ONE FLAW OVER THE CUCKOO'S NEST – MAKING SENSE OF THE 'FLAWED ASSET ARRANGEMENT' EXAMPLE, SECURITY INTEREST DEFINITION AND SET-OFF EXCLUSION IN THE *PPSA*

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I INTRODUCTION

Section 12(2) of the *Personal Property Securities Act 2009* (Cth)[1] provides a list of transactions as examples of the general definition of 'security interest' in section 12(1). An interest in personal property provided by any of the transactions would be a security interest if the transaction, in substance, secures payment or performance of an obligation. The last on the list, in paragraph (l), is 'a flawed asset arrangement'.

This has raised significant concerns among practitioners and industry bodies,[2] and has raised question marks as practitioners advise on the *PPSA*.

Flawed assets are a common and important mechanism. The normal conception of a flawed asset is that it does not create any interest in property. It

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1 *Personal Property Securities Act 2009* (Cth) ('*PPSA*').

2 See, eg, DLA Phillips Fox, Submission No 13 to Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Inquiry into the Personal Property Securities Bill 2009 [Provisions]*, 31 July 2009, 8; Allens Arthur Robinson, Blake Dawson, Freehills and Mallesons Stephen Jaques, Submission No 17 to Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Inquiry into the Personal Property Securities Bill 2009 [Provisions]*, 3 August 2009, 6; Australian Financial Markets Association, Submission No 21 to Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Inquiry into the Personal Property Securities Bill 2009 [Provisions]*, 5 August 2009, 3–4; Allens Arthur Robinson, Blake Dawson, Freehills and Mallesons Stephen Jaques, Supplementary Submission to Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Inquiry into the Personal Property Securities Bill 2009 [Provisions]*, 10 August 2009, 2–3. See also DLA Phillips Fox, Submission No 2 to Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Inquiry into the Personal Property Securities Bill 2009 [Exposure Draft]*, 9 December 2008, 8. In response, the Senate Committee recommended re-examining the inclusion of flawed assets: Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Inquiry into the Personal Property Securities Bill 2009 [Provisions]* (2009) 23–5.

usually has an effect similar to set-off and close-out netting, each of which is excluded from the *PPSA*.[3] This raises a number of questions, not only in relation to flawed assets and set-offs themselves, but also the whole conceptual framework of the *PPSA* and the boundaries of the core concept of 'security interest'.

This paper will survey those questions. First, it will look at the nature of a flawed asset. Second, it will look at the definition of 'security interest' in the *PPSA* and the use of the term 'flawed asset arrangement'. Third, it will look at some of the requirements of the definition in the context of the flawed asset and the flawed asset arrangement. Fourth, it will examine the Supreme Court of Canada decision, *Caisse populaire Desjardins de l'Est de Drummond v Canada*.[4] Finally, it will look at the consequences if a flawed asset arrangement does indeed contain a security interest.

II THE NATURE, PURPOSE AND HISTORY OF THE FLAWED ASSET

The *PPSA* does not define 'flawed asset arrangement'. It is worth exploring first the normal understanding of a 'flawed asset'.

A The Meaning of 'Flawed Asset'

It is not a legal term of art, and has appeared sparingly in case law,[5] but it is used widely by practitioners and commentators.

When used by practitioners it is generally understood to be an obligation (usually to pay money) which is subject to a condition. The obligation is contingent upon the payment of a debt by the obligee or another person, or upon the absence of some event or circumstance (for example, the obligation may be subject to the condition that no default has occurred) or both.

The term looks at its effect on the obligee, in whose hands the obligation is an asset. The presence of the condition is a 'flaw' in what otherwise would have been an entitlement to performance or payment of the obligation. The assets of the obligee available for its creditors only include the contingent obligation, and

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3 *PPSA* ss 8(1)(d)–(e).

4 [2009] SCC 29 (19 June 2009) ('*Caisse Populaire*').

5 It was used in *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214, 225, 227 ('*BCCI (No 8)*'); *Fraser v Oystertec plc* [2006] 1 BCLC 491; and the minority judgment in *Caisse Populaire* [2009] SCC 29 (19 June 2009) [123] (Deschamps J). It is also mentioned in *Money Markets International Stockbrokers Ltd (in liq) v London Stock Exchange Ltd* [2002] 1 WLR 1150, with a slightly different or more expansive meaning: see below n 10. That meaning was very recently used by Lord Collins in the UK Supreme Court in *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc* [2011] UKSC 38 (27 July 2011) ('*Belmont Park*') see below n 12, [84], [89], [96], [101]. See also *Folgate London Market Ltd v Chaucer Insurance plc* [2011] EWCA Civ 328; *Lomas v JFB Firth Rixson Inc & Ors* [2010] EWHC 3372 (Ch) (21 December 2010); *Lehman Brothers Special Financing Inc v Carlton Communications Ltd* [2011] EWHC 718.

will not include a right to actual payment or delivery until the relevant conditions are satisfied.

The main focus of the use of the term has been in connection with security deposits, where the repayment of a deposit is made subject to the fulfilment of a condition. I shall refer to such arrangements as 'Deposit Flawed Assets'. Commentators have tended to focus on these particular arrangements as they raise issues such as charge-backs.[6]

However, the term can be used whenever a contractual obligation is made subject to a condition of the type described above.

One difficulty is in finding the boundaries of this concept. At its widest, it could include a vast array of commercial contracts where an obligation of one party is conditional on performance by another party, or on the absence of an event of default. All could be said to 'secure' performance. The term is normally used when the element of conditionality is designed to avoid the need to have a registrable or stampable charge, or to ensure the relevant asset is not available for distribution to other creditors of the obligee, but that does little to differentiate it from other obligations conditional on performance or the absence of default. If the term in the context of the *PPSA* is not confined to interests in property as conventionally understood, it could have a very wide compass.

Two prominent examples of its use which are recognised as 'flawed assets' are:

- subordinated debt arrangements, where payment of the subordinated debt is conditional upon payment of the senior debt; and
- netting arrangements. The most commonly seen is section 2(a)(iii) of the standard International Swaps and Derivatives Association ('ISDA') Master Agreement used widely in financial markets. Under that clause, the obligations of each party are conditional upon due payment by the other and the absence of events of default involving the other.

Professor Philip Wood describes flawed assets thus:

> **Conditional debt or 'flawed asset'**
>
> A conditional debt is a debt which is not payable at all until an event happens. The creditor does not have an asset at all until that event occurs. The asset is therefore 'flawed'. The depositor's claim for its deposit is conditional on the depositor paying its loan.[7]

6 See, eg, Rory Derham, *Derham on the Law of Set-Off* (Oxford University Press, 4th ed, 2010) 804–6.

7 Philip R Wood, *Set-Off and Netting, Derivatives and Clearing Systems* (Sweet & Maxwell, 2nd ed, 2007).

That is standard among commentators.[8] However, two wider or different meanings have been used:

- Barry Allan seems to have a different concept of what constitutes a 'flawed asset' as one where the debtor will agree not to deal with or reduce the relevant collateral.[9] He quotes Neuberger J; however, His Lordship used it in a different sense.
- Justice Neuberger said that 'property or right subject to removal in the event of insolvency has been described as a "flawed" asset'.[10] He was citing an article which did not use the actual term 'flawed asset'.[11] This usage has very recently been achieving a vogue, as the courts pick over the debris of Lehman Brothers. Lord Collins used the term in the sense used by Neuberger J in *Belmont Park*.[12] That case concerned a 'flip' clause which flipped priorities on insolvency. Lower courts have also recently talked of 'flawed assets'[13] or 'flaws'.[14] The usage arises in examining arguments as to whether the anti-deprivation rule (a public policy rule) would strike down features of an asset which had the result that that asset was not available in its owner's winding up, even though those features existed from the asset's creation and could be said to be intrinsic to the asset. The term in this sense is being used more as an aid to analysis rather than a common name for a particular type of arrangement.

8 In a companion volume Wood gives a narrower definition: Philip R Wood, *Comparative Law of Security Interest and Title Finance* (Sweet & Maxwell, 2nd ed, 2007) 30. For other descriptions of flawed assets see E P Ellinger and Eva Lomnicka, *Modern Banking Law* (Oxford University Press, 2nd ed, 1994) 730; Fidelis Oditah, *Legal Aspects of Receivables Financing* (Sweet & Maxwell, 1991) 8; Mark Hapgood, *Paget's Law of Banking* (LexisNexis Butterworths, 12th ed, 2002) 631; Michael Gedye, Ronald Cuming and Roderick Wood, *Personal Property Securities in New Zealand* (Brookers, 2002) 89; Roy Goode, *Legal Problems of Credit and Security* (Sweet & Maxwell, 3rd ed, 2003) 15; Derham, above n 6, 804; Hugh Beale et al, *The Law of Personal Property Security* (Oxford University Press, 2007) 282. See also Financial Law Panel, below n 21, and the papers referred to below n 20.

9 Barry Allan, *Guidebook to New Zealand Personal Property Securities Law* (CCH, 2002) 55–6. During discussions with the Attorney-General's Department concerning the form of the legislation, it seemed apparent that they were influenced by the wider description in the text.

10 *Money Markets International Stockbrokers Ltd v London Stock Exchange Ltd* [2002] 1 WLR 1150, 1174 [91]. This right of removal on insolvency seems to be very different from the concept referred to by Barry Allan as a restriction on dealing with the relevant asset. Each in turn seems wider than the normal formulation of a condition intrinsic to the obligation that forms the relevant asset in the hands of the obligee.

11 Fidelis Oditah, 'Assets and the Treatment of Claims in Insolvency' (1992) 108 *Law Quarterly Review* 459, 474. He gives a list of examples of situations in which there are contractual limitations on the quantum of the insolvent party's interest, limiting the amount available for distribution, which as he says 'makes the asset flawed'. These do include a conditional deposit, but also rights of re-entry in a lease on insolvency and restrictions on assignment of a debt.

12 [2011] UKSC 38 (27 July 2011) [84], [89], [96], [107].

13 *Folgate London Market Ltd v Chaucer Insurance plc* [2011] EWCA Civ 328.

14 *Lomas v JFB Firth Rixson Inc & Ors* [2010] EWHC 3372 (Ch) (21 December 2010); *Lehman Brothers Special Financing Inc v Carlton Communications Ltd* [2011] EWHC 718.

> When used in that sense, 'flawed asset' would cover any term or feature of an asset which could be said to be intrinsic to it which limits it or its enjoyment in any way. This might include making it or its enjoyment conditional or terminable (automatically or otherwise). It thus would include the narrower sense, outlined above, of conditional obligations.
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> This wider description would cover a vast field and would include the majority of executory commercial contracts. Most would make performance by one party conditional on performance by the other, or allow one party to terminate its own obligations, or the other's rights, on default or insolvency involving the other. Those features could be said to 'secure' performance by the other.

Hugh Beale, Michael Bridge, Louise Gullifer and Eva Lomnicka draw the distinction between a flawed asset, being a conditional debt, and wording to the effect that the balance held in a deposit account is not to be 'released', which they say quite closely resembles the language of charge. As they point out, the wording in *BCCI (No 8)*[15] resembled the latter.[16] Occasionally some practitioners may describe the feature of a Deposit Flawed Asset as being a restriction on withdrawal.[17] One may see arrangements drafted with a deposit and a restriction on the right to withdrawal rather than the standard approach of making the obligation to repay the deposit expressly conditional. That is, the depositor may not withdraw the deposit until the relevant 'secured' obligation is satisfied. There may not be a meaningful distinction between the effect of the restrictive language and the express conditional approach. The effect depends on the drafting and its interpretation, but it is difficult to see how the restrictive language can do anything other than render the obligation to repay the deposit conditional. The restriction on release or withdrawal must qualify the obligation to repay. The bank can only be obliged to repay the deposit if the customer is entitled to withdraw it. It is hard to conceive of drafting or an interpretation that could leave the deposit repayment obligation unaffected as a present obligation of the bank, and at the same time have a separate restriction on access by the depositor. If it were, and the asset being the deposit is untouched, then it is not aptly described as 'flawed'.

In this paper, I shall refer to a 'flawed asset', or a 'simple flawed asset', as a condition in an obligation as described above, arising expressly or as a restriction. As we shall see,[18] arrangements involving flawed assets often involve additional features, but I shall use those two terms in relation to just the core feature of such arrangements.

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15 [1998] AC 214.

16 Beale et al, above n 8, 287.

17 See, eg, 'The PPSA: Shaken but Not Stirred?' (Speech delivered at the 28th Annual Banking & Financial Services Law & Practice Conference, Gold Coast, Queensland, 6 August 2011).

18 See Part II(E) below.

For completeness, I shall occasionally refer to the wider sense used by Collins LJ in *Belmont Park*.[19]

B History and Purpose

The concept of 'flawed assets' is relatively recent. The earliest mention of 'flawed assets' as a term that I could find was in an article in 1981, which expressed some uncertainties about their use.[20]

It started being used with widespread currency in relation to deposits but then was used in other situations.

The concept was used in order to deal with a variety of concerns:

- doubt as to whether one could have a charge over one's own liability;[21]
- to avoid having a charge which might offend negative pledges or, in Australia, be subject to ad valorem stamp duty;
- difficulties posed by *British Eagle International Airlines Ltd v Compagnie Nationale Air France*[22] and concerns that the *pari passu* principle expressed in that case (or the anti-deprivation rule) might strike down netting and subordinated debt arrangements as void against the

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19 [2011] UKSC 38 (27 July 2011).

20 F W Neate, 'Set Off' (1981) 9 *International Business Lawyer* 247. That tallies with my own experience as a practitioner, if I may be permitted to cite it. I can recall earlier that year, while working in England, discussing the technique with senior counsel. At that stage it did not appear to have a name in general usage. The approach seemed then quite novel. However it may be that the technique arose in the early 1970s in relation to parallel loans: Graham Rowbotham, 'Can Banks Secure Their Own Deposits?' (1987) 6 *International Financial Law Review* 18. Another early mention is in a paper by a barrister William Blair 'Charges over Cash Deposits' (1983) 2(11) *International Financial Law Review* 14, though Blair describes it in terms of a postponement of maturity.

21 *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] AC 785 (which referred to liens), with the fears made more real (for a while) in England by the Court of Appeal decision in *Re Charge Card Services Ltd* [1987] 1 Ch 150 ('*Re Charge Card*'). In Australia this was boosted by cases such as *Broad v Commissioner of Stamp Duties (NSW)* (1980) 2 NSWLR 40. See also n 104 below. In 1994 in England the Financial Law Panel in the aftermath of *Re Charge Card* produced a paper *Security over Cash Deposits – A Practice Recommendation*, which suggested parties rely on contractual set-off, but it indicated that practitioners may want additional protection. It said:

> some practitioners take the view that additional protection should be sought, in the form a 'flawed asset' provision. This is a contractual term which provides that the deposit placed with the bank is repayable only if and when the sums owed to the bank have been paid. This does not constitute security. Its purpose is to prevent the bank having to pay back a deposit which it holds, without receiving repayment of its loan. The flawed asset mechanism is not logically inconsistent with a contractual set-off arrangement. Each operates independently of the other, and the use of both should not detract from the effectiveness of either. However, we consider that in most circumstances the adoption of this combined approach does not add appreciably to the protection afforded by the contractual set-off on its own.

The Panel revisited the issue in 1996 after the Court of Appeal decision in what was to become *BCCI (No 8)* (*Morris v Agrichemicals* [1996] Ch 245) in *Security Over Cash Deposits – A Supplemental Practice Recommendation*. They used the term 'charge-back' even though they accepted that at that stage it was impossible for a debtor to have proprietary interest in its own debt, and therefore it operated contractually and not by way of property. This note was more encouraging of the use of a flawed asset approach than its predecessor.

22 [1975] 1 WLR 758.

public policy of having assets available in a liquidation or bankruptcy and applied *pari passu* among creditors;

- any other adverse consequences of insolvency administration, such as a freeze on dealing with the insolvent's assets or on the enforcement of security against the insolvent;
- the possibility that set-offs or charge-backs might not be recognised under relevant systems of foreign law;
- situations where there might be insufficient mutuality to have a set-off, in particular because a party might assign its rights; and
- doubts as to whether obligations to pay foreign currency or to deliver commodities were commensurate with payment obligations in domestic currency and could be the subject of a set-off.[23]

It sometimes simply reflects the commercial nature of the transaction. For example, in funded sub-participation arrangements, the sub-participant bearing the borrower's credit-risk will provide funds to the original lender, and will only be repaid if the borrower repays the original lender.

Though they were generally believed to work, they were not without their doubters (like Francis Neate and William Blair).[24] The first judicial blessing was by Lord Hoffmann in the House of Lords in *BCCI (No 8)*,[25] albeit obiter. That case concerned a deposit made by a third party intended to be security for a borrower's debt to the bank. The depositor signed a letter purporting to give a lien or charge over the deposit, a promise not to encumber the depositor's interest in the deposit, and an agreement that the deposit is payable only if all the liabilities of the borrower are repaid.[26] However, it contained no obligation by the depositor to pay the bank. There was no obvious set-off.[27]

The bank went into liquidation. The depositor was seeking to have the deposit applied against the debt. To do so, it wanted the court to find an obligation owed by it to the bank, which could be the subject of set-off. One argument revolved around the suggestion that to have a charge in favour of a bank over its own deposit was a 'conceptual impossibility'.

In describing the Court of Appeal's decision, Lord Hoffmann said:

> But they said that it could provide perfectly good security by virtue of the contractual provisions in the third paragraph which limited the right to repayment of the deposit and made it what is sometimes called a 'flawed asset'. I agree …[28]

He then went on famously to hold in obiter that a charge-back was not conceptually impossible.

Later he said:

23 Derham, above n 6, 760.

24 See Neate, above n 20; Blair, above n 20.

25 [1998] AC 214.

26 As Beale et al point out, the clause was not expressly written as a condition on the obligation to repay the deposit: above n 8, 287. However, in my submission it should have that effect: see above Part II(A).

27 Ibid 222–3.

28 Ibid 225, citing *BCCI (No 8)* [1998] AC 214, 225 (Lord Hoffmann).

> The Court of Appeal said that the bank could obtain effective security in other ways … If the deposit was made by a third party, it could enter into contractual arrangements such as the limitation on the right to withdraw the deposit in this case, thereby making the deposit a 'flawed asset'. All this is true. It may well be that the security provided in these ways will in most cases be just as good as that provided by a proprietary interest. But that seems to me no reason for preventing banks and their customers from creating charges over deposits if, for reasons of their own, they want to do so.[29]

Fraser v Oystertec plc was another case in which the Court believed that a flawed asset would be effective.[30]

The flawed asset contained in section 2(a)(iii) of the Standard ISDA Master Agreement (which makes each party's obligations conditional on the absence of events of default involving the other) has been blessed in two Australian cases (though the courts did not expressly refer to 'flawed assets' by that name).[31] The English High Court has also confirmed the validity of section 2(a)(iii),[32] but has seen limitations on its effectiveness.[33] Justice Briggs said that the anti-deprivation rule (a public policy rule) may limit the use of section 2(a)(iii) where the other party does not have ongoing payment obligations, or where payments are to be made gross rather than net, so that the insolvent's obligations increase significantly.[34] In Australia, Justice Briggs' reservation is unlikely to be followed, because the majority in the High Court did not see there being some general overarching policy outside the express words of the relevant insolvency legislation.[35] In England it is yet to be seen whether there is room for further consideration of the effect of section 2(a)(iii) and other conditional obligations in certain circumstances following the Supreme Court's very recent framing of the anti-deprivation rule in *Belmont Park*.[36]

In England, following *Belmont Park*[37] flawed asset arrangements will not necessarily be a bulwark against the application of the anti deprivation rule. The Supreme Court saw the rule as a matter of policy applying to the substance rather

29 Ibid 227, citing *BCCI (No 8)* [1998] AC 214, 227 (Lord Hoffmann).

30 [2006] 1 BCLC 491.

31 *Sims v TXU Electricity Ltd* (2005) 53 ACSR 295; *Yallourn Electricity Ltd v Enron Australia Finance Pty Ltd (in liq)* [2005] NSWCA 326 (20 September 2005).

32 *Marine Trade SA v Pioneer Freight Futures Co Ltd BVI* [2009] EWHC 2656 (Comm) (29 October 2009) (Flaux J); *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch) (21 December 2010) (Briggs J).

33 *Lomas v JFB Firth Rixson Inc & Ors* [2010] EWHC 3372 (Ch) (21 December 2010) (distinguished in *Folgate London Market Ltd v Chaucer Insurance plc* [2011] EWCA Civ 328).

34 See also *Lehman Brothers Special Financing Inc v Carlton Communications Ltd* [2011] EWHC 718 (Briggs J). Since these decisions ISDA has decided to review the use of s 2(a)(iii) and a number of amendments are being considered.

35 *International Air Transport Association v Ansett Australia Holdings Ltd* (2008) 234 CLR 151, 180 ('*IATA v Ansett*'). If we strictly follow the taxonomy of rules used by Lord Collins in *Belmont Park*, their remarks related to the *pari passu* rule rather than the anti-deprivation rule, but much of the logic would equally apply.

36 [2011] UKSC 38 (27 July 2011). In that case Lords Walker (at [130]) and Mance (at [175], [179]) referred with approval to Justice Briggs' views. Lord Collins left open the question about executory contracts (at [100]). Lords Phillips, Clarke and Hope and Lady Hale agreed with both Lords Collins and Walker (at [185]).

37 [2011] UKSC 38 (27 July 2011).

than the form (except in some cases).[38] This applies to arrangements described by Lord Collins as 'flawed assets' with the flaws contained in contractual arrangements from the outset.[39] In Lord Collins's opinion, the rule applies even where the relevant asset is conditional, where the enjoyment of the asset is conditional on the absence of bankruptcy.[40]

While this may be seen by some as an extension of the principle, the Court in other ways was limiting it. The Court held that the principle did not apply to the particular transaction before it on the basis that it was a complex commercial transaction entered into in good faith.[41] A majority of the Court also saw the rule as requiring an element of intention to defeat the legislation, objectively or subjectively determined.[42] Various members of the Court mentioned other limitations in reviewing the case law. These included, among others: where the other party in substance supplied the relevant asset to the bankrupt;[43] termination of leases and licenses;[44] and executory contracts.[45] Lord Walker said 'the outer limits of the principle are difficult to define'.[46]

One thing that is clear from the judgment is that the rule only applies where the 'deprivation' is triggered by the liquidation or bankruptcy.[47] In other words, in the case of a flawed asset in the sense used in this paper where the conditional obligation is conditional on payment of the relevant 'secured' obligation, the rule would not apply. Where the conditional obligation is conditional on both the payment of the 'secured' debt and the absence of events of default such as liquidation, and the secured debt had not been paid, then the rule would still not apply even if the conditional obligee was in liquidation. In that sense, it still would be good 'security'.

In Australia, following *IATA v Ansett*,[48] the anti-deprivation rule should not apply. One interesting question would arise if it were in force in Australia as outlined by the UK Supreme Court following the introduction of the *PPSA*. That is, that one of the exceptions to the anti-deprivation rule that must have been so obvious that the Court did not mention it was that it does not apply to understood security interests, mortgages, pledges, liens and charges. This exception, presumably, would be expanded with an expanded concept of 'security interest'. The *PPSA* is occupying some of the policy space of the rule.

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38 Ibid [105] (Lord Collins), [163] (Lord Mance).
39 Ibid [89] (Lord Collins), [159] (Lord Mance).
40 Ibid [91].
41 Ibid [108] (Lord Collins), [134] (Lord Walker).
42 Ibid [78] (Lord Collins). The other members of the Court agreed with Lord Collins, except Lord Mance who listed cases where it applied objectively: [153]. Lord Collins said this does not apply to the *pari passu* rule.
43 Ibid [98] (Lord Collins), [124] (Lord Walker). Lord Mance disagreed: [171].
44 Ibid [85]–[6] (Lord Collins), [123] (Lord Walker).
45 Ibid [130] (Lord Walker), [175], [179] (Lord Mance). Lord Collins left open the question about executory contracts: [100].
46 Ibid [123].
47 Ibid [80] (Lord Collins).
48 (2008) 234 CLR 151.

C Efficacy against Third Parties and the Position of Third Parties

On first principles, if the asset subject to the 'flaw' – the right under the conditional obligation – is assigned to a third party, the third party takes subject to the flaw. It can have no greater rights than the assignor. If the rights being assigned are contractual rights, then they are subject to whatever contractual terms apply to them. The 'flaw' is good against third party assignees.[49]

As the 'security' is merely a condition on the obligations of the 'secured party', there is nothing for a guarantor, or co-surety of the 'secured debt', to be subrogated to, or to marshal against.

D Flawed Asset and Set-Off

As we shall see,[50] where there is a flawed asset comprising a conditional debt owed by one party 'securing' an obligation owed back to it by the other party, it is common to add a contractual set-off clause to the flawed asset. However, it is not necessary to do so. A simple flawed asset operates without set-off between the conditional obligation and the 'secured' obligation, except where the obligor of the conditional obligation is in liquidation or bankruptcy, and insolvency set-off applies under section 553C of the *Corporations Act 2001* (Cth) or section 86 of the *Bankruptcy Act 1966* (Cth).

Suppose a depositor owes a bank \$500 and places \$300 on deposit with the bank on flawed asset terms, that is, the obligation of the bank to repay the deposit is conditional upon the depositor repaying its debt. If the depositor does not repay its debt, then the bank's obligation is simply not payable. It remains a contingent or conditional obligation. No set-off is necessary to protect the bank's position. While it is still owed \$500, it is (using loose language) able to 'retain' \$300.[51] It is not liable to pay that sum. It can pursue the depositor for the \$500 without reference to the amount on deposit (as occurred in *BCCI (No 8)*).[52]

Legal set-off will not apply as there is no debt due. Nor is it likely that there would be any obligation capable of being the subject of equitable set-off. That leaves insolvency set-off. If it is the bank that goes into liquidation, then the depositor has a contingent claim against the bank. The depositor is able to prove for that claim, and the amount is able to be set-off.[53] On the other hand, if it is the depositor that is in liquidation, then the bank is able to make a claim in the liquidation of the depositor, but the depositor has only a contingent claim against

49 See Ellinger and Lomnicka, above n 8, 712.

50 See Part II(E) below.

51 Of course, in the strict sense, there is no active 'retention'. There is simply no obligation to pay an amount which otherwise would have been payable.

52 [1998] AC 214.

53 *Hiley v People's Prudential Assurance Co Ltd (in liq)* (1938) 60 CLR 468; *Day & Dent Constructions Pty Ltd (in liq) v North Australian Properties Pty Ltd* (1982) 150 CLR 85; *MS Fashions Ltd v Bank of Credit and Commerce International SA (in liq)* [1993] 3 All ER 769.

the bank. That will not be the subject of set-off unless the obligation is drafted so as to become an actual debt on liquidation.[54]

Without set-off, then each debt would continue to accrue interest. Because the bank is not obliged to repay the $300 deposit, its maximum net principal loss is the $500 it may lose in recovery from the depositor, less $300, giving a net $200. At some stage, presumably, the accountants of a party would make suitable adjustments to its balance sheets. This is effective, but somewhat untidy.

This also applies when there is no mutuality. That is, when the depositor does not owe money to the bank, but places money on deposit on the condition that it will not be repayable unless and until a third party repays its debt to the bank. This was the position in *BCCI (No 8)*.[55] The only difference from the above analysis is that if the bank is in liquidation, there is still no set-off and there is no 'secured' debt owed by the depositor to be the subject of a set-off. The position is broadly the same: in the absence of payment of the debt, the bank is not liable to repay the deposit or apply it against any actual obligation owed by the depositor. On liquidation or bankruptcy of the depositor, the liquidator or trustee in bankruptcy can only take whatever assets the depositor had. In this case the asset is the obligation subject to the condition.

E Documentary Garnishes – the 'Extras'

A flawed asset therefore works well on its own. For the reasons set out below in Part IV(C)(3), it is not generally regarded as a charge. As we saw above,[56] it does not require the assistance of any set-off. It does not require any other provision to be effective.[57]

However, it is far more common for the drafters of flawed assets to draft them on the assumption that other provisions are useful accessories (and possibly, but incorrectly, necessary ones).

Common garnishes with the flawed asset dish ('Extras') could include one or more of the following:

- at least in the case of a Deposit Flawed Asset, a warranty that the depositor had unencumbered title to the cash deposited;
- a restriction upon the obligee assigning or dealing with its rights under the conditional obligation – the 'flawed asset' – to preserve mutuality. While this is extremely common, on strict analysis it is unnecessary, unless, perhaps, the parties wish to rely on set-off;[58]

54 *MS Fashions Ltd v Bank of Credit and Commerce International SA (in liq)* [1993] 3 All ER 769, 778; *BCCI (No 8)* [1998] AC 214, 224; Derham, above n 6, 394, 805. The position would be different in England under *Insolvency Rules 1986* (UK) SI 1986/1925, r 4.90(4).

55 [1998] AC 214.

56 See Part II(D).

57 As stated above (in Part II(B)) in *BCCI (No 8)* [1998] AC 214, there was a charge, but no personal covenant or set-off right, and there was an agreement not to encumber the deposit. Lord Hoffmann believed that the flawed asset provision would work on its own and provide sufficient security.

58 See Part II(D) above. In *Fraser v Oystertec plc* [2006] 1 BCLC 491 it was said that set-off may not be available for debts incurred after a third party gained an interest in the conditional obligation.

- where the debt 'secured' by the flawed asset arrangement is owed by a third party, some obligation from the obligee to pay that debt, to be the subject of a set-off or application against the conditional obligation;
- in subordinated debt arrangements, sometimes a turnover trust under which the subordinated creditor holds on trust for senior lenders amounts received from the debtor, and sometimes an undertaking in favour of senior creditors not to amend the document;
- a clause giving the obligor of the conditional obligation the right to set-off, apply or appropriate the amount owed against amounts owed to it by the obligee or vice versa (at least so the parties can close off the books); and
- a clause expressly charging the obligee's rights under the conditional obligation to secure obligations owed to the obligor. This was to cover a number of possible issues. One was that the flawed asset may not be legally effective (for instance, because it breached the anti-deprivation rule or the *pari passu* principle). Another was that a set-off clause may not be effective or set-off may not be available. A third was that a flawed asset and/or a set-off clause may itself be construed as a charge. There may have been other reasons for a preference for a charge.[59]

The express charging clause has been more common in England than Australia, for a number of reasons. First, in Australia a charge could be subject to ad valorem stamp duty. Second, in Australia it had been held relatively early that a security arrangement with respect to a deposit giving a right of set-off was not a charge.[60] Third, in Australia there was support for the robustness of insolvency set-off given by a string of High Court cases[61] before the same was done in England by *Stein v Blake*.[62] In both jurisdictions, such an express charge could breach a negative pledge, reducing its popularity (though a well-drafted negative pledge would often cover security deposits and other arrangements).

The addition of a charge to a set-off right and a flawed asset to back each other up – thus adding a nappy-pin to a 'belts-and-braces' approach – was known as a 'triple cocktail'.[63] This has been more common in England than Australia. On analysis, there may appear to be little point in taking security over something that only has value when the secured obligation has been repaid. The conditional debt the subject of the charge does not become due until the secured debt is paid.

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59 See Mark Evans, '"Triple Cocktail Becomes Single Malt?" Some Thoughts on the Practical Consequences of the Decision of the House of Lords in *Morris v Agrichemicals Ltd*' (1998) 13 *Journal of International Business and Law* 115, 116. One is that a charge may destroy mutuality for preventing insolvency set-off. However, in Australia, if the obligee of the conditional debt is not insolvent, there will be no insolvency set-off. See Part VI(E) below.

60 *Broad v Commissioner of Stamp Duties (NSW)* (1980) 2 NSWLR 40.

61 *Hiley v People's Prudential Assurance Co Ltd (in liq)* (1938) 60 CLR 468; *Gye v McIntyre* (1991) 171 CLR 609; *Day & Dent Constructions Pty Ltd (in liq) v North Australian Properties Pty Ltd* (1982) 150 CLR 85.

62 [1996] AC 243.

63 See Wood, above n 7. See also Evans, above n 59, 118; *Fraser v Oystertec plc* [2006] 1 BCLC 491.

However, Australian Authorised Deposit-taking Institutions ('ADIs') may still want to grasp the possibility. See Part VI(A) below.

The combination of a flawed asset and a set-off clause without an express charge was often known as a 'double cocktail'. Of course other permutations and combinations of Extras were possible. For example, in *BCCI (No 8)*,[64] there was a flawed asset and an express charge but no right of set-off or personal obligation. *Fraser v Oystertec plc* had the same plus a personal obligation.[65]

F The Relationship between Flawed Assets and Extras – the Independence or Supremacy of the Ingredients of a 'Cocktail'

Where a flawed asset is combined with one or more Extras in a double or triple cocktail, or some other combination, then the question might arise as to whether in some way they affect one another, or whether one is subordinate to another. For example, a contractual right of set-off may be seen as just a mechanism for the enforcement of a charge.[66] A restriction on withdrawal could be seen as a mechanism for protecting the charge or the set-off right.[67] Whether they do so will be a matter of drafting.

There is no reason why they cannot be entirely independent in operation, though complementary and part of the same arrangement, and this would be the common position in practice. In *BCCI (No 8)*[68] there was an express charge and a flawed asset. The flawed asset appeared to be given an independent existence, as it was relied upon when the charge was not. The members of the Financial Law Panel in England also had the opinion that set-off and flawed assets clauses in the same document could and would operate independently.[69] A true flawed asset results in a condition being contained in the debt: the charge can only be over that conditional debt, and if the charge falls away, that still leaves the conditional debt.

Nor, in the absence of any particular indications in the drafting, should any ingredient be given primacy over the others. As we have seen, each is often included to deal with perceived limitations in the other. Even where one is given some primacy, there is no reason why each cannot be given independent operation, because each deals with the others' limitations.

I shall discuss this issue further in Part VI(D) below, and in relation to *Caisse Populaire* in Part V(C) below.

G 'Enforcement' or 'Exercise' of Flawed Assets

It is important to note that in no sense is a simple flawed asset enforced or exercised. If the obligor is relying on the relevant condition not to perform the

64 [1998] AC 214.
65 *Fraser v Oystertec plc* [2006] 1 BCLC 491.
66 See the discussion in Part IV(C)(5)(iv) below.
67 As it was in *Caisse Populaire*.
68 [1998] AC 214.
69 See above n 21.

relevant conditional obligation, it is merely reflecting the fact that it is not under an obligation to do anything. It is not 'refusing' to honour the conditional obligation nor is it taking any step.[70] Of course, if the Extras which accompany a flawed asset include a right of set-off or a right to appropriate an obligation, the conditional obligor could exercise that right, but it is not necessary for it to do so to be able to rely on the flawed asset.[71]

In the case of a flawed asset in a subordinated debt arrangement the subordinated debt is simply not payable to the junior creditor. The senior creditor is not involved, though it may be involved in enforcement of an accompanying turnover trust.

Conceivably some arrangements which could fall within the wider sense of 'flawed asset' used in *Belmont Park*[72] might be enforced.

III DEFINITION OF SECURITY INTEREST IN THE *PPSA*

A The Wording

Section 12(1) provides the main definition. As originally enacted, it provided:

> A security interest means an interest in relation to personal property provided for by a transaction that,[73] in substance, secures payment or performance of an obligation (without regard to the form of the transaction or the identity of the person who has title to the property).

'Interest', in relation to personal property, is defined (in section 10) to include 'a right in the personal property'.

The words 'relation to' were removed from section 12 and from the definition by the *Personal Properties Securities (Corporations and Other Amendments) Act 2011* (Cth). The change from the ambulatory prepositional phrase 'in relation to' to the more direct preposition 'in' is very significant and I will return to it (in Part IV(C)(a) below).

Subsection (2) provides some examples. It now reads (following the 2011 amendments) as follows:

> (2) For example, a security interest includes an interest in personal property provided by any of the following transactions, if the transaction, in substance, secures payment or performance of an obligation:

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70 *Yallourn Electricity Ltd v Enron Australia Finance Pty Ltd (in liq)* [2005] NSWCA 326 (20 September 2005).

71 See Part II(E) above.

72 [2011] UKSC 38 (27 July 2011).

73 The equivalent language in s 17(1)(a) of the *Personal Property Securities Act 1999* (NZ) ('*NZPPSA*') reads 'created or provided for by a transaction'. This is a curious change, but in the end may not have a significant substantive effect. For an analysis of some of the difficulties in the use of the expression 'provided for', see Craig Wappett, Bruce Whittaker and Steve Edwards (eds), *Personal Property Securities in Australia* (LexisNexis Butterworths, 2011) 30,022 [2.250]. I would submit those words are, however, wide enough to cover existing interests of the secured party with security interests which are not 'created' by the transaction, for example, a lessor under a lease, because the transaction does provide for it in the sense of recognising it and exploiting it.

(a) a fixed charge;

…

(l) a flawed asset arrangement.

While the subsection gives examples, those examples are still in the context of the main definition. Under section 15AD of the *Acts Interpretation Act 1991* (Cth) if there was an inconsistency between the examples and the main definition, the main definition would prevail. Something falling within a description contained in an example would not be included if it did not have a key attribute required under the substantive definition.[74]

The subsection still requires there to be 'an interest in personal property' provided by the relevant transaction,[75] and the transaction must, in substance, secure payment or performance of an obligation. There is no sense in which it can be said that any of the examples enumerated in the paragraphs of subsection (2) are automatically security interests (for example, not every lease of goods or assignment is caught). They still need to satisfy the overall requirements, which are:

(a) that there is a transaction;

(b) that it concern personal property;

(c) that there is an interest in personal property 'provided for' or 'provided' by the transaction; and

(d) that the transaction in substance secures payment or performance of an obligation.

If they satisfy those requirements, we then need to examine whether they fall within an exclusion in section 8.

I shall deal with each in turn, but first we should ask whether there are any policy considerations behind the express mention of 'flawed asset arrangements'.

B Legislative Guidance as to the Meaning and Inclusion of 'Flawed Asset Arrangements'

There is no definition of 'flawed asset arrangement' or 'flawed asset'. The question arises as to what was intended to be covered.

On a policy basis superficially it seems straightforward. Many flawed asset arrangements do in the broad sense of the term 'secure' obligations. The 'secured party' does not have to pay amounts that otherwise it might have paid, and, in one way or another, the economic impact of non-payment is reduced.

This is in line with the functional approach discussed in the outline of the Replacement Explanatory Memorandum issued in relation to the Bill that became the *PPSA*.

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74 *Commissioner of Taxation v American Express Wholesale Currency Services Pty Ltd* (2010) 273 ALR 501, 513 (Dowsett J in dissent).

75 It is interesting to note that the New Zealand equivalent, *NZPPSA* s 17(3), does not make this clear to the same extent: see below n 104. Also, while s 12(1) uses the term 'provided for by a transaction', s 12(2) uses the term 'provided by'. The omission of 'for' probably has no significance. As to the requirement of an 'interest', see Part IV(C)(1) below.

> A security interest in personal property arises from a transaction that in substance secures the payment or performance of an obligation. The interest in the personal property, taken as security for a loan or other obligation, is a security interest. The Bill would apply to transactions which have the effect of securing a payment or other obligation, regardless of the form of the transaction, the nature of the debtor or the jurisdiction in which the personal property or parties are located (subject to specified exceptions). This is known as a functional approach.[76]

However, clearly there are limits to that overall principle.

First, while there is a functional approach, under the wording of the *PPSA* there does need to be an interest in personal property. That interest must be that of the secured party. The functional approach applies to selecting which transactions are included. Once a transaction has been identified that does in substance secure an obligation, it is still then necessary to identify an interest in property provided for by that transaction. That interest could be the transaction itself or just one or a collection of features or parts of that transaction. As discussed below,[77] a simple flawed asset is not an interest in property and there must be very significant doubt as to whether most flawed asset arrangements would contain an interest in personal property.

Second, the economic result of flawed assets is often the same as set-off and close-out netting contracts, which can usually be said to secure obligations in the wider sense, but are expressly excluded from the *PPSA*.[78] Why expressly refer to their analogue?

The Replacement Explanatory Memorandum for the *PPSA* confuses more than it illuminates. It discusses in some detail the inclusion of flawed asset arrangements:

> 5. Certain transactions would create security interests *provided that they secure the payment or performance of obligations*, for example: fixed and floating charges; chattel mortgages; conditional sale agreements; hire-purchase agreements; pledges; trust receipts; consignments; leases of tangible property (including PPS leases); assignments, transfers of title and flawed asset arrangements (clause 12(2)).
>
> 6. A security interest would be created by a transaction that is a flawed asset arrangement that in substance secures payment or performance of an obligation. However, a security interest would *not* be created by an arrangement under which whether one person owes another person an obligation is conditional on the occurrence of certain events: because there is no interest in property that can be the object of the security interest.
>
> **Example**
>
> Person A buys its inventory from Person B on terms requiring it to pay within 90 days. However, if Person B fails to meet its supply obligations, then Person A is entitled to deduct an amount from the account owed to Person B in accordance with a formula specified in the contract. In substance, the account owed by Person A secures performance of Person B's obligation to supply inventory to Person A. Person B's account is a flawed asset: because Person B's entitlement to be paid the account is conditional on it continuing to supply inventory to Person A.

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76 Replacement Explanatory Memorandum, Personal Property Securities Bill 2009 (Cth) 10.

77 See Part IV(C)(5) below.

78 See *PPSA* ss 8(1)(d)–(e).

> **Example**
>
> An arrangement between Person B and Person A obliges Person A to pay Person B an amount on the occurrence of certain events. Person B does not have an interest in personal property that could be the object of a security interest.[79]

The first sentence of paragraph 6 seems to suggest that a flawed asset arrangement that in substance secures payment or performance of an obligation *would be* a security interest, apparently without regard to whether or not it provides an interest in personal property. However, the second sentence then describes what is usually thought of as the essence of a flawed asset, that it is a conditional obligation. If the second part of that sentence is intended to mean that it is not an interest in property in the hands of the obligor, and therefore cannot be a security interest, it is plainly right. If, however, it means what it appears to say, that the arrangement does not create an interest in property that can be the object of a security interest, then it is plainly wrong (assuming 'object' in this case to mean the same as 'subject'). The rights of the obligee, conditional though they may be, are still property that can be the subject of a security interest.

The examples do not help.

The first example in paragraph 6, at least in the first three sentences, seems to suggest a very broad sweep of what is meant by flawed asset arrangements, perhaps even wider than the *Belmont Park* sense. The arrangement described is a normal part of many executory commercial contracts with their quid pro quo in relation to on-going performance (less pro, less quid: no pro, no quid) and would not normally be regarded as including a flawed asset. It might also be regarded as a simple price calculation or adjustment, an abatement or a set-off, depending on the terms. The last sentence, in saying performance is conditional, then seems to narrow down the description significantly, unless one takes an extremely wide view of what is meant by 'conditional'.

The first example does not say whether it is regarded as a security interest, and whether or not it provides an interest in personal property. The authors of the Explanatory Memorandum presumably inserted the example because they thought it was a security interest. It would seem consistent with the first sentence of their previous paragraph, but not the second sentence, to argue that they did. If so, there is no hint as to why there could be a security interest.

The second example does not assist. Clearly Person B does have an interest in property, being Person B's rights (albeit conditional) under the arrangement. They are personal property, transferable (subject to the contract), and can be the subject of a security interest. If the second sentence referred to Person A not having an interest, rather than Person B, then it would have been accurate and relevant.

This unhelpful confusion leaves us with the words of the legislation. The clear words of the section seem to require an interest in property. That would be

79 Replacement Explanatory Memorandum, Personal Property Securities Bill 2009 (Cth) 18 (emphasis added).

consistent with the consequences of something being declared a security interest, which include:

- provisions under which a buyer or lessee of the collateral takes free of the security interest (Part 2.5);
- provisions relating to priority of the security interest as against other security interests (Part 2.6);
- rules as to enforcement of the security interest and provisions giving powers over enforcement, such as to retain the collateral or to dispose of it (Chapter 4);
- provisions under which the security interest, if unperfected, vests in the grantor on appointment of various types of insolvency administrator (Part 8.2); and
- section 20 which sets out the requirements before a security interest can be enforceable against third parties.

One can argue that the *PPSA* should be interpreted with the broadest brush to take account of the economic 'in substance' approach. However, there seems to be little point in taking that very broad brush to the concept of an interest in property, if to take it beyond traditional concepts of proprietary interest (or something akin to a proprietary interest) would mean that most of the provisions applying to security interests would either be meaningless or redundant.

C Meaning of 'Flawed Asset' and 'Flawed Asset Arrangement'

The addition of the term 'arrangement' to 'flawed asset' clearly indicates that it can encompass something wider than a simple flawed asset, so that it could encompass a flawed asset with Extras. That is reinforced by the wide meaning of 'transaction' (see Part IV(A) below). I submit that a 'flawed asset arrangement' is any arrangement of which a flawed asset is a key or major component, and so could cover arrangements which include Extras, such as double and triple cocktails. It is important to note that the term 'flawed asset arrangement' is used to refer to the 'transaction' that provides for the security interest, and not the security interest itself. The entire arrangement need not be a security interest; one must identify an interest in it to be a security interest.

What then is a 'flawed asset' for the purposes of the *PPSA*? It would be consistent with most commentators and the general understanding in the marketplace, and with most case-law which predates the legislation, to regard it as a conditional obligation (as discussed in Part II(A) above), and I shall concentrate on that sense. Nevertheless we should recognise the possibility that it has the wider meaning used in *Belmont Park* and also discussed in Part II(A) above.

IV APPLYING THE STATUTORY REQUIREMENTS FOR A SECURITY INTEREST TO FLAWED ASSETS

As mentioned above, there are four requirements for something to be a security interest. We will examine each in turn.

A A Transaction

'Transaction' is not defined in the *PPSA*. As Bruce Whittaker suggests, dictionary definitions are not helpful.[80]

The term 'transaction' has been given a wide meaning when used in other legislation. When the courts have looked at the word in very different contexts, in tax legislation[81] or in the voidable preference provisions in insolvency legislation,[82] they have given it a very wide meaning. One transaction can, for example, comprise several steps. It has been held to be 'a word of wide import'.[83]

There is some discussion by commentators as to whether it is limited to an agreement or simply requires some voluntary component,[84] but this is moot in relation to something that by definition involves an 'arrangement'. One would think it would be difficult to have an obligation subject to a condition without there being an agreement.

The transaction is not the 'interest' and thus not the security interest, though they may be co-extensive. The interest must be 'provided for' (in subsection (1)) or 'provided' (in subsection (2)) by the transaction. The words 'provided for' seem to be of wider import. For instance, they more easily accommodate the interest of an owner under a lease, where the owner had the interest prior to the transaction. Nevertheless, it is hard to see courts making anything of this distinction.

B Personal Property

To have a security interest, we need an item of personal property to be the subject of the security interest – to be the 'collateral'.

1 *Flawed Assets Generally*

In a simple flawed asset,[85] if the obligee or other party defaults, or the relevant condition is not satisfied, then the obligor does not have to perform the

80 Wappett, Whittaker and Edwards (eds), above n 73, 30,023.

81 See, eg, *Franmarine Services (WA) Pty Ltd v Commissioner of State Taxation (WA)* (1990) 90 ATC 4207.

82 See, eg, *Sportsman's Hall Hotel Pty Ltd v Commissioner of Stamp Duties (Tas)* [1990] Tas R 21; *Mann v Sangria Pty Ltd* (2001) 38 ACSR 307; *Re Emanuel (No 14) Pty Ltd (in liq); Macks v Blacklaw & Shadforth Pty Ltd* (1997) 147 ALR 281.

83 *Re Bowmil Nominees Pty Ltd* [2004] NSWSC 161 (12 March 2004) [16].

84 See, eg, Ronald Cuming, Catherine Walsh and Roderick Wood, *Personal Property Security Law* (Irwin Law, 2005) 96–7; Gedye, Cuming and Wood, above n 8, [17.4], [23.3]; Linda Widdup and Laurie Mayne, *Personal Property Securities Act – A Conceptual Approach* (LexisNexis Butterworths, revised ed, 2002) [2.14]–[2.15].

85 A conditional obligation without Extras.

conditional obligation. It can 'retain' what otherwise might have been delivered or provided under the obligation.[86] The relevant personal property that could be subject to a security interest – the possible 'collateral' – is the conditional obligation owed by the obligor.[87]

Similarly, in the case of a flawed asset with Extras, the relevant personal property which could be the relevant 'collateral' will still be the conditional obligation owed by the obligor.

In each case, it will in most situations be the only relevant asset available.

Where the simple flawed asset is part of a subordinated debt arrangement, then there is no real collateral. The conditional obligation is owed by the debtor, not the secured party. There may be related arrangements, like the turnover trust described above as an Extra, under which amounts received by the subordinated creditor could be described as 'collateral', but not the simple flawed asset itself.

If the wide *Belmont Park*[88] sense of 'flawed asset' is used it is conceivable that some arrangements could give the 'secured party' an interest in an asset and that interest could be a security interest. This might include, say, an arrangement that 'flips' priority in an asset on default or insolvency. The collateral in such an arrangement would be the relevant asset.

2 *Deposit Flawed Assets*

In the case of a Deposit Flawed Asset there is one other possibility that might be considered – the deposited cash. This is the 'money box' idea of a deposit. As children, when we place a deposit with the bank, we find it difficult to understand how the bank could afford to pay us interest. We have an idea that the coins and notes would sit in the bank in a safe in specie.[89] In fact, when we deposit funds with a bank, we are lending it money which becomes its to use as it sees fit, and 'disappears'. All we have against the bank is a chose in action, an obligation on it to repay the amount we deposited together with interest.

However, the 'money box' idea is a persistent mental image. It pervades thinking and language. In everyday speech we talk of having money at the bank, withdrawing funds from the account, and the like, as if a deposit were a pile of cash.

Of course, the cash received on deposit is spent by the bank and used for its own purposes. In practical terms, it would in any event be impossible to trace through the funds into some other asset. The amount deposited by the customer

86 Again using loose language.

87 It might, at least in theory, be possible to construct a scenario where the conditional obligation was to deliver a specific identifiable asset allocated to the particular transaction so that, if the condition were fulfilled, the delivery obligation would be specifically enforceable. In that case, it might be possible to see the 'collateral' including that specific asset. If so, that would be very unusual, and is beyond the scope of this paper.

88 [2011] UKSC 38 (27 July 2011).

89 At least that was my experience.

becomes a liability of the bank. The customer's asset is its right against the bank.[90] As Professor McCracken said:

> there is a natural, albeit mistaken, tendency to picture a deposit as a 'bag of money' from which coins can be taken to pay off indebtedness rather than as the ledger entry required by *Foley v Hill*.[91]

When a customer withdraws funds from the deposit, it is calling upon the obligation owed by the bank. It is not dealing with any underlying funds. The bank discharges or satisfies its obligation by giving value to the customer, by crediting an account, or providing appropriate currency in specie. The same occurs if the bank exploits a contractual right to pay or deduct fees from the account. It reduces the balance in the account, and credits its own account. It is reducing or discharging an amount of its obligation, and thus the asset of the customer, it is not transferring it or otherwise dealing with the asset.

One might still argue that the relevant collateral is the original cash received. Except in the very rare circumstances where the original deposit consisted of notes and coins, even identifying the original property would be fraught with difficulty. Payments received through the clearing system, or by debiting another account with the same bank, will be achieved by debiting and crediting accounts, rather than the transfer of identifiable property. There is no identifiable 'collateral' to which the *PPSA* could apply. There is no separate 'fund'.[92]

The point is so obvious that it is sometimes overlooked, and it is worth repeating. A bank account (even a deposit account) is only a contractual obligation. The parties are free to determine the terms of that obligation.

Any security interest over the deposit is over the contractual rights, not the money.

As Lord Hoffmann said in *BCCI (No 8)*:

> but however one describes what was done to create the security, the fact is that the charge was over the debt and not over the money. The choses in action belonged to Mr Jessa and S.G.G.S.; the money belonged to the bank.[93]

C Interest in Personal Property

The relevant personal property in a flawed asset arrangement is therefore the obligee's rights arising under the conditional obligation. We need to identify an 'interest' in it, but first we should examine what is meant by the requirement that there be an 'interest' in the personal property.

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90 *Foley v Hill* (1848) 9 ER 1002, 1005 (Lord Cottenham LC), 1008 (Lord Brougham); *Matthews v Geraghty* (1986) 43 SASR 576, 580–1 (King CJ).

91 Sheelagh McCracken, *The Banker's Remedy of Set-Off* (Bloomsbury Professional, 3rd ed, 2010) 248. See also Philip R Wood, *English and International Set-Off* (Sweet & Maxwell, 1989) 488.

92 Barry Allan sees the possibility of a security interest in a fund but there appears to be no identifiable fund: *Personal Property and Securities Act 1999 – Act and Analysis* (Thompson Reuters, 2010) 77.

93 *BCCI (No 8)* [1998] AC 214, 230.

1 *What is an Interest in Personal Property?*

There is surprisingly little guidance in existing commentaries. Canadian and New Zealand commentators appear to suggest that a proprietary interest is required.[94]

In Australia, section 10 provides a definition of 'interest', which after the 2011 amendments reads as follows: 'Interest, in personal property, includes a right in the personal property'.

'Interest' connotes some proprietary interest, particularly in the context, but 'right' can have a wider connotation. Nevertheless, it is limited as the right needs to be 'in' the personal property, and this was deliberately chosen in the 2011 amendments to replace 'in relation to'. That would seem to indicate that the right or interest can travel with the property and be enjoyed against third parties, and also that the right or interest is to be able to deal with or enjoy in some way the relevant personal property.[95] Much of the *PPSA* would have no relevance or sense if it applied to rights without those attributes.[96]

That would be consistent with the requirement being described as a 'proprietary interest' or a right 'in rem' as opposed to 'in personam'. That was a feature of traditional forms of security interest.[97]

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94 Gedye, Cuming and Wood, above n 8, 72; Allan, above n 92, 57; Cuming, Walsh and Wood, above n 84, 10, 85–6; Richard H McLaren, *Secured Transactions in Personal Property in Canada* (Carswell, 2nd ed, 1989) 1–17. See also the survey of the literature by Deschamps J in *Caisse Populaire* [2009] SCC 29 (19 June 2009) [90]–[98].

95 The requirement that it in substance secures obligations further limits what types of rights to enjoy or deal would be required for the right to be a security interest. The expression 'rights in the collateral' is also used in relation to attachment in s 19(2)(a). That of course looks at the rights of the *grantor*, whereas s 12 looks at the rights of the *secured party*. There are certain examples listed in s 19(5) where the grantor of a security interest is deemed to have rights in the collateral. Apart from that situation, s 19 still appears to require the grantor to have an interest in the collateral which may be a possessory right. See also Gedye, Cuming and Wood, above n 8, 155; Wappett, Whittaker and Edwards, above n 73, 30, 901; Allan, above n 92, 82; McLaren, above n 94, 2–7.

96 See Part III(B) above.

97 See Edward I Sykes and Sally Walker, *The Law of Securities* (Lawbook, 5th ed, 1993) 3–10. Lord Hoffmann said the following in *BCCI (No 8)* at 226 in a discussion on the nature of charges which was referred with approval by the High Court in *Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd* (2000) 202 CLR 588, 595–6 [6]:

> There are several well known descriptions of an equitable charge (see, for example, that of Atkin LJ in *National Provincial and Union Bank of England v Charnley* [1924] 1 KB 431, 449–450) but none of them purports to be exhaustive. Nor do I intend to provide one. An equitable charge is a species of charge, which is a proprietary interest granted by way of security. Proprietary interests confer rights in rem which, subject to questions of registration and the equitable doctrine of purchaser for value without notice, will be binding upon third parties and unaffected by the insolvency of the owner of the property charged. A proprietary interest provided by way of security entitles the holder to resort to the property only for the purpose of satisfying some liability due to him (whether from the person providing the security or a third party) and, whatever the form of the transaction, the owner of the property retains an equity of redemption to have the property restored to him when the liability has been discharged. The method by which the holder of the security will resort to the property will ordinarily involve its sale or, more rarely, the extinction of the equity of redemption by foreclosure. A charge is a security interest created without any transfer of title or possession to the beneficiary. An equitable charge can be created by an informal transaction for value (legal charges may require a deed or registration or both) and over any kind of property (equitable as well as legal) but is subject to the doctrine of purchaser for value without notice applicable to all equitable interests.

The traditional way of viewing the requirements would be to look for whether it constituted a 'proprietary interest', or a 'real interest' or to contrast rights in personam and rights in rem. However, that may not necessarily answer the question, and there is a surprising lack of precision in those concepts. In *Livingston v Commissioner of Stamp Duties (Qld)*, Kitto J said (in relation to the rights of a beneficiary in an unadministered estate):

> I venture to think that for the purpose of solving a concrete legal problem with respect to such a set of rights, more hindrance than help is likely to come from an attempt to classify them according to Austinian terminology as rights *in personam* or rights *in rem*. …
>
> I must confess, however, that I incline to the view of Mr R W Turner who wrote in his book *The Equity of Redemption* (1931) p 152: 'It is a moot question whether the whole discussion raised by these arbitrary classifications borrowed from Roman law and distorted to fit in with new facts is not a mere academical tourney with no bearing upon the practice of the law, and, being faulty in hypothesis and unsatisfactory in result, will be better abandoned altogether'.[98]

As Sackville J said in *Wily v St George Partnership Banking Ltd*:

> It is not surprising, therefore, that there is often an element of circularity in determining whether a particular interest should be classified as proprietary or not. Are remedies granted because an interest is proprietary? Or is the interest proprietary because legal or equitable remedies are available to the holder? Doubtless, it is unwise to be dogmatic about the indicia of a proprietary interest. As I have said in another context, the concept of property may have different connotations for different legal purposes …[99]

Lists of indicia as to what constitutes a proprietary interest do not provide a complete picture, as some of those indicia (like transferability) can be missing in some interests that are clearly proprietary.[100]

2 *To What Extent Are Old Concepts Relevant?*

The question arises as to what extent the pre-*PPSA* case law and concepts are relevant in deciding whether or not something has the necessary characteristics to be an 'interest' and therefore able to cross the threshold and be a security interest for the purposes of the *PPSA* (there is a separate, but not unrelated, question, once something does cross the threshold and is a *PPSA* security interest, as to whether old distinctions between forms of security interest are at all relevant or whether an entirely new form of statutory security interest is created).

One might say:

- that the old concepts of what is an interest are still relevant in determining whether or not there is an interest – once an arrangement gives an interest under pre-*PPSA* concepts, then it could give an interest for the purposes of the *PPSA*;

98 (1960) 107 CLR 411, 448–9.

99 (1999) 84 FCR 423, 426 [5]–[6] (citations omitted).

100 See Roderick Meagher, Dyson Heydon and Mark Leeming, *Meagher, Gummow & Lehane's Equity: Doctrines and Remedies* (Butterworths LexisNexis, 4th ed, 2002) 126; *Wily v St George Partnership Banking* (1999) 84 FCR 423, 432–3 (Finkelstein J).

- that while old concepts are still relevant in that way, there may be other arrangements previously not recognised as constituting an interest which will be recognised as an interest for *PPSA* purposes; or
- that old distinctions are swept aside, including in deciding whether or not there is an 'interest'.

It is beyond the scope of this paper to examine these questions, or to propose which one is correct.[101] Whichever is adopted, existing concepts and case law should still be relevant, at least to the extent of saying that the old law will assist in informing the new law as to what characteristics are sufficient to create an interest, and when an interest might be created.

For that reason, for the remainder of this paper I will continue to refer to case law and pre-*PPSA* concepts.

3 *'Security Interest-Backs'*

In examining the question as to whether a flawed asset arrangement could be or contain a security interest, the drafting of the *PPSA* at least spares us the question as to whether or not one can have a security interest over one's own obligation.

The matter appears to have been settled in England (albeit in obiter).[102] Following *BCCI (No 8)*,[103] there had been a trend in that direction in Australia, adopted obiter by Spigelman CJ, but the train had not yet definitively arrived.[104]

Section 12(3A) provides as follows:

> A person who owes payment or performance of an obligation to another person may take a security interest in the other person's right to require the payment or the performance of the obligation.

Section 12(4) adopts the same principle for the particular examples of accounts, chattel paper and ADI accounts.

101 Suffice it to say that while the *PPSA* on the whole treats the distinctions between forms of security interest as irrelevant within its confines, it does lapse into using old terminology (see, eg, ss 12(2), 50(3)) and into providing different consequences according to the nature of the security interest and as to which party has title (see, eg, s 63). The amendments to the *Corporations Act 2001* (Cth) made by the *Personal Property Securities (Corporations and Other Amendments) Act* 2010 (Cth) to coincide with the *PPSA* also make distinctions (see, eg, the definition of 'circulating security interest' inserted by sch 1 pt 1 cl 1 of the amending Act). Existing characterisations may still be relevant where the writ of the *PPSA* does not reach, for example, in priority issues between *PPSA* security interests and other interests. See, eg, Struan Scott, 'The PPSA: The Continued Relevance of Conventional Legal Principles in Determining the Existence of a Security Interest' (2009) 15 *New Zealand Business Law Quarterly* 203; Gedye, Cuming and Wood, above n 8, 73. On the other hand, some Canadian authorities treat all PPSA security interests as a new statutory interest (see, eg, *Bank of Montreal v Innovation Credit Union* [2010] 3 SCR 3).

102 *BCCI (No 8)* [1998] AC 214.

103 [1998] AC 214.

104 *Cinema Plus Ltd (admin apptd) v Australia and New Zealand Banking Group Ltd* (2000) 49 NSWLR 513 (Spigelman CJ) ('*Cinema Plus*'); *Emanuel Management Pty Ltd (in liq) v Foster's Brewing Group Ltd* (2003) 178 FLR 1, 359–60 [1434]–[1438]. Peter Ward lists eight Australian cases pre-dating *BCCI (No 8)*, including one at appellate level, which adopt the conceptual impossibility notion: 'Personal Property Securities Reform and the Conceptual Impossibility Doctrine' (2009) 20 *Journal of Banking and Finance Law and Practice* 106, 111.

Note that while these provisions remove a barrier to charge-backs, they do not mean that arrangements which were not previously security interests, become security interests.

One argument against the possibility of charge-backs under pre-*PPSA* law has been that as between the debtor and creditor, the relationship is one of obligation, not property.[105] The question may still be relevant for this paper in deciding whether there is a distinct separation between a right of set-off and a security interest, and whether a condition in an obligation is an interest in it, and so I will deal with it briefly.[106] As McCracken says,[107] this argument is not expressly dealt with by Lord Hoffmann in *BCCI (No 8)*.[108] From the obligor's point of view, an obligation is, in the normal course, just an obligation and not property. However for every obligation, there is a correlative right of the obligee, which is assignable property.[109] Another party can have an interest in that property, such as a charge or a mortgage or other security interest (unless prevented by the terms or nature of the relevant contract). The obligor could hold such an interest, at least in the case of a charge. A charge is not generally regarded as constituting assignment[110] (which might arguably result in merger). As a result of its charge it would acquire rights in relation to the obligation, not directly, but because of its chargee's interest in the obligee's property, which is the obligee's rights in respect of the obligation. It is not necessary that this occur. For the obligor to have security, very similar results can be achieved from the obligor's point of view by simply affecting the obligation, rather than by the more elaborate or roundabout route of taking or enforcing an interest in the obligor's property.[111]

4 *Is a Simple Flawed Asset an Interest in Personal Property?*

If the relevant personal property is the rights of the obligee in relation to a conditional obligation of the obligor, then the condition does not give the obligor any right or interest in it. It is one of the terms of the obligation, but it is a condition, not a right and not an interest. It is not enforced by the obligor, nor exercised by the obligor. If a claim is made under the obligation, it is simply pleaded as a reason that there is no amount owed under the obligation.[112] It defines the personal property.

As we shall see in Part IV(C)(5) below, Extras added to a simple flawed asset may be a security interest, but without them it would seem clear that there is no security interest.

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105 This was espoused by Rose LJ in the Court of Appeal in *Re Bank of Credit and Commerce International SA (No 8)* [1996] 2 All ER 121, 131. See McCracken, above n 91, 265–7; Ward, above, n 104, 109.

106 See Parts IV(C)(5)(iv) and IV(E)(2) below.

107 McCracken, above n 91.

108 [1998] AC 214.

109 See, eg, Ward, above n 104, 119.

110 See the classic statement of Atkin LJ in *National Provincial and Union Bank of England v Charnley* [1924] 1 KB 439, 450.

111 See below Part IV(C).

112 See also Part II(D) above.

The simple flawed asset gives no right to deal with an asset that might be said to 'secure' debt within the meaning discussed in Part IV(D) below. It is merely a term of an asset – merely the condition, diminution or postponement of what otherwise might have been a liability of the obligor and an asset of the obligee.

The learned authors of *Personal Property Securities in New Zealand* think otherwise:

> However, although flawed asset arrangements are expressly included in the list of security interests identified by section 17(3), it may be argued that a flawed asset arrangement will create a security interest only where (as is the nature of all the other transactions listed in section 17(3)) it constituted a proprietary interest in the flawed asset. This argument would draw a distinction between a flawed asset arrangement under which the financier had the right to apply the flawed asset/conditional debt towards an obligation due to the financier (which right would constitute a proprietary interest) and an arrangement under which the conditional debt is never applied towards satisfaction of the obligation owed to the financier but simply remains outstanding until that obligation is otherwise satisfied (which arrangement, it would be argued, does not constitute a proprietary interest in the flawed asset). In the authors' opinion, this analysis draws very fine distinctions that are not justified by the substance approach of the Act. The inclusion of flawed asset arrangements in section 17(3) was presumably intended to counter such an analysis. The economic substance of a flawed asset arrangement is that it secures performance of an obligation.[113]

With respect, this appears to take the substantive approach too far and the discussion by Widdup and Mayne on this point seems preferable.[114] The substantive approach simply goes to whether the transaction is one which, in substance, secures payment or performance. The section still requires that there be an interest in personal property. The distinction between such an interest and non-interest may at times be blurry, but it is not a fine point. Despite the judicial caution expressed above and the elasticity of the terms, differences between real and personal rights are crucial in many areas of the law. In legislation regulating security interests, it is not a fine or peripheral issue to expect security interests to be interests.

The *PPSA* is full of fine distinctions, and as discussed below in Part IV(E) finding the boundaries between the inclusion of flawed asset arrangements and the exclusion of rights of set-off may involve particularly subtle distinctions.

Many contracts contain provisions that can be said to 'secure' obligations in the wider sense, including not only conditional obligations but also termination rights, which operate purely contractually, and do not constitute interests as normally understood. A dividing line is necessary.

The position in Australia on the point will be clearer than in New Zealand. The drafting of the *PPSA* (in section 12(2)) expressly requires the list of examples all to provide for an interest in personal property.[115]

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113 Gedye, Cuming and Wood, above n 8, 90.

114 Widdup and Mayne, above n 84, 14.

115 The New Zealand equivalent provision, *NZPPSA* s 17(3), is not as clear. It provides:

> Without limiting subsection (1), and to avoid doubt, this Act applies to a fixed charge, floating charge, … or a flawed asset arrangement, that secures payment or performance of an obligation.

Further, in Australia the issue has been the subject of some judicial consideration. In *Griffiths v Commonwealth Bank of Australia* the relevant document provided:

(a) that as long as any moneys were owed by the customer to the bank, 'the bank shall be under no obligation to repay the deposit(s) described in the schedule …'; and

(b) that 'the bank may without prior notice to me/us prepay and apply the whole or any part of the deposit and interest accrued thereon in or towards payment of the moneys owing …'[116]

Justice Lee said:

> Apart from the impossibility of the indebtedness of the bank being made the subject of a lien or charge in favour of the bank, the further agreement contained no terms which indicated that an instrument of security was created.[117]

It should be noted that the above analysis applies equally to Deposit Flawed Assets and flawed assets involving obligations other than deposits. It should not matter whether the relevant conditional obligation arose from a deposit of money or for some other reason, nor should it matter whether the consideration was executed or executory.[118]

Finally we must look at the possibility that 'flawed asset' is used in the widest sense used in *Belmont Park* and discussed above (in Part II(A)) – a feature of an asset existing from its inception which prevents the holder enjoying it in certain circumstances. Whether such an arrangement creates an interest in the asset will depend on the particular arrangement. While most will not create an interest in property, it is possible to conceive of an arrangement under which such an intrinsic feature of an asset is an interest in it. This might arise in some circumstances where the rights in an asset of one party 'flip' over to a third party on default or insolvency, or a third-party has an interest in an asset which 'springs up' following another party ceasing to have rights in the asset on default or insolvency. The third party may have an interest in the asset. It is arguable that the arrangement in *Belmont Park*[119] in relation to the priority of a security interest which flipped on bankruptcy or default of Lehman Bros Special Financing Inc was a security interest granted in favour of the noteholders by that company in the security interest held by it.

The above analysis in this Part deals with the common position where the party which is owed the obligation 'secured' (in the broadest sense) by the

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While it may be intended that these words simply clarify what is in subs (1) so that subs (3) only relates to things that would satisfy the test in subs (3), it is possible to give them a wider interpretation, so the words could be taken to include as security interests all of the things listed, whether or not they are interests in property, or widening what is meant by 'interest'. Cuming, Walsh and Wood seem to suggest that similar words in the Canadian statutes may have the effect of bringing other interests under the umbrella: above n 84, 60–2.

116 *Griffiths v Commonwealth Bank of Australia* (1994) 123 ALR 111, 116 ('*Griffiths*').

117 Ibid 120.

118 Justice Briggs thought there was a difference between executed and executory consideration in relation to the anti-deprivation rule in *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch) (21 December 2010). See also above n 36.

119 [2011] UKSC 38 (27 July 2011).

arrangement is the obligor of the conditional obligation. That is not the case with subordinated debt arrangements, where payment of the subordinated debt is conditional upon payment of the senior debt. If anyone is 'secured' it is the senior creditors. They often are not parties to the arrangement at all, and even if they are they have no interest in the conditional subordinated debt solely as a result of the conditionality. As stated above in Part IV(B)(2), the conditional debt is not collateral.

5 *Is a Flawed Asset with Extras an Interest in Personal Property?*

The arrangement in *Griffiths* could be described, using my terminology, as a flawed asset with Extras. Justice Lee was perhaps affected by the (now questionable) conceptual impossibility doctrine when he said so confidently that there was no charge in *Griffiths* despite the language of application, but his decision is consistent with others requiring a clear intention for there to be a charge.[120]

In most flawed asset arrangements the Extras may be a more fruitful hunting ground for security interests. In the words of sections 12(1) and 12(2), the security interest is the 'interest in personal property provided [for] by the relevant transaction', not the transaction itself. While the flawed asset itself is not an interest, and therefore not a security interest, for the reasons given above, the Extras could be, alone or in combination with other Extras.

It is a truism to suggest that the effect of the Extras will depend on their drafting. As mentioned above, they will typically include:

- a restriction on dealing with the obligation;
- a 'set-off' clause; and
- occasionally a charging clause or other clause creating an express security interest.

Where a provision contains an express creation of a security interest, then it is clearly covered by the *PPSA*. For that reason, I shall not dwell on a 'triple cocktail', which, by definition, contains such express provisions, except to look at the effect on the other ingredients of the cocktail.

I shall deal briefly with restrictions on dealing in the discussion of *Caisse Populaire*[121] below.

6 *Set-off clauses*

I shall concentrate for the moment on the 'set-off' clause. Although it is common to entitle such clauses 'set-off' the wording can take a variety of forms. The operative verb as to what is done in respect to one obligation by the other may be 'set-off', but other words may be used that connote application, appropriation, combination, discharge or extinguishment. The result in any case

120 See Part IV(C)(6)(iv) below.
121 [2009] SCC 29 (19 June 2009).

is that the larger debt is reduced to a net balance and the smaller debt discharged or extinguished.

A few observations can be made.

(i) First, as Professor McCracken points out, with set-off generally, while there is agreement as to the ultimate result, there is a variety of ways in which, at the conceptual level, the parties get there.[122] She suggests that the set-off may be explained as an act of one or other (or both) of the parties:

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

Then she suggests another two possibilities with set-off arising by operation of law.

When there is a 'set-off' clause, then the mechanism may depend on the precise drafting employed, though that still may not be clear. Case law is inconclusive. There are, perhaps, four possibilities:

1. simple mutual extinguishment or discharge;[123]
2. the obligor could pay, satisfy or discharge its obligation to the obligee by using or applying the amount owed to it by the obligee;[124]
3. the obligor pay, satisfy or discharge the obligor's obligation to it by debiting or otherwise applying, reducing or discharging the amount it owes the obligee; or
4. the obligor applies the property of the obligee in the amount owed by the obligor to satisfy or discharge the amount owed to the obligor by the obligee.[125]

Possibilities two and three could operate in various ways, including simply debiting one account and crediting the other. The differences are subtle. Analyses lower down the list may be more likely to be held to be a charge or security interest in favour of the obligor, as discussed

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122 See McCracken, above n 91, 135, 231.

123 This (or alternative three) seems to be the method employed in *Cinema Plus* (2000) 49 NSWLR 513. This method also seems to be referred to in *Electro-Magnetic (S) Ltd (mgr apptd) v Developments Bank of Singapore Ltd* [1994] 1 SLR 734, quoting Roy Goode, *Legal Problems of Credit and Security* (Sweet & Maxwell, London, 2nd ed, 1983) 4. It also seems to be the method referred to in *Commercial Factors Ltd v Maxwell Printing Ltd* [1994] 1 NZLR 724, 737 (Hammond J), and by both majority and minority in *Caisse Populaire*.

124 Wood, above n 91, 148; Wood, above n 7, 11.

125 Professor Wood sees this method as the method of enforcement of a charge. See Wood, above n 7, 13.

below. Possibility four will be a security interest, possibility three is much less likely to be one. The obligor can be seen as dealing directly with its obligation, rather than approaching it by dealing with the rights of the obligee.

(ii) It might be said that because the conditional obligation is not due and payable and is only contingent, there cannot be true set-off. However, there does not seem to be any reason why, contractually, the contingent obligation cannot be used to discharge the non-contingent, or vice versa, or that each of the obligations cannot be regarded as simply pro tanto discharged. Professor Goode suggests either the non-contingent obligation is postponed or a valuation of the contingent obligation is necessary.[126] If this is correct, then in the case of a flawed asset, where the maximum amount is known and the main contingency is the payment of the other debt, the latter should be the preferred method of operation. The conditional obligation will be set-off or discharged for the maximum amount of the non-contingent obligation.[127] However, there may be no need for elaborate analysis when the contract simply provides that one is applied against the other.

(iii) It might be argued that no matter what the conception of the set-off clause, if it gave a right of set-off against specific obligations, then in the sense used in the *PPSA*, it could constitute an 'interest in' the right of the obligee that consists of the obligations, and therefore a security interest. It is exercisable against third parties, in the sense that an assignee of the obligation would take subject to its terms, which would include the right to 'set-off'[128] and is subject to equities including set-off.[129]

One important, but not necessary, feature of a security interest is that the third parties against whom it is enforceable should include an insolvency administrator. Contractual set-off is enforceable against voluntary administrators.[130] It is not clear what the fate of a contractual set-off right accompanying a flawed asset (a conditional obligation) would be in the case of the liquidation or bankruptcy of the obligee. Normal analysis is that on liquidation or bankruptcy, it is replaced by mandatory insolvency set-off. However, as discussed above (Part

126 Goode, above n 8, 248.

127 This is the preferred interpretation of Derham: above n 6, 743.

128 See the discussion in Wood, above n 7, 106–7; Derham, above n 6, 838. This is reinforced, in the case of accounts, under s 80(1) of the *PPSA*, but 'accounts' do not include ADI accounts (broadly, bank accounts).

129 See Derham, above n 6, 817. An assignee would also take subject to accrued set-off as an 'equity' under s 12 of the *Conveyancing Act 1919* (NSW) and its equivalents in other jurisdictions, and will also take subject to set-offs under s 80(1) of the *PPSA*, though it should be noted that 'accounts' do not include ADI accounts.

130 *Cinema Plus* (2000) 49 NSWLR 513.

II(D)), in the insolvency of the obligee, insolvency set-off will not apply so long as the obligation remains contingent. Where the 'set-off' is really a charge or other security interest, then on classical analysis it would still be exercisable in the relevant insolvency administration. Even if it is not a security interest, the liquidator or trustee in bankruptcy of the obligee could take no greater rights under the contract than the original party, subject to insolvency legislation or policies (see the discussion of this issue in Part VI(E) below).

Finally, the obligor does have, in the very broadest sense of the term, rights to deal with the relevant obligation that constitutes property in the hands of the obligee.

The above notion would not be uncontroversial, and would certainly have offended the American Professor Grant Gilmore, who famously said, '[o]f course a right of set-off is not a security interest and has never been confused with one: the statute might as appropriately exclude fan dancing'.[131] Most commentators see contractual set-off as a personal right, not a real one, and have said that there is a difference between a set-off and a charge.[132]

This is moot in the context of the *PPSA*. So long as the clause is truly described as a 'right of set-off', section 8(1)(d) provides that the *PPSA* does not apply, though interestingly, it does include such a right in a list of 'interests'. We still need to establish the breadth of this exclusion.

(iv) One difficulty is that commentators generally make a distinction between clauses operating by way of set-off, and those that take effect as a charge (or other form of security interest).[133] Before we can examine the extent of the set-off exclusion in section 8(1)(d),[134] we need to explore which set-off clauses might, on traditional principles, be regarded as charges or other interests in property sufficient to be a security interest.

This issue has perhaps been overshadowed by the controversy as to whether or not a charge-back was conceptually possible.

There have been very few cases examining the area. In Anglo-Australian jurisprudence, cases in which set-off clauses were found to operate as a charge or other form of security interest can be counted on

131 Grant Gilmore, *Security Interests in Personal Property* (Little, Brown & Co, 1965) vol 1, 315–6.
132 McCracken, above n 91, 275; Wood, above n 91, 650; but see Derham, above n 6, 793.
133 See, eg, Wood, above n 91, 162.
134 See Part IV(E)(2).

the thumbs of one hand.[135] The case in question, *Re Tudor Glass*, involved a rough 'businessman's' letter which appeared to purport to give any company in one group the right to set-off any amount it owed to any member of another group against amounts owed by any member of that other group. It was not limited to a bilateral arrangement and of necessity strayed beyond pure set-off into applying debts to satisfying third parties' liabilities and towards the territory of a charge. The decision was described as 'unsatisfactory' by the Singapore Court of Appeal in *Electromagnetic (S) Ltd (mgr apptd) v Development Bank of Singapore*,[136] which held that a set-off clause gave a mere personal right.

The intention of the parties is the principal consideration. In the main case on the issue of charge-backs, *BCCI (No 8)*, Lord Hoffmann found in obiter that there was no charge (albeit there was no set-off right).[137] There was insufficient intention showed by the parties. Similarly in *Cinema Plus*, Spigelman CJ, whilst indicating that a charge-back was possible, said that the general set-off clause in the relevant ANZ bank document was not a charge.

His Honour said:

> Clause 21 does not manifest an intention to make available the company's property in an account as security for the company's obligations. There was no deposit specifically made by the customer for the purposes of security. There was no obligation to maintain any account. There were no restrictions on the conduct of any account. Nor was any account, or indeed the body of accounts as they may exist from time-to-time, appropriated in any way, either immediately or contingently, as security for any present or future debt.[138]

It is not clear from the above whether any of those tests, if satisfied, would have on their own have meant that the relevant clause constituted

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135 *Re Tudor Glass Holdings Ltd; Franik Ltd v Thermal Aluminum Ltd* (1984) 1 BCC 98982 (*'Re Tudor Glass*'). It has been joined by *Caisse Populaire* [2009] SCC 29 (19 June 2009): see Part V below. A referee of this paper kindly suggested that *Fraser v Oystertec plc* [2006] 1 BCLC 491 is another example of a set-off agreement being regarded as a charge. However, I was not able to find any reference in the decision to a relevant set-off clause in relation to the charge issue. That case involved, extraordinarily, an oral agreement between a bank and its customer. The court found at 494 that the agreement was:

> to the effect that monies (ie the monies standing to the credit of Account no 1) would be deposited by Mr Davidson to be held as specific security for Mr Davidson's liability under the guarantee, that the amount to be drawn down under the third party facility would be limited to the monies deposited in Account No 1 and that Mr Davidson could not draw on Account No 1 whilst there was a liability on the guarantee.

Terence Mowschenson QC, sitting as a Deputy Judge of the High Court, gave no reason for the conclusion that this created a charge, save to quote Lord Hoffmann in *BCCI (No 8)* as to the characteristics of an equitable charge. There is nothing to show that the deciding factor was other than the simplest – the fact that the agreement required the deposit to be held as 'specific security'. There was no set-off clause mentioned by the Court in the relevant arrangement. There was a set-off clause in another arrangement, but it had no bearing on this argument.

136 [1994] 1 SLR 734.

137 *BCCI (No 8)* [1998] AC 214.

138 *Cinema Plus* (2000) 49 NSWLR 513, 523 [46].

a charge. Justices of Appeal Sheller and Giles did not mention those factors in forming the conclusion that the arrangement was not a charge. They saw it as a matter of contract, of assessing the intentions of the parties, and they did not feel a need to address the conceptual impossibility point.[139]

As we have seen in *Griffiths* there was held to be no charge.[140]

What confuses the issue further as between a set-off and a charge is that the method of 'enforcement' or delivering the end result seems to be indistinguishable. As Lord Hoffmann suggested in *BCCI (No 8)*, 'realisation of a charge would take the form of a book entry'.[141]

As Professor Goode said:

> But since the only method of realising the charge is by a book-entry debit to the account recording the chargee's indebtedness, which is the self-same method utilised to effect a contractual set-off, it seems that the only way of distinguishing a charge over the debtor's obligation from a contractual set-off is by the label given to the agreement by the parties.[142]

In the absence of clearly expressed or inferred intention that the relevant clause is or is not to operate as a security interest, it could come down to an analysis of which of the four methods outlined above (in Part IV(C)(6)(i)) of arriving at the economic result is selected. Professor Philip Wood suggests that set-off is in essence a payment.[143] However, as Dr Derham points out, that is not the way legal, equitable or insolvency set-off works. Nor is it the way many contractual set-off clauses are in fact applied, one must look at the substance. See the discussion above in item (i) under Part IV(C)(6). Dr Derham clearly sees rights of set-off combined with a segregated security deposit as a charge,[144] but sees a simple flawed asset approach as not a charge.[145]

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139 Justice of Appeal Sheller saw the operation of the clause more as a matter of account representing one net balance, in the manner of a combination of accounts: ibid [113]–[116]. He seemed in part influenced by the fact that the rights given by the clause were no greater than the common law right of combination of accounts: at [116]. Justice of Appeal Giles saw there as objectively determined no intention to create a proprietary interest. Justice of Appeal Giles said that a common law combination of accounts would not apply, but did agree (at [145]), that it was contractual right, and not a proprietary right, in part because it was not assignable. Non-assignability, however, should not, on its own, be definitive as to whether there is a proprietary interest (see *National Trustees Executors and Agency Company of Australasia Ltd v Federal Commissioner of Taxation* (1954) 91 CLR 540, 583) but this did not appear to be his sole reason for this conclusion.

140 (1994) 123 ALR 111, 120. See also *Commercial Factors Ltd v Maxwell Printing Ltd* [1994] 1 NZLR 724 (Hammond J). *Griffith* was influenced by the conceptual impossibility doctrine.

141 [1998] AC 214, 227.

142 Goode, above n 8, 14.

143 Wood, above n 7.

144 Derham, above n 6, 797–9.

145 Ibid 804.

It is often suggested that because a classic definition of a charge uses words such as 'appropriate', if the clause talks about 'appropriation' it must be a charge.[146] However that still cannot be definitive. Appropriation can be used in the sense of selecting or applying. Appropriating the debt may simply refer to choosing which debt to apply against and when to do it. Alternatively it can be used in the sense of making the kind of application or combination referred to in *Cinema Plus*, or electing for extinguishment. It can deal with an obligation. It may not necessarily refer to an appropriation of property or the exercise of proprietary rights.

In part, *Cinema Plus* was a case as to the timing of the relevant 'appropriation' in the broader sense of the term.[147] That is, when the two debts would be applied against each other. The mere fact that the bank had to take a step to achieve that result did not alter the nature of the relevant clause.[148] It should be noted the clause did not use the term 'appropriate', but it did use the term 'apply' (as did the clause in *Griffiths* which was also held to not be a charge).[149]

Chief Justice Spigelman said the following:

> In my opinion, cl 21 is, in effect, a contractual right to 'seize' an account in the future … It does not manifest an intention on the part of the parties to create any form of present right over property of the company. It confers a right to take steps in the future, which have the consequence that the company's chose in action will be extinguished in whole or in part.[150]

It is here that the property/obligation duality might be relevant. Wording can be taken as dealing with one and not the other.

If a reduction, extinguishment, discharge or other act affects the obligation of the obligor, it necessarily affects the correlative right of the obligee as a consequence of the alteration of the obligation. The mere fact that a similar result might be achieved by the obligor, exercising whatever dominion its interest as chargee in the right of the obligor may give it, does not mean that achieving the result necessarily involves an exercise of that dominion rather than the direct approach of affecting the contractual obligation, nor does it mean that the parties choose to rely on a charge rather than on rights to deal with obligations as obligations. Occam's Razor cuts heavily in favour of the contractual approach. Very clear words should be necessary to indicate that the parties chose to do in a roundabout way what could have been achieved directly.

146 See, eg, McCracken, above n 91.
147 (2000) 49 NSWLR 513.
148 *Cinema Plus* (2000) 49 NSWLR 513, 522.
149 *Griffiths* (1994) 123 ALR 111, 120.
150 *Cinema Plus* (2000) 49 NSWLR 513, 522, [42].

> In any event, if a 'set-off' clause is found to be a sufficient 'interest' in property to be a security interest, but for some reason the exclusion in section 8(1)(d) does not apply to the clause, then the relevant interest in property is the set-off clause. The condition on repayment of a debt, which makes it a flawed asset, may be independent and unaffected.[151]

7 *Subordinated Debt Arrangements*

As mentioned above, a common feature of subordinated debt arrangements, whether or not they include a flawed asset, is the turnover trust, under which the subordinated creditor holds on trust for senior creditors amounts received in respect of the subordinated debt. Such turnover trusts are clearly security interests.

D Does the Transaction in Substance Secure Payment or Performance?

The word 'secure' or 'security' can have a wide variety of meanings. In its widest sense, it need not be in respect of property at all,[152] and can include a guarantee or even in some contexts a primary obligation.[153] There is no further clarification in the *PPSA* as to what is meant by 'secure'. Clearly, however, it uses them in the context of having a right to resort to some property or fund, though it must be in the widest economic sense.

Barry Allan sees it thus:

> When those rights exist in respect of personal property, say that the property or some interest in it becomes legally available to the creditor as a substitute for a personal payment or a performance by the debtor, then it could be said that those rights are securing the rights of the creditor to have performance or payment. This contrasts a security interest with a guarantee, for example …[154]

In relation to a simple flawed asset without any Extras, it might be said that as well as creating no interest for the obligor that could be described as a security interest for the purposes of the *PPSA*, there is nothing that secures any obligation in the sense described above. If the obligee or other party defaults, then the obligor is simply not obliged to perform the obligation that otherwise it might have had. It can also be said that it does not 'in substance secure' payment or performance in that case, as there is no resort to any particular asset or fund. That will be the case in subordinated debt arrangements. However, in other arrangements where the 'secured obligation' is owed to the conditional obligor,

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151 See Part II(F) above and Part V below.

152 See *Caltex Australia Petroleum Pty Ltd v Commissioner of State Revenue* [2000] WASCA 54 (8 March 2000), [42]–[65]; *Handevel Pty Ltd v Comptroller of Stamps (Vic)* (1985) 157 CLR 177, 196. See also Sheelagh McCracken and Anna Everett, *Everett and McCracken's Banking and Financial Institutions Law* (Lawbook, 7th ed, 2009) 601.

153 *Inland Revenue Commissioners v Henry Ansbacher and Co* [1963] AC 191; *Glenepping v Commissioner of Stamp Duties (NSW)* (1985) 3 NSWLR 635; *Caltex Australia Petroleum Pty Ltd v Commissioner of State Revenue* [2000] WASCA 54 (8 March 2000); W J Gough, *Company Charges* (Butterworths, 2nd ed, 1996) 3 gives this meaning for security: 'security for the payment of a debt or claim, either by a right to resort to some fund or property for payment or by a guarantee to some person to satisfy the debt or claim for which another person is primarily liable'.

154 Allan, above n 9, 28.

that argument on its own might not be safe, given the broad economic approach as to what is meant by 'in substance secures'. The arrangement does in the widest sense secure obligations,[155] but there remains unfulfilled the requirement of an interest in personal property.

Where there is a flawed asset with Extras, and those Extras include a right to apply the conditional obligation in payment of another obligation, or vice versa, or in some other way to appropriate one against another, then it may be said that, as a matter of economic substance, the arrangement 'secures' the other obligation, but of course it still must be an interest in personal property.

E Do Exclusions Apply?

Once an interest becomes a security interest under section 12, even if it is listed under section 12(2), the question remains as to whether it is excluded under section 8. Section 8(1) contains a list of 'interests' to which the *PPSA* does not apply, except in certain respects.

Section 8, in a sense, overrides section 12(2). That is not to say that section 8 will be interpreted without regard to what is contained in section 12(2), but clear words of section 8 would override any clear words in section 12.

There are two relevant exclusions, netting contracts referred to in section 8(1)(e) and rights of set-off referred to in section 8(1)(d).

1 *Close-Out Netting Contracts*

These are defined by reference to the *Payment Systems and Netting Act 1998* (Cth). The standard form ISDA Master Agreement clearly complies with the requirements of the definition of 'close-out netting contract' with a close-out netting arrangement in section 6 of that standard form. The position is similar to the securities lending agreements reviewed by Finkelstein J in the matter of *Re Opes Prime Stockbroking Ltd.*[156]

The condition precedent in section 2(a)(iii) of the ISDA Master Agreement, a 'flawed asset', is covered by the exclusion. It is contained within a close-out netting contract and, at least from the point of view of the non-defaulting party, it supports some of the aspects that make it a close-out netting agreement. It relates to the obligations the subject of the close-out netting, and sets out some terms of those obligations. The position may be different where the Master Agreement includes some extraneous security interest over some unrelated asset, say, a charge over a car.

On that basis, section 2(a)(iii), even if a security interest, would not be covered by the *PPSA*. That also applies to the operation of the English Law Credit Support Annex published by ISDA (designed to be part of the Master Agreement), which provides for the provision of collateral, but on an absolute transfer basis. There is no obligation for return of the actual collateral, but only

155 See Part II(E) above.
156 (2008) 171 FCR 473.

for a payment which forms part of the close-out netting procedure under the main ISDA Master Agreement.

2 *The Right of Set-Off*

Section 8(1)(d) excludes 'any right of set-off or right of combination of accounts (within the ordinary meaning of the term 'accounts')'.

'Combination of accounts' refers to a bank's ability to treat several current accounts as one net obligation and it is not relevant to our discussion.[157]

'Right of set-off' is directly relevant as most flawed asset clauses will be contained in documents that also would contain a 'set-off' clause, variously expressed. It might be suggested that this should be interpreted narrowly, and in some way to exclude set-offs arising under contract, as not being a true set-off (limiting the field to legal, equitable and insolvency set-off). That would give the exclusion no work to do, as interests in personal property that are created, arise or provided for by operation of the general law are exempted in the immediately preceding paragraph. Contractual set-off is recognised as a distinct category of set-off by most writers on the subject, though Dr Derham talks more of a 'set-off agreement'.[158] Dr Derham does recognise that rights under set-off clauses are described in the cases as rights of set-off.[159] The term 'contractual set-off' is used widely in legal practice.

That raises the question as to whether there is a true distinction between rights of set-off on the one hand and a charge (or other interest sufficient to be a security interest as defined) on the other. Dr Derham seems to be suggesting that an overlap is possibile.[160] If the sole given method of enforcement of the charge or other security interest is effectively set-off,[161] then such an arrangement could arguably be a 'right of set-off' within the meaning of section 8(1)(d). This would particularly apply if the existence of such a right was the main reason for saying it was a charge or other interest. If this was the case, then the vast majority of clauses dealing with set-off, application, or appropriation of obligations, would be excluded from the operation of the *PPSA* unless the relevant clause had other features so it could be said to be more than just a right of set-off.

The dividing mark may remain that 'set-off' deals with obligations and their extinction or discharge, but where a set-off clause strays into dealing with rights of the obligee as property, then it may not be, or may not be exclusively, a right of set-off. If so, in legislation designed to look at substance, there would be some irony in an exclusion depending on such metaphysical distinctions and minor changes in drafting. If a right is a right of set-off, but not exclusively so, then it still may be excluded. Professor Duggan believes that the exception in section 8(1)(d) only applies to a bare right of set-off, and so its inclusion does no more than 're-state the question'. His assumption is that the exclusion is only there to

157 See McCracken, above n 91, 20.
158 Ibid 65; Wood, above n 7, 7; Wood, above n 91, 11; Goode, above n 8, 240; Derham, above n 6, 741.
159 Derham, above n 6, 798.
160 Ibid.
161 Ibid 800; *BCCI (No 8)* [1998] AC 214; *Caisse Populaire* [2009] SCC 29 (19 June 2009) [35].

confirm the view of Professor Gilmore referred to above.[162] As a matter of normal statutory interpretation, there seems to be no reason to prefer that interpretation over one that catches rights of set-off that do operate as security interests. Most (though not all) of the things listed in section 8(1) could operate as security interests. They are not merely for clarification.

V *CAISSE POPULAIRE*

A The Facts and the Result

The case concerned a priority dispute between a bank and the Canadian Crown, under federal legislation which imposed a trust for the benefit of the Crown on property subject to a security interest, to pay certain unremitted taxes.

The legislation defined 'security interest' in very similar terms to the *PPSA*, as follows:

> 'Security interest' means any interest in property that secures payment or performance of an obligation and includes an interest created by or arising out of a debenture, mortgage, hypothec, lien, pledge, charge, deemed or actual trust, assignment or encumbrance of any kind whatever, however or whenever arising, created, deemed to arise or otherwise provided for.[163]

The bank held a security deposit provided by its customer as required under a credit agreement. The customer signed a 'term savings agreement' and a 'security given through savings' agreement. The term savings agreement contained restrictions on disposal and granting of security interests with respect to the deposit, and required the maturity date of the deposit to match the maturity of the loan (five years). Among other things the security agreement contained a right for the bank to withhold the deposit until the loan was repaid and a clause allowing 'compensation' (the Québécois equivalent of set-off, the majority and minority treated it as the same as contractual set-off). It contained events of default allowing the bank to accelerate the loan and use the deposit to compensate its claim under the credit agreement. The security agreement also provided an express security interest (hypothec and pledge) over the deposit and a certificate representing it, thus making the arrangement akin to a 'triple cocktail' but this had no bearing on the case, or at least the majority decision.

The Court found by a majority that there was a security interest, relying mainly on the restrictions in the term savings agreement and the restriction on withdrawal in the security agreement when combined with the compensation rights.

162 Anthony Duggan, 'Some Canadian *PPSA* Cases and their Implications for Australia and New Zealand' (2010) 38 *Australian Business Law Review* 161, 165; Gilmore, above n 131.

163 *Income Tax Act*, RSC 1985, c 1, s 224(1.3).

This has caused some consternation and concern as to its effect in relation to flawed assets. Reactions from practitioners to the *Caisse Populaire* decision have been negative,[164] but those from academia more positive.[165]

B Distinguishing Features

It is worth noting some points of distinction between the case and the position of flawed assets and the *PPSA*:

- While the arrangements were at least very similar to a Deposit Flawed Asset with Extras and may have been one, they did not expressly involve a flawed asset in the sense of having a conditional debt. Repayment of the deposit was not made expressly conditional. In delivering the minority judgment, Deschamps J made the only reference to flawed assets in paragraph [123] where she said that the relevant limits 'can be compared with those applicable to flawed assets'. There was, however, a provision allowing the bank to withhold the relevant sums as long as the credit facility remained unpaid. In substance, this must have had the result of making it a conditional debt. The majority did not focus on this aspect, preferring to see the restrictions as 'encumbrances'.[166] In any event, it seems likely that the attitude of the majority would have been the same had it been expressly conditional.
- The definition is in different legislation with a different purpose, where the consequences of being a security interest are different. Justice Rothstein, delivering the majority decision, distinguished the definition from its use in provincial personal property securities legislation.[167]
- There are differences in the drafting of the legislation. In particular the relevant definition explored in the case expressly includes 'encumbrances'. Justice Rothstein on a number of occasions referred to the restrictions as 'encumbrances'.[168]
- There does not appear to be a set-off exclusion in the relevant legislation.

164 See, eg, Margaret Grottenthaler, *Supreme Court of Canada Decision Reveals Risk of Characterization of Cash Collateral Arrangements as Creating Security Interests* (24 September 2009) Stikeman Elliott <http://www.stikeman.com/cps/rde/xchg/se-en/hs.xsl/13044.htm>; James H Archer and Candace Pallone, *Caisse Drummond Supreme Court of Canada Decision* (1 March 2010) McCarthy Tétrault <http://www.mccarthy.ca/article_detail.aspx?id=4885>; Rob Scavone and Tobias Whitfield, *Set-Off or Security Interest? Supreme Court's Expansion of Enhanced Federal Deemed Trust Provisions Raises Some Troubling Issues* (October 2009) McMillan <http://www.mcmillan.ca/Files/Set-Off_or_Security_Interest_1009.pdf>.

165 Roderick J Wood, 'Journey to the Outer Limits of Secured Transactions Law: *Caisse Populaire Desjardins de L'est de Drummond*' (2010) 48 *Canadian Business Law Journal* 482; Duggan, above n 162. Allan had a more mixed reaction: above n 92, 75.

166 *Caisse Populaire* [2009] SCC 29 (19 June 2009) [30], [32], [36], [38], [55].

167 *Caisse Populaire* [2009] SCC 29 (19 June 2009) [10], [11], [46]. Justice Rothstein did discuss provincial legislation: at [41], [42].

168 See, eg, *Caisse Populaire* [2009] SCC 29 (19 June 2009) [30], [32], [36], [38], [55].

- The documents were replete with the language of security. As Professors Duggan and Wood suggest, this may not have been central to the substance of the argument of the decision.[169] Professor Wood suggests that the Court looked at the substance of the transaction rather than the intention. However, Rothstein J devoted paragraph [31] to the use of security language in the document and he said at [25]:

  > What must be considered is the substance of the agreement. If the substance of the agreement demonstrates that the parties intended an interest in property to secure an indebtedness, then a security interest exists within the meaning of [the relevant section]…

  Intention was relevant.

  Allan suggests that had the bank refrained from expressly giving itself security, there would have been no security interest.[170]
- The documents were governed by Quebec law, a civil jurisdiction, and any 'interest' that arose was under that law. Nevertheless, the Court did discuss common law concepts.

C Analysis

Despite these differences, we must closely examine the decision.

The majority judgment is interesting in that Rothstein J seemed to vary as to what exactly created the security interest. He said a contractual right of set-off could create a security interest,[171] and quoted a passage from Derham that a right of set-off of a segregated deposit could be a security interest.[172] He went on to say that the substance of the agreement must be construed to see whether the parties intended to confer on one of them an interest in property that secures payment or performance of an obligation.[173] He then concentrated on the restrictions on withdrawal, maturity and dealing with the security interest which preserved the conditions in which the compensation could be exercised. He focused on them as creating or constituting the security interest.

He said:

> I agree with [Deschamps J] that compensation or set-off is the extinguishment of mutual obligations. However, mutual obligations must exist to be an effective remedy. If a debtor can, at its own option, eliminate the creditor's liability to it (by withdrawing its deposit), the creditor may have a right of compensation or set-off, but it may not be effective. It is the encumbrances placed on the debtor's claim against the creditor that ensure that the creditor will remain liable to the debtor and, in this way, ensure an effective compensation remedy.[174]

169 Duggan, above n 162, 163; Wood, above n 165, 494.
170 Allan, above n 92, 76.
171 See, eg, *Caisse Populaire* [2009] SCC 29 (19 June 2009) [23], [26], [36], [41].
172 Ibid [24], [38].
173 Ibid [25].
174 Ibid [36].

Later he quoted Professor Goode in saying:

> The party asserting it [the right of set-off] never acquires rights in the other's monetary claim at all; he merely asserts a countervailing claim which operates in pro tanto extinction of his monetary liability.[175]

But he went on to say:

> However, in this case, the Caisse has acquired rights in Camvrac's property by the encumbrances placed on Camvrac's deposit.[176]

This seems to indicate it is the restrictions (the encumbrances) that are the relevant interest or the key to making the agreement as a whole a security interest. The main point appears to have been that the restrictions secured the security provided by the compensation clause:

> It is whether the agreements between the parties – including the Caisse's contractual right to effect compensation – created a 'security interest' to ensure that the remedy of compensation would be effective.[177]

He said:

> If their mutual intention is to create a security interest to ensure that the right of compensation or set-off will be an effective remedy, there is no reason to think that a security interest does not exist simply because the parties have chosen one mechanism for realizing on the security, rather than another.[178]

Although in some passages, he looked somewhat at the right of compensation in context,[179] his Honour seems to have focused upon the restrictions in saying that it is they that constitute a security interest and he seems to see the right of compensation as a mechanism for realising the security interest. The security interest seems to be created by hauling itself up on its own bootstraps. The restrictions create a security interest because they preserve the value of the mechanism for enforcement of the security interest they create. He notes:

> It appears these authors were considering a bare right to contractual set-off such as the standard form deposit agreement I have discussed above. I believe these authors are saying that the remedy of set-off results in no property of the debtor coming in the hands of the creditor as the result of a set-off. All that occurs is the extinguishment of mutual debts. These authors are not addressing the period of time before set-off takes place, where, as in this case, the creditor has taken steps to place restrictions on the debtor's property to ensure that the creditor continuously remains liable to the debtor so that the set-off remedy will be effective.[180]

His Honour contrasted the position with a general set-off clause allowing the appropriation of any bank obligation to satisfy the customer's debt, as there was no obligation there to maintain specific sums. The customer could withdraw the sums at any time. Therefore, he said, the customer's property 'cannot be said to

175 Ibid [38], quoting Roy M Goode, *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell, 4th ed, 2008) [1.19].

176 Ibid [38].

177 Ibid [34].

178 Ibid [25].

179 Ibid [23], [24], [28], [34].

180 Ibid [39]. See also ibid [54], [55].

secure its indebtedness to the bank'.[181] He does not explain why this could not on his terms have been regarded as security over all the accounts and therefore over the balances from time to time.

The majority did not address the argument raised by Deschamps J (in paragraph [131]) that if the parties expressly granted a hypothec security interest, they would be unlikely to have intended also to have separate clauses providing (more subtly) the same thing, save to say the hypothec clause provided that it created 'further' security and therefore was not the primary security.[182] It is unarguable that the compensation clause and other features were intended to be security. What is arguable, with respect, is whether they create an interest in property. If the restrictions' role needs to be explained in the context of other clauses in the documents, that could be preserving the effectiveness and value of the express hypothec rather than preserving the value of the compensation right or demonstrating an intention to have a second security interest.

For completeness, it is worth mentioning that Rothstein J also put another argument based on Quebec law notions of what is a hypothec.[183]

With respect, it is difficult to see how any of the restrictions (that the deposit be a five year term, that it cannot be withdrawn and that it be non-assignable) could be an interest in property, and one which gives sufficient rights of appropriation and dealing to be a security interest. This particularly relates to the maturity of the deposit, but it also extends to the other provisions. Justice Rothstein himself recognised that a negative pledge clause on its own would not suffice,[184] and may not be effective to prevent dealings to third parties.[185] If some of the restrictions are effective against third parties, like assignees, it is because they are part of the terms of the property itself and alter its nature.

It is conceivable, as Rothstein J suggests, that a number of provisions taken together can indicate an intention that a party obtains an interest in property. It is not clear how this particular bundle of provisions, each one of which does not on its own give an interest in property, somehow can combine to be an interest in property, or which of them would suffice. The restrictive clauses only preserve the amount in the deposit and the value of the security as a practical matter. Barry Allan says in his latest book that Rothstein J was 'perhaps a little over-enthusiastic' in counting these towards the finding of a security interest.[186] They could be seen as being intended to preserve the contractual 'security' given by the compensation right, or to give the necessary protection to the express hypothec security, without needing to be seen as preserving proprietary security around the compensation clause. They do not purport to enhance any legal power in relation to the exercise of set-off or its legal effect. They do not purport to address its legal effect, or to have the effect that the compensation clause is

181 Ibid [33].
182 Ibid [31].
183 Ibid [47].
184 As was held in Australia: see *Abalcheck Pty Ltd v Pullen* (1990) 3 ACSR 246.
185 *Caisse Populaire* [2009] SCC 29 (19 June 2009) [54].
186 Allan, above n 92, 76.

straying from the fold of the law of contract to the law of property. They do not give any indication that the operation of the contractual compensation clause should change from a straight contractual extinguishment to a dealing with the rights of the customer, or that the clause should be converted from the primary contractual mechanism into an enforcement mechanism for a security interest provided by it or other provisions. If, as Rothstein J seems to accept, a set-off clause can operate purely contractually,[187] why do clauses ensuring that there is corn for that mill to grind, change the nature of the mill? Though the High Court in *Telstra Corporation Ltd v Commonwealth* said that on occasions property may be described as a 'legally endorsed concentration of power over things and resources',[188] it would be taking that concept too far to take a set of negative restrictions to give a sufficient interest or to indicate an interest.

Much of the above was powerfully put by Deschamps J in her dissent.[189]

The majority judgment raises the possibility that some elements in a 'cocktail' could together constitute a security interest. That assumes they do not have independent, though complementary, existence, which will be a matter of interpretation.[190] That said, it is curious that the majority did not simply say that the compensation clause and restrictions were accompaniments for the express security interest, and that any exercise of the compensation clause was an enforcement of the express security interest. That would have been an easier and less controversial route to their conclusion. They appeared to see the compensation right and restrictions having an independent existence from the express security interest, but not from each other. They combined to form another security interest.

In Australia one would need to ask whether the set-off exclusion under section 8(1)(d) would exclude any security interest arising from the combination.[191]

Professor Wood sees the restriction on withdrawal as constituting a 'flawed asset' and the arrangement as a 'triple cocktail', and sees the decision as meaning that the contractual set-off and flawed asset portion of a triple cocktail is now regarded as creating a security interest.[192] If so, this would be a strange result – taking two elements of the cocktail to replicate the third, the express security interest. Parties presumably go to the trouble of selecting a 'triple cocktail', rather than a straight express security interest, to provide some different benefits that the other ingredients can bring, not for redundancy or duplication. Of course it is possible that a document that appears to contain a 'triple cocktail' is not a 'triple cocktail' at all, but an express security interest with an express set-off

187 *Caisse Populaire* [2009] SCC 29 (19 June 2009) [22].
188 (2008) 234 CLR 210, 231 [44], quoting Kevin Gray, 'Property in Thin Air' (1991) 50(2) *Cambridge Law Journal* 252, 299.
189 *Caisse Populaire* [2009] SCC 29 (19 June 2009) [121]–[125].
190 See Parts II(F) above and VI(D) below.
191 See Part IV(E)(2) above.
192 Wood, above n 91, 496.

clause as a mechanism for enforcement and a restrictive clause for the purpose of only preserving the collateral for the express security interest.

The majority appeared to treat the restrictive clauses in the documents before them as either: (i) ensuring that the compensation clause is treated as creating a security interest; (ii) giving rise to a security interest in combination with the compensation right, as they preserved its effectiveness; or (iii) constituting security interests in their own right in conjunction with the compensation clause. If approach (i) or, perhaps approach (ii), is correct, and followed in Australia, then the security interest could still be exempt under section 8(1)(d). If approach (iii) is correct, then that would have the odd consequence of transmutating negative covenants into a positive ability to seize and sell property and exercise all the other remedies given to security interests referred to above, and would also mean that provisions which protect a set-off right which is exempt from the *PPSA* are themselves subject to the *PPSA*.

At the heart of the reasoning of the majority has, there seems, to be the concept that there is some Platonic notion of a deposit or an obligation, so that a deviation from that ideal in the form of a condition or restriction is an interest in it, rather than simply a specifying of the terms or nature of the particular deposit or obligation. There is of course no such ideal. Whenever a deposit is made, the terms need to be set.

D Some Commentary

At least two academic papers have analysed the decision. Both saw it as having far-reaching and controversial effects.

Professor Wood suggests that the decision would be controversial to some, but to others it will be viewed as 'a victory of substance over form and a vindication of the pragmatic and functional approach of the *PPSA*'.[193] This seems consistent with the sentiments in the New Zealand text of Professor Wood and his learned co-authors discussed above in Part IV(C)(4).[194]

Professor Duggan focuses on the combination of clauses and sees it as consistent with current equitable principles as showing an intention to create a charge.[195] However, the courts have been reluctant to see set-off clauses as constituting changes.[196] It is true that the absence of some of the features which happened to be present in *Caisse Populaire* was mentioned by Spigelman CJ as an indication that there was not a charge in *Cinema Plus*,[197] and Dr Derham does express some similar views; but in my respectful submission, clear words should be necessary to indicate that the parties chose to achieve by an indirect route (taking a security interest in the customer's rights to a deposit) what could have

193 Ibid 495.

194 Gedye, Cuming and Wood, above n 8, 90.

195 Duggan, above n 162, 163. However, as discussed above, the courts have not been particularly ready to find that set-off clauses have been charges. See Part IV(C)(6)(iv) above. See also Replacement Explanatory Memorandum, Personal Property Securities Bill 2009 (Cth) 18.

196 See Part IV(C)(6)(iv) above.

197 (2000) 49 NSWLR 513.

been achieved directly (by set-off and extinguishment). One must ask whether the combination would in any event be excluded under section 8(1)(d).

Professor Duggan points out that the logic of the decision could take us to strange places:

> for example, assume the customer places money on five years fixed deposit with no right of redemption until maturity. This is the functional equivalent of an express promise to maintain the deposit and it reserves a fund which the bank can access, via its right of set-off, if the customer defaults. It seems to follow that the arrangement is a security interest, but this conclusion would no doubt come as a shock to many in the industry.[198]

That may be an understatement. Let us hope (and trust) that the logic of the decision is not accepted by courts on this side of the Pacific.

VI CONSEQUENCES FOR FLAWED ASSET ARRANGEMENTS OF BEING OR CONTAINING A SECURITY INTEREST

A Deposit Flawed Assets – ADIs

We should deal first with that group which has been privileged by the *PPSA* – the ADIs.[199] Any security interest under a flawed asset arrangement over an ADI account would be automatically perfected under section 25, as the 'secured party' would be the ADI. There would be no need to register it to perfect it. However, where the ADI account is not a term deposit (as defined) it will be advisable to register security interests over the account under security agreements made at or after the registration commencement time (as defined in the *PPSA*), disclosing the control, so that they are not circulating security interests and thus would not lose priority to voluntary administrators and statutory preferred creditors.[200]

The ADI automatically would have priority over all other security interests by virtue of section 75 of the *PPSA*.[201] That priority would be safe over all other *PPSA* security interests (including the augmented tracing of proceeds under section 31(2)), though it would not necessarily be safe from the application of constructive trusts, or the priority or tracing of other interests. If it is not a security interest, priority will be determined according to general law.

It is likely that Australian banks will embrace the concept, and deliberately ensure that their security over their own deposits is a security interest. This raises some issues.

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198 Duggan, above n 162, 165.

199 Defined in *PPSA* s 10 as 'short for authorised deposit-taking institutions' and having 'the same meaning as in the *Banking Act 1959*' – basically banks, building societies and credit unions licensed to carry on business in Australia.

200 See *PPSA* ss 318, 340(5)(c), 340(2), 341(1A)(b).

201 Thus, in Australia the ADI appears to be in a better position than in New Zealand where, as Allan points out, a bank may be concerned that it may lose priority to earlier perfected security interests, or security interests over proceeds of purchase money security interests: above n 92, 77.

- If their arrangement is a security interest, it may expose them in cases of active accounts to the 'administration risk', that is, the risk that enforcement of their security interest will be frozen during the appointment of a voluntary administrator over a grantor company, under section 440B of the *Corporations Act 2001* (Cth).

  It will therefore be useful for them to ensure that as well as an express security interest there is a separate and independent flawed asset that is not a security interest, so that effectively the voluntary administrator can get no greater rights to make withdrawals from the deposit than the depositor. It would be useful also to have an independent contractual set-off right that is not a security interest in the deposit and can be enforced during that period.[202] This is particularly so where their security interest is a circulating security interest and will rank behind the voluntary administrator's lien, and the secured party is not able to take advantage of section 441A of the *Corporations Act 2001* (Cth) because it does not have security over all or substantially all of the grantor's assets.

  In other words, it would be useful to have the security interest as part of a 'triple cocktail' arrangement, but with the ingredients of the cocktail independent of each other – neither shaken nor stirred.[203]

- To the extent any part of the arrangement constitutes a security interest, the assignee can take free of it in certain circumstances under Part 2.5 of the *PPSA*. This may be unlikely in relation to a perfected security interest over a deposit – it is hard to see a transfer of a bank deposit as being 'in the ordinary course of business' under section 46.

  Any term of the assigned deposit which is not a security interest (including, if applicable, the flawed asset condition), is still effective against the assignee if it is independent and not part of the security interest.[204] In general terms contractual set-off which is not part of the security interest (and also to some extent legal and equitable set-off) of existing obligations also continues against the assignee.[205]

- If the arrangement contains a security interest then the agreement constituting it is a 'security agreement'. If as an Extra there is a restriction on assignment contained in the same agreement then section 79 means that an assignment can be effective despite that restriction.

  From the bank's point of view, this and the previous point may be more reasons to have the flawed asset and a set-off right clearly independent and not part of the security interest.

- Concerns have been raised as to whether the existence of a security interest destroys mutuality for the purposes of insolvency set-off and

202 See *Cinema Plus* (2000) 49 NSWLR 513, 523.
203 See also Part VI(D) below.
204 See Parts II(F) and VI(C).
205 See Parts II(E) and VI(C).

whether, in those circumstances, a contractual set-off is available. These are discussed below in Part VI(E).

- In New South Wales if a flawed asset arrangement does constitute a security interest, then it may be subject to mortgage duty under the *Duties Act 1997* (NSW).

  The reason is that 'mortgage' is defined in section 205(a) of that Act to include 'a security by way of mortgage or charge over a property wholly or partly in New South Wales at the liability date'. Clause 22A of Schedule 1 to the *Personal Property Securities (Commonwealth Powers) Act 2009* (NSW) provides that any reference in an Act to a 'charge' is to a *PPSA* security interest over personal property.

B All Other Security Interests Provided for by Flawed Asset Arrangements

All other security interests provided for by flawed asset arrangements in relation to accounts, or other forms of intangible property, will not be able to be perfected by control or possession. The secured party will need to register them to perfect them. It may be theoretically possible, but practically difficult, to perfect by control a security interest over a derivative that is an investment instrument.[206]

Once perfected, the normal priority rules and extinguishment rules will apply.

The issues discussed in the bullet points in Part VI(A) above all apply. One further issue arises relating to the transfer question discussed in the second and third bullet points.

If a flawed asset arrangement constitutes a security interest in respect of an asset which is not an ADI account, and the asset is transferred but is still subject to the security interest, then it will only be temporarily perfected against the transferee under section 34 and will become unperfected if not registered within the time periods referred to in section 34.

C Simple Flawed Assets – the Consequences of Non-Perfection

If, despite my arguments above, a simple flawed asset without Extras is a security interest, and the relevant simple flawed asset does not fall within one of the exclusions in section 8, then the consequences of a failure to perfect would include:

- a potential loss of priority to any perfected security interest under section 55(3);
- the ability of a buyer or lessee for value being able to acquire the collateral free of the security interest under section 43; and

206 Under *PPSA* ss 27(4)–(5).

- the security interest (but not the collateral) vesting in the grantor if the grantor becomes subject to one of the insolvency events listed in section 267(1)(a) of the *PPSA*.

The collateral would be the conditional obligation. The security interest would presumably be the condition. Applying those consequences listed above presents a number of difficulties, as the 'security interest' is integral to the nature of the collateral. A buyer of the collateral takes the conditional obligation and would on first principles absent the *PPSA* remain subject to the condition.[207] A security interest over the collateral would be over the conditional obligation and would be the condition itself. The only way in which a buyer or perfected security interest holder could gain 'priority' or get the property free of the security interest would be to rewrite the terms of the contract. How is that done? In some circumstances it might be possible to conceive of applying a blue pencil to the condition and striking it out. In others, that would be difficult. What happens, for instance, if the obligation is expressed not as a payment obligation subject to a condition precedent, but an obligation to make payment when a condition is satisfied? What date for payment does the court enter? Similar issues arise in relation to the security interest 'vesting' on the appointment of an insolvency administrator. It is the security interest that vests, not necessarily the entire agreement. How does a mere condition vest? For the condition to vest in the grantor the obligation would need to be stripped of the condition.

These difficulties reinforce the notion that on a straight interpretation of the language, and also on policy grounds, a 'security interest' cannot include a simple flawed asset.

In addition, if it were a security interest the enforcement provisions in Part 4 of the *PPSA* would apply, but in a simple flawed asset there is nothing that needs enforcement or exercising.[208]

D Extras – the Consequences of Non-perfection

If a security interest arises because of the inclusion of Extras, then the question arises as to which provision or combination of provisions constitutes a security interest and which provisions are independent, or merely features of the security interest. That will be a question of interpretation of the drafting of the relevant document.

It would not be uncommon,[209] and it would be useful[210] for each of the true flawed asset, a set-off clause and, if there is one, an express security interest in the one arrangement to be independent of each other, or at least for the flawed asset clause making the debt conditional to be independent of the others.

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207 See Part II(C) above.
208 See Part II(G) above.
209 See Part II(F) above.
210 See Part VI(A) above.

The collateral will be the right arising from the conditional obligation.[211] If a buyer or a holder of a perfected security interest takes the collateral, they may take it free of any unperfected security interest but they will take it subject to the conditions and any other term which is not part of the security interest.[212] If the security interest vests on insolvency, it is only the relevant provision or combination that is a security interest that vests on insolvency and not the condition or other term.

In those circumstances, the condition will still be effective to protect the initial 'secured party', though presumably parties in that position (and who are not ADIs dealing with an ADI account which is a term deposit) will still register in order to preserve the full gamut of remedies in the Extras and to prevent any argument on this issue.[213]

E Does the Creation of a Security Interest over a Deposit Prejudice Mutuality and Set-off?

Practitioners have raised concerns that if a flawed asset arrangement, particularly a 'double cocktail', is a security interest, then there may be adverse consequences in relation to insolvency set-off under section 553C of the *Corporations Act 2001* (Cth) and section 86 of the *Bankruptcy Act 1966* (Cth).[214]

The concern, as I understand it, is that the security interest destroys mutuality for the purposes of insolvency set-off, but contractual set-off is not available because insolvency set-off overrides it.

I would submit that the answers to this riddle may be as follows.

- For the reasons discussed above in Part II(D) in the liquidation or bankruptcy of the party that is owed the deposit or other obligation that is a flawed asset, there is no insolvency set-off in any event.
- Where the contractual set-off right is not independent, but part of the security interest, then it is an incident of the security interest, and a method of enforcing it.
- Whether the contractual set-off right is or is not independent and a part of the security interest, the secured creditor still has its enforcement rights in relation to the security interest under general law and Part 4 of the *PPSA*.

211 Beale et al (writing about the English position) raise the question that in those circumstances the charge in relation to the conditional debt is a charge over future property, and does not attach until the conditional debt becomes payable, ie, when the condition is satisfied. As that is the satisfaction of the secured loan, can it be said that there is ever a charge in existence? See Beale et al, above n 8, 287. However, as they say, the security interest could be over the obligation to pay the debt upon the satisfaction of the conditions, not just the debt once it arises. That is, the conditional obligation is a presently existing right, in the same way as any other contingent or contingent obligation, like a guarantee, can be a presently existing right in the hands of the promisee.

212 See Parts II(C) and VI(C) above.

213 This is consistent with Dr Derham's analysis on the effect of non-registration of set-offs accompanying flawed assets under corporations legislation: Derham, above n 6, 804–5.

214 See, eg, Busljeta, above n 17; see also Evans, above n 59, 116.

- If the contractual set-off right is independent and not part of the security interest, then on general principles the contractual set-off may only be unavailable on liquidation to the extent it modifies or breaches the statutory rules or applies assets contrary to the statutory order.[215]

  There is no insolvency set-off, and if the solvent party exercises a contractual set-off, then it is merely reducing the amount of its claim against the insolvent party by exploiting an asset which is not available to the liquidator or trustee in bankruptcy of the insolvent party, for two reasons. First, because of the condition its debt is not payable to the insolvent. Second, if there is a security interest, the 'collateral' is not an asset available in the liquidation or bankruptcy.

  The solvent party is fully entitled to make a claim against the insolvent for the full gross amount of its debt and not pay out on its deposit or other obligation. When it effects a set-off which it is not compelled to make it is in effect waiving a right to claim in the liquidation or bankruptcy for the full amount, and making a book entry to recognise that fact, and the fact that it is not in any event obliged to pay the conditional debt to the insolvent.

  The exercise of a contractual set-off in that sense does not prejudice the assets available in the liquidation or bankruptcy or apply assets of the insolvent against the statutory *pari passu* order.[216] It might be suggested that it risks breaching statutory insolvency law if the set-off is seen as applying an asset of the insolvent (the contingent debt) in payment of the solvent party's claim after commencement of the relevant process in breach of statutory restrictions. Similar considerations may apply in assessing the risk that the exercise of the set-off, reducing the amount owed to the solvent party as a creditor, would constitute a voidable preference. For example, would it constitute the insolvent party as creditor receiving anything from the company for the purposes of section 588FA(1)(b) of the *Corporations Act*? However, courts have tended to see the exercise of a contractual set-off and similar rights as not being an activity by the debtor.[217] This may be affected by consideration of which of the alternative analyses set out above in Part IV(C)(6)(i) is adopted for the relevant set-off mechanism.

- If all else fails, and the solvent party is determined to effect a set-off, it can waive its security and waive the condition in its obligation, make a claim for the debt owed to it and insolvency set-off will apply.

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215 See Derham above n 6, 743–61; see also McCracken, above n 91, 235.

216 This depends on first principles rather than authority: see Derham, above n 6, 760.

217 See *Cinema Plus* (2000) 49 NSWLR 513; *Matthews v Geraghty* (1986) 43 SASR 576; *Driver v Commissioner of Taxation* [2010] NSWCA 247. But see Derham, above n 6, 744–53.

VII CONCLUSION

It is tempting to sweep all flawed asset arrangements into the security interest net, on the basis that it is 'in the vibe', and the *PPSA* should catch everything that is economically in substance security, or that the express example in section 12(2)(l) must have a role and it must extend the meaning of 'security interest'. However, we need to look at the particular words and policies of the statute.

A simple flawed asset involving just a conditional debt cannot be a security interest because the putative secured party does not have an interest in the relevant property, which is the debt. That is consistent with the policy and express wording of the *PPSA*, which is to make security interests only things that are interests. To disregard or weaken that policy or wording would make the *PPSA* apply to a wide spectrum of contractual provisions which operate purely contractually. Treating simple flawed assets or such other contractual provisions as security interests would achieve little and would not fit in well with the rest of the *PPSA*. There needs to be a clear wall holding back the waters of the *PPSA* from flooding over a wide range of purely contractual commercial relationships. What falls on either side of that wall should be determined with traditional rigour.

A 'flawed asset arrangement' often contains other elements besides the flawed asset, including a right of set-off or appropriation, and occasionally, a charge or other express security interest. If 'flawed asset' has the meaning used in this paper, the express example in section 12(2)(l) does have a role, and that is in drawing attention to those other elements. Those elements can constitute a security interest or combine to create a security interest. Where there is an express charge or other express security interest, as in a 'triple cocktail', then the search for a security interest is a short one. Where there is a right of set-off, then that right is excluded from the operation of the *PPSA*. That leaves us defining the boundaries (or overlap) between those clauses which give the right to set-off, apply or appropriate debts against each other which are set-off rights and therefore excluded, and those which do give rise to a sufficient interest to be a security interest, but are not rights of set-off.

Even where the appropriation right is a security interest, the condition which makes the transaction a flawed asset arrangement can often be unaffected by the consequences of lack of perfection of the security interest. While its effect is a matter of interpretation of the drafting, it can operate independently of the provisions creating a security interest. The security interest is over the conditional debt, not the debt somehow freed of the condition.

Even giving 'flawed asset' a wider meaning, so that it covers restrictions on dealing and not just conditions on payment, still requires the analysis to focus on the Extras. Such restrictions cannot constitute a security interest on their own; at most they can be an indication that another provision constitutes a security interest when combined with the restrictions, and we should not rush to find contractual set-off clauses constituting security interests.

Finally, if 'flawed asset' is given the wider meaning used by Lord Collins in *Belmont Park*,[218] then some arrangements within that broad church could give rise to interests in property and be security interests. If that is the meaning that the legislature intended, then the exception in section 12(2)(l) has plenty of work to do without disturbing the requirement that there be an interest in property, or upsetting traditional analysis of a flawed asset in the narrower sense used in this paper.

218 [2011] UKSC 38 (27 July 2011).