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DOING BUSINESS IN AUSTRALIA

DEBT FINANCING IN AUSTRALIA



Chapter 7

Debt Financing in Australia

Australia has a sophisticated market for debt financing, which offers financing products in connection with a broad range of businesses, assets and transactions, including general corporate financing, acquisition financing, project financing, leveraged financing, real estate financing, securitisation and structured financing and debt capital markets.

The debt finance market in Australia is generally open to international participants, whether as borrowers or lenders. The well-developed legal system in Australia provides borrowers and lenders with a high degree of certainty in relation to the legal treatment of various aspects of debt financing arrangements. This gives local and international debt market participants confidence to be able to enter into debt financing arrangements that will be legally enforceable against the parties to them.

Lending by foreign entities or to foreign entities

Under Australian law, there are generally no restrictions or limitations on foreign lenders making loans to Australian companies or Australian companies making loans to foreign entities. However, we note the points set out in:

- Chapter 11 of this publication, 'Taxation, Stamp Duty and Custom Duty', in relation to interest payable from Australian companies to foreign entities; and
- Chapter 10 of this publication, 'Foreign Investment Regulation', in relation to the authorisations and licensing and registration requirements in relation to foreign banks and financial institutions.

Guarantees

Unless an Australian company is restricted from doing so in its constitution, it can give a guarantee for the debt of a borrower, whether the borrower is incorporated in Australia or in a different country.

However, there are certain laws in Australia that may affect the enforceability of a guarantee. A guarantee provided by an Australian company may be unenforceable if:

- the company does not have the power, under its constituent document, to provide the guarantee in the relevant circumstances; or
- the directors do not exercise their duty to act in good faith for the benefit of the company and for a proper purpose in giving the guarantee.

In determining whether there is sufficient benefit, all relevant facts and circumstances of the transaction need to be considered by the directors, including the benefits and detriments to the guarantor in giving the guarantee, and the respective benefits to the other parties involved in the transaction. The issue is particularly relevant where a company provides a guarantee in relation to the obligations of another member of its corporate family. In determining whether there is sufficient benefit, the directors need to give primary consideration to the benefits and detriments to the guarantor in giving the guarantee, in addition to the benefits to the other members of the corporate family.

Whether a guarantee entered into in breach of directors' duties can be avoided against a party relying on the guarantee depends on certain factors, including whether the party knew of or suspected the breach. Under Australian law, a person is entitled to assume that the directors have properly performed their duties to the company unless that person knows or suspects that they have not done so.

In addition, in an insolvency of an Australian company, certain transactions may be set aside by a court, on the application of a liquidator of the company. A liquidator has the power to make such an application in respect of transactions entered into in the 6 month period prior to the application to wind the company up (or the commencement of the administration of the company (where applicable)) that constitute 'unfair preferences' or 'uncommercial transactions' and the company was insolvent at the time or became insolvent because of the transaction (or an act or omission made for the purpose of giving effect to the transaction).

Taking security

Security over land

Security over land is typically taken by way of a registered mortgage over the specific piece of land. Land may also be charged under a general security agreement (e.g. over all property which the grantor owns from time to time). A failure to register a security interest in land will

not generally affect the validity of the security in an insolvency of the grantor. However, if that security interest is not properly registered in accordance with the applicable statutory requirements in relation to the registration of security interests in land in the relevant state or territory, it will generally not have the benefit of priority over subsequent registered security interests in the land.

In most Australian states, land dealings are now registered on an online property exchange network known as PEXA, eliminating paper-based registrations and certificates of title. This process was in transition at the time of writing.

Security over property other than land

The grant, validity and priority of security over most classes of property other than land are subject to the *Personal Property Securities Act 2009* (Cth) (**PPSA**) and its related legislation. The PPSA applies to 'personal property', which is defined broadly to include any kind of property other than land (subject to certain exceptions). Personal property therefore includes, among other things, tangible and intangible property, financial property, intermediated securities and intellectual property.

Where a lender is taking security over all of the assets of a grantor, a general security deed will generally be entered into between the parties pursuant to which the grantor will grant security in all its present and after-acquired property. If the grantor is granting security only over only a specific asset or goods (e.g. the shares in a company), a specific security deed will be entered into.

Registration of security interests in personal property

Security granted over most classes of property other than land is required to be perfected under the PPSA in order to protect its validity and priority as against third parties and its validity in an insolvency of the grantor. Except for certain types of property in relation to which security may be perfected through prescribed methods of possession or control, perfection must generally be by registration on the Personal Property Securities Register (**PPSR**). There is no prescribed time period for the registration, however (subject to certain exceptions):

- priority will generally be determined by reference to the order in which security interests have been perfected, so a delay in registration can adversely affect the secured party's priority; and
- if a security interest is not registered within 20 business days after the security agreement which provides for it is entered into, it will generally be void in an insolvency of the grantor

which occurs less than 6 months after registration.

It should be noted that registration on the PPSR provides no assurances of priority – there may be prior security interests perfected through some means other than registration (e.g. by possession or control or under temporary perfection rules). It is also possible that later security interests may also obtain priority by being perfected by control or because they benefit from special priority rules relating to particular kinds of security interests such as purchase money security interests.

Security granted over other certain other specific classes of assets, such as minerals and resource interests, requires the consent of, and/or registration with, certain other government bodies.

Enforcing security interests

A secured party's ability to enforce a security interest will generally be governed by the security agreement pursuant to which that security was created. Therefore, when a security interest is documented, the parties should negotiate the time when the security become enforceable (e.g. on the occurrence of an event of default) and any procedural requirements applicable to the enforcement of the security interest (e.g. notice of enforcement).

If a secured party is a foreign government or a related entity of a foreign government, the enforcement of security will constitute a 'direct investment' to which the requirements under the Australian Foreign Investment Policy may apply (see section 10.2 in Chapter 10 of this publication, 'Foreign Government Investors').

Under the PPSA, in enforcing a security interest, the secured party must act honestly and in a commercially reasonable manner.

If an administrator is appointed to a grantor, a statutory moratorium period will apply to a secured party taking enforcement action against the grantor's security, subject to certain exceptions. The key exception is where a secured party has security over the whole, or substantially the whole, of the grantor's property. In those circumstances, the secured party may enforce its security during the 'decision period', which is the period expiring on the 13th business day after:

- the day that notice of the appointment of the administrator is given to the secured party; or
- otherwise, the day that the administration begins.

A secured party will generally take steps to enforce its security by appointing a receiver or a receiver and manager in respect of the assets the subject of the security. The receiver or receiver and manager would then take steps to realise the assets in order to repay the debt owing to the secured party (e.g. by collecting receivables, seizing and disposing of assets or exercising contractual rights of the grantor under its contractual arrangements with counterparties).

Stamp duty

Under current law, no stamp duty applies to security granted in respect of assets located in any Australian state or territory. However, if any of the loan or security documents contain a declaration of trust, stamp duty may be imposed on that declaration of trust. The duty is generally a fixed amount (currently no more than A\$500) provided that the property over which the trust is declared is only of nominal value or is not dutiable property. If a trust is declared over valuable dutiable property, *ad valorem* rates of duty will apply.

Unfair preferences and uncommercial transactions

The comments in section 7.2 above in relation to unfair preferences and uncommercial transactions would also apply to an Australian company granting security.

Restriction on financial assistance

Part 2J.3 of the Corporations Act precludes a company from providing financial assistance to a person who acquires shares in the company or any of its holding companies except in limited circumstances.

Financial assistance is not defined but is interpreted broadly and will include the giving of a guarantee or granting of security by a company to support debt used to acquire shares in that company or its direct or indirect holding company. A company may financially assist a person to acquire share in the company or any direct or indirect holding company only if:

- the assistance does not materially prejudice the interests of the company, its shareholders or the company's ability to pay its creditors;
- the company obtains shareholder approval in accordance with the prescribed whitewash procedure; or
- the assistance is exempted under section 260C of the Corporations Act.

Lenders are often only prepared to rely on the whitewash procedure. The whitewash procedure includes a 14 day waiting period following lodgement of a notice with the Australian Securities and Investments Commission (**ASIC**) and a requirement that approval also be obtained from the shareholders of any Australian listed holding company or the ultimate Australian-incorporated holding company of the company giving the assistance. Assuming that shareholders' consent to a short notice period can be obtained (which is usually the case where the relevant companies are not listed), the process takes a minimum of 15 days from the date of lodgement of the first notice with ASIC.

Most commonly in acquisition financing, that procedure takes place following the acquisition, and it is a condition subsequent that it is completed and the target companies accede to the financing as guarantors or security providers within a specified time period.

Contravention of the prohibition does not affect the validity of the financial assistance or any related contract or transaction and the company is not guilty of an offence. However, persons (which could include a lender) involved in a breach of the prohibition may be liable for fines of up to A\$200,000 and/or (for individuals whose involvement is dishonest) imprisonment for up to five years. Civil penalties may also be imposed requiring persons involved in a breach to compensate the company concerned for any loss it suffers as a result of the breach.

Subordination

Under Australian law it is possible to subordinate debts such that one lender (the **junior lender**) may agree that a second lender (the **senior lender**) be preferred over the junior lender for repayment of a debt, provided that the subordination does not disadvantage any other creditor of the debtor that is not a party to the subordination arrangements.

In the Australian market, there are two principal contractual methods used to document such an arrangement, which will usually be documented in a tripartite agreement between the senior lender, the junior lender and the debtor:

- contingent debt method: whereby the lender's right to have its debt repaid is contingent upon the senior lender's debt having first been repaid (to a specified extent); or
- turnover agreement / subordination trust method(s): whereby the junior lender agrees to pay the senior lender and/or to hold on trust for the senior lender, any amounts paid by the debtor to the junior lender, until the senior lender has been repaid (to a specified extent). Senior lenders generally prefer for the junior lenders to agree to hold such amounts on trust for the senior lender (rather than to merely pay the senior lender) to protect these funds against the insolvency of the junior lender.

The second method may give rise to a security interest over the junior creditor's claim in favour of the senior lender for the purpose of the PPSA and require registration on the PPSR.

Subordination may also be achieved by way of structural subordination, whereby a lender to a parent company in a group of companies is structurally subordinated to lenders to that parent company's subsidiaries, who have direct claims against the assets of the subsidiaries.

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