Banking and Finance Test Notes

Trimester One, 2019

1. Fundamentals of Bank Lending **2**

2. Key Lending Terms and Concepts **3**

Debt and equity borrowing 3

Secured and unsecured 3

Defaulting, Liquidation, Administration and Receivership 3

Legal security interests 4

Equitable security interests 5

Instruments by way of bailment 7

Registration of Security Interests 7

3. Secured Lending: Pre-PPSA Law **9**

Priority between interests 9

Critique of the pre-PPSA regime 9

Manurewa Transport Limited (HC) 10

3. Secured Lending: PPSA **12**

Background 12

Policy 12

Deemed security interests 12

Unregistered security interests 12

Floating charge 12

Time limit on registration 13

PPSA Structure 13

Losing priority Arguments 20

Healy Holmberg v Grant (HC) 20

Healy Holmberg v Grant (CA) 21

Rabobank v McAnulty (CA) 21

StockCo v Gibson (CA) 22

Future advances 24

Non-PPSA 24

PPSA 26

Bank of New Zealand v Development Finance Corporation (CA) 26

Clayton's Case (Devaynes v Noble) 26

Hopkinson v Rolt (HL) 27

4. Unsecured Lending and Subordination **28**

Structured Subordination 29

1. Fundamentals of Bank Lending

When considering whether to give a loan, a bank will ask three questions:

a) Where can the bank make a profit?

There are three sources of profit: fees (upfront payment with extra fees for default); interest (reflecting the time value of money); and discounting (the sale of financial instruments).

b) How will the loan be serviced?

This depends on the income streams that the borrower has and there are three ways to structure the servicing of a loan:

1) Interest only (**flat**): yearly interest payments are made and the principal is repaid at the end of the term.
2) Principal and interest (**table**): yearly interest and principal payments are made resulting in a smaller principal payment to be made at the end of the term. This tends to work best for longer term debt.
3) **Capitalised interest**: no payments are made during the term of the loan. The interest is added to the loan and compounds and earns interest itself. At the end of the term there is a large payment. This is not a good way to borrow and is only done by those with no cash flow.

c) How will the loan be repaid?

The bank must consider how the loan will be repaid in two situations: expiry of term and default.

- **Expiry**: there are three ways for a bank to get money on expiry of term:
  1) Refinancing: the borrower can get a new loan from another bank and use it to repay the first loan;
  2) Cash flow: the borrower can use income generated to repay the loan;
  3) Asset sales: the borrower can use the original loan to buy an asset which will appreciate over time and at the end of the term can sell the asset and use the money realised to pay back the bank.
     - **Note**: asset sales only work if it is guaranteed that the asset will be worth more at the end of the term. Further, it is only appropriate to borrow intending to sell the purchased asset to repay the loan if you are willing to do so. Lending based on asset sales played a role in the GFC.
- **Default**: if the lender is concerned with how the loan will be repaid on default it will take security over some of the borrower's assets to ensure that it gets its money back.

2. Key Lending Terms and Concepts

Debt and equity borrowing

Debt

This is money borrowed from another person or entity which typically has to be paid back on a defined date with a fixed return (interest). Benefits include:

- In liquidation, holders of debt will be paid before those of equity (s 313 CA);
- Issuers of debt can deduct expenses for tax purposes. This cannot be done for equity.

Equity

This is a contribution to the business which doesn't give the contributor any entitlement to a return. However, a contributor may still receive a return if the business does well and on winding up there is a surplus of assets which will be distributed to the contributors. Benefits include:

- Equity provides a buffer of funds meaning that a business can suffer considerable losses and still be able to pay back creditors.
- A business with a large amount of equity will be able to borrow from banks on more favourable interest rates as the banks will consider their loan to be more secure.

Secured and unsecured

Security gives the security holder an in rem claim against an asset of the debtor. This ensures repayment of a debt even where the borrower is insolvent.

If you do not have security all you have is a claim in personam against the debtor. The debt will not be recovered if the debtor has insufficient funds.

Defaulting, Liquidation, Administration and Receivership

Debenture

In ordinary usage a debenture means an obligation which is charged upon assets of a company so as to provide a priority as against ordinary unsecured creditors (i.e. security interest). At common law, debenture means a written acknowledgment of a debt, whether secured or unsecured.

Acceleration

Under an acceleration clause the money becomes immediately due and payable.

Receiver/receiver and manager

An equitable charge likely contains a clause allowing the holder to appoint a receiver. Receivers are governed by the Receiver's Act and act in the interests of the creditor that appointed them.

Liquidator

A liquidator heads the liquidation. Liquidation occurs at the end of a company's life and a liquidator acts in the interest of all creditors. The liquidator is known as the Official Assignee because your debts are assigned to this individual who will then be able to pay the creditors.

Administrator

Appointed where a company is really struggling. An administrator will provide a report and recommend one of three things:

- Liquidate the company;
- Trade the company out of trouble;
- Return the company to ordinary management.

Administration itself is also a risk as it is an expensive process. If it is unsuccessful, then creditors will receive even less money.

Statutory manager

Appointed under the Corporations Investigation and Management Act or RBNZ Act a statutory manager freezes a company until it can decide what to do. This is a very political process and can only be invoked on the recommendation of the FMA and Minister of Commerce. These are rare and creditors can't apply for a manager. Statutory managers are only used when there is systemic risk.

Liens

A right given at law, sometimes in common law and sometimes in equity. This is common for work persons lien where possession passes. It is not a useful form of security interest as the CA in *Toll Logistics* held liens can lose their identity and become security interests.

Negative Pledge

A negative pledge is the flip side of a security. It is a promise by a borrower that they will not grant security to anyone. At least the creditor will know they are no worse than anyone else. It is only a contract though; it does not convey property rights at all.

Legal security interests

Common law Mortgage

A mortgage is where the mortgagee gets title to an asset while the mortgagor retains possession of it. In the event of default, the mortgagee is entitled to take possession of the asset and realise it to recover his debt. The mortgagor holds an equity of redemption (unless that has subsequently been mortgaged) which entitles him to recover any excess money arising out of the sale of the asset. If the debt is discharged the mortgagee must re-convey title to the mortgagor.

Only the first mortgage given over an asset is a true mortgage as there is only one title to an asset. The second mortgage is an equitable security interest called a chattel mortgage.

Problems:

- Difficulty for manufacturing businesses as the goods mortgaged wouldn’t have been able to be combined with goods that were unmortgaged or mortgaged to someone else.

- Difficulty for businesses that had circulating assets as every time a thing was sold the business would have to go to the mortgagee and get title conveyed.
- Mortgages could not be granted over future acquired property - Courts found them to not pass legal title even though the goods were properly described and so the mortgage was void.

Common Law Pledge

A pledge is where the pledger retains title to the asset however gives possession of it to the pledgee. If the debt is discharged the pledgee must return the asset however if the pledger defaults the pledgee is entitled to sell the asset to realise the debt.

Problems:
- Pledges deprived the owner of the asset of use of it, making it difficult for businesses to secure by way of pledge;
- Pledges could not be granted over future-acquired property;
- Pledges create difficulties for pledgees as they have to find places to store the assets.

Statutory (statutory mortgage)

A mortgage under the Land Transfer Act is in reality a charge. The mortgagor retains title and possession while the mortgagee is given a statutory charge over the asset. It is referred to as a mortgage as this is what it is called in the legislation.

Equitable security interests

Charges

Fixed

A fixed charge is where the chargor retains possession and title however the chargee obtains an equitable assignment of rights in the asset. If the chargor defaults, a court of equity may enforce the charge and allow the chargee to resort to the assets subject of the charge to satisfy his claim.
- A charge does not convey any recognisable ownership interest to the creditor.
- A common law court would only enforce a charge in personam, resulting Common law courts would only recognise a contractual, in personam, claim arising out of a fixed charge.
- It is not practical to take a fixed charge over circulating assets as the charge would have to be released every time that a business sold an item. This would slow commerce.

Floating

The floating charge was created to alleviate the difficulties of pledges and mortgages. The chargor retains possession and title whilst the chargee obtains a charge which floats over the specific class of asset subject of the charge. Before the charge crystallizes, the chargor is able to deal with the asset in the ordinary course of business, subject to the limitations within the security agreement. This allows the chargor to convey title to the asset free of encumbrance by the security interest.

Benefits include:
- Assets which are subject of a floating charge can be disposed of in the ordinary course of business without an onerous process of releasing the charge;
- Floating charges can apply to future acquired assets (*Re Panama*).

Crystallization

Crystallization will happen on a stipulated crystallisation event and may happen automatically (*MTL*), without the chargee having to do anything. An automatic crystallization clause is likely to be interpreted strictly. Common crystallization events include appointment of a receiver, the company ceasing to trade, or the company being wound up.

- The comments about automatic crystallisation were made obiter however they have still been followed.

After crystallization the chargor retains title to the asset however the chargee has an equitable proprietary interest in it. The chargor can no longer deal with the asset in the ordinary course of business and the chargee can turn to the assets subject of the charge to satisfy his claim.

- A charge does not convey any recognizable ownership interest to the creditor, just an equitable interest.
- After crystallization the charge is still an equitable charge, not a legal charge. See *MTL* for a flawed judicial analysis of crystallized floating charges.
- PPSA does not abolish floating charges. What it does is mean that they are unnecessary. This is because s 43 allows security interests to be taken in after acquired property. Further, s 53 allows goods to be disposed of in the ordinary course of business without being subject to the pre-existing security interest. These two provisions provide the benefits of floating charges without the need to contract specifically for a floating charge.

The precise nature of an equitable charge is not settled however charges create proprietary interests which give them priority over unsecured creditors. The intention of the parties determines whether a charge is fixed or floating. The greater the control that the chargee has over the assets, the more likely the charge is to be fixed, and vice-versa.

- The distinction between mortgages and charges is that the charge does not transfer or divide ownership rights, it is just an equitable assignment of an interest in an asset.
- The distinction between pledges and charges is that a chargee does not get a possessory right to the assets.

Second or subsequent mortgage

Any secondary mortgage of an asset is an equitable mortgage. This is where the mortgagor retains possession, the first mortgagee has title to the asset, and the second mortgagee obtains the mortgagor's equity of redemption. If the first mortgagee enforces its security interest and realises the asset, the second mortgagee can claim from the first mortgagee any money that is surplus to the value of the first mortgagee's security interest.

- This only works where the value of the asset exceeds the value of the first mortgage. For example, if an asset is worth $10k a first, legal, mortgage may be granted to secure an advance of $5k and a second, equitable, mortgage may be granted to secure another $5k.
- These aren't used post-PPSA.

Imperfect legal security interests

This is where the parties have attempted to create a legal mortgage however have failed to do so because of a formality. Equity may provide some relief in the form of estoppel.

Instruments by way of bailment

Conditional Sale/Reservation of Title/Romalpa

A conditional sale is where the contract stipulates that title to the asset will only pass on completion of certain conditions. Before the conditions are completed the vendor retains title to the asset while the purchaser obtains possession of it. Once the conditions are met title passes to the borrower but until they are the vendor may enforce its superior interest against the purchaser and recover the asset.

True hire purchase

A true hire purchase is where the lessor retains title and the lessee obtains possession of the asset as well as an option to obtain title to it. This secures the payment of rent for the assets as if the lessee defaults the lessor will be able to enforce his title and recover the assets.

- These are used by financing companies where the company will purchase up front the assets and then lease them to someone else who will have the option to obtain title to the asset for a nominal sum at the end of the lease.
- This enables the lessee to get the benefit of the asset while only paying for it in instalments.

Chattel lease

A chattel lease is where the lessor retains title to the assets and the lessee obtains possession. This secures payment of rent in the same way that a true hire purchase agreement does.

Distinction between bailments and mortgages

In a bailment the debtor acquires an interest, in the right to possession granted by the creditor, while the creditor retains the right to ownership. In a mortgage the debtor loses an interest, in the right to possession granted to the creditor, while the debtor retains the right to ownership.

From this it is clear that the grantee of a conditional sale, hire purchase or lease agreement does not mortgage or charge his assets. He is a bailor.

Registration of Security Interests

Mortgages and charges granted by a company

A mortgage or a charge granted by a company had to be registered at the Companies Office within 30 days of it being given as per the Companies Act 1955.

- Failure to register incurred a $100 fine for the company and rendered the security interest unenforceable against third parties (i.e. you would only have an in personam claim, not an in rem claim
- The fine placed the onus on the debtor (the company) to register the interest.
- Registration did two important things:
    - It gave constructive notice of the existence of the security (*Wilson v Kelland;* CA s 102, CTA s 4(2)). This allowed a registered equitable mortgage or fixed charge to gain priority over a bona fide purchaser etc. see below;
    - It gave constructive notice of the contents of the security so far as they related to chattels (CA s 102; CTA s 4(2)). This allowed a registered floating charge to gain priority over a bona fide purchaser etc. see below.

Company securities that are "instruments" but not mortgages or charges

Security instruments that are instruments but not mortgages or charges are to be registered at the High Court. Failure to register such an interest does not render it invalid however it may lose priority to a properly registered interest.

- **Note**: this places the onus on the secured party to register the interest to secure its priority.

Instruments by way of bailment

Leases or other bailments (except Romalpa clauses) were registrable at the High Court under the CTA however there were no consequences for not registering. Romalpa clauses did not require registration.

3. Secured Lending: Pre-PPSA Law

The pre-PPSA law still applies in New Zealand where the PPSA is excluded or where personal property, as defined in the act, is not involved. Further, it is still relevant in England and Singapore.

Priority between interests

General

The general rule is that the first created security interest that complies with registration requirements has priority.

- **Note**: the person with title has the strongest claim.

Defeating a legal security interest

There is no way to defeat a prior created legal security interest. The bona fide subsequent purchaser rule does not apply.

Defeating an equitable security interest that is not a floating charge

A bona fide subsequent purchaser or mortgagee who obtains a legal interest in an asset that is subject to an equitable interest will take priority over the equitable interest if:

- He purchased it for value; and
- He did not have notice of the equitable security interest OR provision in document creating the charge prohibiting the creation of additional security (floating charge).
    - Registration of an equitable mortgage or floating charge gives constructive notice of the existence of the security (*Wilson v Kelland,* s 102, s 4(2) Companies Act 1955, Chattels Transfer Act 1924).

Critique of the pre-PPSA regime

Pre-PPSA the registration requirements depended on a number of factors, including:

- Nature of debtor:
    - There were different registration requirements if the debtor was a company, an industrial and provident society, or an individual.
- Nature of collateral/secured assets:
    - If the collateral is a motor vehicle the Motor Vehicle Securities Act applies etc.
- Nature of security interest:
    - If the security interest was a mortgage or charge registration was required under the Companies Act if the debtor was a company or under the Chattels Transfer Act if the debtor was not a company.
    - If the security interest was a lease or bailment it was registrable under the Chattels Transfer Act however there were no consequences for not registering.
    - If the security interest was a Romalpa clause no requirements apply.

There were two completely different systems of registration:

1. If registration was required under the Chattels Transfer Act it must have been effected at the High Court.
2. If registration was required under the Companies Act it must have been done at the Companies

Office. There was no comprehensive national register meaning searching was difficult and risky.

There were two completely different systems of priority:

1. Priority of interests registered under the Chattels Transfer Act was determined by date of registration i.e. first registered wins.
2. Priority of interests under the Companies Act was determined by date of creation as long as the interest was registered within 30 days i.e. a prior registered interest could be defeated if an interest was created before it which was subsequently registered within the time limit.

Manurewa Transport Limited (HC)

- This case should not have gone to court. When a security interest is created by a company it is to be registered at the Companies Office within 30 days under the Companies Act. The IWS executed in favor of Gills was registered at the High Court, not the Companies Office. The effect of the incorrect registration would have been that the chattel mortgage was ineffective against the debenture;
- The Court held that even if Gills did not have constructive notice of the contents of the debenture, the debenture would have taken priority because the charge had crystallized through automatic crystallization before the legal interest was given to Gills. This is wrong. A fixed charge is still an equitable interest and is still defeasible by a bona fide mortgagee for value without notice. The only way Labrum could have beaten Gills' legal interest, whether the charge was fixed or floating, was by proving that Gills had notice.
    - **Note**: this means that the comments about automatic crystallization are obiter. Despite this they are followed by other jurisdictions.

Facts

In 1968 MTL granted Labrum a floating charge over all of its assets. The debenture said MTL could deal with its assets in the ordinary course of business however if MTL tried to mortgage or charge any of its assets subject of the floating charge the charge would immediately fix. This document was validly registered at the Companies Office.

In 1969 MTL gave a truck that it owned to Gills for some repairs. Gills refused to give the truck back until either the balance of the repairs was paid or MTL granted it a security interest securing payment of that amount. MTL executed an IWS in favor of Gills granting it a security interest over the truck. The document was then registered at the High Court (*incorrectly*).

In 1970 a receiver was appointed to MTL. There was insufficient money to pay the debts owed to Labrum and Gills so a priority dispute arose between the two parties.

Issue: *whether Gills' security takes priority over Labrum's floating debenture.*

Labrum has priority because it had a prior equitable interest and Gills was not a bona fide purchaser/mortgagee for value without notice (he had notice). Further, even if he didn't have notice, the floating charge crystallised before the mortgage was granted in favour of Gills and so Labrum had a prior in time fixed charge which was registered.

a) *Whether the granting of the security interest over the truck to Gills was prohibited by the terms of Labrum's debenture?*

Yes it was.

- MTL could deal with its assets in the ordinary course of business.

- However, there was an overarching condition that MTL wouldn't charge any of its assets without the written consent of Labrum.
- This means that even charging in the ordinary course of business was prohibited.

b) *Whether an estoppel arose as Labrum encouraged Gills to give up its workman's lien for its security interest in the truck?*

No it does not. There is insufficient evidence to support this contention.

c) *Whether Gills was a bona fide purchaser/mortgagee for value without notice?*

No he was not, Gills had constructive notice of the contents of the security and its prohibition against charging the assets which included the truck.

Gills had notice of the existence and contents of Labrum's debenture because:

- Section 4(2) provides that: all persons have notice of the existence and contents of a security granted wholly or partly upon chattels by a registered company so far as it relates to chattels immediately upon valid registration of the security.
- In this case, Labrum's debenture:
  - is a security as defined in the Act;
  - is granted wholly or partly upon (over) chattels including the truck;
  - A floating charge is granted wholly or partly upon chattels for if it was not the asset would not be charged at all. A security cannot be in vacuo, it must relate to something. The freedom to deal in the ordinary course of business does not remove the charge upon the asset.
  - is granted by MTL, a registered company;

  and ○ is validly registered.
- Accordingly, s 4(2) mandates that Gills had notice of the existence and contents of Labrum's debenture.

If there was no restriction on charging, as there is in condition 1 of the debenture, Gills would obtain priority.

d) *Whether the floating charge had crystallised before the security was granted in favour of Gills?*

Yes it had. This is because:

- A floating charge can automatically crystallise if a crystallisation event occurs. There is authority for this.
- In this case to mortgage or attempt to mortgage an asset is a crystallisation event. When Gills and MTL negotiated the security over the truck MTL was attempting to mortgage an asset and at that point the floating crystallised. As such, Labrum had a specific charge, earlier in time and duly registered and wins priority on this ground as well.

Law: Crystallisation may occur automatically without any action taken by the creditor. This is obiter: see above critique.

3. Secured Lending: PPSA

Background

The PPSA replaced:

- Chattels Transfer Act 1924;
- Companies (Registration of Charges) Act 1993;
- Motor Vehicle Securities Act 1989.

Our PPSA was based on North American models (Saskatchawen). This means that some Canadian case law can be used to determine hard issues - however, there are some differences so reliance cannot wholly be placed on it.

Policy

Deemed security interests

Deemed interests are not traditionally thought of as security interests however are covered by the PPSA regime. A policy decision was taken to include deemed security interests as it is too hard to determine whether they secure payment of an obligation or not.

For example:

- **Leases** for a term of more than one year are included as deemed security interests. It was recognised that operating leases are not intending to secure payment of a debt or performance of an obligation and that financing leases are. It was also recognised that to the outside world, these two transactions are ostensibly the same – it appears that ownership is with the lessee. To avoid the trouble of distinguishing between leases that do and leases that don't secure payment of a debt or performance of an obligation it was decided to include both as security interests. In excluding leases for a term of less than a year unless they secure payment of a debt or performance of an obligation most operating leases are excluded anyway.
    - **Note**: the registration requirement of interests arising out of leases for a term of more than one year originally stung quite a few lessors (see *Graham v Portacom*).
- **Transfers of accounts receivable** are also deemed security interests. This is because under some factoring arrangements the factor has recourse to the vendor for account receivables that do not materialise. In such a situation the vendor must re-purchase those account receivables. Levels of recourse affect the pricing of accounts receivable. A factoring agreement with any recourse against the vendor takes security over some of the vendor's assets to ensure repayment. It is too difficult to distinguish between full recourse (secured) and no recourse (unsecured) factoring agreements and so all are lumped in together.

Unregistered security interests

Unregistered security interests are not void under the PPSA, as compared to those under the previous regime not registered in accordance with the Companies Act. The only consequence of non-registration is a potential loss of priority.

Floating charge

The floating charge wasn't abolished however s 53 renders it unneeded. This is because goods that are sold in the ordinary course of business are taken free of a security interest, just as they would have been under a floating charge.

Time limit on registration

There is a five year time limit on financing statements, after which they will lapse without re-registration. Without an expiry the register would become clogged with interests financing statements arising out of transactions that had long since finished. Once the register starts to get clogged the business must go through and request that interests be removed otherwise it will find it difficult to get financing. It is difficult to request interests to be removed especially where the party who registered it has gone insolvent/no longer exists.

PPSA Structure

The issue is whether [XX] has a security interest which takes priority over the security interest of [YY].

We must first determine whether the Personal Property Securities Act 1999 applies. The PPSA only applies to security interests which are taken in personal property as defined in the Act.

Is there personal property? (s 16)

1. **Goods**: stuff is goods if it is tangible personal property (s 16). The sub-categories are:
    a. Consumer goods;
        i. Goods are consumer goods if at the time the security interest attached they are used primarily for personal, domestic or household purposes (s 16).
    b. Equipment;
        i. Goods are equipment if at the time the security interest attached they are machinery used to make something else (s 16).
        ii. Goods are equipment if they are not inventory or consumer goods (s 16).
    c. Inventory:
        i. Goods are inventory if at the time the security interest attached they are consumed, sold, or leased in the ordinary course of business (s 16).
    d. Sub-sub-categories of goods:
        i. Motor vehicles: see s 57 (wheels/tracks/propelled by power/has rego number).
        ii. Accessions: goods that are installed in, or affixed to, other goods (s 16, 78)
            1. Examples: a replacement motor installed in a car.
2. **Intangibles**: stuff is intangibles if it is personal property that does not fall into any of the other categories.
    a. Examples: trademarks, patents, copyright, accounts receivable (book debts – money owed).
3. **Chattel paper**: writings that evidence both a monetary obligation and a security interest in, or lease of, specific goods.
    a. Examples: a hire purchase agreement.
4. **Documents of title**: a document issued to a bailee that covers identified goods in his possession or fungible portions of an identified mass and that states that the goods identified will be delivered to a named person.
5. **Investment securities**: see s 16.
    a. Examples: shares in or bonds issued by a listed company.
6. **Money**: any currency.

7. **Negotiable instruments**: a bill of exchange, promissory note, any writing evidencing a right of payment of money of a kind that is ordinarily endorsed and transferred by delivery, or a letter of credit.

8. Personal property that falls into any of the above categories may be proceeds:
    a. **Proceeds**: identifiable or traceable personal property derived directly or indirectly from a dealing with collateral or its proceeds and in which the debtor acquires an interest (s 16).
        i. **Note**: this does not include animals that are offspring of collateral.
        ii. **Example**: aluminium becomes a scooter which is sold on credit terms. Security interest in aluminium continues in scooter and then continues in the account receivable.

Is there a security interest taken in that personal property? (s 17)

1. There will be an *actual* security interest if (s 17(1)(a)):
    a. there is an interest in personal property created by a transaction; and
    b. in substance that interest secures payment or performance of an obligation.
        i. Examples: fixed charge, floating charge, chattel mortgage, conditional sale agreement, hire purchase agreement, pledge, security trust deed, consignment, lease, and an assignment securing payment or performance of on obligation.
            1. **Note**: a lease for a term of less than one year may be a security interest if it in substance secures payment or performance of an obligation.
        ii. **Note**: we should not have regard to the form of the transaction or to who has title to the personal property (ss 17 and 24).

2. There will be a *deemed* security interest if (s 17(1)(b):
    a. There is an interest in personal property; and
    b. That interest is created by:
        i. A transfer of an account receivable;
        ii. A lease or bailment for a term of more than one year; or
            1. Including a lease or bailment (*McAnulty*) (s 16):
                a. for an indefinite term;
                b. that is automatically, or at the option of one of the parties, renewable where the total of the terms may exceed one year;
                c. for a term of one year or less where the lessee or bailee retains uninterrupted possession of the goods for more than one year.
            2. Not including a lease or bailment:
                a. By a lessor or bailor who is not regularly engaged in the business of leasing or bailing goods (*McAnulty*) or
                    i. To be engaged in the business of bailing goods a party must be intending to receive consideration with a view to making a profit (*McAnulty*).
                b. Of household furnishings or appliances as part of a lease of land.
        iii. A commercial consignment.

    c. **Note**: for a deemed security interest there is no need for the transaction to secure payment of an obligation. A policy decision was taken to include the above categories as security interests as it is too hard to determine whether they secure payment of an obligation.

Since there is a security interest in personal property the priority rules under the PPSA apply unless the situation is excluded under s 23.

Is the PPSA excluded? (s 23)

The PPSA does not apply to the following situations:

1. Statutory SI's such as liens, charges, and other security interests in personal property except as provided for in Part 8 (s 23(b));
    a. **Note**: the workman's lien in *MTL* would take priority over the GSA under s 93 if it had continued.
2. Rights of set-off, netting, or combination of accounts (s 23(c));
3. Interests in land (s 23(e));
    a. A lease of land is excluded as it is a security interest created from a transaction creating an interest in land (*Marac Finance*).
4. Ships over 24m of length (s 23(e));
5. Aircraft which are subject to the Cape Town Convention (s 23A).

A) Having determined that the PPSA applies to the situation, we must now consider the nature of the security interest.

OR

B) Since the situation is excluded from application of the PPSA, the priority rules under the pre-existing regime apply. (GO TO PRE-PPSA STRUCTURE)

Attachment (s 40)

A security interest attaches to collateral (i.e. comes into existence) when:

1. Value is given by the secured party (s 40);
    a. Value is consideration sufficient to support a simple contract and includes past consideration (s 16).
2. The debtor has rights in the collateral (s 40); and
    a. A debtor has rights in goods that are leased, consigned, or sold to him under a conditional sale agreement (including under a retention of title clause) when he obtains possession of the goods (s 40(3)).
        i. **Note**: *Portacom* confirms that rights under a lease are sufficient for a lessee to grant a security interest in the leased goods to a third party.
    b. Example: A goes to B and asks to buy money to buy a car. B lends A money. A doesn't have rights in the car until he buys it.
3. Either (s 36):
    a. The debtor has assented in writing to a security agreement in proper form; or
        i. There's an adequate description of collateral; or
        ii. Stating that an interest is taken in all present and after-acquired property;
        iii. **Note**: a description is adequate if it allows someone not party to the transaction to understand that the specific personal property is subject to a security interest (*StockCo*).
    b. The secured party has possession of the property.

4. **Note**: if (i) and (ii) are satisfied there is attachment between the two parties to the agreement. For there to be attachment which will bind the third party (iii) must be satisfied.

Perfection (s 41)

1. The security interest has attached; and
    a. Either:
        i. A financing statement is validly registered (see below); or
            1. Motor vehicles or aircraft: a financing statement in respect of an interest in a motor vehicle or aircraft must include the serial number (s 142)
                a. Need to register the serial number and identify if it's equipment, inventory or consumer goods – not perfected otherwise
            2. Expiration: a financing statement lapses if it is not renewed within five years of the date on which it was registered (s 153).
            3. Misleading: a financing statement is invalid if it contains a defect, irregularity, omission or error which is seriously misleading (s 149).
                a. A financing statement is seriously misleading if a search of the register would not lead the searcher to believe that an interest was taken over certain collateral.
                b. A financing statement is not seriously misleading if it overstates the extent of the security interest but may be if it understates it (*Service Foods*).
                c. Seriously misleading if there is an error or omission in the serial number required to be registered (s 150);
                d. Seriously misleading if there is an error or omission in the name of the debtor (s 150).
                    i. Once the secured party has notice of the name change of a debtor he must register a financing change statement.
        ii. The secured party has consensual possession of the collateral.

    b. **Note**: the order of these requirements is not important. A financing statement can and should be registered before attachment.
    c. **Perfection in insolvency**: the PPSA is silent as to whether an interest can be perfected after a debtor company is insolvent. Some obiter comments from the CoA suggest that you cannot do so (*Gibston v Downs*) however today the position is that you probably can as there's nothing stopping you. This is different to the position in Australia which establishes that perfection must occur before insolvency.

A) Both parties have security interests in the personal property and so the priority rules in Part 7 apply.

B) Only one party has a security interest in the personal property and so the extinguishment rules in Part 5 apply.

Secured vs secured (s 66)

General rules:

1. A perfected security interest has priority over an unperfected security interest (s 66(a));
2. Where both security interests are perfected the first to register or take consensual possession of the collateral has priority (s 66(b));
    a. **Note**: it was confirmed in *Healy Holmberg* that the first to register *not* the first to perfect takes priority.
3. Where both security interests are unperfected the first to attach has priority (s 66(c)).
    a. **Note**: this isn't really necessary as if there is ever a dispute between unperfected and unperfected one of the parties would just perfect its interest and take priority. The position is that you can perfect even after insolvency however this may change (see *Gibston v*

Downs).

PMSI:

1. A PMSI perfected within the relevant time has priority over an earlier perfected non-PMSI security interest (ss 73, 74, 75). There are four types of PMSIs (s 16):
    a. **Vendor finance**: a security interest taken by the seller of the collateral to secure the unpaid purchase price (e.g. a supplier giving goods on credit);
    b. **Acquisition finance**: a security interest taken by someone who has given value to enable the debtor to acquire the collateral (e.g. a bank giving money specifically for that purpose);
    c. The interest of a lessor of goods under a lease of more than one year (see definition above); and
    d. the interest of a consignor who delivers goods to a consignee under a commercial consignment (where someone sells goods on your behalf).
        i. **Note**: the onus is on the PMSI-claimant to establish that he has a PMSI.
2. The relevant time depends on the nature of the collateral:
    a. Collateral other than inventory or intangibles or its proceeds: PMSI must be perfected not later than 10 working days after the debtor obtained possession of the collateral (s 73);
    b. Inventory or its proceeds: PMSI must be perfected at the time the debtor obtained possession of the collateral (s 74);
    c. Intangible or its proceeds: PMSI must be perfected not later than 10 working days after the security interest in the intangible attached (s 75).
    d. *Think through whether a vehicle would be inventory (car dealer) or equipment (anyone else)*.
3. If there are two PMSIs which have both been registered and perfected, then:
    a. Vendor finance, lessor, consignor has priority over acquisition finance (s 76)
    b. If both are the same type, first to register will have priority (s 66)

Special rules:

1. Accessions:
    a. A security interest in goods which become an accession and is attached at the time it becomes an accession continues in the accession and has priority over any security interest taken in the whole (s 79).
2. Crops (s 100);
    a. There are special rules around crops, negotiable instruments, investment securities, chattel paper, negotiable documents of title, money.
3. Paper collateral and negotiable instruments:
    a. Security interests over money and other fungibles must be perfected by possession rather than registration as these instruments need to be taken out of circulation.
4. Comingled (s 82, 85)
    a. A security interest in goods that subsequently become part of a product or mass continues in the product or mass if the goods are so manufactured, processed, assembled, or commingled that their identity is lost in the product or mass (s 82).
        i. Perfected beats unperfected (s 85). If more than one party has perfected, each perfected entitled to a share in the product or mass according to the ratio of value given (s 85).
5. Lienholders (s 93):
    a. A lien arising out of materials or services provided in respect of goods that are subject to a security interest in the same goods has priority over that security interest if (s 93, Part 8) (*StockCo*):
        i. The materials or services relating to the lien were provided in the ordinary course of business; and

   ii. The lien has not arisen under an Act that provides that the lien does not have the priority; and
   iii. The person who provided the materials or services did not, at the time the person provided those materials or services, know that the security agreement relating to the security interest contained a provision prohibiting the creation of a lien by the debtor.
6. Transfer of collateral (s 88):
   a. Where a debtor transfers collateral the subject of a perfected security interest the security interest will continue to have priority if the secured party registers a financing change statement within 15 days of becoming aware of the transfer (s 88).
7. Previously paid creditors (s 95):
   a. A creditor who receives payment of a debt owing through a debtor-initiated payment has priority over a security interest in the funds paid, whether or not the creditor knew of the security interest (s 95(1)).
      i. A debtor-initiated payment is a payment made by the debtor through the use of a negotiable instrument, transfer of funds, etc. (s 95(3)).
         1. **Note**: this facilitates commerce as without it creditors would not be willing to discharge debts.

<u>Secured and Unsecured vs Buyers (ss 45, 52, 53, 54, 55, 58)</u>

General rule:

1. A security interest in collateral that is dealt with (sold) or otherwise gives rise to proceeds:
   a. Continues in the collateral; and
   b. Extends to the proceeds
2. Unless the secured party expressly or impliedly authorized the dealing (s 45(1)).

Buyer Exception:

1. A buyer for value takes collateral free of any **unperfected security interest** (except where the unperfected security interest arises from a transaction to which the buyer is a party) (s 52);
2. A buyer of goods sold in the **ordinary course of business** of the seller takes the goods free of a security interest created by the seller (unless the **buyer knows that the sale is in breach** of the security agreement creating the security interest) (s 53);
   a. Determining whether the goods were sold in the ordinary course of business is an objective factual assessment based on all the circumstances of the particular case. The test has two steps (*StockCo, Orix*):
      i. First, what was the ordinary course of business of the seller?
      ii. Second, were the goods sold in the ordinary course of that business?
         1. If the agreement was made at the business premises of the seller it is more likely to be in the ordinary course of business (*StockCo*);
         2. A sale to an everyday consumer is more likely to be in the ordinary course of business than a sale to a dealer or a financial institution (*StockCo*);
         3. A sale of one or two articles is more likely to be in the ordinary course of business than a sale of a large proportion of the stock of the seller (*StockCo*);
         4. A reasonable and fair price paid is more likely to be in the ordinary course of business than a discounted price (*StockCo*).
3. A buyer for new value of **consumer goods valued at not more than $2,000** at the time the security interest attached takes them free of any security interest (unless the buyer had knowledge of the security interest) (s 54);
   a. This categorization is in the hands of the buyer.

4. A buyer of consumer goods or equipment required to be described by a **serial number** (motor vehicles and aircraft) takes them free of any perfected security interest if the buyer did not have knowledge of the security interest and the **serial number was incorrect** (s 55);
    a. This categorization is in the hands of the buyer.
    b. **Note**: ss 149, 150 and 152 mean that this exception is not required. If the incorrect serial number was registered the financing statement would be invalid as it would be seriously misleading. As such the interest would be unperfected and a buyer of the collateral would take it free of the interest.
5. A buyer as a consumer for value of a motor vehicle takes the motor vehicle free of any interest except if: (s 58)
    a. The seller is a registered motor vehicle dealer
    b. The SI was not created/provided for in the transaction to which the buyer was not party
    c. The SI was not disclosed to the buyer in writing
6. **6th exception**: a buyer of collateral takes the goods free of any security interest if the secured party expressly or impliedly authorizes the dealing (s 45(1)).

Special rules:
1. Accessions:
    a. A security interest in goods which become an accession and is attached at the time it becomes an accession continues in the accession and has priority over any security interest taken in the whole (s 79).
2. Crops (s 100);
    a. There are special rules around crops, negotiable instruments, investment securities, chattel paper, negotiable documents of title, money.
3. Paper collateral and negotiable instruments:
    a. Security interests over money and other fungibles must be perfected by possession rather than registration as these instruments need to be taken out of circulation.
4. Comingled (s 82, 85)
    a. A security interest in goods that subsequently become part of a product or mass continues in the product or mass if the goods are so manufactured, processed, assembled, or commingled that their identity is lost in the product or mass (s 82).
        i. Perfected beats unperfected (s 85). If more than one perfected each perfected entitled to a share in the product or mass according to the ratio of value given (s 85).
        ii. A PMSI in commingled goods has priority over a non-PMSI in the same goods (s 86).
5. Lienholders (s 93):
    a. A lien arising out of materials or services provided in respect of goods that are subject to a security interest in the same goods has priority over that security interest if (s 93, Part 8) (*StockCo v Walker*):
        i. The materials or services relating to the lien were provided in the ordinary course of business; and
        ii. The lien has not arisen under an Act that provides that the lien does not have the priority; and
        iii. The person who provided the materials or services did not, at the time the person provided those materials or services, know that the security agreement relating to the security interest contained a provision prohibiting the creation of a lien by the debtor.
6. Transfer of collateral (s 88):
    a. Where a debtor transfers collateral the subject of a perfected security interest the security interest will continue to have priority if the secured party registers a financing change statement within 15 days of becoming aware of the transfer (s 88).
7. Previously paid creditors (s 95):

a. A creditor who receives payment of a debt owing through a debtor-initiated payment has priority over a security interest in the funds paid, whether or not the creditor knew of the security interest (s 95(1)).
   i. A debtor-initiated payment is a payment made by the debtor through the use of a negotiable instrument, transfer of funds, etc. (s 95(3)).
   ii. **Note**: this facilitates commerce as without it creditors would not be willing to discharge debts.

<u>*Losing priority Arguments*</u>

A party that is losing in a priority dispute may argue a number of things, including:

- PPSA does not govern the dispute:
  - This may be because:
    - There is no personal property (*Whaitiri Potato Company*);
    - There is no security interest; or
    - The PPSA is excluded by s 23.
- Prioritised interest is not perfected:
  - Invalid registration of financing statement:
    - Motor vehicles or aircraft: a financing statement in respect of an interest in a motor vehicle or aircraft must include the serial number (s 142)
    - Expiration: a financing statement lapses if it is not renewed within five years of the date on which it was registered (s 153).
    - Misleading: a financing statement is invalid if it contains a defect, irregularity, omission or error which is seriously misleading (s 149).
      - A financing statement is seriously misleading if a search of the register would not lead the searcher to believe that an interest was taken over certain collateral.
      - A financing statement is not seriously misleading if it overstates the extent of the security interest but may be if it understates it (*Service Foods*).
      - Seriously misleading if there is an error or omission in the serial number required to be registered (s 150);
      - Seriously misleading if there is an error or omission in the name of the debtor (s 150).
        - Once the secured party has notice of the name change of a debtor he must register a financing change statement.

<u>*Healy Holmberg v Grant (HC)*</u>

Facts

In 2005 HH loaned money to LBD. HH registered a financing statement on 20 January 2006. RIGA was granted a GSA over LBD's present and after-acquired assets. It registered this interest on 17 August 2007.

LBD was put into liquidation. The liquidators couldn't find the security agreements relating to HH's loans so requested copies from HH. HH provided these however the liquidators were concerned that it had back-dated the agreements. An expert testified that the agreements were likely signed on or after 31 August 2007.

Decision

The HC ruled HH's interests did not have priority. HH never had a security interest because the security agreements were signed after liquidation rendering them invalid - it is an unsecured creditor. RIGA has priority as it has a security interest. Moreover, its security interest is perfected.

The court held HH never had a security interest that could attach or be perfected as the agreement granting it was invalid as it was entered into after liquidation.

Even if the Court held that the agreements were valid and gave HH a security interest, the Court would have been likely to conclude that they were signed on or after 31 August 2007. This would have meant that HH's interest attached and perfected on or after 31 August 2007. In the Court's eyes, since this perfection was after the perfection of RIGA (17 August 2007) RIGA's interest would have priority.

Law:

Section 66(b) reinforces the general rule that the greatest priority is given to a security interest holder who perfects first.

Commentary

The Court thought that in a dispute between two perfected security interests the first interest to perfect would win. This is not correct. Section 66(b) provides that in a contest between two perfected security interests (as we have here), the first registered interest *not* the first perfected will win. HH's interest was registered on 20 January 2006 whereas RIGA's was registered on 17 August 2007. If it was found that the agreements were valid (i.e. signed before liquidation), under s 66(b) HH's interests should have had priority over RIGA's.

Healy Holmberg v Grant (CA)

Decision

The NZCA provided no conclusion. It cannot be determined from the evidence whether HH had a valid security interest. Accordingly, the appeal was dismissed and no order confirming HH as a secured creditor was given.

- The Associate Judge had insufficient evidence for his positive finding that the documents were signed after liquidation;
- The onus was on HH to prove that the agreements were made before liquidation and it failed to discharge this onus.

Law:

In a situation where both parties have perfected a security interest by registration, the party that registers its interest first will take priority.

Section 66 sets out the residual priority rules - the rules that will apply when no other priority rules apply.

Rabobank v McAnulty (CA)

Facts

A owns a horse. They enter into an arrangement whereby B, the owner of a stud farm, will look after the horse. It is agreed that B is bailee of the horse. B subsequently entered into a GSA with C. C registered a

financing statement in respect of the GSA, perfecting its interest. B went into receivership. C claims priority to the horse as it claims it has a perfected interest while A has an unperfected interest.

Issue

Whether the arrangement between A and B is a lease for a term of more than one year under s 16.

Decision

It is not because:

- The fact that s 16(a) refers to a "lease or bailment of goods" yet ss 16(b) and 16(c) do not appears to be a legislative oversight. What should be read in ss 16(b) and (c) where it says "lease" is "lease or bailment of goods". It would be odd not to do so and no policy reason behind the definition of "lease for a term of more than one year" justifies not reading those words in.
- Accordingly, a bailment for a term of three years, as is the situation here, will be excluded from being a "lease for a term of more than one year" by s 16(c) if it is made by a bailor who is not regularly engaged in the business of bailing goods.
- The words "engaged in the business of bailing goods" indicate that the bailor must be intending to profit from the bailment or lease.
- A is not in the business of bailing goods. It did not intend to profit from the bailment arrangement, it is a horse racing syndicate. As such, the arrangement between A and B is not a lease for a term of more than one year and A does not have a security interest under the PPSA.

Law:

In the definition of "lease for a term of more than one year", "lease" is to be read as "lease or bailment of goods" and every reference to lessors, lessees, or leasing, shall include bailors, bailees, and bailing respectively.

To be engaged in the business of bailing goods a party must be intending to receive consideration with a view to making a profit.

StockCo v Gibson (CA)

Facts

Bank had a GSA over the Group's personal property, including livestock. Plateau (a member of the group) decided to sell StockCo 4,000 heifers which StockCo would then lease to Nugen. In relation to this transaction StockCo argues that it took the heifers free of any security interest given by Plateau because the sale was done in the ordinary course of business (s 53).

Nugen (not a member of the group) sold 750 cows, which used to be owned by the Group, to StockCo. Nugen then leased back the cows. These cows are subject to the bank's security interest. StockCo argues that there was a valid gift of these cows to Nugen before the sale and lease-back transaction was entered into. The banks argue that there was not.

Decision

The issue was whether the sale of the 4,000 heifers to from Plateau to StockCo was done in the ordinary course of business under s 53. The court found it was not, because:

- The ordinary course of the business of Plateau was buying and selling livestock (normally calves) amounted only for about 10% of Plateau's revenue.

- The sale of 4,000 heifers was not in the ordinary course of Plateau's business. It was unique and unprecedented, involving raising funds in an unusual manner. Lawyers were involved and funds were strangely advanced to Nugen.

Law

Determining what is the ordinary course of business under s 53 requires an objective factual assessment based on all the circumstances of the particular case. The test has two steps:

- First, the ordinary course of the business of the seller must be determined;
- Second, it must be considered whether the transaction was in the ordinary course of that business.
  - If the agreement was made at the business premises of the seller it is more likely to be in the ordinary course of business;
  - A sale to an everyday consumer is more likely to be in the ordinary course of business than a sale to a dealer or a financial institution;
  - A sale of one or two articles is more likely to be in the ordinary course of business than a sale of a large proportion of the stock of the seller;
  - A reasonable and fair price paid is more likely to be in the ordinary course of business than a discounted price.

Where a sale is effected in the ordinary course of business the proceeds of that sale, almost invariably cash, become subject to the same security interest as the goods that were subject of the sale were (s 45(1)).

This interpretation meets the commercial objective of facilitating commerce without undermining the equally important commercial objective of ensuring those who provide credit on the security of the debtor's goods are not unfairly deprived of the benefit of that security.

Future advances

Non-PPSA

Common law rules

A first mortgagee, whose mortgage covers future advances, loses priority in respect of such advances if they are advanced after a second mortgage is granted and after the first mortgagee had actual notice of the second mortgage (*Hopkinson v Rolt*).

- **Note**: registration of a subsequent mortgage is not sufficient notice.
- Example:
  - Situation:
    - 1: GT takes mortgage;
    - 2: GT advances $100;
    - 3: PN takes mortgage;
    - 4: PN gives GT actual notice of mortgage;
    - 5: PN advances $100;
    - 6: GT advances $50;
    - 7: Property sells for $200.
  - Order of priority: GT $100, PN $100, GT $50. Since it sells for $200 GT loses the last $50

In the absence of appropriation and where the sums paid in form one blended fund the first sum paid in is the first one drawn out. In other words, the first item on the debit side of the account is discharged or reduced by the first item on the credit side (*Clayton's Case*).

- Example:
  - Situation:
    - 1: GT lends $100;
    - 2: PN gives notice;
    - 3: PN lends $150;
    - 4: borrower repays GT $100;
      - This rule requires that the $100 satisfies the first $100 debt.
    - 5: GT lends $100;
      - Since the first $100 debt is satisfied this is a subsequent advance.
    - 6: Property sells for $200.
  - Order of priority: PN $150, GT $100. Since it sells for $200, GT only gets $50 back.

Statutory rules

Generally, advances made under a mortgage after a subsequent mortgage has come into force do not take priority over the subsequent mortgage (s 89(1) PLA). However, the advance under the prior mortgage will take priority over a subsequent mortgage if:

- When the advance was made, the first mortgagee did not have **actual** notice of the subsequent mortgage or was required to make such an advance (s 91 PLA);
  - **Note**: this is a codification of the *Hopkinson v Rolt* rule.
  - **Note**: registration of a mortgage does not constitute actual notice
- An agreement executed between the two mortgagees provides for such priority (s 89(1)(a) PLA); o **Note**: this is a deed of priority.
- The prior mortgage states that future advances will have priority over subsequent mortgages up to a stated limit and the advance is within the stated limit (s 92(1) PLA).

    - **Note**: this is allowed because mortgage documents are registered online, allowing them to be searched for and read by prospective subsequent mortgagees. In doing so a subsequent mortgagee will know what priority limit the first mortgage has.

Note that a bank will often have a security interest in the land as well as a GSA (personal property).

Ways around the rules

There are four ways to change future advances priorities:

- Give notice to the prior mortgagee:
    - Any subsequent mortgagee that wishes to obtain priority over a prior mortgagee must give the prior mortgagee notice of its mortgage. This will engage the rules in *Hopkinson v Rolt* and *Clayton's Case*, discussed above, and cause the subsequent mortgagee to have priority over future advances made by the prior mortgagee.
- Ruling off:
    - Where a prior mortgagee does not want to lose his priority by having a mortgagor pay off a prior advanced amount he can rule off the account to prevent *Clayton's Case* from applying.
    - Process; the creditor advances an amount from account A. Creditor creates a new account, account B. Any amount that is repaid to the creditor is put in account B, preventing the money from paying off the first advance made in accordance with *Clayton's Case*. If a subsequent advance is made it is done from account B. This protects the creditor's priority surrounding the first advance.
- State a priority limit:
    - Section 92(1) allows a first mortgage to stipulate an amount up to which future advances will take priority over subsequent mortgages. This displaces *Hopkinson v Rolt* and allows a mortgagee to be comfortable in advancing future amounts.
        - **Note**: there are commercial limitations to this work-around. Ideally a mortgagee would include a very large number in the mortgage so as to be sure of his priority. However, mortgagors will find it difficult to obtain a subsequent mortgage if there is a large limit. Accordingly, mortgagors do not allow mortgagees to stipulate extremely large priority limits and a sensible number is normally included (typically 1.5x the amount initially advanced).
- Enter into a deed of priority:
    - A deed of a priority is a deed between the mortgagees agreeing priority limits. For example the document might agree that the first mortgagee has priority up to $150,000 while the second mortgagee has priority from thereon in. Commonly the mortgagor is a party to the agreement. All mortgagees must agree to the document, otherwise the rules in *Hopkinson v Rolt* and *Clayton's Case* will govern the situation with the mortgagee that is not a party to the deed, defeating the purpose of the deed.
        - **Note**: if a third mortgagee entered the mix the first mortgagee could decide to either stop advancing money or could try and get the third mortgagee to agree to the deed of priority.
        - **Note**: deeds of priority are not always registered online however sometimes memorandums of priority are registered to effect a change in priority.
    - **Note**: difficulties with deeds of priority were highlighted in *BNZ v DFC.* It may be worth including a Pudding Hill clause in the deed to ensure that the first mortgagee discharges its mortgage once its priority interest has been paid out, avoiding unexpected consequences under s 105 LTA 1952.

PPSA

Under PPSA a security agreement may provide for future advances (s 71). Further, the security holder's priority will rank the same for all advances, including future advances (s 72).

Difference between PPSA and non-PPSA future advances

Under the PPSA the party with priority has automatic priority to all future advances. However, outside the PPSA the party who has priority will only have priority over future advances if they are not aware of subsequent mortgages or they take steps to displace that priority.

Bank of New Zealand v Development Finance Corporation (CA)

Facts

Yates owned Pudding Hill. He organised an advances facility from BNZ (1st mortgage). He then borrowed from DFC (2nd mortgage) and subsequently from a family trust (3rd mortgage) . BNZ entered into a deed of priority with DFC to regulate the priority of future advances under its facility. BNZ's mortgage would take priority over DFC's up to $170,000 plus interest.

Yates went insolvent. At this point BNZ had leant $360,000 to Yates, well exceeding its priority interest. DFC enforced its mortgage and sold the property to itself. DFC paid BNZ $200,000, the amount that it was entitled to under the priority agreement, expecting that BNZ would then discharge its mortgage. However, BNZ claimed that its full mortgage ranked in priority to DFC's and so under s 105 continued despite the sale and that for it to discharge it the full amount of its lending must be paid.

The bank paid the third mortgagee. This is because the third mortgagee was not a party to the deed of priority and therefore the *Hopkinson v Rolt* and *Clayton's Case* rules still applied to the third mortgagee.

Court of Appeal

The court held BNZ's mortgage was not split. Accordingly its entire mortgage ranked prior to DFC's and subsisted even after the land was sold.

This is because:

- When a mortgagee exercises a power of sale over land, the land shall be transferred to the purchaser free the mortgagee's mortgage and all other mortgages except those that rank in priority to the vendor mortgagee's mortgage (s 105).
- The deed of priority did not split BNZ's mortgage into two parts. As a result, the purchaser of the land takes it encumbered by BNZ's full mortgage.

Note: this is completely wrong. It is clear from the deed of priority that BNZ's mortgage was intended to be split into two parts – one ranking prior and one ranking subsequent to DFC's mortgage.

This case caused parties to include Pudding Hill clauses which force the first mortgagee to discharge its mortgage if the amount to which it has priority is paid out.

Clayton's Case (Devaynes v Noble)

Facts

Clayton was a customer of a banking partnership. When one of the partners died, the amount due to Clayton was $1,717. The surviving partners paid Clayton this amount and Clayton continued to deposit and withdraw money. The firm subsequently went bankrupt. Clayton claims for some money from the estate of the dead partner.

Decision

In a situation where the sums paid in form one blended fund, the first sum paid in is the first one drawn out. The first item on the debit side of the account is discharged or reduced by the first item on the credit side. This is because:

- It would be absurd if when a man's banker broke owing him $1000 the man could say "I have drawn out all that I paid in during the last four years but there is $1000 that I paid in five years ago that I have never drawn out.

Where the sums paid in form one blended fund, the first sum paid in is the first one drawn out. The first item on the debit side of the account is discharged or reduced by the first item on the credit side.

Hopkinson v Rolt (HL)

Facts:

- 1: M granted A a mortgage over his land;
- 2: A advanced money;
- 3: M granted R a mortgage over his land to secure advances given by R;
- 4: R gave A notice of its mortgage;
- 5: A continued to advance M money;
- 6: M went bankrupt.

A claims priority over R.

Decision

The court held a first mortgagee, whose mortgage covers future advances, loses priority in respect of such advances if they are advanced after a second mortgage is granted and after the first mortgagee had notice of the second mortgage.
This is because:

- There is no binding authority:
  - *Gordon v Graham* was misreported. In that case priority was given to the first mortgagee for all advances but *only* because it he did not have notice of the second mortgage. Accordingly, it does not stand for the proposition that a first mortgagee with notice still retains priority on future advances.
  - The misreported rule in *G v G* is not widely adopted and acted upon. It should be overruled.
- A first mortgagee should not have priority to advances made after notice of a second mortgage as he is under no obligation to make such advances. Further, his past advances are still secure.
- Commercial necessity requires this principle.

Law (basic common law rule)

A first mortgagee, whose mortgage covers future advances, loses priority in respect of such advances if they are advanced after a second mortgage is granted and after the first mortgagee had notice of the second mortgage.

4. Unsecured Lending and Subordination

The only recourse that an unsecured lender has against a borrower in default is a suit for breach of contract. This claim is in personam, not in rem, as contracts can only bind the parties.

Where a debtor has more than one unsecured creditor and the amount owed to the unsecured creditors is greater than the amount that the debtor has, the assets of the debtor will be pooled up and distributed on a pari passu basis (s 313 CA).

If one of the unsecured lenders agrees to be subordinated the rule in s 313(3) will kick in and the unsecured subordinated lender will only be paid after the other unsecured lender is paid out in full. This is effective as per *Stotter v Ararimu Holdings Ltd* which departed from the UK position.

Commercial constraints around unsecured lending

An unsecured lender doesn't have security that it can enforce if things go badly. To compensate for this lack of control it will impose business constraints on the borrower including measurements which must be met. Typically, there are covenants around certain business ratios. The common ratio is debt-equity ratio: the unsecured borrowings of the company can't exceed x% of the shareholders' funds in the company. This is to try to maximize the likelihood that an unsecured creditor will get its lending back.

A bank can boost its equity by issuing subordinated debt as this doesn't need to be paid before general unsecured debt. As a result, it insulates the lender's money.

Company ranking

1. Statutory charges;
2. Mortgages and security interest over things other than inventory or accounts receivable;
    - For example, security over land, equipment, or consumer goods.
3. Preferential claims; unpaid holiday pay, wages/salaries up to a maximum per employee) (sch 7 CA);
    - A policy decision was taken to rank these above security interests over inventory and accounts receivable.
4. Security interests over inventory and accounts receivable;
5. General unsubordinated unsecured debts (s 313 CA);
    - These are contractual rights to receive payment.
    - At this point the unsubordinated unsecured debts are pooled up and distributed to unsecured creditors on a pari passu basis (all unsecured creditors share equally in the pool).
6. Subordinated unsecured debts (potentially multiple levels) (s 313(3))
    - A creditor can agree to receive a subordinated claim to a debt (s 313(3)). A creditor may do this so it can charge higher interest rates. Subscribing as an unsecured subordinated lender to a stable business (Fonterra, spark) does not carry much risk so the higher interest rates would be worth it. However sometimes this can backfire (see *Solid Energy*).
    - Subordinated debt is issued to bolster a balance sheet as it is quasi-equity.
    - 313(3) says you can be as creative as you like in structuring subordination and the agreement will be effective in liquidation i.e. there can be infinite levels of subordination.
        - In contrast, the House of Lords doesn't recognise subordinated debt as it believes the pari passu rule is sacrosanct
7. *Twilight Zone*;
8. Redeemable preference shares.

Structured Subordination

This is the concept that a lender to a company will not have access to the assets of the company's subsidiary until after all of the subsidiary's creditors have been paid and the remaining assets have been distributed up to the company as an equity holder. This is because debt (to creditors of subsidiaries) is paid prior to equity (to parent company and their creditors)

This can be remedied through these two measures (note these can be combined in one document but are conceptually separate):

1. Guarantee

This is a debt obligation which creates a direct debt link between the parent company's creditors and the subsidiary. This will mean that the parent company's creditors will rank equally to the subsidiary company's creditors.

2. Security

The guarantee will be matched with a GSA extending over the assets of the principal and subsidiary as well. This will secure the debt obligation created by the guarantee.

Once this is done, normal ranking rules apply. A secured creditor of the parent company would have priority over an unsecured creditor of the subsidiary: see p 16 – 20.