed below) to refuse to approve a scheme that is unfair or unjust to those involved. The likely effect of this is that grievances about the composition of classes may now be increasingly ventilated at the second court hearing — giving s 411(4) heightened prominence in contemporary scheme litigation.

Favouring the swift, efficient formation of voting classes at the first hearing and reserving extensive scrutiny of the proposed schemes for the second hearing, the *Boart* approach also suggests that those opposing schemes should carefully plan the time they expend their resources to challenge a proposed scheme.

The s 411(6) power is expansive — second Court of Appeal decision

The second appeal was fundamentally concerned with the courts' discretionary power under s 411(6). While it is more likely that a court will exercise its s 411(6) power where amendments to a scheme are minor or technical,[62] both decisions made it clear that the s 411(6) power is not limited to such amendments. Black J stated that it is not confined by circumstances where similar alterations have been previously made,[63] reiterated by the Court of Appeal's statement that the broad terms of s 411(6) are "not to be confined in a way which has not been articulated by Parliament".[64]

These judgments should not give rise to a concern that courts now have a "blank cheque" to amend schemes presented to them as they please. Courts must exercise their discretionary power under s 411(6) "judicially, having regard to its statutory purpose and in the light of the whole of the circumstances surrounding the matter".[65] The s 411(6) power is also limited by "the requirement that the Court thinks the [proposed] alteration is one that is just".[66]

In determining what was "just", Black J had regard to a range of relevant matters. One was that "those who are most directly affected by [the amendment] consent to it".[67] Another "relevant factor"[68] was "whether the proposed variation was so novel or substantial as to take the varied scheme beyond the reasonable contemplation of shareholders at the time they agreed to it".[69] The commercial and financial consequences of the scheme for affected members or creditors are other considerations,[70] along with the possibility of restarting the restructuring process[71] and the impact of the scheme for creditors, employees and the communities in which the relevant corporations operate.[72] Both decisions therefore reinforced that what is just is not conducive to any rigid definition, but requires the court to consider all relevant facts and circumstances in each case.

Accordingly, while the court's power might now be more expansive than previously thought, it will not be exercised arbitrarily or unfairly.

It is also worth noting that Black J, after considering Lindgren J's observation that a court must be satisfied that the "scheme as proposed to be altered would have been agreed to by the requisite statutory majorities"[73] at the creditors' meeting, held it was more appropriate for a court to exercise the s 411(6) power after considering the *present* views of the scheme participants. Black J's approach prevents the court from speculating about "what creditors would have done at the earlier meeting" if the alterations were then proposed.[74] It appears desirable because it limits the possibility of erroneous speculation,[75] focuses on parties' immediate commercial concerns and reduces judicial intrusion into commercial relations.

The flexibility of the courts' approach to facilitating scheme litigation

The Boart decisions emphasised that courts will facilitate scheme litigation flexibly, with the aim of assisting the parties to achieve the most satisfactory commercial outcomes for all involved.

First, this flexible approach was shown by the formation of the s 411(1) classes whereby Black J (upheld by the Court of Appeal) adopted a practical business-like approach and warned against being overly assiduous, as explained above.

Second, this flexibility was illustrated by the courts' affirmation of the broad nature of the s 411(4) and (6) discretionary powers. Section 411(6) was interpreted as an expansive power to be exercised with regard to the unique circumstances of each case, as discussed above. Section 411(4) was similarly construed, with there being no specified "matters as to which the court must be satisfied before granting approval"[76] to a scheme under s 411(4) after the requisite majorities agree to it.[77] Ensuring they remain tools for courts to flexibly facilitate scheme litigation, these constructions of s 411(4) and (6) also embrace parliament's intention for s 411 to "provide a flexible mechanism to facilitate compromises and arrangements between insolvent companies and their creditors as an alternative to liquidation".[78]

Third, although distinct from the s 411 machinery, Black J exemplified this flexible approach by ordering the parties to mediate 4 days into the second court hearing, in circumstances where it may be inferred that his Honour was apprehensive of the original schemes.[79] This order gave the creditors an opportunity to reduce the scope of their disagreement and develop a fairer scheme — serving as a *de facto* creditors' meeting where the statute did not provide for such a meeting to be held at that point. The effectiveness of the mediation should put practitioners on notice that scheme proceedings are not exempt from the contemporary trend towards alternative dispute resolution in commercial litigation and suggests that mediation may become more common in the scheme process.

Ultimately, the courts' approach allowed the schemes to be approved without having to restart the substantial, costly and time-intensive scheme process and therefore limited the possibility of BLY falling into liquidation.

Accordingly, the Boart litigation illustrated the desirability of this flexible judicial approach — assisting companies to avoid liquidation and its potentially financially catastrophic consequences for the relevant company, its creditors, employees, and to a degree the wider economy, while also ensuring that scheme arrangements are fair for all involved.

However, this flexibility may cause greater difficulties for those seeking the total rejection of a proposed scheme. The Boart decisions have shown that courts are unlikely to reject schemes outright but will instead use all their powers, including mediation, to assist the parties to propose a scheme that is fit for s 411 approval, even if objectors do not want that.

The effect of the terms of approval on s 411(4) and (6)

Both decisions have suggested that the courts' s 411(4) and (6) powers cannot be excluded by the terms of members' or creditors' approval of a scheme.

Black J explained that the terms of the scheme document itself and resolutions approved at scheme meetings "cannot confine the Court's power under s 411(6) … although they are plainly relevant to the exercise of the Court's discretion whether to approve the schemes as altered".[80] Similarly, the Court of Appeal stated that it would be an improper view of the s 411(6) power to conclude that it was unavailable because of the "terms in which the creditors had formally expressed their approval, notwithstanding their demonstrated approval of the altered scheme".[81]

Regarding s 411(4), the Court of Appeal emphasised, as explained above, that there are only two "necessary and sufficient conditions prescribed by s 411(4) for a compromise or arrangement to be binding".[82] Therefore, the court held that any condition or term subject to which members' or creditors' votes are cast "does not go to"[83] the courts' power to approve a scheme, although such a condition or term may be relevant to the court's exercise of its discretion.

This sends a clear message to members and creditors to ensure that they unwaveringly approve of a proposed scheme before entering any resolution to formalise this approval. They cannot rely on terms of the resolution by which approval is granted to prevent the courts' s 411 powers being enlivened. The Boart decisions have made it explicit that once a scheme goes to court, the only way it can be rejected is if the court decides that their powers should not be exercised.

Conclusion

The Boart decisions have provided some important clarifications of the law surrounding schemes of arrangement and the courts' role in facilitating the scheme process. While not without controversy, by articulating a clear method by which share classes are to be determined and emphasising the broad, flexible nature of the courts' discretionary powers under s 411(4) and (6), the decisions have somewhat settled the law in this important area of commerce and provided essential guidance for practitioners. A key takeaway from the decisions is that the courts will attempt to flexibly facilitate schemes within the limits of the law and with careful regard to the interests of all involved. As the esteemed practitioners Apáthy and Rich remarked:

> The decisions of the New South Wales Supreme Court and Court of Appeal in the Board Longyear restructurings are, perhaps, the most important scheme of arrangement decisions in Australia in almost 40 years. They set important new precedents which are relevant to both creditors' schemes and members' schemes.[84]

Nicholas Saady
Tipstaff
Supreme Court of New South Wales
www.supremecourt.justice.nsw.gov.au

About the author
Current Tipstaff to Schmidt J and former Tipstaff to Sackar J, who will return to Herbert Smith Freehills in 2018 as a graduate solicitor.

Angus Moore
Researcher
Supreme Court of New South Wales
www.supremecourt.justice.nsw.gov.au

About the author
Researcher to the Supreme Court of New South Wales's Commercial List and Technology & Construction List, who will commence at King & Wood Mallesons in 2018 as a graduate solicitor.

Footnotes

1. *Re Boart Longyear Ltd (No 2)* [2017] NSWSC 1105; BC201706605 at [5].
2. *First Pacific Advisors LLC v Boart Longyear Ltd* (2017) 121 ACSR 136; [2017] NSWCA 116; BC201703849 at [1].

3. Above n 1, at [5].
4. Above n 2, at [2].
5. Within the meaning of s 563A(2) of the Act.
6. Centerbridge Partners LP is a US private equity firm which specialises in distressed debt buyouts.
7. Above n 2, at [3]–[4].
8. Above n 1, at [1].
9. *Re Boart Longyear Ltd* [2017] NSWSC 567; BC201703346.
10. Above n 2, at [105]–[107].
11. Above n 1, at [27].
12. Above n 1, at [27].
13. Above n 1, at [28].
14. Above n 1, at [97].
15. Above n 1, at [86].
16. Above n 1, at [86].
17. Above n 1, at [86].
18. Above n 1, at [87].
19. Above n 1, at [88].
20. Above n 1, at [2] and [85].
21. Above n 1, at [26].
22. Snowside Pty Ltd as trustee for the Snowside Trust and Maurici Nominees Pty Ltd as trustee for the AP Maurici & Associates Pty Ltd Superannuation Fund.
23. Above n 1, at [22]; *Snowside Pty Ltd as trustee for the Snowside Trust v Boart Longyear Ltd (Boart Appeal)* [2017] NSWCA 215; BC201706783 at [4].
24. Above n 1, at [22].
25. Above n 1, at [22].
26. Above n 1, at [347].
27. Above n 1, at [94] and [108].
28. Above n 1, at [106].
29. Above n 1, at [106].
30. Above n 1, at [106].
31. Above n 1, at [106].
32. Above n 1, at [106].
33. Above n 1, at [95].
34. Above n 1, at [108].
35. Above n 1, at [108].
36. Above n 1, at [108].
37. *Boart Appeal*, above n 23, at [11].
38. *Boart Appeal*, above n 23, at [8].
39. *Boart Appeal*, above n 23, at [9].
40. *Boart Appeal*, above n 23, at [16]–[19] and [26].
41. *Boart Appeal*, above n 23, at [19].
42. *Boart Appeal*, above n 23, at [22].
43. *Boart Appeal*, above n 23, at [26].
44. *Boart Appeal*, above n 23, at [26].
45. *Boart Appeal*, above n 23, at [9].
46. *Boart Appeal*, above n 23, at [27].
47. *Boart Appeal*, above n 23, at [27].
48. *Boart Appeal*, above n 23, at [27].
49. *Boart Appeal*, above n 23, at [28].
50. *Boart Appeal*, above n 23, at [28].
51. Above n 2, at [77] referring to *Sovereign Life Assurance Co v Dodd* (*Sovereign Life*) [1892] 2 QB 573 at 583.
52. *Sovereign Life*, above n 51.
53. Above n 2, at [80] referring to the authorities cited there.
54. Above n 2, at [81]–[86].
55. Above n 2, at [84] referring to *Re Apcoa Parking Holdings GmbH* [2015] 4 All ER 572; [2014] EWHC 3849 (Ch) at [109].
56. Above n 2, at [78] citing *Re Opes Prime Stockbroking Ltd* (2009) 179 FCR 20; [2009] FCA 813; BC200906876 at [66].
57. See P Apáthy and A Rich, *Court of Appeal Upholds Scheme Classes Decision in Boart Longyear Restructuring*, 31 May 2017, www.herbertsmithfreehills.com/latest-thinking/court-of-appeal-upholds-scheme-classes-decision-in-boart-longyear-restructuring.
58. D Brown, *Schemes of Arrangement and Classes — Boart Longyear — A Class Act to Follow?*, 5 June 2017, https://blogs.adelaide.edu.au/law-rocit/2017/06/05/schemes-of-arrangement-and-classes-boart-longyear-a-class-act-to-follow.
59. Justice M Beazley, "Judicial session — case law update" paper presented at the 34th Annual Conference of the Banking & Financial Services Law Association (2 September 2017).
60. Above n 9.
61. See above n 59.
62. As courts had in the pre-*Boart* precedent: see for example, *Re Permanent Trustee Co Ltd (Permanent Trustee)* (2002) 43 ACSR 601; [2002] NSWSC 1177; BC200207461; *Re Investorinfo Ltd* (2006) 24 ACLC 44; [2005] FCA 1848; BC200511086; *Re Kalgoorlie Lake View Pty Ltd* (2005) 56 ACSR 144; [2005] FCA 1440; BC200510296.
63. Above n 1, at [98].
64. *Boart Appeal*, above n 23, at [22].
65. Above n 1, at [108].
66. *Boart Appeal*, above n 23, at [26].
67. Above n 1, at [92].
68. Above n 1, at [100].
69. Above n 1, at [100] and [104].
70. Above n 1, at [101]–[105].
71. Above n 1, at [108].
72. Above n 1, at [312].
73. Above n 1, at [95].
74. Above n 1, at [95].
75. See *McArthur v Mercantile Mutual Life Insurance Co Ltd* (2001) 163 FLR 236; [2001] QCA 317; BC200104673 at [23] — "the court does not speculate when it may know".
76. Above n 1, at [56] referring to *Permanent Trustee*, above n 62, at [8].
77. *Boart Appeal*, above n 23, at [28].
78. Above n 1, at [93] referring to *Re Fowler v Lindholm; Opes Prime Stockbroking Ltd* (2009) 178 FCR 563; [2009] FCAFC 125; BC200908415 at [73].
79. This is stated more highly by Apáthy and Rich who explain that "the Court ordered this mediation after coming to the view that it was unlikely to approve the schemes as originally proposed":

see P Apáthy and A Rich, *Boart Longyear Schemes Amended and Approved: Triumph of Fairness over Class?*, 30 August 2017, www.herbertsmithfreehills.com/latest-thinking/boart-longyear-schemes-amended-and-approved-triumph-of-fairness-over-class.

80. Above n 1, at [107].
81. *Boart Appeal*, above n 23, at [27].
82. *Boart Appeal*, above n 23, at [28].
83. *Boart Appeal*, above n 23, at [28].
84. Above n 79.

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Understanding s 75 of the PPSA: the inventory financier vs the accounts financier

Alan Parnell UNIVERSITY OF TECHNOLOGY, SYDNEY

Introduction

This paper addresses a priority dispute that might arise between an inventory financier and an accounts financier over the same secured collateral under the Personal Property Securities Act 2009 (Cth) (PPSA). After identifying the position at law and how such a dispute might arise in practice, this paper identifies that an accounts financier generally defeats an inventory financier, and addresses why this is the case and whether the outcome is fair. That being said, this paper contends that the strict priority afforded to authorised deposit-taking institutions (ADIs) is not necessarily justifiable and that the law can be improved by providing ADIs with super priority only in particular situations as opposed to in all cases by definition.

Definitions and lexicon

"Inventory" is defined in s 10 of the PPSA as personal property that in the course of an enterprise is held by the person for sale or lease, as raw materials or work in progress; or held, used or consumed as materials, among other purposes.

An inventory financier provides finance to a borrower to acquire inventory, or supplies inventory on finance terms. A retention of title arrangement is a common example. An inventory financier usually has the improved protections of a purchase money security interest (PMSI). A PMSI includes an interest taken in collateral to the extent it secures the collateral's purchase price,[1] and when value is given for the grantor to acquire rights in the collateral.[2]

"Accounts" are monetary obligations arising from disposing property (through various methods), or through granting rights or providing services in the ordinary course of business. Accounts receivable are a common example of accounts. Accounts receivable are performed contractual obligations not yet paid — otherwise known as book debts.[3] Under the PPSA, an account is not an ADI account.[4]

An accounts financier includes a party who acquires the accounts, or provides finance and takes security over the accounts receivable such as a debt factoring entity.[5] It also includes a financier that has a security interest over accounts through other means, for example, an all present and after-acquired property (AllPAP).

An "ADI account" is an account kept with an ADI that is payable on demand or in the future.[6]

"Proceeds" are identifiable or traceable personal property including that which is derived directly or indirectly from a dealing,[7] provided the grantor has an interest in the proceeds.[8] Proceeds are ordinarily cash. When accounts are realised, they often give rise to a claim to proceeds by a PMSI holder.[9]

The commercial context: accounts receivable financing

Businesses often require finance to purchase inventory, whether trading stock or raw materials to produce trading stock. An inventory financier will supply the means to the grantor to start production. The finance provided is usually the amount required to acquire the inventory, that is, the inventory's purchase price (or cost of goods).[10]

Businesses then sell their product to purchasers on terms giving rise to accounts, that is, moneys that the purchaser has not yet paid. These are accounts receivable. If the business received cash in exchange for a product, there would be no account for a creditor to extend security over — and indeed no security interest would arise.

Grantor businesses must meet repayment obligations to the inventory financier (usually on trade terms such as 30 days), but may not have the necessary cash flow. Instead, the grantor business may hold substantial accounts receivable.[11] Although an inventory financier might have recourse to those accounts receivable as security (depending on the security agreement), this requires default and enforcement, subjecting the business (if the inventory financier had an AllPAP) to other assets' seizure and often the closure of that business.

Instead of defaulting, grantors can raise short-term capital through accounts receivable financing, also known as debt factoring. This involves either assigning (selling) accounts receivables to a third party (accounts receivable financier (ARF)), or taking a loan from the ARF who secures the debt against the accounts receivable. The ARF's security interest extends to the value of the accounts (the inventory's sale price), while the inventory financier's interest extends only to the inventory's purchase price.[12]

The grantor meets its debt obligations to the inventory financier and receives cash (albeit less than the value of the accounts receivable) to continue its operations. Accounts receivable financing is a common commercial practice[13] not only to alleviate temporary cash flow vulnerability but also as a means of division of labour: the grantor can spend more time selling its product and less resources enforcing payment.[14]

The law

In summary, PMSIs have priority against non-PMSIs,[15] except when the non-PMSI is a security interest:

- over accounts receivable the original subject of a security agreement;[16] or
- in an ADI account controlled by an ADI.[17]

Section 62 of the PPSA

Section 62(2) provides that a PMSI satisfying the formalities (registered in time and complying with requirements under the Personal Property Securities Regulations 2010 (Cth)) will have priority over a non-PMSI. The rationale is that suppliers will be willing to supply inventory to a grantor despite the potential existence of prior creditors.[18]

If the supplied inventory became an ordinary part of the asset pool, an inventory supplier is exposed to higher risks, despite the supply's benefit being that the grantor's business is more likely to continue, trickling through to other creditors who can then be paid.

Section 64 of the PPSA

Section 64 provides an exception to the general rule in s 62 that PMSI holders have higher priority. When a non-PMSI is granted for new value in an account as original collateral, that non-PMSI has priority over the PMSI, provided the formalities of notice in s 64(1)(a) or (b) are complied with.

This scenario essentially only applies to a perfected creditor who takes security over accounts (usually accounts receivable) for "new value" and as original collateral. This means that the security agreement creating the "priority interest"[19] must not extend over the account merely through the secured party's security over the original personal property that was disposed of to give rise to the accounts. The priority interest must be over the accounts themselves, and not as a result of disposal of inventory.

Overall, an ARF that provides new value with no interest in the inventory itself, and takes security over the accounts that arose from the inventory's disposal, has a higher priority than an inventory financier in relation to the accounts receivable.

The rationale of s 64 is to preserve the commercial arrangement of debt factoring and accounts receivable financing.[20]

Sections 57 and 75

Sections 57 and 75 provide another circumstance where a PMSI holder is defeated by a non-PMSI holder.

Section 57 provides that a security interest perfected by control has priority over any other security interest in the same collateral.[21] Section 21(2)(c) provides a list of property that can be perfected by control, the relevant item being ADI accounts. Section 25 provides that a secured party has control of an ADI account automatically if they are the ADI with whom the account is held. An ADI account can only be perfected by control by that ADI.[22]

Section 75 provides that an ADI's perfected security interest over an ADI account has priority over any other security interest in the account.

Application of the priority regime to a dispute between an inventory and accounts financier

The following table displays the variables relevant under ss 64, 57 and 75 to determine the successful creditor in a priority dispute between an inventory financier and an ARF.

The reason for the outcome is emphasised in italics.

Is inventory proceeds (including accounts)?	Does the inventory financier (IF) have an interest in proceeds?	Is the ARF an ADI?	Proceeds in an ADI account?	Does the ARF have an interest in proceeds as original collateral[23] or as proceeds of original collateral?	Party with priority	Comment and statutory reference
No	N/R[24]	N/R	N/A[25]	N/R	IF	Section 62(2): PMSI versus non-PMSI.
Yes	Yes	Yes	*Yes*	Original collateral	ARF	Section 75: ADI with control wins.
Yes	Yes	Yes	*Yes*	Proceeds of original collateral	ARF	Section 75: ADI with control prevails.
Yes	Yes	Yes	No	*Original collateral*	ARF	Section 64 applies: ARF prevails.
Yes	Yes	Yes	No	*Proceeds of original collateral*	IF	Section 62(2): PMSI defeats non-PMSI. Section 64 only applies when proceeds are the original collateral of the security agreement.
Yes	Yes	No	N/A	*Original collateral*	ARF	Section 64 applies: ARF prevails.
Yes	Yes	No	N/A	*Proceeds of original collateral*	IF	Section 62(2): PMSI defeats non-PMSI.
Yes	No	Yes	*Yes*	Original collateral	ARF	Section 75: ADI with control prevails.
Yes	No	Yes	*Yes*	Proceeds of original collateral	ARF	Section 75: ADI with control prevails.
Yes	*No*	Yes	No	Original collateral	ARF	IF's security interest does not extend to proceeds.
Yes	*No*	Yes	No	Proceeds of original collateral	ARF	IF's security interest does not extend to proceeds.
Yes	*No*	No	N/A	Original collateral	ARF	IF's security interest does not extend to proceeds.
Yes	*No*	No	N/A	Proceeds of original collateral	ARF	IF's security interest does not extend to proceeds.

Explanation

Of the above 13 permutations, the inventory financier prevails in three circumstances:

- proceeds have not arisen out of the inventory;
- a non-ADI ARF did not take security over the proceeds as original collateral; or
- an ADI ARF did not take security over the proceeds as original collateral, and the proceeds are not controlled in an ADI account.

There are two classes of success.

The first occurs because there would not yet be an accounts financier interested in the same collateral. In this scenario, no accounts receivable have been derived. Consequently, it is noted that this success is not important when considering a dispute between an inventory financier and ARF interested in the same collateral.

The second class involves a situation where the ARF had an interest in the inventory originally, in which case they are not strictly ARFs for the purposes of s 64 of the PPSA.

Comparatively, an ARF prevails in three instances:

- it is an ADI with control of proceeds that are funds in an ADI account;
- it is an ARF (ADI status is irrelevant) complying with s 64; or
- the inventory financier's security interest did not extend to proceeds.

The first class relates to the s 75 super priority.

The second class relates to the s 64 exception to PMSI priority. The third relates to an inventory financier failing to protect themselves adequately.

The third class is not a direct priority dispute because the two interests are not competing over the same collateral (the inventory financier merely retains an *in personam* right).

Overall, in scenarios where there is a direct priority dispute over the same collateral between an inventory financier and ARF, the ARF always wins.

The fairness of the outcomes

Despite the inventory financier losing in all situations where there is a priority dispute, the effect of the law is orthodox.

The parties' interests

The inventory financier's interest is to supply inventory (their profit-making vehicle) while not subjecting themselves to losing an enforceable security. The inventory financier faces the conceptual issue that to take security, the main source of security is the inventory itself. If that collateral is disposed, a third party holds the inventory. Due to the taking-free provisions (particularly s 46), the inventory financier is usually unable to extend their security to the third party purchaser. Upon disposition of the underlying collateral, the inventory financier only retains contractual rights against the grantor.[26] This is consistent with the very purpose of inventory, namely, to be used up in a production process or to be onsold.[27] Consequently, this purpose is incompatible with an inventory financier retaining security over only the inventory.[28] This has been described as a "self-liquidating loan".[29]

On the other hand, accounts receivable are a relatively liquid security, albeit unrealised.[30] An ARF's interest is to provide finance (which incurs interest), or acquire accounts receivable for less than the value of the accounts. The main factor is the strength of the accounts receivable as this impacts the commercial risk and thus the price. Consequently, an ARF's interest is to either acquire or take security over strong accounts receivable, for as low as an acquisition cost or as high as an interest rate as possible.

The parties' risks

Aside from the ordinary commercial risks of supplying inventory without payment, or lending funds generally, an inventory financier is exposed to the risk that without appropriate protection through perfection of its security interest, the collateral becomes vulnerable to other creditors.

ARFs, on the other hand, by their super priority through ss 64 or 75, only carry the ordinary risk that the security will fail.

The parties' benefits

Both parties benefit from each other. Without the supply of inventory, there would be no accounts receivable for the ARF to take as security. The inventory financier likewise benefits from the ARF because of cash injections for the grantor to pay the inventory financier with.[31]

This paper contends that the inventory financier is more important when considering creditors as a whole.

Inventory financier vs ARF

Although the above table indicates inventory financiers lose against ARFs, the practical impact is small.

Despite the assumption that accounts receivable would be purchased at discounted rates, thus prejudicing the interest of an inventory financier to recoup its debt, Greenberg notes the value of an inventory financier's security interest is generally the *cost of the inventory*.[32] The value of the ARF's security interest will extend to a discounted value of the *accounts receivable*. Consequently, in a priority dispute over the proceeds as accounts receivable, once liquidated, there should be enough remaining to satisfy at least a portion of the inventory financier's interest, depending on the facts.

Second, s 64(3)(a) provides that an inventory financier's PMSI status extends to the new value provided by the ARF.

Third, s 64 requires notice to be given (or effectively given through prior registration of the ARF's interest) by the ARF to the inventory financier when the ARF takes an interest in the accounts. This provision's effectiveness is questionable: even with notice, an inventory financier could only enforce its rights *after* accounts become security for a higher-ranked creditor by taking more security or negotiating the grantor to pay down debt. Both of these options depend on the inventory financier's commercial leverage.

Nonetheless, this provision addresses a common historical issue of secret liens that only became known upon insolvency.[33] Although such an arrangement may be fraudulent,[34] at least the inventory financier now is *entitled* to notice; and without notice will retain priority over an ARF that does not comply with s 64.

Consequently, the practical outcome is relevant in ascertaining the law's fairness: here, the inventory financier is less likely to be prejudiced than face value suggests.

Inventory financier vs ADI

This situation is similar when the ARF happens to be an ADI. Despite the ADI having the s 75 super priority, if their finance was only in relation to accounts receivable, the inventory financier is not prejudiced any more than if the ARF was not an ADI.

However, the position differs when the ADI holds security over accounts receivable through an earlier provided AllPAP or other arrangement where the accounts are not original collateral. Here, s 64 is not invoked because there is no new value provided, yet the ADI still prevails if the accounts have been liquidated and subject to s 75.

Fairness of ADI's super priority

The fairness hinges on whether the rationale underlying ADI's super priority is justified.

On the one hand, ADI supremacy has been interpreted in Saskatchewan to arise from the goal of leaving money and cheques free from security interests and preserving Canada's payment system's integrity.[35] Turner adds that allowing a security interest to defeat an ADI account would impair the fluidity of funds.[36] An additional argument is that one of the PPSA's objectives was to "[accord] with and [support] sound commercial practice".[37] Harris and Mirzai comment that an ADI's super priority reflects an ADI's pre-PPSA rights,[38] including rights of set-off and netting. Thus, the argument is that ADIs serve a legitimate and important economic function for society, and are at least entitled to preserve their general law rights.

On the contrary, Turner contends that ADIs have super priority merely because of their existence *as* an ADI,[39] claiming this is insufficient to support this ultimate right. This paper agrees, further adding that ADIs now derive benefits absolutely, as opposed to situationally, like the benefits offered to PMSIs under s 62 and ARFs under s 64. In those scenarios, the inventory and accounts financiers offer legitimate advantages not only to the grantor's continuing business, but also to other creditors. An ADI provides no such absolute benefit, yet is provided an absolute statutory right.

Furthermore, the PPSA's objective of maintaining existing commercial practice is not exactly applied to an ADI. For example, although true that an ADI has a statutory set-off right (combining accounts had a potential effect of removing funds from the creditors' asset pool and being applied first to the ADI),[40] this right is not available if the ADI knew of the company's insolvency during its dealings.[41] However, under s 75, an ADI retains its super priority even if aware of the company's insolvency. It is acknowledged that a combination of accounts could not occur, yet s 75 produces the same benefit.

Improving the law

It is the author's opinion that because inventory financiers and ARFs are both treated fairly according to their commercial scenarios, the law is in a stable position while these commercial practices remain common. However, the area that could be improved is ADI superiority.

It is acknowledged that banks serve crucial societal and economic functions. However, absolute priority does not provide a commercial answer appropriate to commercial practice. It is clear that inventory financiers will always lose against an ADI that takes security over accounts receivable, unless the security is not over accounts as original collateral or the ARF does not protect itself. However, because ADIs are the biggest lenders, it is not unlikely that a grantor in need of cash will seek short-term finance from an ADI, or the ADI will have an AllPAP over the accounts. For an ADI to be able to circumvent the requirements of s 64, particularly notice requirements, through simply controlling proceeds derived from accounts receivable, weakens the underlying purpose of s 64. This scenario would be acceptable if a commercial benefit or risk was involved that was unique to the ADI. However, in a situation where the ARF happens to be an ADI, this is no excuse for s 64 to be circumvented.

Furthermore, it is noted that the New Zealand, Manitoba and Saskatchewan PPSAs do not offer ADIs automatic super priority.[42] While the US offers super priority, it is not automatic, but arises upon a security interest being granted.[43] However, this effectively is the same as the Australian position because s 75 is only useful to banks with granted security interests. The jurisdictions most similar to Australia omitted ADI priority, questioning the correctness of Australia's decision to provide ADIs super priority above the general law.

Conclusion

In conclusion, although disputes between inventory financiers and ARFs rarely result in inventory financier success, considering the commercial dealings between them, the PPSA provides for a mutually beneficial priority regime. However, regarding the ADI's automatic super priority, this paper contends that the PPSA's benefits to ADIs exceed the commercial value ADIs provide society and commerce, and exceed the general law benefits available to ADIs.

Alan Parnell
Law Student
University of Technology, Sydney
alan.p.parnell@gmail.com
www.uts.edu.au

About the author
Alan Parnell is undertaking his final year of Law at the University of Technology, Sydney. He has worked for the Law Society of New South Wales on its report on The Future of Law and Innovation in the Profession, and was a Summer Clerk at Clayton Utz. He is currently completing his honours thesis. In 2018, Alan will return to Clayton Utz as a graduate.

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Footnotes

1. PPSA, s 14(1)(a).
2. Above n 1, s 14(1)(b).
3. W S Seidman *Accounts Receivable and Inventory* Masterco Press 1957 p 17.
4. Above n 1, s 10.
5. A Dunham "Inventory and accounts receivable financing" (1949) 62(4) *Harvard Law Review* 588 at 596.
6. Above n 1, s 10.
7. Above n 1, s 31(1)(a).
8. Above n 1, s 31(3)(a).
9. Above n 1, ss 10 and 19(5).
10. R H Greenberg "Inventory and accounts receivable financing" (1956) *University of Illinois Law Forum* 601 at 613.
11. Above n 10, at 601.
12. Above n 10, at 613.
13. J Harris and N Mirzai *Annotated Personal Property Securities Act 2009 (Cth): with Regulations 2010 (Cth)* (2nd edn) Wolters Kluwer CCH 2014 p 273; C W Phelps *Accounts Receivable Financing as a Method of Business Finance* Commercial Credit Co, Educational Division 1957 p 15.
14. Above n 10, at 613; D Palia and B J Sopranzetti "Securitizing accounts receivable" (2004) 22(1) *Review of Quantitative Finance and Accounting* 29.
15. Above n 1, s 62.
16. Above n 1, s 64.
17. Above n 1, s 75.
18. *Re DCD Industries (1995) Ltd* (2005) 7 PPSAC (3d) 251 at [9].
19. Above n 1, s 64(1).
20. *Transamerica Commercial Finance Corp Canada v Royal Bank of Canada* (1990) 1 PPSAC (2d) 61; Harris and Mirzai, above n 13, at p 276.
21. Above n 1, s 57(1).
22. Explanatory Memorandum, Personal Property Securities (Corporations and Other Amendments) Bill 2011 (Cth), at [79].
23. Assuming elements of s 64 are satisfied.
24. Not relevant.
25. Not applicable.
26. Above n 5, at 588.
27. Above n 1, s 10.
28. Above n 5, at 588.
29. Above n 5, at 597.
30. M Pinto and E Horton "Accounts receivable financing" (1982) *CPA Journal, New York* 90; Above n 10, at 601; R Chillemi "Inventory and accounts receivable financing" (1954) 27 *Temple Law Quarterly* 91.
31. Above n 10, at 613.
32. Above n 10, at 613.
33. Above n 5, at 598; Chillemi, above n 30, at 92, 96 and 101.
34. *Lee v State Bank and Trust Co* 54 F 2d 518 (2nd Cir, 1931).
35. *Flexi-Coil Ltd v Kindersley District Credit Union Ltd* (1993) 107 DLR (4th) 129.
36. D C Turner "Debtor-induced payments" (2014) 35(1) *Adelaide Law Review* 97 at 102.
37. Law Reform Commission *Personal Property Securities* Report No 64 (May 1993) 65 para 6.2.
38. Harris and Mirzai, above n 13, at p 299.
39. Above n 36, at 124.
40. Corporations Act 2001 (Cth), s 553C.
41. Above n 40, s 553C(2).
42. Above n 36, at 124.
43. *Uniform Commercial Code* (US), Art 9; Above n 36, at 124.

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