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## **Recent decision by the Victorian Court of Appeal highlights the need for Security Deposits paid by tenants under leases of premises to be registered**

Landlords often require and rely on payment of a security deposit by a tenant. If the tenant defaults, that security deposit is intended to provide funds to cover unpaid rent and other obligations of the tenant.

For this kind of security deposit to be enforceable in all relevant scenarios, it is now essential for the landlord (or its agent) to register a financing statement on the Personal Property Securities Register (**PPSR**). It is also desirable for landlords to improve some of the drafting of the security deposit clauses in leases of premises.

Typically, a security deposit is placed into a trust account with an agent or is set aside in a separate account of the landlord so that it is available:

- (a) for refund to the tenant on expiry of the lease, where the tenant has performed all of its obligations; or
- (b) for application by the landlord against any unpaid rent or other obligations of the tenant.

When parties enter into an agreement to set aside moneys in this way, they create what is now characterised as a 'security interest' for the purposes of the Personal Property Securities Act 2009 (Commonwealth) (**PPSA**) (See *note below on the recent Victorian Court Appeal decision of Hue v Dura*)<sup>1</sup>.

The tenant continues to have an interest in the moneys and to recover those moneys if it performs under the lease. But obviously if there is default by the tenant, the landlord wants to have priority over other creditors in relation to the security deposit.

In the past, this kind of arrangement was enforceable in most situations simply as a matter of contract law<sup>2</sup>.

For transactions made since 30 January 2012<sup>3</sup>, if the landlord (or its agent) does not register a financing statement on the PPSR, and if the tenant becomes insolvent<sup>4</sup>:

1. the rights of the landlord in relation to the security deposit 'vest' in the tenant (in practice this means that the landlord's rights to the deposit come to an end and the tenant is entitled to the deposit); and
2. if there is another secured creditor of the tenant with a security interest affecting the security deposit, the landlord will be postponed to that security interest (one situation where this could happen is if the tenant's bank has a general security agreement or charge over all present and after acquired property of the tenant).

***Putting it simply, without a registration on the PPSR, the landlord is unlikely to be able to access the security deposit funds at the exact moment when it most needs to do so.***

What if a landlord does not register on the PPSR but exercises its rights to the security deposit before the tenant becomes insolvent? If the landlord does this in the period of 6 months before the commencement of the winding up, the use of the security deposit may be challenged by a liquidator of the tenant on the grounds that it is a preference

<sup>1</sup> This characterisation of a security deposit paid under an agreement as a 'security interest' was highlighted by the reasoning in a recent decision of the Victorian Court of Appeal (on 17 December 2014): *Hue v Dura* [2014] VSCA 326. In effect, a payment of a security deposit to an account will be a security interest if it arises under a "consensual" transaction that confers contractual rights on another party to access the funds to secure obligations owed by the payer. For this purpose, payment under the terms of an agreement such as a lease would be a consensual transaction.

<sup>2</sup> Obviously subject to rules relating to voidable transactions on insolvency of the tenant, but in practice these created few difficulties for landlords.

<sup>3</sup> There are transitional provisions of the PPSA relating to transactions made before 30 January 2012 but their effects are beyond the scope of this paper.

<sup>4</sup> Insolvency is defined in section 267 of the PPSA but relevantly will include administration or winding up of a tenant that is a company.

(although depending on the particular facts, and the terms establishing the security deposit, it may be a permissible form of set off). By contrast, this type of challenge by a liquidator is most unlikely to be available if the landlord has a security interest that is “perfected” by a registration on the PPSR.

A registration on the PPSR for a security deposit should be made in the collateral class ‘General Intangible’. It should be made by the landlord or its agent within 20 business days of the signing of the lease that provides for the security deposit. If the registration does not occur within this period, the rights of the landlord will not be enforceable in a winding up that commences within 6 months of the date of registration. In practice this registration should therefore be made at the time when a lease and any supporting documentation is signed with a tenant (assuming that the lease or that supporting documentation provides for payment of a security deposit).

A landlord or its agent should also carry out a search of the PPSR to identify any prior registered security interests that may take priority over the landlord’s rights to the security deposit. For example, a bank with a general security agreement or charge affecting all present and after acquired property of the tenant would have priority over the landlord’s interests in the security deposit, if its registration on the PPSR was made before the landlord’s registration. From the landlord’s point of view, this priority issue can be fixed with a simple letter from the bank (or other secured party) agreeing that the landlord should have priority. From a commercial bargaining perspective, this should not be difficult to obtain at the time when a tenant is negotiating to take up new premises.

Landlords and their agents should also be ensuring that provisions governing the payment of the security deposit contain rights and remedies that are appropriate for enforcement under the new legal regime established by the PPSA. It is also commercially desirable, but not legally essential, for the lease to contain an acknowledgement of the landlord’s intention to make a registration on the PPSR against the tenant. A landlord has a legal right to make a registration if it has reasonable grounds for believing it has a security interest, but an acknowledgement within the lease will save any subsequent debate about that subject and will ensure that the landlord’s intentions are transparent to the tenant from the outset.

Landlords and their agents should also be considering whether or not any other registration is needed on the PPSR in connection with a lease of premises. For example, if the landlord is allowing use of some of its chattels or goods by the tenant, there will be a form of bailment that is likely to be treated by the PPSA as a ‘PPS lease’ of the chattels goods. This is taken to be a security interest granted by the tenant in favour of the landlord in those chattels or goods. A PPS lease should be the subject of a separate registration on the PPSR by the landlord or its agent; most likely, in the collateral class ‘Other Goods’.

#### **Authors:**

Tony Coburn  
Consultant  
Head of Banking Regulatory (Australia)  
Herbert Smith Freehills  
0402 206 377  
[tony.coburn@hsf.com](mailto:tony.coburn@hsf.com)

Philip Sheezal  
Principal  
PS Law  
0412 578 240  
[philip@pslaw.com.au](mailto:philip@pslaw.com.au)

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