

Secured Transactions Law Reform: What is involved and what it looks like - briefing for Malaysian private sector

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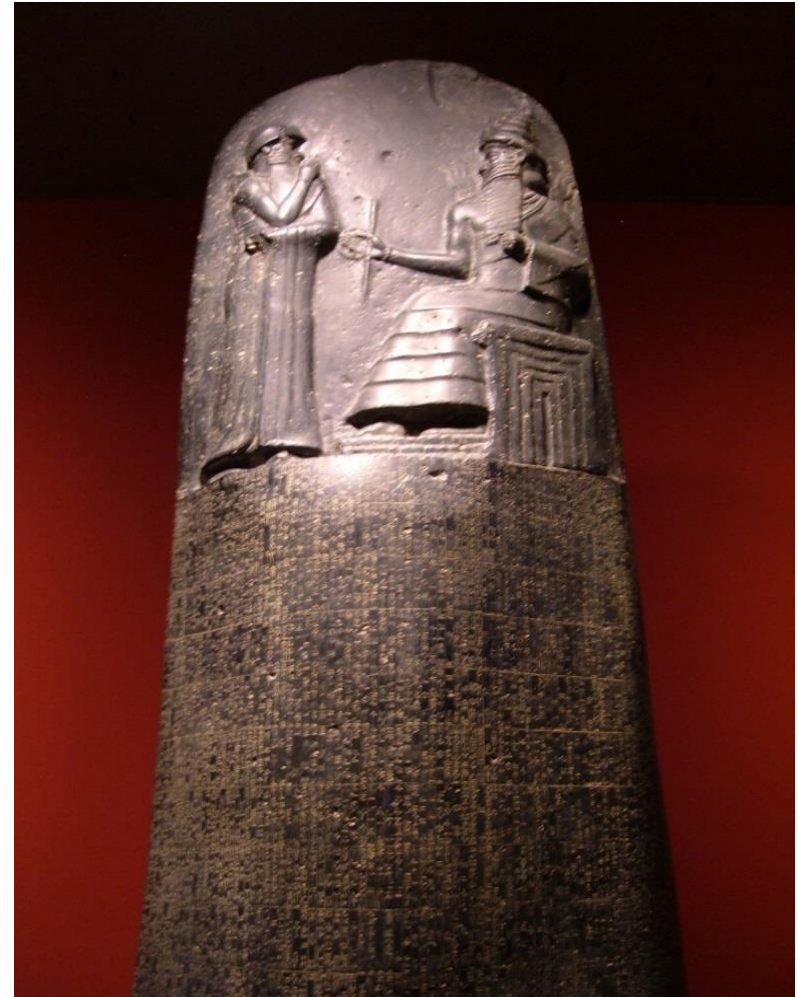
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What is secured transactions law ?

- Creditors often take security over the property of their debtors to enhance the creditor's position in the event that the debtor fails to pay.
- Secured transactions law sets out:
 - which transactions constitute security (by defining "security interest")
 - the steps that need to be taken to obtain an enforceable security interest;
 - the steps the creditor must take when enforcing a security interest; and
 - the priority ranking of third parties who claim a competing interest in the same property.

What is secured transactions law ?

- The recognition of secured transactions and the principles underpinning them have existed from at least the time of the Babylonian Code of Hammurabi of circa 1700 BC.



What is secured transactions law reform and why is it done?

- Over the ages, common law and civil law legal systems have adopted different approaches to secured transactions and even within common law systems significant differences have developed in different jurisdictions so the rationale for reform will vary.
- But a common feature is that over time gaps, anomalies and technical obsolescence have arisen so that in many jurisdictions the law does not meet modern needs.
- Reforms can be anything from minor improvements to radical change.
- **But in all cases the reason for reform is to facilitate access to credit to allow businesses and the economy to prosper.**

What is the best approach to reform?

- Must focus on results and not on historical doctrines
 - This approach will likely lead to reforms based on the commercial function of a transaction and not on the legal form that it takes.
 - It should apply to all forms of business structure (companies and unincorporated businesses) so that it can facilitate micro financing as easily as corporate debt funding.
- In the USA, Canada, New Zealand, Australia and elsewhere this has led to reforms based on a functional security interest originally derived from Article 9 of the American Uniform Commercial Code.
- In Canada, New Zealand and Australia the legislation is called the Personal Property Security[ies] Act.
- In 2016 UNCITRAL published a model law based on similar principles.
- But given the focus on economic function and the departure from historical precedents, this is not legislation that can be understood simply from reading it.
- In NZ, an early survey of legal and insolvency practitioners showed a 95+% approval rating for the reforms.

What is a secured transaction?

- The key concept is the definition of a security interest. This defines the scope of secured transactions law and is vital to understanding the impact of any reform.
- Under the functional approach, a security interest is essentially an interest in personal property (known as collateral) that is created by contract and the commercial purpose or function of which is to secure performance of an obligation (usually payment of a debt) regardless of the legal form that the contract adopts.
 - Interests not created by contract are not security interests.
- Distinctions between incorporated and unincorporated debtors, the common law and equity, fixed or floating charges and whether the debtor or creditor hold legal title to the collateral all become irrelevant for the purpose of this law. What matters is the commercial function of the transaction.
- Essentially, the concept covers all forms of financing transactions that allow the creditor to have recourse to personal property if the debtor does not pay.

What is a secured transaction?

- This approach sweeps up all existing forms of security currently recognised in Malaysia such as fixed or floating charges.
- The most radical aspect of the concept is that it also covers transactions not currently consistently regarded as secured transactions such as certain leasing arrangements, hire purchase agreements and other retention of title arrangements.
 - Effectively, where a title retention arrangement comes within the definition of security interest, the owner is reconceptualised as a secured creditor and the debtor is reconceptualised as the owner
- In many jurisdictions it is also extended to cover all leases over a certain duration and transfers of receivables.

Impact on existing financing arrangements

- PPSA allows for an easily created form of security over circulating assets that is superior to the current floating charge because it abolishes the distinction between fixed and floating and the common law and equity.
 - This is very favourable to banks and other financial institutions
- PPSA still allows asset financiers to maintain their status if they follow the formalities prescribed by the legislation:
 - In NZ and other PPSA jurisdictions this means that lessors and other retention of title financiers must get a written agreement and register their claim or they may lose their assets

Impact on other interests in personal property

- The definition of “security interest” effectively defines the scope of the Act – where there are competing claims to personal property at least one of those claims must be a security interest before the Act can apply
 - Eg where a thief sells stolen property to an innocent buyer, the rights of the innocent buyer and the original owner are not dealt with by a PPSA because neither has a security interest in the stolen property.
- Otherwise the existing law continues to apply.
- Note that even where one of two competing interests is a security interest, a PPSA may not always govern
 - Eg where a security interest competes with an interest created by a court.

Impact on other areas of Malaysian law

- Proposed reform applies only to security over personal property so mortgages over land are largely unaffected:
 - But there is some potential overlap where crops or fixtures are involved or where mortgages in land are transferred.
- Can impact on insolvency and judgment enforcement law:
 - Eg General Electric case in Australia cf outcome in NZ.
- Other security and registration laws can be repealed: eg Bills of Sale legislation, Companies Act registration of charges provisions, potentially motor vehicle security legislation.
- PPSA simplifies but it would be naïve to think of it as simple: it is as complex as the needs of the business community require.

- Although precise quantification is not possible, the long term benefits of secured transactions law reform are generally regarded as outweighing the short term transitional costs such as staff training, new documentation, reregistration and costs of non-compliance:
 - Simplified documentation;
 - Cheaper and more efficient registration;
 - Greater certainty;
 - Elimination of anomalies in current law.
- Transitioning to a new registration regime:
 - Shorter transition period with higher upfront cost or longer transition period with more prolonged uncertainty (in either case can include migration of existing registrations but this was a disaster in Australia)
- Banks etc quickly see the advantages of the reform but the rental/leasing industry will require educating to ensure they understand the new requirements and do not suffer unnecessary loss from non-compliance:
 - Eg New Zealand Bloodstock in NZ; General Electric in Australia

Questions?

Key concepts of secured transactions law

- The three key conceptual issues in secured transactions law are:
 1. What constitutes a security interest;
 2. The technical requirements for creating a security interest (eg what written evidence is required).
 - In the PPSAs, the moment of creation is called “attachment”;
 3. The publicity requirements and the consequences of failing to publicise (this usually involves registration in a public register).
 - In the PPSAs, registration is referred to as a “perfecting step” and when a security interest satisfies the requirements for attachment and a perfecting step (usually registration) has been taken the security interest is said to be perfected.

The key product of a secured transactions law

- Although the above concepts are essential to understanding secured transactions law, for financiers the key product is the code of priority rules, the most important of which determine:
 - Which of two competing secured parties wins;
 - When a buyer prevails over a secured party.
- The priority rules enhance certainty and hence lead to more efficient decision making.
- Sometimes this is at the expense of traditional notions of fairness.
- The priority rules generally revolve around perfection and the time of registration.

Summary

- Many important conceptual innovations but two of the most significant are:
 1. Retention of title arrangements such as hire purchase and many leasing transactions are brought within the regime and require registration to be fully effective.
 - “Title” has a less significant role to play under PPS legislation and this is the source of the greatest anxiety amongst those who do not fully understand the regime.
 2. The old equitable floating charge is replaced by what is effectively a fixed legal charge over circulating assets such as inventory and accounts receivable.
 - It is not wise to say that PPS legislation abolishes the floating charge. The PPSA creates a superior form of security over circulating assets and as such is very bank friendly legislation.
 - Indeed, it is important to ensure that there are checks and balances to ensure it is not too bank friendly.
- Results in reduced transaction costs and easier access to credit.
- No distinction between incorporated and unincorporated debtors so all forms of business can access secured credit.

Questions?

The New Zealand reforms

- The New Zealand reform proposals had the backing of the Law Commission, the legal profession, the insolvency profession, the judiciary and the finance sector.
- Although the NZ reforms are based on North American precedents, they are tailored to NZ needs, eg:
 - The time of registration plays a greater role in NZ and notice and knowledge are much less important under the NZ regime than in North America.
- A survey of NZ practitioners indicated:
 - Overall approval rating amongst all legal practitioners around 95%
 - Overall approval rating of legal practitioners who specialised in the area of 100%
 - Overall approval rating of insolvency practitioners of 100%.
- The most controversial aspect of the NZ Act is the validity of unperfected (which generally means unregistered) security interests in insolvency
 - Compare the Canadian and Australian approaches.
- Would lesser reforms have sufficed? (eg reform of the registration laws without reform of the substantive law).
 - In my opinion, no. This would have been a lost opportunity.

Three vital requirements for successful secured transactions law reform

1. Engender support from key stakeholders and involve them as early as possible
 - **Banks** and other financiers, **lawyers**, accountants, judges, bureaucrats, etc
 - Preferably a senior politician who is prepared to champion the project.
2. Follow a successful model (eg the law of another jurisdiction or the UNICITRAL model law) and fully document, justify and explain any departures from that model:
 - stylistic or substantive; for cultural reasons or due to local business needs or modern international trends
 - Eg will Islamic banking requirements necessitate an expanded definition of security interest or other changes
 - Any departures from precedent model risks unintended consequences and reduces value of foreign precedents and commentary
3. Educate stakeholders early and often and continue post-implementation
 - The Government, professional bodies, law schools, professional firms all have a role to play in educating the business and finance communities.

Questions?