DUNCAN A WEBB

THE SCOPE AND INTENT OF THE DRAFT PERSONAL PROPERTY SECURITIES ACT: BORDERLINE TRANSACTIONS

LLM RESEARCH PAPER

SALES AND FINANCING (LAWS 527)

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Abstract

This paper is an examination of the probable scope that the proposed Personal Property Securities Act would have in New Zealand. The writer examines an number of transactions and types of collateral that are less commonly used in financing arrangements and reaches conclusions as to whether or not such transactions would come within the scope of the draft Act if passed in its present form. Some comment is also made as to whether certain transactions ought to come within the scope of the draft Act and whether amendments ought to be made.

The conclusion reached is that amendments to the draft Act will be necessary in some areas to enable the courts to include or exclude certain transactions in accordance with the intent of the Act. However equally important will be the approach which the judiciary take to the reforms when passed into law. It is clear that a generous and purposive interpretation will be needed to ensure that the a technical and formalistic distinctions which plague our current law do not infect any reforms.

Word length

The text of this paper (excluding contents page, footnotes, bibliography and annexures) comprises approximately 19 200 words.

I INTRODUCTION

The current law relating to the creation, priority and enforcement of security interests in personal property is based on common law and statutes which have their origins in the formalistic era of the Victorian age and before. Different rules have evolved for different transactions dependant on the nature of the parties, the subject matter, and the form of the arrangement. This prompted one commentator to say in respect of the United Kingdom system upon which our's is modelled:[1]

> There should be a new law on security interests to replace the multitude of different rules we now have. This would simplify the law enormously and speed up business transactions, and would ensure that like transactions are treated alike. There is a well-tried model in Canada and the United States on which the new law should be based.

This view was endorsed by the New Zealand Law Commission in its *Report No 8: A Personal Property Securities Act for New Zealand.*[2] In that report the Commission recommended the adoption of a system of personal property security regulation based on Article 9 of the Uniform Commercial Code which is in force in most of the United States and has been adopted in varying forms by most of the Canadian provinces. A draft Act was included in the report.

Under the current law innocent purchasers and security holders will commonly be disappointed due to the prior claim of some undisclosed and undiscoverable interest. Such prior interests commonly take the form of title based arrangements such as retention of title clauses or true hire purchase agreements. The intent of the proposed Personal Property

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[1]A L Diamond, *A Review of Security Interests in Personal Property* (1989, Department of Trade and Industry (UK)).

[2]Law Commission, Wellington, 1989.

Securities Act (PPSA) is to ensure that a consumer or financier can act with the assurance that the assets in one person's possession will have no encumbrances over them other than those shown on a central register.

The PPSA seeks to provide a comprehensive code in respect of all types of personal property security arrangements. In doing so it spreads its net wide in order to bring all such transactions within its scope. In general the parameters of the proposed Act are limited by three factors. Firstly the property which is the subject of the transaction must fall within one of the categories in clause 4(1)(a) to (g) which attempt to classify all types of personal property. Secondly the transaction must be intended to secure the performance or payment of some obligation. Thirdly the transaction must be effected by the creditor holding an *interest* in personal property (regardless whether it be title or some lesser interest). The manner in which these boundaries of the Act are interpreted by the courts will have a significant impact on the effectiveness of such reforms in achieving their intended ends.

The question of whether a transaction falls within the scope of the PPSA will have substantial ramifications for all parties concerned. A security interest perfected in accordance with the Act will be granted priority over any other later perfected or unperfected interests over the same property. Furthermore any security arrangement will be unenforceable against third parties unless certain minimum criteria are satisfied.[3] In other jurisdictions where Article 9 type legislation has been implemented any unperfected

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[3]Clause 8.

security interests are unenforceable against a liquidator of the debtor.[4] Similar provisions exist under our current legislation.[5] The draft Act does not, at present, have such a provision although it is likely that one will be inserted before the Act is passed into law.[6] Accordingly whether an arrangement falls within the scope of the legislation will have an important impact on whether or not a creditor gets preferential treatment on the liquidation of the debtor. A further departure in the draft Act from its origins is the absence of provisions dealing with remedies on the debtors default.

Whether or not a particular transaction needs to be registered under the draft Act for full protection of the creditor may have a significant impact on the utility of certain transactions in the marketplace. In some cases to have to disclose financial information on a public register may be so repugnant to the parties that the likelihood of such a device being used (or at least registered) is greatly reduced.[7] In some cases the current attraction of certain transactions is the fact that they need not be registered. Conversely there will exist other situations which would not provide the creditor with the certainty that the collateral held was valuable as security and may reduce the likelihood of such arrangements being reached.[8]

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[4]Uniform Commercial Code Article 9-301 (1)(b)(3), also s 20 Personal Property Securities Act 1989 (British Columbia).

[5]Section 103 Companies Act 1955, section 18 Chattels Transfer Act 1924.

[6]Dugan "Subordination Agreements, Deposit Account Financing, and Loan Participation under the Draft Personal Property Securities Act" in Prebble (ed) *Dimensions in Business Finance Law* (Butterworths, Wellington 1992).

[7]This may be the case in respect of participation agreements. See above part IV E.

[8]This is likely to be the case in respect of security over licences and quotas. See above part VI.

This paper examines a number of transactions and attempts to identify firstly whether they fall within the scope of the draft PPSA and the implications of this, and secondly whether from a policy viewpoint they ought to be brought within, or excluded from the scope of the Act. A number of important questions are not touched on in this paper. The relationship between interests arising from contracts of sale and security interests is not examined.[9] Neither is the nexus between a lease, a finance lease and a security arrangement examined.[10] Similarly transactions which fall in the grey area between consensual and non consensual security interests have not been discussed.

II THE PHILOSOPHY ARTICLE 9

The proposed reforms involve a fundamental shift in the philosophy behind personal property securities regulation. The current law is based on concepts of title, the nature of interests held and the identity of the parties. The result is that personal property security problems are addressed under the current law by establishing the legal and conceptual form of the arrangements entered into. This formalistic view is rejected under the North American model in favour of a substantive or realist approach which deals with arrangements according to their nature and effect as between the parties. The new regime seeks to replace the sometimes fine distinctions of ownership and possession, legal and

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[9]The draft Act seeks to many such problems by providing that all commercial consignments, hire purchase agreements and retention of title arrangements will be subject to the provisions of the Act. However it is likely uncertainties will exist in respect of vendor's liens, implied terms on sale and other areas.

[10]The draft Act seeks to circumvent the difficulties experienced in other jurisdictions which distinguish leases and leases intended as security by including all leases for a term of more than a year within the scope of the Act: cl 4(4)(b).

equitable interests, title and interests and so on. In their place will be an approach which looks to the substance and result of a transaction and treats it accordingly. Similarly the PPSA recognises interests in kinds of property which did not exist or were not recognised when our existing rules were developed. Such property includes chattel paper, negotiable instruments, intellectual property and intangible property generally.

Because the current law looks to the form of a transaction and the legal incidents flowing from that form the generic label of "security" is of little use under the current system. Once it is established that the agreement is a mortgage or charge one need go no further to discover the results of the arrangement. The PPSA takes a view which is arguably more akin to the civilian approach to the law in so far as it requires one to look first to the effects of the transaction and to then categorise it as a security transaction if appropriate.[11] This realist, transaction based approach was first imported into the common law securities area in the drafting of Article 9 of the Uniform Commercial Code by Karl Llewellyn and others.[12] In the interpretation of the PPSA it has been necessary to recognise it as reform legislation and abandon the traditional conceptions of categorised security arrangements.

This is not to say that the approach adopted by Article 9 is wholly a break with the past. Rather it was viewed by its drafters as part of an ongoing process of refinement.[13] Before the Code the law of personal property securities in the United States was spread

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[11]D E Allan "Security: Some Mysteries, Myths, & Monstrosities" (1989) 15 Mon ULR 337.

[12]S.Herman "Llewellyn the Civilian: Speculations on the Contribution Continental Experience to the Uniform Commercial Code" (1982) 56 Tul LR 1125.

[13]G Gilmore *Security Interests in Personal Property* 290 (Little Brown and Co, Boston, 1965).

inconsistently amongst several statutes which categorised transactions according to their form, the nature of the collateral and the parties to the arrangement, much as is the case in New Zealand law today. In attempting to rationalise this situation the drafters saw a common thread in all of these transactions which had previously been considered wholly dissimilar. The Code therefore set out to provide a uniform framework within which such transactions could exist and develop independently of the previous artificial distinctions. This was not considered necessarily a novel approach as much as a natural and necessary progression. Gilmore, who assisted in the drafting put it thus:[14]

> In a sense the unified structure of personal property security law had already been built: all that remained was to knock down the scaffolding which had been a temporary necessity during construction.

Thus Article 9 was not so much a creation of new rules as an attempt to remove old distinctions to enable the law to reflect what was already a commercial reality.

Although the Article 9 approach undeniably does away with a myriad of rules it does not attempt to abolish any particular method of security. Thus parties may still enter into mortgages, hire purchase arrangements, or assignments by way of security. However the significance of the distinctions is greatly reduced. Many security devices arose in order to avoid the constrictions of available methods of secured financing. Clear examples of this can be seen in hire purchase arrangements and retention of title agreements. Under the Article 9 approach it is futile to attempt to create some new form of security arrangement to avoid the requirements of registration. The Code approaches such a question in terms of the effect of the transaction rather than the guise which has been constructed for it.

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[14]Above n 13, 289.

This is not to say that the previous law is irrelevant. Rather the provisions of the new law will be interpreted in accordance with existing conceptions. Whether something functions as security is a question which is not answered by the legislation but rather by reference to the historical understanding in the law of what security is. Thus it could be said:[15]

> What is important to remember is that the Article 9 security interest floats, unmoored in a void. Whether any particular transaction creates "an interest ... which secures ... an obligation" is a question for judicial determination.

Similarly it is impossible to erase the legal history simply by the passing of an Act like the PPSA. Furthermore the draft Act, in common with Article 9 expressly preserves existing law unless inconsistent.[16] These existing concepts will provide a framework within which to apply the provisions of the Code. However it will also be possible to draw on the considerable jurisprudence from the North American jurisdictions in the implementation of an Article 9 approach.

III THE CONCEPT OF A SECURITY INTEREST

Both at common law and by statute our current system recognises only four types of transaction as being "security transactions".[17] These are categorised as mortgage, charge, lien and pledge. To fall within one of these categories the arrangement must meet certain formal requirements. Goode, in attempting to find a common element, makes the following statement in respect of security arrangements generally:[18]

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[15]Above n 13, 334.

[16]Clause 8.

[17]R Goode *Legal Problems of Credit and Security* (2 ed, Sweet & Maxwell, London, 1988).

[18]Above n 17, 1.

A Security interest:

(1) arises from a transaction intended as security;

(2) is a right *in rem*;

(3) is created by a grant of declaration of trust, not by reservation;

(4) is fixed or specific, implies a restriction on the debtors domination over the asset;

(5) cannot be taken by the creditor over his own obligation to the debtor.

Such a statement is arrived at by examining the currently accepted forms of security and distilling common factors from them. The PPSA takes a fundamentally different approach.

The functional approach first poses the question "what is security for?". One widely accepted answer to that question is to provide preference over unsecured creditors in the case of insolvency, and to provide a right of pursuit against particular property in the event of default by the debtor.[19] Therefore when examining a transaction under the PPSA scheme the question is firstly whether the parties intended to create those rights of preference and pursuit. Secondly whether the transaction effectively does so. If the answer is yes to both those questions then the scheme of the Act will apply. Clause 4 of the proposed PPSA provides the following general test of whether the features of security are present:

> (1) Subject to subsection (4), for the purposes of this Act "security interest" means an interest in [any personal property] created or provided for by a transaction that in substance secures payment or performance of an obligation, without regard to the form of the transactions and without regard to the identity of the person who has title to the collateral.

That clause then continues to make specific inclusions and exclusions as to what will or will not constitute a security interest and therefore be subject to the legislative scheme.

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[19]D Allan, above n 11.

The PPSA appears to retain one central concept from the traditional approach to security transactions; the creditor must hold a interest in the goods which act as security. That is to say the creditor must have a right *in rem*. However the interest can arise by the creditor retaining, rather than the debtor granting the interest. This is apparent from the rule that it is irrelevant whether the creditor's interest be title to the goods or some lesser interest such as the right to seize the goods and satisfy their claims from the proceeds of the sale of the property.[20] An interest in property is distinct from a right to demand some kind of performance in respect of the property against the owner. An interest in the property is enforceable against third parties.[21] However, if one views security as an arrangement which gives the security holder the right of pursuit against particular property and preference over other creditors,[22] then the need for an interest in property may not always be necessary.

In some circumstances it will be possible to create arrangements which, whilst not conferring a property interest, binds the parties in such a manner as to give the creditor rights to property which will pre-empt those of the unsecured creditors and thereby give priority. Such arrangements create rights which are enforceable only against the debtor, and are therefore *in personam*. Accordingly they will be defeated by any real rights (*in rem* rights) held by others. However they may enable the holder of the contractual right to get paid before other unsecured creditors. Such arrangements may include a promise by a debtor not to enter into any security arrangements, or not to do so without granting the

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[20]Clause 4(1).

[21]R Goode "Security: A Pragmatic Conceptualist's Response" (1989) 15 Mon LR 361.

[22]D Allan above n 11.

creditor security,[23] an agreement to set off reciprocal obligations[24] or, in some instances, an agreement to subordinate debt.[25]

That such arrangements are not intended to fall within the scope of the PPSA is supported by the Law Commission report[26] which states:

> Other security arrangements such as subordination agreements and negative pledge contracts will not normally fall within the general part of the definition unless, due to the terms of the transaction and the surrounding circumstances, they create an interest in personal property that secures the payment or performance of an obligation.[27]

That stance was also adopted by the Australian Law Reform Commission in their recent report on a proposed PPSA and was justified in the following manner:[28]

> Parties can make contractual arrangements under which one of them can have [a right to take, or keep possession of, or otherwise deal with, the property on default] without creating an interest in the property. The Commission considered whether to apply the regime to cover such rights. It would not be appropriate to do so. The overseas proposals do not: they are limited to rights that are founded in an interest in property. Rights not founded in an interest in property are effective, in general law, only as between the parties to the contract that created the rights.[29]

It is submitted that the Australian Commission is incorrect when it asserts that rights not

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[23]See above part IV C.

[24]See above part IV A.

[25]In particular this will be the case where both the subordinated creditor and the debtor are insolvent. See part IV B above.

[26]New Zealand Law Commission *A Personal Property Securities Act for New Zealand: Report No 8* (law Commission, Wellington 1989).

[27]Above n 26, 102.

[28]Australian Law Reform Commission *Personal Property Securities: Report No 64* (Australian Law Reform Commission, Sydney, 1993).

[29]Above n 28, 44.

conferring an interest in property are effective only against the parties. As noted there will be instances where such rights will be effective against third parties insofar as they will give one party rights to property ahead of the general body of creditors.

The manner in which one interprets the requirement of an "interest" under the PPSA is important to this question. In legal parlance, and particularly in respect of securities matters, interest is taken to mean a real right in certain property. This is the interpretation which is presumed by the drafters of the proposed Act. However it should be noted that a more generous interpretation is possible. The meaning of "to have an interest in property" could be construed to mean "will be effected by", or "have some control over the manner in which the property is dealt with". Under such an interpretation mere personal rights to insist that the debtor deal with certain property in a particular way could be thought of as a security interest. Whether the traditional restrictive stance ought to be taken, or the more generous one is largely a matter of policy. The way in which such questions are decided will determine the how comprehensive the PPSA is when enacted. From the statements in the Law Commission's reports it appears likely that the antipodean courts will follow their North American counterparts and adopt a traditional approach which requires a right in property to establish a security interest.

III ARRANGEMENTS NOT CONFERRING AN INTEREST IN PROPERTY

A Set Off Between Lender and a Depositor/Borrower

The ability of parties with reciprocal debts to set off those debts is a well established common law right. Such rights can exist outside of contractual arrangements and exist as a matter of course when certain criteria are satisfied.[30] However as well as set off by operation of law parties may agree that certain obligations will be unenforceable in the absence of performance of their own obligations. The usual relationship between depositor and banker is one of creditor and debtor. Although the depositor may notionally deposit into a certain account, in actual fact the bank keeps all general deposits in an undifferentiated manner and deals with those funds in the course of its business. As such the obligation of the bank to repay the deposit is simply that of a debtor to repay in accordance with the original banker-customer contract. The deposit therefore is an ordinary debt and may be dealt with as such by the depositor. One of the things that the depositor may wish to do with the debt is to assign it, either absolutely or by way of security. Consider the following facts:

> A deposits $100 000 with Bank for a fixed term of three years. Shortly thereafter A seeks to obtain finance from Financier. As security for the advance A assigns the right to payment from bank on maturity to Financier on the basis that it will be reassigned once the loan and interest is repaid in full (ie an assignment by way of security).

In such a case the secured party's interest in the deposit would fall under the scope of the PPSA in one of several possible categories. If the right to payment of the depositor/creditor is viewed as being transferred by such a transaction then it would fall squarely within clause 4(4)(a) as the transfer of an account receivable. If the right to receive payment was transferred in a documentary form (such as a deposit certificate) then it would fall under clause 4(1)(e) as a security interest in a negotiable instrument. It would therefore seem sensible that, if the depositor assigns the deposit to the same bank which holds the deposit by way of security for an advance or other facility, that the interest of the

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[30]Those criteria are that the debts exist between the same parties in the same capacity, the debt is mature, and the debt is a liquidated amount.

bank should also fall within the scope of the PPSA because the only difference is that in such a case both lender and depositee are the same person. However the point is by no means clear.

The situation is problematic for several reasons. In some instances the right of set off exercised by the bank will not be created or intended by the parties. This would be the case where a customer is insolvent and the bank seeks to set off a credit balance against an overdraft. Although such a set off does effectively give the bank an exclusive right of recourse to a particular fund it does not arise consensually and therefore probably falls outside of the Act. However where the right of set off is contained in a more formal arrangement the case for regulation becomes stronger as there is a clear intent that the bank gain priority over other creditors and recourse to that particular fund for payment in the event of default.

To bring such arrangements within the scope of the Act is however difficult. A right to a set of, even if viewed as a security interest, poses problems in respect of registration and perfection under the Article 9 regime. A major difficulty is the fact that the collateral (ie the deposit) is in the possession of the secured party. Accordingly pursuant to clause 18(1) the security is perfected by possession and the interest need not be registered. Such a situation is unsatisfactory as it is not apparent to third parties that the bank holds the funds as security in its capacity of creditor, rather than as debtor in its capacity of banker.

If deposit accounts were expressly included in the Act special provision would also need to be made for the description of the collateral and perfection of the interest. Existing general provisions as to description would not be adequate.[31] Identification by reference to institution, account number and sum held would be necessary. Particular problems would arise in respect of accounts with changing balances, especially where the balance fluctuated below the amount of the secured debt. Accordingly set off transactions which are intended as security ought to be expressly brought with in the ambit of the Act, however in so doing amendment will be necessary to ensure that such arrangements are dealt with in a manner consistent with the scheme and philosophy of the Act.

Whether such a transaction falls within the scope of the draft Act in its current form is not clear. The difficulty that such an arrangement gives rise to is the fact that the bank, in receiving a transfer by way of assignment of the deposit to secure an advance, is receiving a transfer of its own indebtedness. If this is followed through to its logical conclusion, in the event that the depositor did not repay the loan the bank could then proceed against itself to enforce its security. The absurdity of such a situation has led commentators to say that such an arrangement does not give rise to any security interest in favour of the bank but rather a right of set off whereby the obligation to repay the deposit is dependant on the depositor fulfilling other obligations.[32] This approach has been adopted by the English Courts. In *Re Charge Card Services*[33] a credit card company financed its operations by assigning its accounts receivable to a finance company. The finance contract provided that the financier could retain such amounts obtained by the realisation of the receivables as it deemed fit as security for the outstanding obligations of the charge card company. That

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[31]Clause 9(1)(b).

[32]Above n 17, 10.

[33][1986] 3 All ER 289.

is to say that the financier took "security" by entering into an agreement whereby it was not obliged to repay its indebtedness until the charge card company had discharged its obligations. It was argued that this amounted to a security arrangement which was void for non registration under the company securities legislation.[34] However the Court held that the arrangement was not a charge when it said:

> The sum due from Commercial Credit to the company under the agreement is, of course, a book debt of the company which the company can charge to a third party. In my judgement, however, it cannot be charged in favour of Commercial Credit itself, for the simple reason that reason that a charge in favour of a debtor of his own indebtedness to the chargor is conceptually impossible.

By such an analysis a contractual arrangement such as that in *Re Charge Card Services Ltd* must be viewed either as a right to set off reciprocal obligations, or an agreement that the amount of indebtedness is to be determined by taking an account of the indebtedness of the parties to the transaction to each other.

By this approach the right to a set off is not a security interest. It is not even an enforceable right. Rather it is simply a defence which may be raised to any claim for payment of the indebtedness before the creditors own obligation is discharged. This is a strictly procedural approach and does not sit well with the manner in which the parties to the transaction view the situation or the practical effect of the arrangement. It has been cogently argued that the assignment of a debt to the debtor by way of security ought to be viewed as a security arrangement as there was no intention to merge the indebtedness and the amount secured.[35]

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[34]Section 95(1) Companies Act 1948 (UK).

[35]Above n 11.

The approach in *Re Charge Card Services* is based in a formalistic mode of thinking which the PPSA is actively trying to avoid. The UCC makes specific provision for such arrangements. Article 9-105(1) provides that that Article (which equates with the provisions of the PPSA) does not apply to "a transfer of an interest in any deposit account". The effect of this provision is to exempt the right of set off from any registration requirements. However a bank's right of set off is subject to the article 9 provisions in respect of a secured party's right to proceeds[36] and priorities to proceeds.[37] Thus under the US system it is recognised that the ability of a bank to set off the indebtedness of a depositor against funds held has the effect of creating the rights of preference over other creditors and pursuit against particular property which make it tantamount to a security interest. However as a matter of policy the United States legislators have given such arrangements priority over other perfected security interests without registration unless it can be shown that the funds in the account are the proceeds of collateral over which a perfected security interest existed and the rules of tracing allow the creditor to follow the proceeds into that fund. Thus in *Citizens National Bank* v *Mid States Development Co*[38] a secured party was seeking to trace the proceeds of the realisation of collateral (inventory and accounts) into the bank account held with the appellant bank. The security interest was a clearly perfected pursuant to Article 9. The Court saw this as a matter in which the priority rules contained in Article 9 were applicable. Therefore because the proceeds could be traced into the bank account, the interest of the secured party existed in respect of those funds and prevailed over the right of set off of the bank.

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[36]Article 9-306.

[37]Article 9-312.

[38](1978) 380 NE 2d 1243 (Ind Ct App).

It should be noted that the approach found in *Citizens National Bank* v *Mid States Development Co* is applicable only for set offs in respect of deposit accounts because of the relationship between Articles 4 and 9 of the UCC.[39] The position where such provisions do not apply is similar to that in *Re Charge Card Services*[40] insofar as the common law rules on set off will determine whether or not the set off will be able to be maintained against a party who alleges a security over the funds held. In *Indian Head Credit Union* v *Andrew*[41] the credit union held a security interest in respect of a herd of cattle which had been disposed of and the proceeds deposited with the bank. The bank, was on notice that the debtor was expecting funds for the cattle and that the credit union had an interest in those proceeds. However knowing this they advanced a sum equal to the proceeds to the debtor on the security of the deposit. When the credit union attempted to recover the proceeds from the bank the bank purported to set of the proceeds against the indebtedness of the debtor and thereby extinguish the obligations. It was held by the Saskatchewan Court of Appeal that the fact that the bank knew of the interest of the credit union in the proceeds meant that by applying common law rules the bank was denied the right of set off.

Interestingly California, in its adoption of the Uniform Commercial Code, deviated from the official text, presumably in an effort to address the problem. The official text reads[42]

> This Article does not apply:...

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[39]Which deal with banker customer relations and personal property securities respectively.

[40]Above n 33.

[41](1992) 97 DLR (4th) 462 (Saskatchewan CA).

[42]Article 9-104.

(i) To any right of set off; or to a security interest of a bank, savings and loan association, or any like organisation in any deposit, savings, passbook or like account maintained with such organisation;

In contrast the corresponding provision of the California Code simply provides that "This [Article] does not apply;...(i) To any right of set off.[43] The absence of the further exclusions in the California Code indicates that in that jurisdiction where a lending institution takes security over funds deposited with it the arrangement will be viewed as a secured transaction and subject to the Code accordingly. Such an approach accords with the understanding and intent of the parties to the transaction and should be adopted in New Zealand. The utility of the California provision is however somewhat undermined, at least from the perspective of third parties, insofar as under the Code the security is perfected on execution.[44] Consequently the only impact of the Code is on the remedies of the parties in case of default of which there are no corresponding provisions in the draft Act. It is submitted that in the New Zealand Act provision needs to be made for the registration of such arrangements for perfection notwithstanding possession of the collateral by the secured party.

It is submitted that where a set off over the debtors own obligations arises from an consensual arrangement between the parties the provisions of the PPSA ought to apply. Whilst it is arguable that such a set off falls within the clause 4 definition of security interest the authorities clearly weigh against this. Despite the view expressed in the cases discussed above such an arrangement is clearly intended by the parties to act as a security

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[43]Article 9-104.

[44]Article 9-302(1)(g)(i).

arrangement whereby the creditor will have recourse to a particular fund in the event of default by the debtor. Furthermore, in the event that the set off is upheld in the case of a dispute, it clearly has the effect of depriving other creditors of the benefit of those funds in the event of the insolvency of the debtor and thus has all of the effects of a security arrangement. In particular, whilst the existence of a right of set off in such an arrangement is known and intended between the parties to the arrangement, it is hidden from third parties who may deal with the debtor. Accordingly registration is appropriate. The existence of a discrete set of common law rules in respect of the determination of the right of set off as against parties who allege a security interest in the fund is to be avoided. To enable this substantial amendment of the draft Act is needed to accommodate such transactions in a manner consistent with the scheme and intent of the reforms.

B Subordination Agreements

It has long been recognised that it is open to creditors to enter into arrangements altering the order in which their respective debts will be paid. Thus if A holds a first ranking debenture and B a second ranking debenture they may agree between themselves to reverse the order of priorities.[45] Similarly if A and B are both unsecured creditors (and therefore ranking equally) one party may agree to postpone their rights of payment to those of the other debtor.[46] Subordination agreements as a method of increasing the likelihood of repayment appear to have their origins in the United States.[47]

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[45]The ability to subordinate securities is confirmed in clause 33 of the draft Act.

[46]*Equitycorp Finance Group Ltd v Cheah* [1991] 1 NZLR 299 (CA).

[47]P Coogan, H Kripke, F Weiss "The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements" (1965) 79 Harv LR 229.

One common situation is when the subordinating creditor has an interest in the company such as that of a major shareholder, and subordinates existing debt to enable funding from other sources. Such arrangements may exist from the inception of the business and the debt of the subordinated creditor will often be accounted for as part of the equity of the undertaking.[48] A second kind of arrangement where debt subordination is likely to occur is where an enterprise is in financial difficulty and the existing creditor(s) subordinates to increase the chances of recovering what might be a doubtful debt by enabling further finance or inventory to be obtained. A third situation where such a device is employed is where a company seeks to obtain debt capital by issuing subordinated debt securities. Such securities may be held by numerous investor/creditors who, in return for higher yields, agree to subordinate their debt to the general body of creditors.[49] The inclusion of some other frequently used (and currently unregulated) security devices within the scope of the PPSA may result in subordination agreements becoming a more popular means of security in New Zealand.

A further and important aspect of subordination agreements is the identity of the parties between whom they are reached. In some cases the agreement will be directly between the subordinated and preferred creditors as, would probably be the case where a creditor/shareholder was seeking finance for a company. Alternately the agreement might

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[48]D Chisholm "The Pari Passu Rule" (1993) 72 Accountants Journal vol 9, 49.

[49] A recent example of this can be found in the Brierly Investments Limited public offer of capital notes contained in its prospectus in 1993 (Brierly Investments Limited, Wellington, 1993). The terms of which provided inter alia:

> 2.3 The obligations of either or both of the Company of the Guarantor to the noteholder ...
>
> (a) rank in point of priority and right of payment behind, and are subordinated to, all senior debt [defined as all debt not expressly subordinated] of the Company and the Guarantor as the case may be.

be directly between the debtor and the subordinated creditor as in the case of publicly issued subordinated debt securities. Thirdly the agreement may be tripartite including debtor and creditors as might be the case where an existing creditor is willing to subordinate its debt to enable further finance which may facilitate a financial recovery of the debtor. In respect of subordination concerning unsecured debt the transaction is simply an agreement that the subordinated creditor has no right to payment until the debt owed to the other (senior or preferred) creditor has been discharged. If, in breach of this arrangement, the subordinated creditor receives payment, the preferred creditor would have an action against the subordinated creditor for breach of the contract. The question arises as to whether such arrangements create security interests which are, or ought to come within the scope of the PPSA.

At first blush a subordination agreement seems quite innocuous, creating only personal rights between the parties to the arrangement. In the event that the debtor trades successfully it is established law that the subordination agreement will be binding on the parties to it.[50] To date the courts have been reluctant to uphold such arrangements in the event of liquidations on the basis that they upset the *pari passu* rule and are therefore

[50] *Re Ararimu Holdings Ltd* (1989) 4 NZCLC 65,104 where a subordination agreement was enforced where a company was in statutory management.

against public policy.[51] However with the passing of the Companies Act 1993 such arrangements will be upheld.[52] This may well make subordination agreements as a means of securing a debt more attractive to financiers. In so far as such agreements do displace the presumption of equal distribution they have one of the indicia of security agreements, namely preference over other creditors. In this sense it has been suggested that because, on the liquidation of the debtor, the senior creditor effectively gets a prior claim to in the insolvent's estate such agreements ought to be brought within the scope of the PPSA. This argument becomes even more forceful if one views the subordination of debt as a transfer of the subordinated creditors right to payment (or right to a dividend in the case of insolvency) to the preferred creditor, conditional on the preferred creditor not being paid in full. In effect the preferred creditor is receiving the right to seek a dividend from the estate of the insolvent debtor both for its own debt and for the debt of the subordinated creditor until it is satisfied in full. This looks very similar to an assignment of an account receivable by way of security. Such an arrangement is clearly intended to give one creditor priority over another and in a limited fashion to enable the preferred creditor to realise its claim from the assets of the insolvent debtor to the exclusion of others.

The case for regulation of such agreements is even stronger where both debtor and

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[51]It is not intended to go into the issue of whether such agreements are or ought to be enforced under the current law. Suffice to say that authorities are divided on the point: *AG* v *Mc Millan & Lockwood Ltd* [1991] 1 NZLR 51 (CA) where an arrangement by the crown to subordinate the debt of head contractors in favour of sub contractors was set aside. Compare *Re Walker Construction Ltd (in liquidation) [1960] NZLR 523* where such an agreement was enforced where a company being involuntarily wound up. Most recently se *Re Ararimu Partners Ltd* Unreported, 4 June 1993, High Court, Auckland Registry, CL 51/92, Barker J where a subordination agreement was set aside as in breach of s 293 of the Companies Act 1955.

[52]Section 313(3).

subordinated creditor become insolvent. The likelihood of both debtor and subordinated creditor becoming insolvent is especially apparent where the subordinated creditor is closely connected with the company, and therefore may suffer financial disaster from the same event. Consider the following:

> A founds and operates Company. Rather than have a large share capital(and consequent restrictions on dividends and buybacks) Company's capital is comprised of $100 000 of subordinated debt provided by A. A then seeks $50 000 of personal finance and shows the $100 000 account receivable as a personal asset. Bank provides the finance. Subsequently Company becomes insolvent and A quickly follows. The liquidator of A seeks a dividend from the estate of Company but is denied it in favour of the unsubordinated creditors. Bank seeks a dividend from the estate of A.

In such a case the creditors of the (now insolvent) subordinated creditor are deprived of the asset of the debt owed by the (also insolvent) debtor. The benefit of that asset (which amounts only to a dividend if any) in the insolvent debtor's estate, goes to the preferred creditor under the subordination agreement. Thus it can be argued that by this hidden arrangement the creditors of the subordinated creditor are deprived of what appeared as an asset in that parties records. Moreover the arrangement had the effect of transferring a right to payment as security for an advance to the common debtor.

It may be that to bring such arrangements within the provisions of the Act would be highly impractical. Under such a regime the preferred creditor would have to register the interest in the account receivable of the subordinated creditor. In some cases, such as publicly issued subordinated debt securities, it would not be viable or efficient to require registration. Similarly where the shareholder/director is a subordinated debtor many trade creditors would be unaware of their preferred status. Such registration would only be workable where the subordination agreement was between two creditors such as a shareholder and a financier. If in such a case the interest was registered this would be notice to third parties that the subordinated debtor did not have an unencumbered right to payment of the debt. However from one perspective this gives an inaccurate view of the arrangement. The right of the preferred creditor is simply a right to be paid first and not in fact a transfer of the right to payment of the subordinated creditor. It should also be noted that in its current form the draft Act contains no provision avoiding securities against a liquidator. Unless such a provision is included the question of subordination agreements becomes largely academic as the contentious issues arise only in the event of the liquidation of both debtor and subordinated creditor.

In any event such arrangements do not and ought not fall within the scope of the PPSA. Although they do give one creditor priority, such priority exists only as against the subordinated creditor(s). Any other unsecured creditors will be dealt with on equal terms with the preferred creditor. The PPSA is designed to provide a system to ensure that hidden security interests will not exist. In the large proportion of cases subordination agreements are known to all parties who may be effected by them. Accordingly there is no reason or need to bring such arrangements under the PPSA. The position of other creditors, at least of the debtor company, is unaffected by subordination agreements. Although creditors of the subordinated party may be adversely effected in the case of a double insolvency this is not grounds for requiring registration. The subordinated creditor had not granted or disposed of an interest in property. Rather it has entered into a simple contract which transpired to be disadvantageous. That the subordinated party has entered into a contract which transpired to be disadvantageous and reduced the amount available for distribution does not mean that it is a security arrangement which ought to be regulated. The position is in substance no different from that where an insolvent has executed other contracts which have caused loss. Subordination agreements do not create the rights of preference over general creditors and the right to pursue their claim against particular property. Accordingly there is no need for registration to protect third parties.

A further argument for not including such transactions within the scope of the PPSA can be found by examining the nature of the transactions themselves. As has been noted, on one analysis, the agreements appear to effect an assignment of the debt owed to the subordinated creditor by way of security to the preferred creditor. However this is in fact not the case. The rights conferred by such an arrangement are wholly contractual. Whilst this is not to say that the parties could not arrange the transaction as an assignment and thereby create a security arrangement, this is not the manner in which such agreements are usually construed. Consider:

> Company is in financial difficulty so Financier agrees with Bank to subordinate its debt to that of Bank in consideration of a further advance. Notice of the arrangement is given to Company. company then discharges Financier's subordinated debt without discharging Bank's preferred debt. Financier refuses to disgorge the amount received to Bank.

It is submitted that in this situation the preferred creditor would be limited to an action against the subordinated debtor under the contract. A different result would be reached in the event that the agreement provided for an assignment of the debt. If that were the case the preferred creditor would have an action against the subordinated creditor for money had and received (a proprietary claim) or alternatively could claim against the debtor for payment in accordance with the assignment. Similarly in the event that the contract was between the debtor an the subordinated creditor (as in the case of subordinated debt securities) and the debtor paid the subordinated creditor(s) before or pari passu with the preferred creditors the preferred creditors could not allege a property interest in the amount paid, or seek repayment from the debtor as if it were an assignment.[53]

The inclusion of subordination agreements within the scope of the PPSA would be an artificiality which is disproportionate to the need for such a provision and the impact it would have. In any event such an inclusion would be meaningless in the absence of a clause which avoids unregistered interests against a liquidator. Also the framework of the Act, in respect of registration in particular, is inappropriate for the vast majority of subordination arrangements. Such arrangements are not constructed or intended to confer a security interest within the meaning of clause 4. Accordingly such arrangements ought to fall outside of the scope of the Act.

C Negative Pledges

The Negative pledge, whilst not a common form of lending is used in some, predominantly large, transactions. Such arrangements take the form of an agreement whereby the debtor undertakes to conduct its business in a certain manner. This may include maintaining certain debt to asset ratios, strict financial reporting requirements, and the maintaining of other monitors on a company's performance.[54] Most importantly a negative pledge will

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[53]It should however be noted that in such a case the preferred creditors might have an action in contract under s 4 of the Contracts (Privity) Act 1982. The only issue will be whether the preferred creditors will be able to bring themselves within the terms of "a person designated by name description or reference to a class" which seems likely.

[54]J Farrar *Contemporary Issues in Company Law* (CCH, Auckland, 1987) 126.

include a covenant that the debtor will not encumber its property. More complex clauses may grant a conditional right to other security, or prescribe certain results if security is given in breach of the clause. Negative pledge arrangements are particularly attractive to the debtor as it gives the appearance of creditworthiness and the fact that the assets of the company are unencumbered makes the financial position of the debtor look healthy. The utility of such arrangements for financiers is more questionable. The arrangement can be less complex than alternate security arrangements and there are (apparently) no registration requirements. However the effectiveness of such an arrangement in preventing the debtor from breaching the arrangement or ensuring a dividend *pari passu* or better with all other creditors on insolvency is doubtful.

Although transactions which seek to prohibit a debtor from encumbering its assets are generically called negative pledges there are a number of permutations of the arrangement which, although placed in the same category, differ from each other substantially. Thus it may be that some kinds of negative pledges will come within the scope of the PPSA whilst others will not depending on the wording of the agreement and its effect. The most simple kind of negative pledge is simply a covenant by the debtor not to give security or otherwise encumber its assets to any other creditor. Such an arrangement will be sufficient where the creditor is the sole source of finance, or the debtors and other creditors are insignificant in proportion with the amount financed. Such an arrangement falls outside the scope of current personal property securities regulation and similarly would not be covered by the PPSA. Although the creditor may seek remedies against third parties, and certain rights against the assets of the debtor may exist[55] the agreement does not create any interest in property. In terms of security, the arrangement does not seek to give to the creditor any preference over other creditors, or the right to obtain payment from any particular fund. Rather the arrangement seeks to ensure that all creditors are treated equally. As such the arrangement is not one which creates an interest in property which secures the payment of an obligation within the meaning and intent of clause 4 and therefore will fall outside the scope of the PPSA.

The simple negative pledge clause is not entirely attractive to financiers for the obvious reason that in the event of the debtor granting a security in breach of the clause the financier's remedies will be limited and will likely be subordinated to those of the newly secured creditor. Understandably therefore the creditor will often seek to protect itself by including in the agreement clauses which attempt to prevent or protect against the eventuality of the debtor breaching the agreement. The most often employed method of seeking to ensure that another creditor does not obtain priority over that of the negative pledge lender is to provide for the giving of security to the lender in the event of the breach. The nature of the obligation to grant security on breach will be important.

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[55]Such as the right to appoint a receiver of the debtor company: *Bond Brewing Holdings v National Australia Bank* [1990] ACLC 366 (HCA) where a syndicate of banks lent money to Bond Brewing Holdings which was secured by negative pledge agreements. On default it was held that the Court could appoint a receiver to the company on the application of the Banks. See also J Stone "Will the Court Appoint a Receiver at the Request of a Negative Pledge Lender?" (1991) NZLJ 312. Also the lender may have an action in tort for inducement to breach contract against the other (secured) creditor: *First Wyoming Bank, Casper v Mudge* (1988) 748 P2d 713, J Stone "Negative Pledge Clauses and the Tort of Interference With Contractual Relations" in J Prebble (ed) *Banking and Foreign Exchange Law* (Butterworths, Wellington, 1992).

A distinction can be made between cases where the debtor is under a contractual duty to provide equal or better security, and those where the security comes about because the breach of the negative pledge was a condition precedent to the creation of the security.[56] The distinction may be observed by contrasting clauses which might create such an agreement. The first might be created as follows:

> The debtor covenants not to grant security or encumber its assets in any way in favour of any other creditor unless the debtor grants an equal and rateable security to the creditor over the same assets that have been secured or encumbered to the other creditor.

Such a clause creates only a contractual obligation on the debtor to grant a security in favour of the creditor. The failure to grant the security, like the breach of the agreement is a breach in contract and does not give rise to a security of any kind. Contrast however a clause which provides that a security interest will be created and attach on breach. Such a clause might provide:

> The debtor covenants not to grant security or encumber its assets in any way in favour of any other creditor. Should the debtor breach this clause, or take steps to breach this clause, there shall, immediately prior to the granting of any other security, attach to the assets which the debtor seeks to secure or encumber, a charge in favour of the creditor for the entire amount of the indebtedness of the debtor to the creditor.

Such an arrangement is not dependant on any further acts by the debtor to create the security interest. Provided that the precondition has occurred the negative pledge lender will have a security interest in the property.

Under the first type of arrangement it is clear that the parties intended a security interest to arise in the event of breach. However the agreement alone will not effect this intention.

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[56]J Stone "The "Affirmative" Negative Pledge" (1991) NZLJ 364.

Rather a further act on the part of the debtor (which is unlikely to be forthcoming) is required to grant the security. Accordingly such a clause is not a charge and is not subject to existing personal property securities regulation, nor would it fall within the scope of the PPSA. Whether or not the second type of arrangement would create a security interest is the source of considerable division amongst academics and judiciary. Goode[57] maintains that such an arrangement will be ineffective to create a security. He bases this proposition on the basis that the clause, at its inception, creates only a contractual right. To turn that contractual right into a security, value be given. It is maintained that the prior advance by the negative pledge lender cannot amount to consideration for the grant of a present security. This view is rejected by other writers[58] who maintain that equity will "see done that which ought to be done" and therefore once the condition precedent has occurred (the breach of the clause) the charge will be created. The fact that the later security is not voluntarily provided at the time of the breach by the debtor, but pursuant to an earlier agreement means that the earlier consideration will be sufficient to support the security.

The cases on the point are divided and do not provide a clear analysis of the matter. In support of his view Goode cites *Kelly v Central Hanover Bank and Trust Co.*[59] In that case the debtor company issued debenture notes which contained a negative pledge clause. A party took security with notice of the clause and was sued by the debenture holder who alleged an interest in the assets of the company on a number of different grounds including the existence of an equitable charge. This was rejected by the court who viewed the

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[57]Above n 17, 20.

[58]P Gabriel, *Legal Aspects of Syndicated Loans* (1986), J Stone "The "Affirmative" Negative Pledge" (1991) NZLJ 364.

[59](1935)11 F Supp 497. Later set aside and remitted on the facts: (1936) 85 F 2d 61.

agreement as creating solely contractual rights. The opposite end of the spectrum can be found in *Connecticut Co v New York, New Haven & Hartford Railroad*[60] where the negative pledge debtor created subsidiaries and transferred property subject to the clause to them in return for shares. The subsidiaries then charged the property. This was a common manner of evading negative pledges.[61] The agreement between the parties contained the following clause:

> The [company] further promises that if it shall hereafter mortgage the whole or any part of the property and franchise by it owned except to renew existing mortgages, this debenture and the indebtedness evidenced herby shall participate in the security of such mortgage on equal terms with all other indebtedness or evidence of indebtedness to be secured by such mortgage.

The Superior Court of Connecticut held that this clause created a security interest in the property of the company from the moment of the creation of the contract. In so finding Gager J said "While not an absolute agreement to give a mortgage it is an absolute agreement that if a mortgage is given these debentures shall be brought under the wing of its security".[62]

It is submitted that negative pledges that provide for the automatic attachment of a security interest do create rights in property. The question therefore becomes whether or not such interests are or ought to be within the scope of the PPSA. Such an interest would have the effect of creating both priority over other creditors and a right of pursuit against particular assets. Similarly the parties intend it to have exactly that effect in the event of a breach of the negative pledge covenant. Under the current law such an arrangement (at least if

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[60] 107 Atl Rep 646 (1919).

[61] Above n 13, 1002.

[62] Above n 60, 562.

created by a company as will usually be the case) is not registerable as a charge. The reason for this is that the agreement does not create a charge until the breach and therefore is not registerable until that point.[63] This problem may be duplicated under the PPSA if adopted on its present wording. The negative pledge will not create an interest in property until the precondition (breach) occurs. Similarly the security will not attach until that point. This is due to the provisions of clause 10(1) which provides that the interest will attach to the goods when the parties intend it to attach. Until the moment of breach no security interest has been created or attached and therefore no registerable interest exists. However once attachment occurs an interest in property securing an obligation in terms of clause 4 exists and registration would be appropriate.

Unlike a floating charge the negative pledge does not create a "present security which presently effects all the assets of the company expressed to be included in it".[64] Until such time as the agreement is breached no security exists whatsoever. The PPSA does not expressly provide for the registration of agreements which might at some later date create security interests. However clause 14 provides that a security interest is perfected by attachment and perfection (ie registration or possession) regardless of the order in which these steps occur. This clause seems to imply that a right that has not yet attached can be registered. Whether this applies only to security interests which, whilst created, have not attached (ie floating charges) or to contractual rights which may create security interests is ambiguous.

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[63]Such an arrangement would therefore not fall within s 102(2) of the Companies Act 1955 as a charge on the company's assets.

[64]*Evans v Rival Granite Quarries Ltd* [1910]2 KB 979 per Buckley LJ 999.

If registration cannot occur until a security interest has attached then registration is practically impossible as a creditor will rarely know when and if a negative pledge clause has been breached. However there is no logical bar to the registration of a clause which will, in prescribed circumstances, create a security interest which attaches immediately.[65] Clearly arrangements such as the negative pledge which provide for automatic creation and attachment of a security interest on breach ought to be brought within the scope of the PPSA. It may be appropriate to enlarge the definition of security interest to include arrangements which create an interest subject to the satisfaction of a condition precedent (such as the breach of a negative pledge clause), or to make clear that such arrangements can be effectively registered and will create a perfected security interest once the charge is created and attaches. It should however be noted that to subject such arrangements to the scheme of the Act may well reduce their utility. The attraction of such arrangements is in part their relative informality and the (apparent) lack of a need for registration. If negative pledges needed to be registered and were shown as charges on the debtors property they would, in effect, be little different to floating charges and it is likely that their use would decline.

D Non Recourse Lending

A further transaction which has some of the attributes of a security arrangement and bears consideration is that of non recourse lending. The non recourse lender agrees to seek payment from a particular fund and only that fund. An early example of such an arrangement can be found in *Matthew v Blackmore*[66] A trustee of an estate borrowed

[65]Above n 56.

[66](1857) 1 H&N 762; 156 ER 1409.

money and agreed to repay the loan:

> out of the money which shall come into his hands, as such trustee of the aforesaid, from all and singular the land, hereditaments, and premises comprised in the said recited securities or the personal estate (if any) of the said [deceased].[67]

When an action was brought against the trustee for payment of the debt the Court held that the words of the contract dictated that there was no obligation to pay except from the identified fund. More recently the approach has been approved in *De Vigeur v IRC*[68] where the arrangement was identified as a loan notwithstanding that the right to repayment was conditional on the specified fund being sufficient.

One situation where such an arrangement might be used is that in *Matthew v Blackmore* where the borrower was acting as a trustee and therefore had legitimate reasons for not wishing to be held personally liable. An alternate reason for adopting such a form of transaction is that the lender may wish to participate in the risk of the enterprise and receive proportionately higher returns. This was the case in *Ensign Tankers (leasing) Ltd v Stokes*.[69] That case concerned a transaction whereby company A lent $10.75m to company B. Company B applied $3.25m of its own funds to the enterprise of producing a film. The loan was to be repaid from (and only from) the proceeds of the film. The formula for repayment provided that the proceeds would be distributed between the companies (approximately) according to their financial contributions to the enterprise. Although as against the Commissioner of Inland Revenue the transaction was set aside and viewed as a joint venture, as between the parties it is likely that it would still be seen as

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[67]Above n 66, 765; 1410.

[68][1964] 2 All ER 907.

[69][1992] 2 WLR 469.

a non recourse loan.[70] In such a case the return for the lender may well differ according to the returns of the enterprise.

Whether such transactions ought to come within the scope of the PPSA will depend on whether such an arrangement creates an interest in property which secures the repayment of an obligation pursuant to clause 4. Although often referred to as simple loans the fact is that in many ways the creditor assumes the rights of ownership of the asset or fund to which recourse is to be had, as well as the liabilities attendant upon the ownership of an asset. For example in the *Ensign Tankers* case the lender was to receive proportionately the benefits of the proceeds of the loan, namely the film. In reality this is not a simple loan and a repayment but a sharing in the profits of the enterprise, as the Commissioner of Inland Revenue successfully argued. From the other perspective the lender also adopts the risk of the failure of the enterprise. In the event that the fund from which the loan is to be repaid is worthless there will be no other liability on the debtor to repay.[71] In this sense the lender is a joint venturer in the business and, according to the terms of the agreement, bears a proportion of the risks along with the borrower. In such a transaction the line between that of a lender and a part owner of an enterprise becomes blurred.

Another aspect of such an arrangement which sets it apart from other types of simple loan transactions is the right to be paid from a particular fund. As has been noted the right to

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[70]J Prebble "Remedies of a Non Recourse Lender" in J Prebble (ed) *Dimensions in Banking and Foreign Exchange Law* (Butterworths, Wellington, 1992) 148.

[71]*The King v New Queensland Copper Co Ltd* (1917) 23 CLR 495: a stipulation that a loan was payable only from the proceeds of a certain project was enforceable notwithstanding the absence of any trustee capacity.

payment from a particular fund is one of the features (along with preference over other creditors) which indicates that a security interest exists. Thus in the same manner as a charge holder may, the debtor under a non recourse loan may insist on payment from a particular fund, or the proceeds of certain assets.

Some writers consider that non recourse loans confer no property interest whatsoever. If this were so then clearly they would be outside the scope of the PPSA. However this is not necessarily the case. Prebble takes this view.[72] He suggests that whilst security can exist alongside a non recourse loan, it will not of itself create it. However Goode (who Prebble strangely cites in support), citing *Matthew v Blackmore*[73] states in respect of a non recourse loan where the fund is expressed to be the proceeds of an account receivable:[74]

> [A] non recourse loan on the security of receivables, in which the assignor undertakes no personal repayment obligation and the financier agrees to look exclusively to the receivables to secure recoupment, looks very much like a sale disguised as a mortgage. But the concept of non recourse lending is well established in English law. The transaction remains a loan transaction even though the parties have agreed that the assignor is to make repayment only from an identified fund and not from his own resources. The transaction is in fact distinguishable from a sale in that once the financier has his advance with stipulated interest, any remaining value in the receivables belongs to the assignor.

Thus Goode observes that it is possible to create a non recourse loan which effectively grants a mortgage interest over the specified fund. Thus, depending on the agreement and its effect, a non recourse loan may create property rights.

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[72]Above n 70, 142.

[73]Above n 66.

[74]Above n 66, 108.

One way in which one can answer the question of the nature of the lender's rights in a non recourse loan is to determine their standing as against third parties. Consider the situation where, as in Goode's example above, a debtor has lent money which is to be repaid only from the proceeds of an account receivable in the hands of the debtor. The debtor obtains payment of the account receivable and refuses to pay the lender. In the event of the insolvency of the debtor, would the lender have a right to the fund (providing the rules of tracing were satisfied) or would it rank as an unsecured creditor? It is submitted that the answer to that question is to be found not by classifying the transaction as non recourse, but rather by examining the agreement and intention of the parties.

At its most simple such an arrangement is not intended to give any property rights over a fund. In the event of insolvency the lender will rank as an unsecured creditor for the value of the claim against the fund and be paid a proportionate dividend. Thus if the loan was for $10 000 but the fund from which the claim is to be paid is only $5000 then the lender will have a claim against the estate for only $5000. If the debtor is insolvent and the dividend paid out is only 10 cents in the dollar then the final dividend of the lender will be $500.[75] However this may not be the intention of the parties. In many cases the parties will intend that the fund be set aside to be exclusively applied to the satisfaction of the loan. Goode, in the extract cited above, whilst maintaining that the property is not transferred maintains that such an arrangement is a security over a book debt in the same manner as an assignment of the debt would be. If the intention of the parties to set aside a particular fund for the satisfaction of the indebtedness it may be that a property interest

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[75]See above n 70, 154.

in favour of the lender is created.

One obvious way in which such an interest could be conferred is that of a trust. Such a trust might be implicit in the words of the agreement. Thus if the debtor agreed to keep the proceeds of certain accounts receivable separate and account for them to the lender this may be sufficient to put the debtor in the position of trustee in respect of such funds. This was the view of the court in respect of proceeds in *Len Vidgen Ski and Leisure Ltd v Timaru Marine Supplies (1982) Ltd*[76] where the matter was considered in the context of a retention of title clause rather than non recourse lending. Alternately the parties could create a trust by explicit wording in the agreement whereby the fund from which the loan was to be repaid is expressly held on trust for the benefit of the lender. Alternately the arrangement may make clear that the right to the fund (including the right to require payment direct from the original borrower) is transferred to the non recourse lender. In any of the above situations a property interest is conferred on the lender in respect of the fund. The question then becomes whether such arrangements would fall within the scope of the PPSA.

An arrangement whereby the lender received a property interest in a fund held by the debtor as in the above situations will be registerable under the PPSA. Not because it forms part of a non recourse loan agreement, but rather because of the nature of the agreement and the intention of the parties. The reason that the parties to such an arrangement would do so in such a manner as to create such rights is clearly to ensure repayment of the loan to the full extent of the agreement to the exclusion of third parties. Where the fund is held

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[76][1986] 1 NZLR 349.

on trust by the debtor for the creditor this clearly falls within clause 4(1) as a transfer of an interest in property for the purposes of security. Where the right to receive payments form a particular source is transferred then this will be caught under clause 4(3)(a). In such cases the creditor is gaining, not only recourse against a particular fund, but recourse against that fund to the exclusion of others and in priority to unsecured creditors. Non recourse transactions will be subject to the Act according to the intentions of the parties and the result of the agreement. If the arrangement gives the lender preference over other creditors and the right to be paid from a particular fund to the exclusion of others, and was intended to do so, then the Act ought to and will apply.

E Loan Participation Agreements

Loan participation agreements are a method by which financiers dispose of the benefits and burdens of financial interests to other parties and thereby increase the capital available for utilisation in their business. It should be noted that participation agreements may extend to the disposition of assets other than loans. Such transactions may include participation in business ventures as in the *Ensign Tankers*[77] case. Whilst the principles and issues of such arrangements will be the same in either case, this paper will use loan participation agreements as a vehicle for discussion. Such transactions can have many of the features of a non recourse loans and many of the same issues will arise. One of the difficulties in discussing participation agreements is that the phrase has never been clearly defined and many diverse kinds of arrangement have been brought under the heading. The essence of such an arrangement is the sharing of the risk in and proceeds of loan assets by a financier.

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[77]Above n 69.

This might be done when the loan is being proposed or after the loan has been made to free up the capital of the financier.

A simple example of such an transaction might be where a smaller financier has an opportunity to enter into a large and lucrative loan transaction but has insufficient funds or is reluctant to risk that much capital in one transaction therefore invites a second financier to participate in the transaction by supplying a proportion of the funds and receiving a proportionate amount of the returns. Alternately a bank (or large corporation) might seek contributions from the general public to participate in a particular loan (or other enterprise) and issue debt participation securities. Warren[78] provides some further examples of such transactions:

> (a) Bank A loans $1 000 000 to D and takes from him an unsecured negotiable promissory note for that amount. Bank B agrees with bank A that it will participate in the loan to the extent of $500 000. Bank A can now assign to bank B an interest in the note by giving Bank B a certificate of participation; the note itself can be left with bank A.
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> (b) Bank A buys $1 000 000 of conditional sales contracts from a finance company; bank B agrees to participate on a without recourse basis to the extent of $500 000.

Such arrangements are, of course, documented in a far more complex manner than the brief description provided above. In respect of the PPSA the question becomes whether or not such arrangements create security interests within the meaning of clause 4, and whether such financial arrangements are appropriate for inclusion within the scheme of the Act.

Whether such arrangements fall within the provisions of the PPSA if passed will have a

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[78]W D Warren "Coverage of the Secured Transactions Division of the California Commercial Code" (1966) 13 UCLA LR 250.

significant impact. Firstly the lead bank may be reluctant to have to disclose the financial details of such large and potentially sensitive transactions on a public register. Furthermore to be categorised as a debtor rather than a joint venturer or participator may be at odds with the parties perception of the arrangement. In any event, in the case of large financial institutions, it is unlikely that third party creditors of the lead bank would inspect the register, or be concerned with the details of such a transaction. Also the loan assets in which the other bank is participating would not be accounted for, or appear, as assets of the lead bank and therefore it is unlikely that any third parties would be misled. At least part of the difficulty can be found in clause 4(4)(a) of the draft Act which deems the transfer of account receivables to be security interests. Whilst this increases clarity it also means that an element of artificiality is introduced into the Act which will cause hardship in cases such as the present.

Some such arrangements will expressly not grant any interest in the indebtedness owed by the primary borrower to the participator. Such arrangements are often on a purely non recourse basis and therefore the participator takes the double risk that either the original borrower or the lending bank will be unable to repay the sum. Such an arrangement is described by Goode as a sale of sub participation of loan assets.[79] Such an arrangement, is in fact not a sale at all, but rather the creation of a contractual right to payment from a particular fund. As it creates no property interests will not fall within the scope of clause 4 of the PPSA.

However other participation arrangements are clearly intended to grant an interest to the

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[79]Above n 17, 24.

participating financier. Such an interest may be in either the account receivable due from the original borrower, or in a security interest underlying the original loan, or in both. Participation arrangements can involve a complex series of transactions including guarantees, underwriting, trust arrangements, and the use of third parties. This is particularly the case where the participation is in respect of a large number of smaller loans.[80]

One of the problems which has concerned the courts in respect of such transactions is whether they constitute an absolute assignment of the assets or a mortgage of them.[81] However by virtue of clause 4(4)(a) all assignments of account receivables will fall within the scope of the Act regardless of whether they are intended as security, or as an outright transfer. Therefore wherever such participation agreements grant to the participating financier anything more than a mere contractual right against the lending financier to receive a proportion of the proceeds of the loan, the provisions of the PPSA will apply. Put another way, wherever a participation arrangement gives to the participating financier a right to receive payment directly from the original borrower, or a right to demand that the original lender account for funds received, then the arrangement will fall within the

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[80]Such arrangements have been labelled securitisation arrangements. In recent years both the United building Society and the Housing Corporation of New Zealand have securitised large numbers of loans (residential mortgages). For Further discussion see D Ross "Securitisation" in J Prebble (ed) *Dimensions in Banking and Foreign Exchange Law* (Butterworths, Wellington, 1992)

[81]*Re George Inglefield Ltd* [1933] 1 Ch 1 where hire purchase agreements were discounted to a financier and the Court found this to be an outright sale. Compare *Re Curtain Dream Plc* [1990] BCLC 925 where a sale of inventory to a financier and conditional sale back was held to be a security arrangement. Also *Hayes Securities Ltd v Bambury* [1991] 1 NZLR 304 where a right to payments under contracts for the sale of land were assigned to a financier with a right of reassignment if certain conditions were met was found to be a security arrangement.

scope of the PPSA. Even if this were not the case it is submitted that one of the main reasons that the participator holds an interest in the account receivable is to give some security for repayment in the event of the insolvency of the original lender and would therefore fall within the scope of clause 4 of the PPSA in any event.

In *re SOAW Enterprises Inc*[82] the financier, Castle Rock, entered into an agreement whereby funds were loaned to SOAW to purchase land for subdivision. Repayment was to be made by payment of 30% of the sale price of the subdivided land. The agreement provided that until repayment was made Castle Rock had an interest in the underlying property and was entitled to the possession of deeds of sale in respect of the land. When SOAW became insolvent it fell to be determined whether the interest of the financier was a security interest or not. The Court approached the problem by inquiring whether the financier had risked its funds as a stakeholder. On concluding that under the arrangement the financier was to be paid in any event the participation agreement was held to be a security arrangement. The fact that the financier was not limited to a 30% share of the proceeds of sale and could have recourse against the property generally in the event of a shortfall meant that the agreement was more than a joint venture type arrangement with both parties as co owners.

Another example of a priority dispute between a security holder and a loan participant can be found in *Army National Bank v Equity Developers Inc*[83] where Equitybank had made

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[82]37 UCC rep serv 885 (1983) (Tex SC), discussed in D Redle "Identifying Collateral as Real or Personal Property" (1990) 23 UCCLJ 185.

[83](1989) 9 UCC Rep 2d 722 (Kan SC).

loans to Equity Developers Inc. Army National Bank agreed to participate in the loans and an agreement to that effect was drawn up. Under the agreement the loan documents were to be held by an independent custodian but this never occurred. Equitybank pledged the loan documents to the Bank of Kansas to secure its own indebtedness. On the insolvency of Equitybank it came to be determined whether the security interest of the Bank of Kansas, which was perfected by possession, or the alleged part ownership of the loans by the Army bank prevailed. It was held that the Army bank failed and that its interest was an unperfected security interest. Comment has been made that if the Army Bank took the interest in the loans at the outset and was genuinely a co-owner of the loans then the decision would have been the reverse.[84]

The fact that such arrangements fall within the scope of the PPSA and, for complete protection, ought to be registered would probably not be well received by financiers. It may well be that in the absence of a provision that avoids unregistered security arrangements against the liquidator of the debtor the practical effect of this will be minimal. Participating financiers may well choose not to register on the basis that the risk of insolvency of the original lenders is small and the likelihood of a competing security interest is also small. Another factor which has been identified in respect of registering financing statements in such situations is the reluctance of financiers to disclose such arrangements on a public register.[85] Furthermore the acknowledgement by the original lender that the obligation to pay the participating financier is in fact a debt secured over

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[84]B Clark *The Law of Secured Transactions Under the Uniform Commercial Code: 1993 Cumulative Supplement* (Warren Gorman Lamont, Boston, 1993).

[85]Above n 47.

certain assets would defeat one of the major purposes of the transaction which is to reduce the debt to assets ratio of the institution.

It has been argued that such arrangements are inappropriate for inclusion in the scheme of PPSA type legislation.[86] The writer concurs with this approach. Such a stance may be justified on a number of grounds. The arrangements are not intended to be secured loan arrangements in the usual sense of the expression. Rather they are a mode whereby financiers can avoid committing large amounts of capital to loans and act in a more intermediary role. The participating financier is not so much a lender as a joint venturer with the original lending bank who carries the risk of the failure of the loan along with the lending bank. The purpose of the PPSA is to provide a uniform system of registration and notice of interests held in personal property to ensure that third parties are not disadvantaged by unwittingly dealing with property in which a party holds a hidden interest. Such protection is not necessary in respect of participation transactions because of the nature of both the assets being dealt with and the parties to the transaction. On a practical level, one method of avoiding complications is for the participation to occur at the outset of the transaction and therefore the parties would be genuine co-owners rather than an assignee.

F Subrogation

The right of subrogation is not one which readily springs to mind when considering security arrangements. However the right to receive a right of action against another by virtue of subrogation may well fall within the scope of the PPSA. One area in which the

[86] Above n 47.

doctrine operates is the law of guarantees. In such circumstances the doctrine of subrogation serves to transfer to a party who has discharged the obligations of another pursuant to a contract of guarantee the right to receive payment under the original contract, and any security that the original creditor may have held in respect of the debt. Consider the following:

> A guarantees the obligations of B to Bank. In addition to the guarantee Bank takes security over certain property belonging to B. B defaults and A is called upon to discharge, and does discharge, the obligations of A.

In this case B will have three separate rights against A. Firstly it will have a right to be indemnified for the amount paid (but only the amount paid) which is implicit in any relationship of guarantee. Secondly it will be able to assume the right to be paid the debt on the same terms as existed between A and C, including the right to claim interest, by virtue of the doctrine of subrogation. Also by virtue of the doctrine of subrogation B will be able to exercise any rights that C had in respect of security held over property. It is common for contracts of guarantee to stipulate the circumstances in which the right to subrogation may be exercised however the existence of the right is not dependant on an express contractual provision.

The applicability of the PPSA can be argued on the basis that the existence of a right to subrogation is an arrangement which grants an interest in property and is intended to secure the performance of an obligation in terms of clause 4. The right to subrogate exists solely to protect the interests of the guarantor and to increase the likelihood of payment from the defaulting debtor. In the first place the right to subrogate to the debt which the guarantor discharged may give the guarantor rights greater than exist under the right of indemnity.

Such a transfer of what is effectively an account receivable is solely to facilitate the payment of interest and charges to the guarantor as would have been payable to the original creditor and is therefore intended as a security arrangement. In any event the transfer of an account receivable comes within the scope of the PPSA automatically by virtue of clause 4(4)(a). More obviously the transfer by operation of the doctrine of subrogation of securities which were held by the creditor clearly creates a security interest in favour of the guarantor to secure the payment of the amount the guarantor paid to the original creditor under the guarantee.

More contentious is the transfer to the surety, by subrogation, of security type interest which, whilst not needing registration in the hands of the original creditor, would usually need registration in the hands of any other party to be enforceable. An example of such a situation could be as follows:

> Bank is a creditor in respect of a loan of $100 000 to Debtor. Bank also holds a 3 year term deposit of $50 000 which it is agreed will not be released until the loan is repaid and may be applied to reduce the loan in the event of default. The loan is guaranteed by Guarantor who, on default by Debtor repays the entire $100 000.

Under the doctrine of subrogation the right to apply the deposit in reduction of the amount owing would be transferred to Guarantor. However in the hands of Bank such an interest (arguably) need not be registered as it is a right of set off which arises by operation of law. However in the hands of Guarantor it is an account receivable and therefore needs to be perfected by registration.

Whether rights to security conferred by virtue of the doctrine of subrogation come within the scope of the draft Act will be of profound significance. If registration is needed then the utility of the doctrine is greatly undermined as the rights of the guarantor only arise where the debtor is unable to pay. Presuming that the Act, when passed, will include a provision avoiding unperfected securities against a liquidator, it is likely that in such cases any registration by the guarantor would be to late. In any event it would lose any priority it had to earlier registered interests.

One argument against the bringing of rights held by virtue of the doctrine of subrogation under the PPSA is that they are transferred by operation of law and therefore excluded by operation of clause 4(5)(a). However this is by no means clear. In *Orakapo v Manson Investments*[87] The right of subrogation was treated quite clearly as arising from contract. In that case a loan had been received and was expressly used to discharge encumbrances on certain property. The lender purported to take security over that property for the loan advanced. Due to inadvertence on the part of the lender certain regulations were not complied with which made the contracts unenforceable. the lender attempted to argue that because the funds advanced had been used to discharge earlier mortgages they were subrogated to those mortgages. The House of Lords held that the right of subrogation was founded in contract and, whilst the mortgages would have otherwise been transferred, because the contract was unenforceable no right of subrogation could exist. Thus if subrogation is seen not as an interest arising by law but rather by implication in the contract between the parties, then it may well be subject to the PPSA. In any event it is artificial to say that the interest is created by operation of law. Even if subrogation is considered to be founded in law rather than contract, it only operates to effect the transfer of the security. The creation of the security interest is effected by the original agreement

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[87][1978] AC 95.

between the debtor and creditor.

Alternately it may be argued that rights received by virtue of subrogation are excluded from the scope of the Act by the operation of clause 4(5)(b)(ii) which excludes:

> a transfer of an unearned right to payment under a contract to a person who is to perform the transferor's obligations under the contract.

If construed literally the guarantors right to payment from the debtor is unearned and the guarantor is a person who was obliged to perform the transferor's obligations under the contract. It is on this basis that the United States courts have excluded rights received by virtue of subrogation from the scope of comparable legislation.[88] However it is clear that that clause was intended to apply to situations where the right to payment is yet to be earned and the transferee has undertaken to do the work in consideration for the transfer of the right to receive payment for it, as in the case of a subcontractor who receives a right to direct payment from a project owner when undertaking work on behalf of a head contractor. The application of that clause to the case of subrogation is clearly inappropriate.

This view was adopted in *Transamerica Insurance Co v Barnett Bank of Marion County, NA*[89] where Article 9 was applied to a transfer of a security interest by subrogation. That case involved a guarantor of the obligations of a head contractor in a construction project. When it paid under the guarantee it was subrogated to the ultimate buyer of the building's rights to retain payments due to the head contractor. However the bank who had been

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[88]Clause 4(5)(b)(ii) is materially identical to article 9-104(f) of the UCC.

[89](1988) 5 UCC Rep 2d 879 (Fld Dist Ct App).

financing the project had a floating charge on the undertaking of the head contractor. The issue was one of priority between the subrogated guarantor and the charge holder in respect of payments due from the ultimate buyer. The court held that a subrogation was subject to Article 9 and non registration of the subrogated interest meant that the bank's interest prevailed. However the case was overturned on appeal to the Florida Supreme Court.[90] That Court decided that a right received by subrogation gives the guarantor priority over other secured interests without registration under Article 9. This has been the orthodox approach.[91]

It is submitted that it would be inappropriate to require holders of subrogated rights to register their interests under the PPSA. The doctrine of subrogation seeks to place the subrogated surety in the same position that the creditor was in and give the surety the same rights against the debtor and any property that may have been secured. The rationale of the doctrine of subrogation lies in the perception that the surety adopts the same risk that the creditor would have had but for the guarantee. Thus the subrogated surety should be placed in an identical position to that of the creditor. On this analysis the *Transamerica Co* case was decided correctly before the Florida Court of Appeal. The surety is claiming not in its own right but through the creditor. In the same way as any personal defenses of the debtor against the creditor would be available against the guarantor, so all protection available to the creditor, including a right to set off or to withhold payments, should be available to the surety. If the creditors interest was a registered security interest, or an

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[90](1989) 823 F2d 712 (3rd Cir).

[91]See *Interfirst Bank Dallas, NA v United States Fidelity and Guarantee Co* (1989) 774 SW 2d 391 where on facts similar to *Transamerica* the surety had priority over the financier in respect of the right to retained payments.

interest which was perfected without registration then the surety should gain the same benefits. If the creditor held an unperfected security interest the clearly the surety cannot be put in a better position than the creditor by subrogation but could take steps to perfect the interest.

V INTERESTS IN REAL PROPERTY

The PPSA seeks to provide a code in respect of the regulation of security interests in personal property. In order to achieve its objects it is drafted in a wide and general manner. This ensures that the court will not be encumbered by technical definitions or rigid frameworks when considering whether a transaction comes within the scope of the Act. Rather the courts will be able to apply the Act to novel situations according to its intent and purpose. By and large this is a praiseworthy feature of the legislation however it results in an amount of vagueness as to the application of the Act. One of these peripheral areas is the concept of personal property. The areas which have caused the most difficulty are not new to the law. Firstly there remains a large grey area between intangible property and rights which do not amount to property at all. Secondly the distinction between personal property and real property, whilst obvious in some circumstances, is particularly unclear in respect of the transfer of the rights originating from or connected to interests in land.

The distinction between real and personal property is one that has remained vague since time immemorial. There are a number of arrangements which straddle this conceptual boundary. The anomalous position of leases of real estate as "chattels real" has long been recognised. Similarly the practical difficulties of distinguishing between property which had been temporarily brought onto the land (chattels) and those which were intended to form part of the real estate (fixtures) has given rise to considerable litigation. The PPSA seeks to circumvent this problem by providing that where a security interest is held in goods which are subsequently affixed to land, they will be deemed to be separate goods for the purposes of the security interest.[92] This is an example of the readiness of the drafters to cut across orthodox legal rules and fine conceptual distinctions in order to avoid results based on anomalous historically based categories of property. The nature of rights to income derived from an interest in land such as the assignment of mortgage payments is another uncertain area. Whether such debts are independent accounts receivable or are conceptually inseparable from the interest in land from which they derive has caused conflicting case law in North American jurisdictions.

The obvious intent of the PPSA is to reform the law in respect of security interests in personal property. A separate and conceptually distinct set of rules exist in respect of the holding and transferring of interests in real property under the Land Transfer Act 1952. Despite the fact that these two areas of property law are dealt with in entirely separate manners there has been little attention in the PPSA directed towards distinguishing the two. The first guidance is found in clause 4(1) which states the classes of property over which security interests may be granted under the Act as: goods, a document of title to goods, a security, chattel paper, a negotiable instrument, money or, an intangible. When reference

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[92]Clause 29.

is had to the definitions of these terms in clause 2 it becomes apparent that one is taken no further than a general division of personal property into a number of classes. In particular intangible is described as personal property not fitting into any of the other categories, giving an entirely open ended definition. The only other guidance in the body of the Act is found in clauses 4(5)(b)(iii) and (ix) which provide that the Act will not apply to:

> (iii) the creation or transfer of an interest in land [or];
>
> (ix) a transfer of a right to payment that arises in connection with an interest in land, including a transfer of rental payments payable under a lease or licence to occupy land unless the right to payment is evidenced by a security

This clearly excludes security interest in real property and transfers of income from land itself from the scope of the Act. However there is still a large residual category of interests which include the transfer of rights to payment secured by interest in land, and the transfer of contractual rights concerning land. The division of rights to payment generally and rights to payment arising from an interest in land is problematic and arguably at odds with the anti-formalistic philosophy of the Act.

The problem of the division between real and personal property is not a new one. There is a substantial body of case law dating back centuries providing principles upon which interests have been categorised. The difficulty with such doctrines is that they are primarily historically based and are not always in accordance with modern business practice and the common understanding of such transactions. The PPSA is intended to sweep away the cobwebs of an archaic system using on fine technical distinctions based on legal concepts, and deal with transaction according to their substance and effect. Any court addressing issues of the scope of the PPSA should approach the question with an eye to ensuring a rational and practical application of the Act rather than perpetuating distinctions which are a result of the peculiar historical development of the law of property.

A Assignments of Payments Secured by an Interest in Land

One kind of transaction which has come before the Canadian courts in respect of the scope of the PPSA on several occasions is where a one party has assigned its right to payment under a mortgage of land to another party. Consider the following situation:

> Ltd is in the business of advancing money on the security of real property mortgages. It advances money on the security of such mortgages to mortgagors X Y and Z. Ltd finances its transactions by an assignment of the loan agreements (but not the mortgages) to Bank in return for funding as required. Bank, after searching the PPSA register and ascertaining that no other secured parties exist in respect of the debt, registers its interest under the PPSA. Ltd falls upon hard times and assigns the mortgages (including the right to receive payments) to Financier who has searched the land transfer registry and ascertained that they are in fact held in the name of Ltd. The assignment is registered under the Land Transfer Act.

In such a case both secured parties can arguably say that they ought to prevail in the event of the insolvency of Ltd.

In the first place Bank can argue that the interest it took was the assignment of a purely personal debt. This point is illustrated by noting that in the event of default by Ltd, Bank would not be able to effect its security by obtaining a transfer of the mortgages and foreclosing under those mortgages in the event that the debtors did not pay. Rather it would be limited to requiring the mortgagors to pay the instalments directly to them and in the event of default taking personal actions against the mortgagors. On the other hand Financier will argue that it searched the land transfer registry and ascertained that the mortgages were held in the name of Ltd and they received an assignment of the rights under the mortgages which were perfected by registration under the Land Transfer Act.

As can be seen, whether or not such transactions are brought within the scope of the PPSA will have a significant effect on the rights of the parties. In the first place the secured creditor who receives an assignment of both the mortgage and the right to payment would otherwise have to register in two registries for full protection. Similarly third parties seeking an interest in such collateral would have to search multiple registries to ensure that both the mortgage and the account receivable was unencumbered.

One (traditional) manner in which the problem can be resolved is by recourse to the underlying conceptual basis upon which a real property mortgage and the associated obligation to pay has been construed to exist. On such an analysis the transaction involves two elements;[93] firstly the obligation to repay the loan which is the primary element and, secondly the mortgagees interest in the land which secures the obligation to repay the loan. A mortgage and the associated obligation to pay has long been recognised as of a dual nature; the debt itself being created by the personal covenant of the mortgagor/debtor and the mortgage itself being a grant of an interest in land creating rights which could be exercised in the event of a default of the personal covenant.

The problem has been dealt with before the Canadian courts in a conflicting manner. *Re*

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[93]"An Article Nine Scope Problem- Mortgages, Leases and Rents as Collateral" (1976) 47 U Col LR 449, 455.

Urman[94] concerned a case similar to the example above. A mortgage broker (Urman) was in the business of arranging loans secured by mortgages over real property and then selling them, either outright or to syndicated trusts. Urman's business was financed by a revolving line of credit which was subject to a PPSA registered security over all of his book debts generally. When in financial difficulty Urman assigned two mortgages to a third party by way of security for a further loan. The assignment was registered at the land registry office and the mortgagors were notified. The Court of Appeal (reversing the lower court) held that the obligation to pay and the rights over the land were inseparable. Therefore the bank's interest was defeated in favour of the assignees of the mortgages who had registered their interest under the land transfer legislation.

Royal Bank v Kleemola[95] adopted the reasoning of the lower court in *Re Urman* which had been rejected on appeal.[96] In *Kleemola* one James was the mortgagee of some land and was entitled to receive payments under the arrangements. In order to obtain and secure a loan the right to those payments was transferred to the Royal Bank who registered their interest in the PPSA registry. Kleemola then loaned money to James and sought to secure his interest by an absolute assignment of the mortgage which was registered in the land transfer office. The Court held that the interest of the bank prevailed on the insolvency of the mortgagee. The basis for this decision was that James had effectively disposed of the

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[94](1983) 3 PPSAC 191 (Ont CA). Since this decision the matter has been clarified by an amendment which inserts s 3(1)(e) which operates to exclude "The creation or assignment of an interest in real property including a mortgage charge or lease of real property".

[95](1991) 2 PPSAC 2d 5 (Man QB).

[96]For a discussion of the first instance judgement in *Re Urman* see J Ziegel "The Scope of the Ontario Personal Property Securities Act- Recent Developments" (1981) 6 Canadian Business Law Journal 107.

right to receive payments under the mortgage to the bank and the bank's right, being personal, was perfected by registration. Kleemola therefore could only receive the residual interest which was the worthless mortgage with no attached obligation to pay. The approach of treating assignments of real property mortgages as having a dual character has come in for criticism.[97] One aspect of that criticism is the observation that the result of treating mortgages as being of a dual nature is to require registration of their transfer in two registries: a complication to the law that such reform is seeking to avoid.

Interestingly in *Kleemola* Hirschfield J noted that he had considered the earlier case before the same court of *Ranjoy Sales and Leasing Ltd v Down.*[98] In *Ranjoy* a mortgage broker had become bankrupt. The unsecured creditors in the liquidation maintained that certain transfers of the mortgages and trust instruments conferring legal and equitable interests respectively were void on the insolvency under the Manitoba PPSA. The court in that case came to the conclusion that the interests transferred in the mortgages (including the right to receive payment) were real property and not subject to the provisions of the Act. In *Ranjoy Sales and Leasing* Wright J referred to the (later overturned) first instance decision in *Re Urman*[99] and noting the similarities between the facts and that the provisions of the Ontario and Manitoba statutes were materially identical said:

> However after a careful review of that case I am unable to conclude that it can be relied on as an accurate interpretation of the Manitoba Personal Property Security Act. Certainly the decision that real property security is subject to either the Manitoba or Ontario Act seems on the face to be totally inconsistent with the with the nature and intention of the legislation. A reading of the

[97]See Ziegel above n 96.

[98](1982) 2 PPSAC 107 (Man QB).

[99](1981) 1 PPSAC 340 (Ont HC).

Manitoba statute in full reveals numerous sections where this is evident, and it appears to me that the Manitoba Act at least can be reasonably interpreted as *not* intending to cover real property interest.

In saying this Wright J acknowledged and approved the comments of Ziegel[100] which suggested that interests in mortgages should be treated as indivisible from the land.

The approach in *Ranjoy Sales and Leasing* seems to be the more widely accepted approach.[101] The adoption of the dual analysis of a mortgage as found in *Kleemola* is less widely accepted. A technical approach as found in *Kleemola* would not be appropriate under the proposed Act. The Act is founded in principles which seek to avoid overly technical distinctions in an effort to avoid a multiplicity of registers and to simplify the registration procedure. The division of real mortgages into real property interests and personal covenants ignores the fact that a perfectly workable system for the recording of the holding and transfer of interests in mortgages exists in the form of the Land Transfer Registry. If the Act were passed into law in its present form clause 4(5)(b)(ix) could act as a vehicle for the courts in avoiding the trap into which Hirschfield J in *Re Kleemola* fell.[102] Provided that that section was interpreted purposively the right to receive payments under a mortgage could be described as a right to payment arising in connection with an interest in land. The simple way around the problem would be to amend the provision to also exclude rights to payment arising from a security interest in land.

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[100] J Ziegel, above n 96.

[101] *Assiboine Credit Union Ltd v CIBC* (1984) 3 PPSAC 177 (Man CA).

[102] The American courts are further hampered by Article 9-102 which provides:

> The application of this Article to a security interest in a secured obligation is not effected by the fact that the obligation is itself secured by a transaction or interest to which this Article does not apply.

B Assignment of in personam Rights Concerning Land

Another area where the division between real and personal property is unclear is in respect of contractual or personal rights concerning land. One such right is a contractual right to occupy and control land; that is to say a lease. Leases occupy a strange place in property law and have been labelled "chattels real" thus denoting the fact that they are personal property but conferring rights in respect of land. It is established law that the right of a lessee to occupy land does not amount to an interest in that land and under the doctrine of tenure no estate is held. However the fact is that the right to occupy can be maintained against the world and is tantamount to an interest in the land. Furthermore, provision exists for the registration of such interests under the Land Transfer Act. Whether interests in leases will fall within the scope of the PPSA is unclear. Rights in respect of land that amount to property other than leases may exist. One such right may be the right to use land in a particular manner issued by an administrative body such as a liquor licence which attaches to the premises rather than the proprietor. A right to receive money in respect of a contract for the sale of land is also personal property. It is possible for any of these rights may be transferred either unconditionally or by way of security. It will therefore be necessary to determine whether such arrangements would fall within the scope of the PPSA or not.

The draft Act expressly excludes interests in land and rights to payments under an interest in land including rent.[103] However this does not necessarily exclude any of the transactions described above. Interestingly both Ontario and British Columbia have included in their Personal Property Security Acts provisions attempting to clarify the

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[103]Clause 4(5)(b)(iii) and (ix).

position of such transactions under the Act. The Ontario Act provides that it does not apply to "the creation or assignment of an interest in real property including a mortgage, charge or lease of real property".[104] The British Columbia Legislation excludes from its scope: "the creation or transfer of an interest in land, other than an interest arising out of a licence, including a lease". The draft Act has no such provisions and, looking at the Canadian experience, will require one. To include such interests within the scope of the Act would mean registering the assignment of leases by way of security in both the personal property security and land transfer registry. Correspondingly third parties would have to search both registries to determine with certainty what interests existed in such leases.

An example of a lessee using its interest as security can be found in *Re CTL Uniforms Ltd*[105] where CTL had given a floating charge over its entire undertaking to its financier. On the insolvency of CTL the liquidator had sold the company's assets including its rights of occupancy as lessee to three retail sites. The financier was arguing that, unlike the other assets of the company, the leases were real property and therefore the security interest in them was not void on insolvency under the PPSA. This argument was rejected by the court who found the leases to be personal property and the charge, not being perfected by registration, was void against the liquidator. This case was heavily criticised[106] and resulted in an amendment to the legislation.[107] Similar problems in respect of leasehold interests have been experienced in the United States under Article 9. In *E Landau*

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[104]Section 3(1)(e)

[105](1981)1 PPSAC 308 (Ont SC).

[106]J Ziegel, above n 96.

[107]Above n 94.

Industries Inc v 385 McLean Corp[108] a lessee assigned its interest in the lease as security for a $30 000 advance. The interest in the lease was registered in accordance with real property law. When the creditor sought to enforce its security it was held unable to do so due to a breach of the remedies provisions of Article 9. It was held that the arrangement was subject to Article 9 as it amounted to a mortgage of a leasehold and this was therefore a mortgage of personal property under that Article.[109]

If the draft Act is passed in its present form a conclusion such as that in *re CTL Uniforms Ltd* would be almost inevitable before the New Zealand courts on similar facts. The classification of leasehold interests as personal property is a well established rule of property law and would be applied accordingly. This would be the case notwithstanding the fact that such a conclusion would clearly be against the intent of the drafters. The inappropriateness of such a conclusion is particularly apparent in light of the fact that securities over rental payments under a lease are excluded[110] and the Land Transfer Act 1955 provides a comprehensive scheme for the registration of interests in leaseholds. The draft Act needs to be amended to clarify this matter and the only sensible manner to clarify it is to exclude security transactions over leases from the scope of the Act altogether as in British Columbia and Ontario.[111]

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[108] (1969) 296 NYS 2d 707 (Sup Ct).

[109] Interestingly this decision was made notwithstanding the provisions of Article 9-104(j) which provides that the Article does not apply:

> except to the extent that provision is made for fixtures in section 9-313, to the creation or transfer of an interest in or lien on real estate including a lease or rents thereunder...

The court seemed to take the approach that that section applied only to the lessors transfer of an interest in the lease.

[110] Clause (4)(5)(b)(ix).

[111] Above n 94.

Leasehold interests are not the only *in personam* rights which are connected with land. Another such right which has caused difficulties is the vendors right to receive payments under a contract for the sale of land. Such a right to receive payment (rather than the ownership of the land itself) might be used as security for an advance. An example of this can be found in *Re Starblanket.*[112] In that case the debtors were attempting to sell their home. They obtained an advance of $25 000 from the Continental Bank of Canada. As security for the advance they assigned the right to the proceeds of the sale of the property to the bank. In due course the house was sold however before the bank was repaid the debtors became bankrupt. Under the Ontario Act unperfected security interest in personal property are ineffective against a liquidator. In order to avoid this the bank argued that the security was an interest in land and therefore enforceable. It was held by the Court that the assignment of the debt of a future purchaser of real estate did not create an interest in land but was personal property and the security was unenforceable.

In contrast to the vendor's right to receive payment under a contract of sale is the purchaser's right to performance of a contract for the sale and purchase of real estate. In *Dominion Bank NA v Wilson*[113] the debtor had an option to purchase real property. The creditor had a floating charge which extended to all personal property including contractual rights (which would have included the option). The debtor exercised the option but the vendor was unable to settle. When the creditor sought to enforce its security and assume the contract of purchase it was held by the court that the right to enforce the contract was not personal property and therefore outside of the scope of Article 9. Rather once an

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[112](1988) 8 PPSAC 195 (Ont SC).

[113](1989) 867 F2d 203.

agreement to purchase existed the intending purchaser obtained equitable title to the land which was a real property interest.

The reasons for finding the rights in *re Starblanket* and *Dominion Bank* to be real and personal interests respectively are not contentious nor do they contravene the spirit of intent of the Act. The cases are however an indication that where financiers choose to take security in an unusual manner careful attention is needed to ensure that the security is perfected appropriately. Similarly where security is taken over an entire undertaking as in the case of many floating charges it should be recognised that the assets of the debtor may in the course of dealing change from real to personal property or vice versa.

The philosophy of the PPSA is firmly based in the realist tradition and it has little time for the fine distinctions which the common law places on different kinds of property. The draft Act fails insofar as it does not prevent those distinctions from finding their way into the new system of registration. The Act needs to be amended along the lines of the Ontario Act[114] to ensure that the scope of the Act is determined according to the nature and subject matter of the transaction rather than the niceties of the law and the history of the doctrine of tenure. As was said in *National Trust Co v Bouckhuyt*[115] when Henry J was rejecting an argument based on common law doctrines in respect of the distinction between real and personal property:

> Having regard to the general purpose of the PPSA, which is to consolidate into one statute, and so harmonise the law of personal property as security for debts, it is not open to parties to frustrate the

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[114]Above n 94.

[115](1987) 7 PPSAC 113 (Ont SC), later overturned on appeal: (1987) 7 PPSAC 273.

operation of the Act by a constructive conversion of what is in fact a chattel or intangible intended as security into a notional form of real property.

Similarly the Act should ensure that it reflects business reality. The fact is that a system exists for the registration of interests in mortgages and leases in the form of the Land Transfer Registry. To enable such transactions to also fall within the scope of the PPSA would be to perpetuate complexities and duplicities in the law which the PPSA seeks to avoid.

VI RIGHTS IN THINGS NOT AMOUNTING TO PROPERTY

The PPSA recognises that many classes of things can be described as personal property. Whilst in the middle ages anything other than tangible property was considered to be nothing more than a right *in personam,* the law has developed with business practice to recognise many other less tangible things as capable of being owned. However there will be things which are not property for one reason or another. Whether something is property at all can be thought of as largely a matter of prescriptive law. It was not until the nineteenth century that it was accepted by the common law that account receivables were personal property which were capable of being transferred. A more recent phenomena is the proliferation of permissions to engage in otherwise prohibited conduct issued by administrative governmental bodies. These often take the form of licenses (as in the case of liquor licences or casino licences) or quotas (such as fishing quotas). The terms upon which such rights are granted vary according to the governing rules. Such licences may be transferred with varying degrees of freedom. In cases where they may be transferred, and the governing bodies issue them in a limited amount, it is not unusual for premiums well in excess of the issue price to be paid. This has caused considerable difficulty in

Canadian jurisdictions. The courts have been divided in their approach to such problems, some treating such rights as property capable of being used as collateral whilst others have considered them to be merely personal rights.

It is clear from the case law that such quotas and licences are used as collateral relatively frequently, as is to be expected where such an asset will form a large part of the total worth of a business. To exclude them from the PPSA would be to undermine their value as property which can be used as collateral and deprive their owners of an otherwise legitimate method of raising capital. Financiers may be unwilling to accept such a thing as collateral unless they can be reasonably certain that it was free of existing interests. In the absence of a system of registration this would not be possible. Conversely to recognise such things as capable of serving as collateral would reinforce their status as property and recognise a fact which is already a commercial reality. Inclusion within the draft Act would avoid the existence of a discrete area of property security law being subject to a separate set of rules.

An obvious example of such a right is a quota for the production or harvest of primary produce. In Canada there exist primary produce marketing boards, similar to those in New Zealand, who are authorised by statute to regulate the production of certain products by the issuing of quotas. The leading Case on the matter is *National Trust Co v Bouckhuyt*[116]. In that case a farmer had sold a farm and taken a mortgage back over all the real property which was intended to include a quota for the production of tobacco. Some time later the

[116](1987) 7 PPSAC 273 (Ont CA) reversing the earlier decision found at (1987) 7 PPSAC 113 (Ont HC).

buyer of the farm obtained finance from the National Trust Co and granted security over certain personal property including the quota. The security arrangements were registered in the Land Transfer and Personal Property registries by the different secured parties respectively. It arose to be determined which secured party had priority in respect of the quota. The Court of Appeal, reversing the trial judge's finding, concluded that the quota was neither personal nor real property at all therefore the PPSA security was ineffective. In so finding the court recognised the factual observation in the court below that the quota could be leased and transferred however the court stated that "although the [quota] might be sold in a limited market, the mere fact that it could be exchanged, sold, pledged or leased does not in itself make it property".[117] One of the grounds for the decision was the fact that the creation and transfer of the rights was subject to the discretion of the regulating body. The case has been followed and applied to similar arrangements.[118] Such an approach is at odds with the philosophy of the Act which is intended to be flexible and able to adopt to include novel transactions. The finding of the Court of Appeal rested on an outmoded (and arguably incorrect) classification of what will amount to property. The decision has been strongly criticised. In an annotation in the reports[119] it was noted that this was a departure from the American approach which treated such transferrable rights as subject to Article 9 and further that it failed to take account of commercial realities.

The *Bouckhuyt* case was considered and not followed in *Saskatoon Auction Mart Ltd v*

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[117]Above n 116, 285.

[118]*Re Canadian Imperial Bank of Commerce v Hallahan* (1990) 69 DLR 4th 449 (Ont HC) where a milk production quota was held not to be personal property.

[119]R H McLaren (1987) 7 PPSAC 285.

Finesse Holsteins.[120] The case concerned a security granted over "all goods chattels and personal property of every nature and kind" which had been registered under the PPSA. The sole question for determination was whether a milk production quota (which was materially identical to the tobacco production quota in *Bouckhuyt*) came within the scope of the charge. Matheson J considered the Ontario Court of Appeal to have been wrong in *Bouckhuyt* and found that such quotas are personal property capable of being subject to a security agreement.

In the cases discussed above the quotas referred to were transferrable providing that purely formal steps were complied with. This element of transferability has been considered essential to classifying such rights as property. Thus where a security interest was purportedly created over a licence to operate a nursing home it was held that the licence was not property because no provision existed for the transfer of the licence.[121] In *Re Foster*[122] several parties alleged security interests in a taxi operator's licence on the bankruptcy of the holder. The governing statute created a right to renew and a right to transfer limited by the time the transferor has held the licence, fees, and other formalities. The Court held that notwithstanding that at the time the arrangements were entered into the licence could not have been transferred, the fact that it could be transferred at a later date meant that it was property and the security interests came within the scope of the PPSA.

One writer, in considering liquor licences under Article 9, noted the manner in which such

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[120](1992) 4 PPSAC 2d 67 (Sask QB)

[121]*209991 Ontario Ltd v Canadian Imperial Bank of Commerce Ltd* (1988) 8 PPSAC 135 (Ont HC).

[122](1992) 89 DLR 4th 555 (Ont Ct GD).

rights acquire the characteristics of property:[123]

> Whatever the qualities conferred upon the licence, where the numbers in which it is issued are limited a licence can acquire great value provided that it has some element of transferability. Value, together with transferability, makes the liquor licence a candidate for hypothecation in the form of an Article 9 security interest. This invests the licence with all it needs to be treated as property in the marketplace, whatever the characterisation it may have received at the hands of a licensing statute. The liquor licence under these circumstances might thus be said to have acquired a market definition of property.

This suggests that it is the manner in which such rights are treated and dealt with in the marketplace which ought to define whether or not they are capable of being property under the PPSA. Clearly if such rights are capable of being bought and sold then it will be equally possible to enter into arrangements using them as security for obligations. To ignore such arrangements would be to exclude a small but important class of property from the scope of the Act.

To ensure that such assets are included in the scope of the Act is not easily effected by amending the legislation. Such transferrable rights can exist in many forms. To attempt to expressly include such arrangements would be likely to impose on the Act an inflexibility which would render it incapable of adapting to novel situations which might arise. This may be a situation where the New Zealand judiciary will need to learn from their North American counterparts. It is impossible to reform and codify an area of the law as technical and diverse as that of property security without an appropriate judicial attitude to the statute attempting to effect that purpose. Once the reform legislation is in place it

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[123] S Knippenberg "Tacit Exclusion: Defining code Terms Using Extraneous Referents" (1988) 39 Syracuse LR 1261, 1271.

must be left to the judges in each particular case to give effect to it in the manner in which it is intended. One area where this will be particularly apparent is that of transferrable rights conferred by government organisations like quotas and licences. It is hoped that the courts will approach such transaction by looking at the market realities and the intent and effect of the transaction between the parties rather than by traditional methods of categorising the rights into existing classes of property.

VII CONCLUSION

This paper has attempted to highlight certain transactions which fall in one way or another on the fringes of the law of personal property securities. In some instances the inclusion or exclusion of such transaction from the scope of any proposed reform may be one of pure policy. This will be particularly the case in respect of transactions between large institutions where notice of the party's interests need not be made public and third parties are not generally put at risk by such arrangements. However in other instances it is necessary to include certain transactions within the scope of the legislation to avoid creating imbalances and anomalies in the law. This is particularly the case in respect of the practice of banks to take security over deposits which may be categorised a right of set off rather than a security arrangement. Such transactions need to be included within the scope of the PPSA in order to ensure that the law accords with the practice and perception of business in the community.

Other arrangements are simply a matter of the clarification of the borders of the PPSA. The position in respect of the crossover between real and personal property falls into this category. As was demonstrated, in some jurisdictions this grey area has led to a need to register securities in multiple registries. Some Personal Property Security Acts have been amended to clarify this point. It would seem sensible for interests in leases, and interests in funds secured by a interests in land to be subject to the Land Transfer Act 1955 rather than the PPSA. In any event clarification is required.

In some instances to attempt to clarify the situation by amending the draft Act would serve no purpose other than to complicate and rigidify the Act. For this reform to be effective a purposive approach will need to be taken by the courts. One situation where this has been shown to be particularly apparent in other jurisdictions in respect to quotas and licences. In such cases the courts, to give effect to the legislation, need to view the commercial realities of the situation rather than relying on established and sometimes archaic principles of law. The key to effective reform will be in providing a comprehensive and coherent structure for the registration of security interests in personal property which is capable of adapting to the changing practices of the business community. This can be only in part effected by statute. A large part of the task will lie in the hands of the judiciary who, to give such an Act its intended effect, will need to adopt a new, realist, approach to security transactions which is at odds with the functional tradition familiar to our current law.

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