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Set-off as a security device

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Introduction

- Some types of set-off as security
 - Combination and contractual set-off rights
 - Set-off in insolvency
- Priority of bank's right to combine or set-off a deposit
 - Application of the Personal Property Securities Act 1999 and the Companies Act 1993
- Some implications for collateral transfer arrangements (e.g. ISDA Credit Support Annex)

Some types of set-off as security

- A has a deposit of \$100, and an overdraft of \$50, with Bank X
 - Bank's rights of combination
 - Contractual set-off rights (set-off provision or separate deed, Deed of Set-off and Charge)
 - Statutory and equitable set-off rights
 - Close-out netting provisions (e.g. ISDA Master Agreement)
 - Collateral transfer arrangements (e.g. ISDA Credit Support Annex)
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Insolvency set-off

- A owes B \$10, B owes A \$5, B in liquidation
 - With set-off, A pays \$5
 - Without set-off, A pays \$10 and proves for \$5 in liquidation. If only receives \$0.50 in the dollar (\$2.50), has effectively paid \$7.50 instead of \$5
- Liquidation
 - Mandatory set-off of liquidated, mutual debts (section 310, Companies Act)
 - Overrides other set-off rights, except certain “netting agreements”

Insolvency set-off

- Bilateral netting agreements
 - *An agreement that provides that, in respect of transactions between two persons to which the agreement applies...that amounts payable by each party to the other party are to be paid or satisfied by payment of the net amount of those obligations by the party having a net debit to the party having a net credit*
 - Also covers close-out netting provisions
 - Effective in liquidation (section 310C)
 - Not limited to financial markets participants or transactions
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Insolvency set-off

- *Transotway Limited v Shepard* (2006)
- Section 310 set-off not available as (section 310(2))
 - Within 6 months of liquidation
 - Transotway did not prove it did not have reason to suspect Newman was insolvent
- In any event, arguably a “bilateral netting agreement” so voidable as reduced an amount owing at the time it was entered into

Insolvency set-off

- Similar provisions apply in voluntary administration
- Receivership itself does not affect set-off rights
- Statutory management moratorium on set-off and netting
 - Does not apply to netting agreements

Priority of set-off and security interests

- A has a deposit of \$100, and an overdraft of \$50, with Bank X. A has given a general security agreement (“**GSA**”) to Bank Y securing a term loan of \$100.
- The answer to two questions determine how the PPSA applies here
 - Is any right Bank X has to combine or set-off these accounts a “security interest”?
 - Is the deposit an “account receivable”?

Is a set-off a security interest?

- A security interest is
 - An interest in personal property created or provided for by a transaction that in substance secures payment or performance of an obligation
- On its own, no
 - Bank X does not have a proprietary interest in A's right to be paid its deposit
 - Section 23(c) provides that the PPSA does not apply to rights of set-off (except section 102)
- In some circumstances though...

Collateral transfer arrangements?

Security interest

- Recipient obtains a proprietary interest in the collateral
- The recipient's exposure is reduced
- In substance, the collateral provider's obligations have been secured
- Title is irrelevant, and an "assignment that secures" is a security interest

Not security interest

- Proprietary interest not the kind the PPSA intended to apply to, as recipient has no obligation to return the same collateral
- Is the set-off, not the proprietary interest, that secures the collateral provider's obligations
- Under section 23(c), PPSA does not apply to set-offs

Is the deposit an account receivable?

- Account receivable is
 - *a monetary obligation that is not evidenced by chattel paper, an investment security, or by a negotiable instrument, whether or not that obligation has been earned by performance*
- Yes, but *CIR v Northshore Taverns Ltd* (2008)
 - Not all monetary obligations but only “book debts”
 - Should be possible to limit to Schedule 7 of the Companies Act (priority of security interests and preferential creditors)

Section 102 of the PPSA

- Bank Y's rights to the deposit as a secured party subject to
 - Terms of the contract between the account debtor (Bank X) and the assignor (A) (section 102(1)(a))
 - Any defence or claim arising from the contract or a closely connected contract (section 102(1)(a))
 - Any rights of set-off (or other defence or claim) that accrues before Bank X knew of the assignment (i.e. Bank Y's GSA) (section 102(1)(b))

Post-notice contractual set-offs

- Bank X also has contractual set-off rights, and after learning of Bank Y's advances a further \$50 to A
 - Do post-notice contractual set-offs rank ahead of Bank Y's GSA? (i.e. does 102(1)(a) or (b) apply?)
 - No, or may be not, camp
 - Section 102(1)(a) was not intended to change common law
 - Section 102(1)(b) expressly refers to rights of set-off and 102(1)(a) does not
 - Bank X should take a security interest in the deposit, and register a financing statement, as well
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Post-notice contractual set-offs

- Yes, or may be, camp
 - Different views on the common law position on the priority of assignees and contractual set-offs
 - Section 102(1)(b) only expressly applies to “defences by way of right of set-off”, which contractual set-offs are not
 - The problem of section 310B(2) of the Companies Act.
- Section 310B(2) if A in liquidation
 - Requires netting of post-notice transactions between Bank X and A, which might ordinarily be precluded
 - If “no” camp correct, Bank X would still have to pay Bank Y

When do set-off rights “accrue”?

- A has a deposit of \$100, an overdraft of \$50, and a term loan of \$50 with Bank X when Bank X learns of Bank Y’s GSA.
- Right to combine overdraft but not the term loan as “accrues” post-notice – statutory set-off the same
- Contractual set-off rights probably accrued (as long as term loan accelerated when Bank Y claims the deposit)
- Same result in liquidation

Priority of set-off and proceeds security interests

- A buys inventory on credit from B, who takes a security interest over the inventory to secure the purchase price. A deposits the proceeds of the inventory with Bank X.
- B's security interest extends to the proceeds
- Under section 102(1)(b), B would rank ahead of Bank X's right to set-off advances to A, post-notice of B's security interest
- But...

Priority of set-off and proceeds security interests

- Sections 94, 95 and 96 of the PPSA allow Bank X to take cash, cheques and debtor-initiated payments free of B's security interest
 - Cash, give value
 - Cheques, give value and did not know the particular cheque was proceeds
 - Debtor-initiated payment of an amount owed
 - Payment in reduction of overdraft would be covered
 - Payment into deposit account might be "value"
 - Applies to collateral transfer arrangements also
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