INSOLVENCY

Insolvency

- = when a person or company cannot pay their debts.
- In insolvency situations the law intervenes to decide who is and isn't going to be paid with whatever money there is.

Pari passu rule

- = all creditors should be treated equally
- Every creditor gets paid the same proportion of the full amount they are owed
- Assumes that every creditor is unsecured: secured creditors can get past this rule and gain priority (get paid first) over other unsecured creditors.

Receivership

- Only available to secured creditors.
- Contractual right: contracts with the debtor will contain a clause stating that if the debtor defaults, the creditor has a right to appoint a receiver.
- The receiver acts on behalf of that individual secured creditor only.
- Their job is to manage the debtor's assets and to try and make money from them to pay the debt.
- Receivers have certain duties, contained in the Receiverships Act, eg. they have to sell assets at the best price that is reasonably obtainable at the time of sale.

Liquidation

- A statutory right: Companies Act and other statutes
- Liquidators act on behalf of unsecured creditors generally.
- They deal with what assets are left over after the secured creditors have taken what they need. Often there will be nothing or very little left over.
- Liquidators have powers under the Act, eg. they can challenge certain transactions which took place prior to liquidation.

The balance sheet: assets, liabilities and equity

- Every economic entity has a balance sheet.
- Key thing is that it needs to be balanced on each side!

Assets	Liabilities
Car $100 Receivables $100	Bank $100 Payables $50 Equity $50
Total: $200	Total: $200

- Assets must be balanced with liabilities + equity.
- *Receivables* = an amount someone else owes you, a kind of asset.
- *Liabilities* = amounts you owe to someone else.
- *Payables* = a kind of liability. Amounts you owe, a legal obligation to someone else. Often things like bills owed to power companies (also known as trade creditors).
- *Equity*
    - What is left over after your liabilities are paid, your share of the economic entity.
    - The buffer that protects creditors from losing their money: if assets go down, equity suffers first as opposed to liabilities (ie. the bank isn't owed any less money and they don't suffer a loss. Only the debtor suffers the loss as their equity goes down)
    - Equity fluctuates to keep the balance sheet balanced.
    - Where assets decrease by so much that liabilities cannot be paid, equity can go into the negative.
    - While equity provides a buffer for creditors, it doesn't provide a guarantee they will be paid. Hence creditors take out security interests over the debtor's assets.
    - This gives them priority over unsecured creditors, and pari passu goes out the window. They will get paid first. Any unsecured creditors have to scrap it out over whatever assets are left over (ie. which do not have a security interest over them).
- In reality, often only secured debt gets paid off and unsecured creditors get nothing (and there's certainly no equity left over).

<u>Comparison: debt vs equity</u>
- Debt
    - Normally fixed term
    - Interest is a specific amount- must be paid
    - Fixed claim- must be paid to avoid insolvency
    - Claims limited to amount due (ie. Amount of debt + interest)- no right to profits or residual assets (ie. you don't get extra if the business does really well)
    - No automatic control right- must be contracted and usually "negative"
- Equity
    - Perpetual/no fixed term
    - Dividends are not fixed in amount (can go up and down depending on how well the business does) or obliged to be paid (only paid if the business is solvent. Creditors rank ahead of equity, they get paid first)
    - Residual/"contingent" claim- must meet solvency test for any distribution
    - Entitled to entity's residual assets after fixed claims met
    - Positive control through voting and appointment of directors

PPSA BASICS

Purpose

- Only applies to personal property, not land.
- Only really becomes relevant when debtors become insolvent and can't repay their debts.
- Gives creditors a legal framework to maximise their position and gain an advantage over other creditors, by creating a system of priorities.
- Supports the giving of credit by protecting creditors.
- Personal property is called "collateral" in the PPSA

Meaning of "security interest": s 17(1)

- = an interest in personal property created or provided for a transaction that in substance secures payment or performance of any obligation.
- (without regard to the form of the transaction or the identity of the person who has title)
- The PPSA therefore creates a statutory type of security interest/proprietary right.
- Security interests can be registered under the PPSA, through what is called a financing statement.

Attachment

- Ie. when a security interest "attaches" to personal property, so that the creditor can enforce their claim against the property.
- If there is no attachment, the creditor will have no claim under property (only a personal claim)

Section 40

- Where there is only one creditor claiming the property: a security interest attaches if (a) the secured party gives value and (b) the debtor has rights in the property.

Section 36

- Where there is more than one creditor claiming the property: s 40 needs to be satisfied AND there must be a written, signed agreement containing a description of the property that is secured.

Perfection: s 41

- Perfected security interests take priority over unperfected security interests.
- Thus you need perfection in order to get priority over other creditors who are claiming the property.
- Perfection = attachment + registration of a financing statement on the PPSA register OR taking possession of the secured property.

Basic priority rules: s 66

- A perfected security interest has priority over an unperfected security interest
- If there are multiple creditors with perfected security interests, the main rule is that the first person to register their interest takes priority.

"Lease of more than 1 year": s 17(1)(b) and s 16

- A "lease of more than 1 year" is a security interest under s 17(1)(b).
- That phrase is defined in s 16.
- It can include bailments (*Rabobank*)
- The lessor must be "regularly engaged in the business of leasing goods", meaning that they intend to profit from the lease.
- The PPSA deems that leases of 1+ years are security interests because in reality, many commercial leases are indistinguishable from hire purchase agreements or conditional sale contracts. They create some degree of apparent ownership (they are ways of financing a person so that they can use goods as if they are the owner).

POLYMER SYSTEMS V MONTGOMERIE
(pre-PPSA)
Facts
- High Court, 2002
- A company enters into a contract to lay a water pipe for a council. It obtained pipes from Polymer.
- The contract between Polymer and the company contained a retention of title clause (title in the pipes remained with Polymer until full payment).
- The contract also allowed the company to on-sell the pipes, but the proceeds were to be held on account for Polymer.
- The council paid the company in full, but the company went into liquidation before accounting to Polymer.
- Polymer sues.

Result
- Polymer loses.
- Polymer had an unregistered charge against the book debt which was void against the liquidators.
- If they had registered that charge under the Companies Act, it wouldn't have lost its rights
- Note: under the PPSA, a retention of title clause is a security interest under s 17(3). So under the PPSA Polymer might have won.

BROOKSHANK V FELTEX
Facts
- Court of Appeal, 2009
- Brookshank supplied wool to Feltex.
- B created a new supply agreement with F, providing that possession and title in the wool would only pass to F once B had received payment by way of cleared funds. Once B received payment, they were to tell the wool stores to release the wool to the carriers.
- Some wool was delivered to F without payment. F realised the mistake and set the wool aside, but refused to give it back to B.
- F goes insolvent.
- F's bank (ANZ) had a perfected security interest over all of F's property. They claimed that this security interest applied to the wool, and took control of it.
- B brings a claim against F for conversion of the wool.

Result
- Trial court found the supply agreement created a security interest under s 17 of the PPSA. the interest had attached when the wool was released to F. ANZ's perfected security interest had priority over B's unperfected interest. B loses. B appeals.
- There was conversion of the wool.
- The supply agreement did not create a security interest under s 17.
    - It was not intended to secure payment.
    - Rather, it was formulated to prevent B from having any credit exposure to F.
- Thus, ANZ's security interest had not attached to the wool.
- = appeal allowed.

GRAHAM V PORTACOM
Facts
- High Court, 2003
- Portacom leases portable buildings to NDG.
- The bank had lent money to NDG. The bank had a registered security interest in the buildings.

- Portacom did not register its security interest in the building.
- NDG goes into receivership.
- The receiver sought directions from the court as to who had priority over the buildings.

Result

- Issues: was the lease of the buildings a security interest? Does it matter that NDG only had a lesee's interest in the buildings?
- Did Portacom have a security interest?
    - S 17(1)(b): a "security interest" includes a lease for a term of more than 1 year. The lease is treated as a security agreement and the lessee is treated as the owner of the leased goods for the purpose of registration and priority.
    - Here, NDG was a lessee and had possession of the buildings. The lease was indefinite. Therefore NDG could grant Portacom a security interest over the buildings.
- Did the bank's security interest attach to the buildings?
    - S 40(1): here the bank had given value and NDG had rights in the buildings
    - So the bank's security interest had attached.
- Who had priority?
    - The bank, because their security interest was perfected (they had registered it).

What if Portacom leased the buildings on a deferred payment basis, and title didn't pass until payment?

- Still comes within s 17(1)(a). NDG would still have an obligation to pay.
- S 17(2) states that a "security interest" includes conditional sale agreements.

What if the buildings weren't portable?

- If they are fixed to the land, then they are no longer personal property. The PPSA wouldn't apply.
- Under normal property law then, NDG only had a lessee's interest and that's all they could have passed on to anyone else. They would not have been able to grant a security interest over the buildings.

RABOBANK V MCANULTY

Facts

- Court of Appeal, 2011
- The Syndicate sent a horse to SBL.
- SBL had borrowed money from Rabobank.
- SBL defaults.
- The Syndicate took the horse back before Rabobank could do anything about the situation.
- Rabobank claims a perfected security interest over the horse.

Result

- Was the agreement between the Syndicate and SBL a "lease for a term of more than 1 year"?
    - Under s 17(1)(b), a "lease for a term of more than 1 year" can be a security interest. That phrase is defined in s 16.
    - Here the agreement was really only a bailment, but the court finds that the term "lease for a term of more than 1 year" can include bailments.
    - But the definition excludes leases/bailments by a lessor who is not "regularly engaged in the business of leasing goods".
    - Here, the Syndicate was not regularly engaged in the business of leasing goods. It was not intending to make a profit from the bailment.
    - So the agreement was not a "lease for a term of more than 1 year", the PPSA does not apply, and Rabobank can't have had a security interest over the horse.

What would be the result if McAnulty had an arrangement with the stud farm under which the farm paid $100/month for using the horse, and paid a percentage of the stud fees? Would there be a security interest?

- This might mean that the Syndicate was in the business of leasing goods.

- = Rabobank could have had a security interest over the horse.

What if the bailment was for a term of 6 months, the agreement expired, but the horse was still at the stud farm and McAnulty was still paying fees? Is that a lease for a term of more than one year?

- Yes, if they retain possession for more than one year.

STOCKCO V GIBSON

Facts

- Court of Appeal, 2012
- Crafar is a dairy farm. The bank had a security agreement covering all of Crafar's assets. Normally Crafar would sell cows and the bank would get security over those cows.
- But, Crafar is deeply in debt. They instead try to sell the cows to StockCo and get them to lease the cows back to Crafar. The bank wasn't keen on this.
- Crafar then got Nugen involved. Nugen wasn't under the bank's security agreement. Crafar sold the cows to StockCo, who leased them to Nugen. The cows never left Crafar's land.
- The money from the sale (what StockCo paid to Crafar) was then loaned to Nugen to buy more land.
- But because the cows were under the bank's security agreement, the bank has a claim over any proceeds from a sale of the cows.
- Crafar argues they are protected by s 53: the sale was in the ordinary course of business, and so they did not need to check whether there was an existing security interest over the cows.

Result

- The purpose of s 53 is to protect innocent purchasers, so that they do not need to check whether there are any security interests over the goods they purchase.
    - This facilitates the flow of commerce
    - But, it creates a risk for lenders that the debtor will sell goods in the ordinary course of business, even if it is in contravention of the security interest.
    - However, if the purchaser knows the sale is in breach of a security agreement, they will not be protected and the bank's interests prevail. It's fine if the purchaser knows there is a security agreement and take no steps to find out if the sale is in breach of it, though.
- Test for s 53
    (a) What was the ordinary course of business? Can look to the *Fairline* factors:
        - Where the agreement is made: if the agreement is made at the business premises of the seller, it is more likely to be in its ordinary course of the business
        - Parties to the sale: if the buyer was an ordinary everyday consumer, as opposed to a dealer or a financial institution, it is more likely to indicate a sale in the ordinary course of business
        - Quantity of goods: if one or few articles are sold in the ordinary way, this is more likely to be in the ordinary course of business as compared with a sale of a large quantity.
        - Price charged: if a discounted price is paid, this indicates against the sale being in the ordinary course of business.
    (b) Was this sale within the ordinary course of business?
- Was this sale of cows in the ordinary course of business?
    - No.
    - The transaction was unusually formal
    - It involved external lawyers
    - It was an unprecedented number of cows sold (4000)
    - It was a one-off transaction
    - The sale took place in suspicious circumstances.
- Thus, Crafar is not protected by s 53.

- This case highlights two competing policy objectives of the PPSA: the commercial objective of facilitating commerce, and the equally important objective of ensuring that those who provide credit on the security of debtor's goods are not unfairly deprived of the benefit of that security.

What difference would it make if the facts were the same, but SC had been provided with a copy of the security agreement between the farm and the bank?

- StockCo would have had actual knowledge of the contents of the security agreement
- But might still not realise that the sale is in *breach* of that agreement.
- So potentially doesn't change the result.

What if the 4000 cows had actually been moved onto the buyer's farm?

- Would suggest the sale is in the ordinary course of business
- But probably not enough to outweigh the other factors

What if the money received from the sale of the cows had been deposited into the farm's bank account, and was still there when the farm went into receivership?

- Then the bank would have had a security interest over the money, and the case wouldn't have gone to court.
- Here, the money never made it into the farm's account, it basically disappeared, so it wasn't any good to the bank.

STIASSNY V COMMISSIONER OF IR

Facts

- Supreme Court, 2012
- Receivers of a company sold off some assets, which generated GST.
- The receiver were worried they would be personally liable for the GST under s 58, so they preemptively paid for it to IRD.
- However, the bank claimed that the GST belonged to them as a secured creditor.

Result

- Bank's arguments:
  - Argue that the receivers were holding the GST on trust for the bank, and so shouldn't have given it to IRD
  - Arguing under equity/trust law
- IRD's arguments
  - S 95 applies.
  - IRD has priority because they are a creditor who received payment of a debt owing by the debtor through a debtor-initiated payment.
  - The bank argues that IRD cannot rely on s 95, because IRD had not acted in accordance with s 25 (acting in good faith). They argue that IRD knew the GST had been paid in breach of a security agreement.
  - The IRD knew a security agreement existed, but there is no evidence that IRD knew the payment was in breach of that agreement. They did not contravene s 25
  - Therefore, IRD gets priority under s 95
- The PPSA priority rules therefore overrule pre-existing rules of equity, where there is conflict.

What if IRD had received a letter from the banks, stating that the payment was in breach of the security agreement

- IR would have actual knowledge of the breach = breach of s 25, and can't get priority under s 95.

What if the tax had been paid in cash rather than cheque?

- Look to s 94: a holder of money takes the money free of a perfected security interest if the holder had no knowledge of the security interest, or if they did have knowledge, they are a holder for value (ie. Gave some value for the payment)