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New Zealand's Personal Property Securities Act - some of the difficult issues

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1. Background

1.1 Mike's paper has highlighted quite a number of issues we, as lawyers, financiers and insolvency practitioners (and others) have had to grapple with since the PPSA came into force.

1.2 It is against this background that I wish to comment on a couple of areas:

a. First, what realistically has changed post PPSA for a party (in particular a lessor or bailor of goods) who had relied on its title to those goods.

b. Second, whether lawyers should be opining (in solicitors' opinions) as to priority, creation and perfection of security interests under the PPSA.

2. Lessors & Bailors - What has Changed?

2.1 As Mike has indicated, under the PPSA there are obviously opportunities for general financiers to improve their security position (which they would not have had under the prior law).

2.2 Take for example a lessor or bailor leasing or bailing goods to a debtor (lessee/bailee) under a master lease or bailment agreement. Lessees and bailees do not have title to those goods and as a result (under the prior law) general financiers of lessees and bailees had no rights to those goods. Nevertheless, under the prior law most bailors, for example, obtained an acknowledgment and waiver from the bailee's general financier under which

the general financier would confirm (amongst other things) that it had no claim to the bailed goods.

2.3 As Mike has pointed out there is considerable uncertainty concerning the degree of specificity required in describing collateral in security agreements. Although I am reasonably comforted by his opinion that self contained descriptions should not be required, at the end of the day this would obviously depend on interpretation by the New Zealand Courts.

2.4 The practical difficulties for lessors, bailors and retention of title suppliers in complying with a strict (more onerous) interpretation of section 36 could make doing business far too hard. It appears that current practice is for such entities to describe all acknowledgments, invoices, schedules and the like, which adequately describe the collateral to form part of the master lease agreement, bailment agreement or terms of trade.

2.5 General financiers who fund debtors on a day to day basis would know the debtor's business and would know if items of inventory and leased items are supplied by consignors/bailors/lessors. A general financier would scale its security value accordingly and for goods on bailment or lease, in most situations, no security weighting would be given to such goods. Post PPSA the general financier would have no residual interest in the leased or bailed goods and in this regard it is important to stress that leases and bailments for a term of more than one year and commercial consignments are not caught by Part 9 Enforcement (unless the lease/bailment/consignment secures payment or performance of an obligation). In this context it is also worth noting that under the PPSA a lease or bailment of goods for a term of less than one year is not a security interest and therefore not caught under the PPSA. The prior law would therefore apply (refer to my comments in paragraph 2.2 above).

2.6 In my view a prudent lessor/bailor should obtain a waiver from the lessee/bailee's general financier, pursuant to which the general financier would waive any rights it may have to the bailed/leased goods and its proceeds. The bailor/lessor would of course need to provide the general

financier with evidence (at the necessary time) of the goods bailed or leased. Such waivers would also provide a level of certainty for receivers.

3. Legal Opinions

3.1 Mike has canvassed some of the issues relating to priority, creation and perfection. The question therefore is whether lawyers should be opining as to priority, creation and perfection of security interests.

3.2 One of my colleagues once pointed out to me that to give an opinion as to priority would mean one would have to go through the PPSA section by section and add all necessary qualifications and assumptions. After going through the exercise myself (I gave up in the end) I appreciated what he meant!

Opinion on priority of a security interest

3.3 The general consensus is that lawyers should not be opining as to priority of a security interest in collateral. This issue was raised at last years conference session on the PPSA by Matthew Yarnell – since then it appears that most banks and lawyers understand the issue, when explained, and do not press for opinions on priority.

3.4 Some of the reasons for not providing an opinion as to priority are:

a. As indicated previously there are a raft of provisions in the PPSA that could undermine the priority of a security interest created under a general security agreement (where a security interest is created in all the debtor's present and after acquired required personal property). Some examples include:

i. security interests created by the debtor in collateral may have been perfected by possession by a third party at the time of registration of the secured party's financing statement. The types of collateral capable of being perfected by possession include chattel paper, goods, negotiable instruments,

investment securities, documents of title and money (section 41(b)(ii));

ii. buyers or lessees of goods will take the goods free from certain security interests in certain situations (sections 53-56) eg. under section 54 a buyer or lessee of goods who acquires goods as consumer goods will take them free of any security interest if the value of the consumer goods did not exceed $2,000 at the time the security interest in the goods attached, the buyer or lessee gave new value for the interest acquired and the buyer or lessee bought or leased the goods without knowledge of the security interest;

iii. a purchase money security interest in collateral or its proceeds, other than inventory or intangibles, given by the same debtor to a third party before *or after* the registration of the secured party's financing statement, will have priority over the secured party's non-purchase money security interest if the holder of the purchase money security perfects its security interest within 10 working days of the debtor, or other person, on behalf of the debtor, obtaining possession of the collateral (section 73);

iv. a purchase money security interest in collateral which is inventory or its proceeds will have priority over the secured party's non-purchase money security interest given by the same debtor if the purchase money security interest in the inventory or its proceeds is perfected at the time the debtor, or other person on behalf of the debtor, obtains possession of the collateral (section 74);

v. security interests and other interests in chattel paper, negotiable instruments, documents of title, investment securities or money, may have been transferred before *or after* registration of the financing statement, and the person

acquiring the interest obtains possession or delivery of that collateral (sections 94-103);

vi. if the goods over which a security interest is held subsequently become part of processed or commingled goods, the security interest may rank equally with other security interests in that product or mass and may be limited to a proportion of the total value of the product or mass (section 85);

vii. claims of preferential creditors on receivership or liquidation of a debtor, may (in relation to collateral which is inventory and assuming the security interest is not a purchase money security interest) take priority over the secured party (Seventh Schedule, Companies Act 1993);

viii. claims arising under statute (e.g. certain rates and taxes) or under general law (e.g. repairers' liens).

(and the list goes on and on.....)

b. There are other interests and securities which are not caught under the PPSA which may undermine the priority of a security interest and in any event it may be difficult to identify what those other interests and securities are;

c. There are rights and other matters which fall outside the PPSA and which may undermine the priority of the security interest. Examples include:

i. the right of a landlord to distrain (under the Distress and Replevin Act 1908) on goods situated on premises leased by the debtor. There is however an anomaly under the Distress and Replevin Act 1908 which would mean that the landlord's right would only apply to individual lessees and not to corporate lessees. This means that where a company granted a security interest under a general security agreement, the

secured party would take priority over the landlord. A proposed amendment under the Business Law Reform Bill to the Distress and Replevin Act will remove the distinction between corporate and individual lessees so that the landlord's right to distrain will apply to both individual and corporate leases;

ii. the Courts may impose equitable principles such as unjust enrichment to undermine a security interest.

d. Events that determine priority between security interests in the same collateral may occur after the issue of the opinion. Obviously such events would not been known at the time the opinion was issued; and

e. Most importantly (from a secured party's perspective) there would need to be so many qualifications and assumptions that an opinion as to priority would be of little use to the secured party (and of course the issue of such an opinion would be expensive).

Reports of PPSR searches

3.5 Given the issues relating to providing an opinion as to priority it may be useful for a secured party to obtain reports (prepared by solicitors) of the PPSA searches. I understand this is the practice in Canada. Such reports would not be intended to be opinions. In my view, reports should ideally be given to the secured party as early as possible to ensure there is adequate time to obtain (if required) appropriate waivers, subordination agreements, financing change statements or discharges before settlement. This is particularly important in New Zealand. Given the infancy of the PPSA legislation there are (as would be expected) a number of issues arising from searches (e.g. collateral descriptions too wide or incorrect). I was involved in a transaction where quite clearly the collateral details were incorrect and further there was no security agreement in place between our debtor client and the "secured party" (who was a supplier). The settlement date was looming (20 working days to go) and it became clear early on that the supplier did not understand the issue. Rather than prolonging the process I asked our debtor client to give written demand to the supplier (under section 162) requesting a discharge of the financing statement (under section 163). Settlement occurred smoothly!

3.6 I recently came across one of the worst examples I have seen of a financing statement. The secured party did just about everything wrong. The name of the debtor was incorrect (quite clearly "seriously misleading"), the secured party's contact details were listed in the debtor's contact details category and the collateral was described (in the description box) as a "guarantee from…" (clearly not a security interest in anything).

Opinion relating to creation of a security interest

3.7 In my view an opinion in relation to creation of a security interest can be given but not without the necessary assumptions and qualifications.

3.8 An opinion on creation might say "The security agreement creates a security interest in the collateral in favour of the secured party".

3.9 In considering the various qualifications and assumptions, lawyers should have regard to the following:

a. No opinion should be given as to priority. The qualification might say "No opinion is given as to priority of the security interest and our opinion is limited as to whether a security interest has been created under the PPSA";

b. The law applying to the creation of the security interest – it should always be assumed that the security interest is governed by the New Zealand PPSA;

c. No opinion should be given that the security agreement creates a security interest in proceeds. Under the PPSA "proceeds" must be "identifiable and traceable" personal property. Therefore a security interest will not extend to any proceeds from the collateral which are not identifiable or traceable. It is prudent therefore to qualify the opinion. Such qualification might say "No opinion is given as to a security interest in proceeds of personal property which are not identifiable or traceable";

d. The requirements for the creation of a security interest (enforceable against third parties) must be satisfied. These requirements are (in the case of a non-possessory security interest):

i. Section 36(1)(b). *The debtor has signed, or assented to (in writing), a security agreement that has the descriptions or statements relating to the collateral contained in any of 36(1)(b)(i)(ii) or (iii).* If the collateral is expressed by item or kind it may be prudent to include an assumption that "The description of the collateral in the security agreement is accurate";

ii. Section 40(1)(a). *The secured party has given value to the debtor.* Consider including an assumption that value has been given;

iii. Section 40(1)(b). *The debtor has rights in the collateral.* Consider an assumption that the debtor has (or will have) rights in the collateral. This is important because there is no personal property registry in New Zealand to ascertain the rights. In this context consider whether it is necessary, post PPSA, to quality the opinion (so that no opinion is expressed as to title) given that the PPSA deals with "rights" of the debtor (which includes title). Also consider including a qualification in relation to creation of a security interest in after-acquired property as attachment does not occur until value is given and the debtor has rights in the collateral;

(subparagraphs ii and iii could be qualified in a perfection opinion – see paragraph 3.15.);

iv. Section 40(2). *The debtor and secured party have agreed that a security interest attaches at a later time.* Such an agreement can occur outside the security agreement. Consider including an assumption that the debtor and the secured party have not agreed to postpone attachment.

Opinion relating to perfection of a security interest

3.10 I have limited my discussion under this part to registered security interests (ie non-possessory security interests) as most security interests are perfected by registration.

3.11 As you know the ingredients for perfection by registration are attachment (i.e. value is provided by the secured party, the debtor has rights in collateral and the security agreement is enforceable against third parties) and registration of a financing statement. Therefore the qualifications and assumptions for opinions on perfection are the same as those contained in an opinion on creation.

3.12 New Zealand banks generally undertake the registrations themselves. However, law firms may be called upon from time to time to register on behalf of overseas financiers.

3.13 It is important to consider (in the context of perfection) provisions of the PPSA which may defeat the registered security interest such as the priority of a purchaser of negotiable instruments, investment securities, chattel paper and negotiable documents of title (sections 96, 97, 98 and 99). Under those sections a perfected security interest may be defeated by a purchaser for value who takes possession of such collateral. For investment securities that are shares (for example) a secured party with a security interest in shares should hold all share certificates (perfection by possession) and in addition (although not strictly necessary but prudent to do so) would perfect by registration. However, it may still be prudent to include an appropriate qualification in the opinion to deal with the position where a perfected security interest can be defeated by possession.

The qualification might say:

"Notwithstanding that registration will perfect (subject to attachment) a security interest in negotiable instruments, investment securities, chattel paper and negotiable instruments of title, the security interest in such collateral may in certain circumstances be defeated by a third party who takes possession of such collateral."

3.14 The opinion should also contain a qualification dealing with perfection of serial numbered goods – in order to create a perfected security interest in serial numbered goods a financing statement must contain a description of the collateral including the serial numbers.

3.15 As mentioned earlier, a qualification as to the provision of value and debtor rights in the collateral could be dealt with in an opinion relating to perfection. Such opinion might say (assuming the financing statement has been registered at the time the opinion is given):

"The security interest will be perfected in the collateral:

(i) when value is given by the secured party to the debtor; and

(ii) if the debtor has rights in the collateral existing at the date of this opinion and, in relation to after-acquired collateral, if the debtor has rights which are sufficient to perfect a security interest in the after-acquired collateral."

3.16 As you know opinions given are expressed as at the time they were given. However, it may be prudent (particularly for overseas financiers) to address in the opinion matters which may "unperfect" a security interest. To list some examples:

a. If the debtor changes its name (assuming the secured party has "knowledge" (within the meaning set out in section 19)), or transfers its interest in the collateral (see sections 88 to 91), the security interest will become unperfected unless a financing statement is registered within the prescribed time periods under the PPSA;

b. A financing statement must be renewed (by the secured party) prior to its expiry;

c. A financing statement will be discharged or amended in accordance with a written change demand given to the secured party by the debtor or a person having an interest in the collateral under section 162 and 163 of the PPSA; if:

i. the secured party fails to comply with the change demand within 15 working days after it was given; or

ii. the secured party fails (within 15 working days after the change demand was given) to give to the person who issued the change demand, a Court order maintaining the registration of the financing statement.

Opinion as to enforceability

3.17 An opinion as to enforceability typically states that "each transaction document constitutes the legal, valid and binding obligations of the debtor, enforceable against the debtor in accordance with its terms."

3.18 Further qualifications will need to be considered in light of the PPSA such as:

a. Part 9 (Enforcement) – some provisions under Part 9 cannot be contracted out of although the security agreement may state otherwise. Therefore one cannot strictly say that the security agreement is "enforceable against the debtor in accordance with its terms";

b. Section 25 – a duty is imposed on the secured party to exercise all rights, duties or obligations that arise under a security agreement and the PPSA in good faith and in accordance with reasonable standards of commercial practice.

It may be that such PPSA considerations can be addressed by a qualification stating (in effect) that the terms in the security agreement are enforceable against the debtor but only to the extent that such terms are not contrary to or inconsistent with the provisions of the PPSA.

3.19 Other considerations under the PPSA in relation to enforceability relate to sections 26 to 33 of the PPSA. Pre-PPSA it was sufficient to state that "no opinion is given as to the validity or effectiveness of any security interest in property located outside New Zealand". Post-PPSA, such qualification should be revised so that "no opinion is given as to whether or not the law of any other jurisdiction may operate to affect the validity or effectiveness of any security interest".