



**Australian Government**  
**Attorney-General's Department**

**Civil Law Division**

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2 March 2009

Mr Peter Hallahan  
Secretary  
Senate Standing Committee on  
Legal and Constitutional Affairs  
Department of the Senate  
Parliament House  
CANBERRA ACT 2600

Dear Mr Hallahan

**Requirement to act in a commercially reasonable manner**

By e-mail of 26 February 2009, Ms Dawes provided the Department with further questions on notice, relating to clause 235 of the draft Personal Property Securities Bill:

1. Is it the Department's view that it is preferable for this requirement to be included in the reform?
2. If so, is this because it fills what would otherwise be a 'gap' in reasonable protection for some parties to secured lending transactions?
3. If so, what is the 'gap'?
4. Does the Department expect that the inclusion of the requirement will have any affect on the cost of transactions?
5. Will the requirement undermine the ability of parties of similar bargaining power to contractually settle what constitutes exercising duties in a "reasonably commercial manner"?

As you know, stakeholders have raised a number of concerns about this aspect of the Bill. While it would not be appropriate for the Department to comment on which approach is preferable, the following pages provide further background on this issue and address the other questions.

Yours sincerely

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First Assistant Secretary

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## **CLAUSE 235: DUTY TO ACT IN A 'COMMERCIALY REASONABLE MANNER'**

The requirement to act in a 'commercially reasonable manner' appears in clause 235 of the Bill:

### **^235 Rights and duties to be exercised honestly and in a commercially reasonable manner**

- (1) All rights, duties and obligations that arise under a security agreement or this Act must be exercised or discharged:
- (a) honestly; and
  - (b) in a commercially reasonable manner.

Clause 235(1) is derived from:

- Personal Property Securities Act 1999 (NZ), s 25(1)
- Personal Property Security Act 1993 (Saskatchewan), s65(3)
- Uniform Commercial Code (USA), Article 9–607(c).

These provisions are set out in **Attachment A**.

### ***Capacity to negotiate own arrangements***

2. The Bill provides that '[a] security agreement is effective according to its terms' (clause 58). As a result, the parties to a security agreement may determine for themselves the terms that will govern their relationship, subject to requirements imposed by other laws. A security agreement may be as detailed, or lacking in detail, as the parties to the agreement consider appropriate.

3. Clause 235 would become relevant when a party seeks to exercise their rights under the security agreement in a manner that is not governed by the security agreement (or the Act or other legislation). In these circumstances, clause 235 operates to 'fill in the blanks' to oblige the party to act in a commercially reasonable manner. Clause 235 would not undermine the ability of parties of similar bargaining power to contractually settle what constitutes exercising duties in a 'reasonably commercial manner'. Instead, the scope for clause 235 to affect the relationship between the parties is affected by the extent to which they have addressed these issues in their security agreement. The fewer the 'blanks' left by the parties in relation to matters that arise over the life of the security agreement, the less work there would be for clause 235. It follows that clause 235 would have the most work to do when the parties have made a relatively simple security agreement.

4. The Bill contemplates that a security agreement might provide no more than that specified property of the grantor secures specified payments or obligations. Clause 235 then applies to require the parties to act in a commercially reasonable manner, subject to the other provisions of the Bill and other legislation.

### *Affect on transaction costs*

5. When the parties to a security agreement agree that their conduct towards one another should be commercially reasonable, clause 235 makes it unnecessary for them to develop complex agreements governing how a range of different circumstances should affect their relationship. Instead, as those (potentially unforeseeable) circumstances arise, clause 235 would require the parties to act in a commercially reasonable manner towards one another.

6. It follows that clause 235 should reduce transaction costs for parties who accept that their relationship should be governed by commercial reasonableness, or do not have the resources to negotiate more complex agreements.

7. In particular, clause 235 should reduce transaction costs by making it unnecessary for the parties to a security agreement, and their professional advisers, to contemplate in advance how their relationship should be affected by emerging circumstances. Some parties, particularly those engaged in complex high value transactions, may wish, and be able, to invest resources negotiating security agreements contemplating specific outcomes across a range of different circumstances. However, for parties that do not have access to these resources, or agree to commercial reasonableness, clause 235 would oblige them to act in a commercially reasonable manner.

8. Clause 235 therefore offers the potential to reduce transaction costs. Whether it achieves this outcome would be something that the parties to security agreements would need to determine for themselves, depending on the extent the parties consider it necessary to negotiate for specific outcomes to be included in their security agreement.

9. The US provision is specifically directed at the duties held by a secured creditor on the enforcement of a security interest, while the provisions in Canada and New Zealand are directed generally at both the secured party and the grantor as the parties to a security agreement. Nevertheless, in both Canada and New Zealand, the provisions are most relevant in relation to the enforcement of a security interest.

10. In Canada, the requirement that the secured party act in a commercially reasonable manner replaced more specific and rigid tests under the earlier law. The policy objective of facilitating business transactions while balancing the rights of all the parties made it necessary to introduce an objective standard of measurement within a particular business context.

The concept of commercial reasonableness can best be described as the actions of the reasonably prudent business person in similar circumstances. It is both an objective and pragmatic standard of conduct, conditioned by the established practices of the business community. The concept is not fixed and rigid, but rather is shaped by changing circumstances.<sup>1</sup>

11. Whether particular conduct is commercially reasonable will always be a question of fact. Expert evidence may be required in some cases.<sup>2</sup>

Commercial reasonableness depends upon the circumstances of the sale, including a consideration of variables such as the method of sale, the subject matter of the sale, advertising or other methods of exposure to the public, the time and place of the sale, and related expenses.

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<sup>1</sup> McLaren, *Secured Transaction in Personal Property in Canada* (2nd ed), Carswell at 7-16 – 16.1.

<sup>2</sup> *Bank of Montreal v Judges* (1991), 1 PPSAC (2nd) 240 (Ontario General Division) where expert evidence was required to value a specialized film laboratory and processing equipment.

A receiver is under a particular duty to make a sufficient effort to get the best possible price for the assets. See *Royal Bank v Soundair Corp* (1991), 4 OR (3rd) 1 (CA). This duty is not to obtain the best possible price but to do everything reasonably possible with a view to getting the best possible price.<sup>3</sup>

12. The Bill includes a corresponding duty at clause 169:

**^169 Duty of secured party disposing of collateral to obtain market value**

A secured party who disposes of collateral under section ^166 (other than by purchasing the collateral) owes a duty, to any person (including the debtor and the grantor) who has an interest in the collateral immediately before the disposal, to exercise all reasonable care:

- (a) if the collateral has a market value at the time of disposal—to obtain at least that market value; or
- (b) otherwise—to obtain the best price that is reasonably obtainable at the time of disposal, having regard to the circumstances existing at that time.

Clause 169 is in turn based on section 420A of the Corporations Act 2001:

**420A Controller's duty of care in exercising power of sale**

- (1) In exercising a power of sale in respect of property of a corporation, a controller must take all reasonable care to sell the property for:
  - (a) if, when it is sold, it has a market value—not less than that market value; or
  - (b) otherwise—the best price that is reasonably obtainable, having regard to the circumstances existing when the property is sold.

The Department considers that a person who complies with the duty imposed by clause 169 of the Bill also meets the commercial reasonableness standard required by clause 235.

13. The Canadian Personal Property Securities Acts do not include a provision corresponding to clause 169. Instead, the secured party's duty in relation to the price obtained on disposal is governed by the duty to act in a commercially reasonable manner. Canadian courts have found the following kinds of conduct to be commercially unreasonable:

- delaying a sale in a falling market<sup>4</sup>
- disposal of collateral to businesses that the secured creditor had also placed into receivership and that owed significant amounts to the grantor<sup>5</sup>
- disposing of a vehicle without an appraisal by a person with sufficient expertise to value specialised equipment on the vehicle.<sup>6</sup>

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<sup>3</sup> *Greyvest Leasing Inc v Merkur* (1994) 8 PPSAC (2nd) 203 at 216 (Ontario General Division).

<sup>4</sup> *Coward v Rich* (1995) 9 PPSAC (2nd) 236 (Ontario General Division).

<sup>5</sup> *Re Station de L'Eleveur St-Redempteur* (1984) 4 PPSAC 231 (Ontario Master).

<sup>6</sup> *Royal Bank v Michaels* (1983) 2PPSAC 302 (Man. Co. Ct.).

### ***Relationship with existing law***

14. The duty in clause 235 to act in a commercially reasonable manner would intersect with duties imposed by other Acts. For example, section 51AC(1) of the *Trade Practices Act 1974* and section 991A(1) of the *Corporations Act 2001* provide as follows:

#### **51AC Unconscionable conduct in business transactions**

- (1) A corporation must not, in trade or commerce, in connection with:
  - (a) the supply or possible supply of goods or services to a person (other than a listed public company); or
  - (b) the acquisition or possible acquisition of goods or services from a person (other than a listed public company);engage in conduct that is, in all the circumstances, unconscionable.

#### **991A Financial services licensee not to engage in unconscionable conduct**

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

15. These provisions are directed at circumstances when one party exploits the weaker party's disadvantage. They would apply when the parties have included in their security agreement provisions governing how specific events should affect their relationship.

16. Under the existing law, these provisions would also apply in circumstances not covered by a security agreement. They set the standard of conduct at unconscionability.

17. However, the parties to a security agreement may consider that unconscionability is too low a standard, and that this leaves a gap in the law. As a result, they may seek to negotiate agreements that reduce the potential for their having to rely on the unconscionability standard. Clause 235 would replace the unconscionability standard with one based on commercial reasonableness. One potential outcome is that parties to security agreements may be more willing to rely on a standard set at commercial reasonableness, than at unconscionability. These parties would be able to negotiate less complex security agreements, with fewer transaction costs.

## **ATTACHMENT A: OVERSEAS PRECEDENTS**

### ***Personal Property Securities Act 1999 (NZ), s 25(1)***

*Rights or duties that apply to be exercised in good faith and in accordance with reasonable standards of commercial practice*

- (1) All rights, duties, or obligations that arise under a security agreement or this Act must be exercised or discharged in good faith and in accordance with reasonable standards of commercial practice.

### ***Personal Property Security Act 1993 (Saskatchewan), s65(3)***

- (3) All rights, duties or obligations that arise pursuant to a security agreement, this Act or any other applicable law are to be exercised or discharged in good faith and in a commercially reasonable manner.

### ***Uniform Commercial Code (USA), Article 9–607(c):***

A secured party shall proceed in a commercially reasonable manner if the secured party:

- (1) undertakes to collect from or enforce an obligation of an account debtor or other person obligated on collateral ...