LEGAL AND MARKET DEVELOPMENTS IN NEW ZEALAND INSOLVENCY

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The past year has seen a range of interesting and sometimes unexpected legal developments in the New Zealand insolvency sphere. This paper aims to explore not only the headlining decisions of New Zealand's highest courts, but also several notable judicial decisions at first instance.

Part one of this paper provides an update on changes in the regulation of the industry, from the Insolvency Practitioners Bill to developments in industry self-regulation via RITANZ (Restructuring Insolvency & Turnaround Association of New Zealand).

Part two explores developments in New Zealand's voidable transactions regime, particularly the significant decisions from our two highest courts, which have brought clarity to practitioners and comfort to creditors. Notably, the two decisions each interpret statutory language adopted from the equivalent Australian provisions. The Supreme Court followed the Australian interpretation of the words it was considering, while in each case the Court of Appeal eschewed the Australian case law.

In Part three, the continued evolution of the courts' ability to pierce the corporate veil is explored by reference to two somewhat unusual first-instance decisions. In the first, a receiver was alleged to have acted as a director of a subsidiary and in the second, a parent was held liable for the debts of a subsidiary.

Part four includes discussion of the changing rules regarding litigation funding in New Zealand.

Finally, part five collates recent legal updates from the New Zealand courts at both first instance and appellate level, particularly:

- IRD priority;
- Liquidators' powers to disclaim leases;
- Construction Contract Act 2002 amendments; and
- KiwiSaver balances and bankruptcy.

1 INDUSTRY REGULATION

Insolvency Practitioners Bill

1.1 The initial policy work for the Bill was carried out in 2008, and the Bill was introduced to the House in April 2010. In its initial form, it proposed a system of negative licensing. Any person could accept an insolvency assignment unless disqualified by the Registrar of Companies. In effect that would be a modest change to the current state of legislation, under which any person can take appointments, provided some basic criteria are met. The court has the power to bar individuals from taking formal appointments.

1.2 The negative licensing system was proposed, at least partly, on the basis that the cost of a full licensing system would be prohibitive, given the small size of the industry in New Zealand.

1.3 In select committee, the design of the bill was criticised, leading to a revised version under which a registration system would be established. Only registered insolvency practitioners would be permitted to act as liquidators etc. In addition, insolvency practitioners would be required to provide greater information to creditors. The select committee reported in 2011.

1.4 The bill has received its second reading. The next stage is for Parliament to review the bill, clause by clause, in committee. However, the bill is at number 39 on the order paper and is likely to be revised further before being returned to Parliament for debate.

1.5 The bill is not currently one of the top priorities for the Minister of Commerce, and in the short to medium term is unlikely to be progressed.

RITANZ and self-regulation update

1.6 As we have seen over recent years, insolvency practitioners (*IP*s) will be appointed to all sorts of different businesses in all sorts of different industries. They may be appointed as voluntary administrators, receivers and managers, liquidators, deed administrators, personal creditor compromise trustees or statutory managers. The appointment may be by a company's directors, shareholders, secured creditors, the High Court, a personal insolvent or (in the case of statutory managers) the Crown. There may be a range of reasons giving rise to the appointment, but almost always:

(a) the IP will be required to deal with other peoples' money in circumstances where there is insufficient to go around;

(b) the IP's decisions and the way in which he or she goes about the appointment can have a profound effect on a range of stakeholders including owners, employees, creditors and communities; and

(c) IP's are entitled to charge professional fees and to have these paid out of the company's (already insufficient) assets.

1.7 Given the nature of their role and the significance their efforts can have on the interest of others it is perhaps surprising that IPs in New Zealand have remained so unregulated for so long. Indeed, the insolvency profession in New Zealand must be one of the very few with so many of its members calling for more regulation rather than less. With the Insolvency Practitioners Bill continuing to languish down the order papers, and in a state which many believe does not address all the issues facing the profession, significant steps have now been taken towards designing and implementing a regime of self-regulation.

The parties

1.8 The original impetus for this came from INSOL (NZ) (*INSOL*). INSOL was a special interest group of the New Zealand Institute of Chartered Accountants (*NZICA*) and the New Zealand affiliate of INSOL International. More recently, following an industry consultation process, INSOL has effectively been replaced by the Restructuring Insolvency & Turnaround Association of New Zealand (*RITANZ*) which was incorporated in September 2014.

1.9 One of RITANZ's first tasks, again following the industry consultation, was to sign a Memorandum of Understanding with NZICA to implement an IP accreditation regime.

1.10 It was originally hoped that this regime would be implemented by 30 June 2015. However, NZICA has recently joined with the Institute of Chartered Accountants Australia to form Chartered Accountants Australia New Zealand (*CA ANZ*). This new relationship has given rise to some operational issues concerning the implementation of the accreditation regime. The parties are currently working through these issues, and are hoping to have implementation of the new regime by 30 September 2015.

The Proposed Accreditation Regime

1.11 The aims and objectives of the self-regulation regime are to:

(a) distinguish the quality of services provided by RITANZ members;

(b) increase public confidence in the work of members accepting insolvency engagements;

(c) improve standards, by mandating verifiable admission requirements and developing best practice guidelines; and

(d) align member qualifications more closely with equivalent overseas models.

1.12 To this end RITANZ members who wish to take "*regulated insolvency appointments*" will need to become accredited in order to do so. This will include taking employment as a receiver, liquidator, administrator, deed administrator, personal creditor compromise trustee, statutory manager, Part 14 administrator, supervisor or monitoring accountant. In order to become accredited practitioners will need to demonstrate certain levels of competence and experience:

(a) CA ANZ members & non-member partners: one thousand hours of higher level restructuring and insolvency experience at a senior level over the previous three years.

(b) Non-CA ANZ members: two thousand hours of higher level restructuring and insolvency experience at a senior level over the previous three years, or as otherwise demonstrated.

(c) Competency and experience endorsed by another practitioner approved to do so.

1.13 Applicants for accreditation will also need to demonstrate that they are "*fit and proper*" to take on insolvency engagements, taking into account such things as:

(a) prior removal as an insolvency office holder;

(b) criminal convictions involving dishonesty, breach of financial markets regulation etc;

(c) whether they have been banned as a director, subject to bankruptcy or insolvency, dismissed or asked to resign from a position of trust or fiduciary appointment;

(d) whether they have been subject to current or prior disciplinary action by a professional body, leading to censure, suspension or removal.

1.14 In terms of implementation, CA ANZ will administer the accreditation regime pursuant to contractual arrangements to be entered into with CA ANZ. This makes sense for a number of reasons. CA ANZ already has the infrastructure in place to manage the accreditation regime given the statutory regulatory function already undertaken by NZICA/CA ANZ. Many RITANZ members who take appointments as IP's are already members of CA ANZ. RITANZ members who are not members of CA ANZ will be required to enter into a Compliance Agreement with it whereby they will agree to be bound by the ethical and disciplinary practices and procedures to which New Zealand members of CA ANZ are already subject. The final details of exactly how this will operate are being finalised at the time of writing this paper.

1.15 Once the regime is under way those IP's who have been accredited by CA ANZ will be able to market themselves accordingly. They will have Continuing Professional Development (CPD) obligations and will be subject to practice review. In tandem with this RITANZ is developing a Code of Practice with which all members will need to comply, and developing further the education programmes and already strong conference programme that will help enable accredited insolvency practitioners to meet their CPD requirements.

2 DEVELOPMENTS IN VOIDABLE TRANSACTIONS

2.1 The first half of 2015 saw two significant aspects of New Zealand's voidable transaction regime clarified, following a period of uncertainty for both liquidators and creditors. The Supreme Court and the Court of Appeal, respectively, were faced with questions as to the operation of the statutory defence to insolvent transaction claims, and the validity of the "peak indebtedness" approach in cases of continuing business relationships (or running accounts).

2.2 While these two key judgments have blunted several of the tools available to liquidators in pursuit of insolvent transactions, creditors still face other significant hurdles in this context. It remains to be seen whether more weight may be placed by the courts on other aspects of the voidable transactions provisions, particularly the other limbs of the statutory defence, with the effective redundancy of the "gave value" limb in the wake of the Supreme Court's decision.

2.3 This paper addresses these two important developments in the New Zealand voidable transactions regime, and also touches on several other interesting recent legal developments in insolvency law. The decision of the High Court late last year in *BB2 Holdings* has demonstrated the risks for secured creditors holding less security than the amount that they are owed.[1] An even more recent decision of the same Court illustrates how both New Zealand's voidable transactions provisions and the prejudicial dispositions provisions of the Property Law Act 2007 may be deployed to recover Ponzi payouts.[2]

The New Zealand insolvent transaction regime

2.4 The competing policy considerations underlying the voidable transactions regimes in New Zealand and Australia are materially similar. Both regimes emphasise the *pari passu* sharing principle as a primary policy aim,[3] with the competing aim of commercial certainty for individual creditors. The most recent reform of the New Zealand voidable transactions regime sought to align the New Zealand position with that of Australia's, and many of New Zealand's current provisions are modelled on those found in the Australian Act.

2.5 The New Zealand voidable transactions regime is governed by ss 292-298 of the Companies Act 1993 (*Act*). The regime recognises three types of voidable transaction: insolvent transactions that are voidable (voidable preferences);[4] voidable charges;[5] and transactions at an undervalue.[6]

2.6 Under s 292 of the Act, a transaction will be voidable if it is an insolvent transaction, and is entered into within the specified period.[7] A transaction is an insolvent transaction if:[8]

(a) it was entered into at a time when the company was unable to pay its due debts; and

(b) it enabled a person (a creditor) to receive more towards the satisfaction of a debt owed by the company than that person (creditor) would receive or would be likely to receive in the company's liquidation.

Statutory defence broadened by Supreme Court

2.7 The statutory defence that was the subject of the *Fences and Kerbs* litigation is available to creditors in respect of all actions taken by a liquidator to make

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1 *Grant v BB2 Holdings Ltd* [2014] NZHC 2504.

2 *Fisk v McIntosh* [2015] NZHC 1403.

3 Jason Harris and Michael Murray Keay's Insolvency: Personal and Corporate Law and Practice (8th ed, Thomson Reuters, Sydney, 2014) at [14.30]. See also Law Commission Report no.9 *Company Law Reform and Restatement* [649] and [696], which led to the enactment of the New Zealand Companies Act 1993.

4 Companies Act 1993, s 292.

5 Ibid., ss 293 and 299.

6 Ibid., ss 297 and 298.

7 Ibid., s 292(1).

8 Ibid., s 292(2).

recoveries, not just voidable transactions, and not just actions taken under the Companies Act.[9] In that regard, it is wider than Australia's defence.

2.8 To successfully invoke the defence in s 296(3), a creditor bears the onus of proving that:

(a) it received the payment in good faith;

(b) it did not suspect or have reasonable grounds to suspect that the company was or would become insolvent; and

(c) either:

(i) the creditor gave value; or

(ii) changed its position in reliance on the payment.

2.9 The third element is broken up into two alternatives. A creditor must show either that it gave value, or that it altered its position as a result of the payment it received from the debtor company. The first of those alternatives was a new addition in the reforms of 2007, borrowed from the Australian statute.

The issue – "gave value"

2.10 While the wording of the defence was intended to align New Zealand's position with that of Australia's, the drafting of the defence (in 2007) initially resulted in confusion and inconsistent application by the courts. The issue was whether "value" meant new value given at or after the time the payment was received by the creditor, or whether it could be the original value given by the creditor when the goods or services were supplied.

2.11 Historically (before the "gave value" requirement was added), it had been commonly understood that that "value" must have been provided at the time of, or after, the allegedly voidable payment. Creditors could avail themselves of the defence if they had received the payment in good faith and relied on its validity to their detriment. That defence was a form of estoppel, whereby the Courts prevent a party from reneging on a promise or representation where another party has relied to its detriment on the promise or representation.[10]

2.12 In 2012, the High Court held, in a number of cases, that value prior to the voidable payment by the debtor company would suffice to trigger the defence. In other cases, it held to the opposite effect.[11]

2.13 In holding that prior value was sufficient, the High Court was particularly persuaded by the argument that the 2007 amendments to New Zealand's Companies Act 1993

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9 Brown and Telfer, *Personal and Corporate Insolvency Legislation* (LexisNexis NZ, Wellington, 2013) at 207.

10 *Baker Timber Supplies v Apollo Building Associates (Tauranga)* (1990) 5 NZCLC 66,791; Heath and Whale on Insolvency at [24.1].

11 *Meltzer v Allied Concrete* [2013] NZHC 977; *Farrell v Fences & Kerbs Ltd* [2012] NZHC 2865; *Farrell v ACME Engineering* [2012] NZHC 2874. See also *Jollands v Mitchill Communications Ltd* [2011] NZCCLR 20 (HC) and *Blanchett v McEntee Hire Holdings Ltd* (2010) 10 NZCLC 264,763.

were intended to align our law with equivalent Australian law. In Australia, the Court said, it is well-established and widely accepted that a creditor who gave value prior to the voidable payment will be able to rely on the "good faith" defence.

2.14 Those cases were appealed to the Court of Appeal, which reversed the decisions of the High Court, finding that the New Zealand regime differed in this respect from the Australian approach.[12]

2.15 The Court of Appeal found, consistent with the stated policy aims behind the 1993 legislation, that the rationale for the insolvent transaction provisions is to promote *pari passu* sharing. The interests of each unsecured creditor are to be superseded by the interests of the body of unsecured creditors as a whole. The analysis adopted by the High Court would undermine that policy.

2.16 The Court saw no evidence that Parliament had intended to expand the good faith defence in line with Australia. Although Parliament may have indicated its intent generally to harmonise New Zealand's insolvent transaction law with that of Australia, it did not go so far as to suggest that it intended to follow the Australian Corporations Act provisions in every respect. In particular, the Court noted that the terms of the Corporations Act provisions were substantially different, and in particular did not stipulate a temporal link to the time when payment is received (unlike the New Zealand provisions).

2.17 The New Zealand provision reads:[13]

> A court must not order the recovery of property of a company ... if the person from whom recovery is sought (A) proves that **when** A received the property—
>
> a) A acted in good faith; and
>
> b) a reasonable person in A's position would not have suspected, and A did not have reasonable grounds for suspecting, that the company was, or would become, insolvent; and
>
> c) A **gave value** for the property or altered A's position in the reasonably held belief that the transfer of the property to A was valid and would not be set aside (emphasis added).

2.18 It was persuasive that, historically, the section required proof of detriment to the recipient of the payment (i.e. the creditor). Allowing creditors to avail themselves of the good faith defence where value had been given prior to payment would be a significant policy shift. None of the materials provided to the Court signalled that Parliament had intended such a shift.

2.19 Ultimately, in February of this year, the Supreme Court held that original value given by a creditor, prior to the impugned payment, would be sufficient to engage the defence, provided that the value was real and substantial. A creditor does not have to provide "new" value in order to fall within s 296(3)(c). The Court held that the

12 *Farrell v Fences & Kerbs Limited* [2013] NZCA 91; [2013] NZCA 329.

13 Companies Act 1993, s 296(3).

word "when" used in the New Zealand section merely meant that there had to be "linkage or connection between the impugned payment and the elements of section 296(3)".

2.20 The Supreme Court saw its decision as essentially a policy question. It acknowledged the importance of *pari passu* sharing, but considered that certainty for recipients of payments was also a worthy policy aim. Historically, voidable transaction regimes here and overseas have long incorporated protections for creditors receiving payments in ordinary circumstances.

2.21 The Supreme Court found that Parliament had intended that New Zealand's position be aligned with that of Australia's, and that any minor differences in the language of the relevant provisions in each jurisdiction did not affect the policy decision which intended that New Zealand's provision be interpreted consistently with Australia's.

2.22 The Supreme Court's decision has now settled the law in New Zealand in relation to the s 296(3) defence. A creditor will be taken to have provided value in satisfaction of the third element of the s 296(3) defence regardless of whether the value was provided before, at the time of, or after the voidable payment. Because creditors will have always provided some value (by advancing supplies to the debtor company), this element will now always be satisfied in cases under s 292. In effect, creditors will only have to prove the first two elements of the defence. As a result, the Supreme Court's decision has significantly expanded the scope of the defence in New Zealand.

2.23 A payment to a creditor will never be voidable under s 292 where the creditor both acted in good faith and had no reason to suspect insolvency. Lack of good faith would include where a creditor knew it was receiving a preference.

2.24 If the insolvent transactions regime is truly underpinned by the *pari passu* sharing policy, the good faith of the recipient should not be a guiding factor, except for as a check on whether there was in fact a genuine reliance in the estoppel-type situation.

2.25 The Supreme Court has effectively returned the insolvent transactions regime to, or at least towards, its origins, where the focus was on the moral culpability of the creditor and debtor involved in the transaction. While the *pari passu* principle has been given greater prominence by Parliament over the recent series of reforms, the Supreme Court did identify what it saw to be clear indications that Parliament intended that ordinary transactions should continue to be protected. That requires an assessment of the recipients' state of knowledge and intentions.

2.26 The decision has radically changed the regime:

(a) As formerly understood, the regime set aside payments based on a strict effects-based test, but with a defence if the creditor can show that it specifically relied on the payment in question (in good faith and without knowledge of insolvency).

(b) Now, the regime sets aside payments based on a strict effects-based test, but only where the creditor is unable to show that it received the payment in good faith and without knowledge of insolvency. While the creditor bears the onus of proof as to good faith and knowledge, practically speaking, liquidators will need to be confident of those aspects before going to court.

2.27 A question for Parliament is whether the knowledge and intentions of the recipients of preferences should be as important as they now are, in light of the stated aim of the 1993 reforms, which sought to move away from moral culpability to a strict, effects-based test to uphold equal sharing as the guiding principle.

Peak indebtedness

2.28 The peak indebtedness rule, originating in *Rees v Bank of New South Wales*,[14] is part of the Australian voidable transaction regime. In Australia, it appears that the courts have allowed liquidators to choose the point of the company's maximum indebtedness to the creditor as the starting point of the continuing business relationship. Liquidators can accordingly maximise recoveries from creditors who have been preferred, resulting in a larger recovery for the general body of creditors as a whole. The issue is not entirely settled, as many courts prefer to adopt the "ultimate effect" test outlined in the *Air Services v Ferrier* case.[15]

2.29 In New Zealand, the 2007 reforms, in s 292(4B), introduced the concept of a "continuing business relationship" into New Zealand law. The concept has its origins in Australian law[16] and provides that, where:

(a) a transaction is an integral part of a continuing business relationship (for example, a running account) between a company and a creditor of the company; and

(b) in the course of the relationship, the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship;

then all the transactions forming part of the relationship have to be taken into account when determining whether there is a voidable transaction. If the net effect of all the transactions taken together is that a creditor has been preferred, then the transaction will be voidable (if also an insolvent transaction).

2.30 The cases responding to this change produced mixed results at the High Court level. In *Blanchett v McEntee*[17] in 2010, liquidators' ability to choose the point of peak indebtedness as the starting point for the continuing business relationship was tacitly accepted by the Court. However, across 2013 and 2014 the High Court rejected the peak indebtedness rule in a succession of cases.[18] The peak indebtedness rule was then accepted in the High Court in late 2014 by Associate

14 *Rees v Bank of New South Wales* (1964) 111 CLR 211.

15 (1995) 185 CLR 483.

16 Including the High Court of Australia's decision in *Airservices Australia v Ferrier*. The wording of s 292(4B) is modelled on s 588FA(3) of the Corporations Act 2001 (Cth).

17 *Blanchett v McEntee Hire Holdings Limited*, (2010) 10 NZCLC 264,763, [2011] NZCCLR 4 (NZHC) at [44].

18 *Shephard v Steel Building Products (Central) Ltd* [2013] NZHC 189; *Levin v Z Energy Limited* [2014] NZHC 688; *Levin v Timberworld Limited* [2013] NZHC 3180.

Judge Bell in *Farrell & Anor v Max Birt Sawmills Limited*.[19] Associate Judge Bell found that Parliament in enacting this "drop in pitch" legislation[20] had indicated that the New Zealand voidable transactions regime was intended to follow Australia's; because Australia follows the peak indebtedness rule, it should also apply in New Zealand. He also found that it was consistent with the regime's policy aims.

2.31 The Court of Appeal earlier this year resolved this confusion and found that the peak indebtedness rule was not part of New Zealand law.[21] Although it accepted that Parliament intended the New Zealand regime to follow the Australian regime when it adopted the continuing business relationship test, that did not extend to the peak indebtedness rule. The Court made this decision on the basis that an examination of Australian authorities demonstrated that the application of the rule in Australia was not actually well reasoned or well developed. The Court of Appeal found that the Australian courts often "*assumed the rule had the weight of authority and sufficient pedigree to warrant its direct application….without analysing its relationship to the legislation*"[22] and provided "*nothing further by way of explanation or policy justification*" when applying the peak indebtedness rule.[23]

2.32 The Court held that the legislative history of the Australian provision, s 588FA, showed that the provision was based on the High Court of Australia's decision in *Airservices Australia v Ferrier*, which emphasised the need to take into account the "ultimate effect of the dealings". That idea is inconsistent with the peak indebtedness rule.[24]

2.33 The Court of Appeal found that the correct starting point is the beginning of the specified period. It held that all transactions within the continuing business relationship should be included if they fall within the specified period (and where the continuing business relationship starts after the beginning of the specified period, all transactions would be included).

2.34 Importantly, the Court of Appeal's preferred starting point only makes sense in situations where the debtor company was unable to pay its due debts through the entire specified period. The Court of Appeal did not consider a situation where the debtor company becomes unable to pay its due debts part-way through the specified period. Therefore, whether transactions entered into between the start of the specified period and when the company becomes unable to pay its due debts will be included in the continuing business relationship remains unclear.

2.35 On the plain words of the section such transactions would be included. This, with respect, cannot be correct. Pre-insolvency transactions should not be included within the continuing business relationship, which seeks to establish the net effect of transactions during insolvency. Where all transactions take place prior to the onset

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19 *Farrell v Max Birt Sawmills Limited,* [2014] NZHC 3391.

20 Ibid.

21 *Timberworld Limited v Levin* [2015] NZCA 111.

22 Ibid., at [41].

23 Ibid., at [37].

24 *Airservices Australia v Ferrier* (1995) 185 CLR 483.

of a debtor company's solvency, even if some of those fall within the specified period, none will be voidable because none of them meet the basic test for voidability, which requires that the transaction be an "insolvent transaction". Accordingly, it should be the point of the debtor company's insolvency that should be taken as the correct starting point for the continuing business relationship, or the start of the specified period if insolvency pre-dates that period.

2.36 The Court of Appeal's decision should not apply to the scenario in which a debtor company becomes unable to pay its due debts part-way through the specified period. Nevertheless, the position is left a little unclear.

2.37 It is important to note that the Court of Appeal's decision dealt only with the question of which transactions within a continuing business relationship were to be considered in calculating the amount of any preference. The Court of Appeal's decision does not deal with the question of when a continuing business relationship starts and finishes. That is, to what degree must there be some form of continuation of business? How frequent must the transactions be? What events will bring a continuing business relationship to an end? Some of those questions will be highly fact-specific, but it is fair to say that the law on the point is not fully developed in New Zealand as yet.

2.38 The Court of Appeal's decision is not being appealed to the Supreme Court.

Security – *BB2 Holdings*

2.39 *BB2 Holdings* provides an example of what presiding Judge, Associate Judge Bell, described as "adventurous liquidators [who] continue to probe the outer reaches of the changes made in the law".[25] In this case, the liquidators of Doyle by Design challenged payments made by the company to a secured creditor, BB2.

2.40 BB2 sold computer hardware and software to the company in liquidation, Doyle. Under the credit sale agreement, BB2 retained title in the equipment until it was paid in full, and this security interest was registered under the Personal Property Securities Act 1999 (*PPSA*). Doyle defaulted, and upon BB2 learning that its proprietor had essentially abandoned the business, BB2 repossessed the assets. Rather than selling the assets, BB2 entered into an arrangement with the director under which he continued to pay instalments under the credit sale agreement.

2.41 The liquidators of Doyle claimed that because BB2 did not sell the equipment, any payments were made to it as an unsecured creditor; after BB2 took possession of the equipment, it allowed the director of Doyle to take it. In those circumstances, BB2 had no right to the equipment, and as such, any payments it received must have been as an unsecured creditor, open to attach as voidable payments. In contrast, BB2's position was (as stated by the Associate Judge): "once a secured creditor, always a secured creditor."[26]

2.42 Ultimately, the Court held that both arguments went "too far". So long as the value of the asset taken as security is worth more than the debt payable by the company,

[25] *Grant v BB2 Holdings Ltd* [2014] NZHC 2501 at [2].

[26] At [31].

there can be no element of preference.[27] However, where a creditor is partly secured, any payment it receives goes first to reduce the unsecured part of the debt. Payments received as an unsecured creditor were vulnerable to claw back, and here, BB2 received more than it would have received in the actual liquidation.

Ponzi schemes – *Fisk v McIntosh*

2.43 The collapse of David Ross' Ponzi scheme saw just under $99 million in investor funds lost. Only around $15 million remained of $114 million in investor contributions, while investor statements purported to record $387 million in investments. At least 700 investors were involved in the Ponzi scheme, the largest in New Zealand's history.[28]

2.44 One such investor was pursued by the liquidators of Ross Asset Management (*RAM*). Mr McIntosh had invested $500,000 in 2007, and withdrew $954,000 in 2011. There was no dispute that Mr McIntosh received the payments in 'good faith' – i.e. without knowing that he was profiting from a Ponzi scheme. In the High Court,[29] the liquidators sought to recover the amounts paid to the investor, under both the prejudicial dispositions regime under the Property Law Act 2007 and the voidable transactions provisions in the Companies Act.

2.45 Under New Zealand's prejudicial dispositions regime, a court may make an order under s 348 of the Property Law Act clawing back a debtor's dispositions of property to third parties where the debtor, when disposing of the property:

(a) intended to prejudice a creditor, or gift it, or did so without receiving reasonably equivalent value in return; and

(b) was insolvent or became insolvent, engaged or about to engage in business or a transaction for which the remaining assets were unreasonably, or intended to incur, believed, or reasonably should have believed, that the debtor would incur, debts beyond the debtor's ability to pay (we refer to these tests as the near/insolvency test).

Result

2.46 The Court set aside Mr McIntosh's $454,000 'profit' as a prejudicial disposition under s 348 of the Property Law Act (*PLA*) and as a voidable transaction under s 294 of the Companies Act (*Act*).

The Court's application of the PLA and Companies Act provisions

2.47 The Court had no difficulty finding that the payments made by RAM were dispositions for the purposes of the PLA, and transactions for the purposes of s 292 of the Act. Similarly, RAM was patently a debtor and a company for the purposes of the relevant provisions.

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27 Payments made to a secured creditor will either reduce the debt or prevent the debt increasing on account of additional interest arising upon default – see [40].

28 Serious Fraud Office "David Ross sentenced for New Zealand's largest ever Ponzi" (15 November 2013) <https://www.sfo.govt.nz/david-ross-sentenced-for-new-zealands-largest-ever-ponzi>.

29 [2015] NZHC 1403.

2.48 The next requirement under both the PLA and Companies Act provisions was RAM's insolvency at the time the payments were made. The Judge treated the statutory tests compendiously as being whether RAM was able to pay debts when due at the time it made the payments. For this purpose the Judge reasoned:

(a) RAM received investments on trust, subject to contractual obligations;

(b) RAM misapplied investments immediately upon receipt: the funds were never held and Mr Ross never intended to hold them, on the terms on which they were received. RAM thus committed a breach of trust immediately on receipt of investor funds, and came under an immediate duty to remedy that breach;

(c) Every investor thus accrued an immediate cause of action for breach of trust in November 2011, when Mr McIntosh was paid. Those causes of action constituted debts in terms of the tests for insolvency under the PLA and Act;

(d) RAM was insolvent in November 2011 as it was unable to pay those debts.

2.49 The Judge rejected the application of a legal presumption of insolvency where a Ponzi scheme is established, on the (with respect, dubious) basis that the United States cases applying the presumption were concerned with contractual debtor/creditor relationships. This case concerned trust obligations.

2.50 The Judge inferred for the purposes of the PLA an intention to prejudice creditors because Mr Ross must have known that each payment to an investor exposed other investors to a significantly enhanced risk of not recovering their funds. Despite that inference, however, he rejected the submission that an intention to defraud could as a matter of law be inferred from the very fact of a Ponzi scheme.

2.51 For the purposes of the Act the clear effect of the payments was that Mr McIntosh received more than he would have in a liquidation.

Defences

2.52 Good faith receipt was not disputed. Mr McIntosh also gave value to the extent of his original $500,000 investment, which RAM had appropriated to itself.

2.53 However, RAM received no value in respect of the $454,000 fictitious profit paid to the investor. In reaching that conclusion the Judge rejected the submission that some allowance should be made for RAM's use of money and the investor's unfulfilled promise to pay management fees, and disagreed that the 'fictitious profit' payment was in discharge of a debt. Further, the $500,000 payment was not value or reasonably equivalent value for the fictitious profit.

2.54 The case clearly signals that *bona fide* investors will be able to retain repayments up to the amount of their net principal investment. In this case, the defendant retained $500,000 – being the amount of his original contribution – of a $945,000 repayment.

2.55 The judgment has been appealed, by both sides. It is quite possible that our law on redistribution of Ponzi "profits" will change further as a result.

3 THE CORPORATE VEIL

Receiver as Shadow Director (HC)

3.1 In *Aquaheat New Zealand Limited v Hi Seat Limited* (*in receivership & liquidation*) & *Ors*[30] the High Court had to consider whether the receivers of a holding company had become deemed or shadow directors of its operating subsidiaries (which were not in receivership) during the process of negotiating, documenting and settling the sale of the subsidiaries' assets.

3.2 There was no dispute that the receivers had necessarily taken a significant role in the transaction. The sale of the subsidiaries' assets was a major transaction requiring the approval of the shareholder for the purposes of s 129 of the Companies Act 1993 (*Act*). That approval could only be given by the shareholder's receivers. Moreover, completion of the sale required the security trustee to release its security over the assets to be sold, and in that regard the receivers would advise the security trustee as to whether the sales process was appropriate and likely to have achieved the best price reasonably obtainable. However, the allegation in *Aquaheat* was that the receivers had gone beyond their role as receivers of a shareholder, to become deemed or shadow directors of its subsidiary. In particular, it was alleged that the receivers had:

(a) initiated, organised and overseen the sale process; and

(b) ultimately made decisions for the subsidiaries concerning the terms of the Sale and Purchase Agreement (*SPA*), and the final decision whether or not enter into the SPA – notwithstanding that the appointed director of the subsidiaries executed the SPA on their behalf.

Background

3.3 On 8 August 2012 Aquaheat New Zealand Limited (*Aquaheat*) entered into an agreement with Hi Seat Limited (*HNZ*) and LIA Limited (*AIL*) to purchase most of their assets for $5,250,000. The purchase price was based on financial statements prepared as at 31 May 2012 and was payable at completion on 31 August 2012. This was subject to working capital and outgoing adjustments between 31 May 2012 and 31 August 2012. The sum of $250,000 was to be held on escrow for the purpose of the working capital adjustment.

3.4 As it turned out, the required working capital and outgoings adjustment was $1,750,716. HSL and AIL were both unable to meet the adjustment shortfall of $1,500,716 because they had been placed into receivership on 7 September 2012, shortly after completion but prior to the calculation of the adjustments.

3.5 At all material times the vendors' parent, Hastie Holdings (NZ) Limited (*Hastie Holdings*) had been in receivership. Aquaheat sued various parties including one of the receivers of Hastie Holdings for the adjustment shortfall. Aquaheat alleged that

[30] [2014] NZHC 2430 (*Aquaheat*).

the receiver was a shadow or deemed director of the vendors when they negotiated the sale and entered into the SPA.[31]

3.6 Aquaheat alleged that:

(a) the receiver made all major decisions relating to the sale and that the vendors' sole appointed director acted in accordance with the receivers' direction; and

(b) the receiver breached its duties under s136 of the Act by causing the vendors to agree to pay the working capital and outgoing adjustments without having reasonable grounds to believe that they would be able to meet those obligations.

3.7 The receiver claimed to have a number of defences to the claim.[32] However the primary issue in the case was whether or not the receiver was a shadow or deemed director. For the reasons discussed below the Court ultimately held that he was not.

Law

3.8 S126(1) of the Act provides:

SECTION 126 MEANING OF DIRECTOR

126(1) **[Interpretation]** In this act, **Director**, in relation to the Company includes –

(a) A person occupying the position of director of the company by whatever name called; and

(b) For the purposes of sections 131 to 141 [etc] –

(c) a person in accordance with whose directions or instructions a person referred to in paragraph (a) may be required or is accustomed to act; and

(i) a person in accordance with whose directions or instructions the board of the company may be required or is accustomed to act; and

(ii) a person who exercises or who is entitled to exercise or who controls or who is entitled to control the exercise of powers which, apart from the constitution of the company, would fall to be exercised by the board; and

(iii) for the purposes of sections 131 to 149 [etc] … a person to whom a power or duty of the board has been directly delegated by the board with that person's consent or acquiescence, or who exercises the power or duty with the consent or acquiescence of the board.

3.9 Aquaheat alleged that the receiver was both: a shadow director in terms of s126 (1)(b) (i.e. the appointed director was required or accustomed to act in accordance with the receiver's directors or instructions); and a deemed director in terms of s126 (1)(c) (i.e. the receiver exercised a power or duty of the board with its consent or acquiescence). As noted above Aquaheat alleged that the receiver "*initiated, organised and oversaw the process leading to the sale of the vendor's assets*" and

[31] Aquaheat had also sued the vendors, the security trustee and the vendors' solicitors, but these claims were discontinued. Aquaheat did not sue the appointed director of HNZ and AIL who had gone on to be employed by Aquaheat.

[32] *Aquaheat*, at [4]-[10].

was the "*ultimate decision maker*" for the vendors "*in respect of the sale, the price the assets were sold for and a final decision to agree to the sale and purchase agreement*".[33]

3.10 Gilbert J distilled the relevant legal principles from well-known decisions of the English and Australian Courts. He referred to Millett J's judgment in *Re Hydrodam (Corby) Limited*[34] which set out what must be proved to establish that a person is one *"in accordance with whose directions or instructions the directions of the customers are accustomed to act…"*:[35]

(a) who are the directors of the company, whether de facto or de jure;

(b) that the defendant directed those directors how to act in relation to the company or that he was one of the persons who did so;

(c) that those directors acted in accordance with such directions; and

(d) that they were accustomed so to act. What is needed is first, a board of directors claiming and purporting to act as such; and secondly, a pattern of behaviour in which the board did not exercise any discretion or judgment of its own but acted in accordance with the directions of others".[36]

3.11 Gilbert J also referred to the judgment of Finn J in *Australian Securities Commission v A S Nominees Limited.*[37] This considered the (essentially identical) definition of shadow director contained in s 60(1) of the Corporations Law (Australia). Finn J held that[38]:

(a) The requirement that the appointed directors be "*accustomed to act*" on the instructions or directions of the alleged shadow director do not require that there be directions or instructions embracing *all* matters involving the board. It only requires that, as and when the directors are directed or instructed, they are accustomed to act.

(b) Formal directions or instructions are not necessary to secure compliance as a matter of course.

(c) The essential question is: Where, for some or all purposes, is the locus of effective decision-making? If it resides in a third party who is not an "*advisor*"[39] then that person may be a shadow director.

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[33] Ibid., at [12].

[34] *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 (Ch).

[35] This being the definition of "shadow director" for the purposes of s 251 of the Insolvency Act 1986 (UK).

[36] *Re Hydrodam*, page 83.

[37] *Australian Securities Commission v A S Nominees Limited* (1995) 133 ALR 1 (FCA).

[38] Ibid., page 52.

[39] I.e. for the purposes of s 60(2) of the Corporations Law, or s 138 of the Act.

3.12 Gilbert J also noted Robert Walker LJ's judgment in the re *Kaytech International PLC*[40] who stated the crucial issue to be:

> *"…whether the individual in question has assumed the status and functions of a company director so as to make himself responsible… as if he were a de jure director."*

3.13 Robert Walker LJ considered that this would be someone who has:

> *"…exercised real influence (other than as a professional advisor) in the corporate governance of a company. Sometimes that influence may be concealed and sometimes it may be open. Sometimes it may be something of a mixture…"*

3.14 Gilbert J also referred to the decision of the English Court of Appeal in *Secretary of State for Trade and Industry v Deverell*[41] which agreed with the judgments of Finn J and Robert Walker LJ referred to above to the effect that while the purpose of the legislation is to identify those (other than professional advisors) with real influence in the affairs of the company, it is not necessary that such influence be exercised at all times and in respect of all its activities. The English Court of Appeal also considered that:[42]

(a) Whether a particular communication is a "direction or instruction" must be objectively ascertained in light of all the evidence. It is not necessary to prove the understanding or expectation of either giver or receiver of the alleged direction or instruction. It will usually be sufficient to prove the communication and its consequence. Evidence of subjective understanding or expectation may be relevant but is not conclusive.

(b) Non-professional advice may amount to a "*direction*" and/or "*instruction*". All three share the common feature of "*guidance*".

(c) The statutory requirement that the board is "*accustomed to act in accordance with*" such directions or instructions does not require proof that the appointed directors have assumed a subservient role to that of the alleged shadow director, or surrendered their discretions to him or her (although such evidence would be sufficient).

3.15 Finally, Gilbert J referred to the decision of the New South Wales Court of Appeal in *Buzzle Operations Pty Limited (in Liq) v Apple Computer Australia Pty Limited.*[43] In that judgment Young JA referred to a number of leading authorities (including those referred to above) before noting that *"there is probably little to be gained by exhaustively trawling through other cases. Circumstances are infinitely variable…"*.[44] However, Young JA distilled from those leading authorities the following principles that it is worth setting out in full:[45]

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40 *Re Kaytech International PLC* [1999] 390 (CA) at [402].

41 *Secretary of State for Trade and Industry v Deverell & anor* [2001] Ch 340 (CA).

42 Ibid.,at [35].

43 *Buzzle Operations Pty Limited (in Liq) v Apple Computer Australia Pty Limited* (2011) 81 NSWLR 47 (CA).

44 Ibid., at [22].

45 Ibid., at [228]-[232].

> *3First, not every person whose advice is in fact heeded as a general rule by the board is to be classed as a de facto or shadow director.*
>
> *Second, if a person has a genuine interest of his or her or its own in giving advice to the board, such as a bank or mortgagee, the mere fact that the board will tend to take that advice to preserve it from the mortgagee's wrath will not make the mortgagee, etc a shadow director.*
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> *Third, the vital factor is that that shadow director has the potentiality to control. The fact that he or she does not seek to control every facet of the company or the fact that from time to time the board disregards advice is of little moment.*
>
> *Fourth, Millett J's proposition that the evidence must show "something more" than just being in a position of control must be shown. The whole of the facts of the case must be shown to see whether that power to control was put into practice. The emphasis that one must judge on the whole of the facts and circumstances is made many times over in the leading cases.*
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> *Fifth, although there are problems with cases whether the board of the company splits into a majority and minority faction, so long as the influence controls the real decision-makers, the person providing the influence may be a shadow director.*

Analysis

3.16 Having noted that whether or not a person is a shadow or deemed director of a company will "*always depend on the close scrutiny of the relevant facts*"[46] Gilbert J duly set out his close scrutiny of those facts at paras [20] – [80] of the judgment. This included a relatively detailed consideration of correspondence between various parties including the receiver, the appointed director, the vendor, the parties' respective solicitors and Grant Samuels.

3.17 Ultimately the learned judge held that this "*close examination of the facts*" showed that the claim could not be supported. He held that:[47]

> *Mr Grenfell did not involve himself in the corporate governance of AIL and HNZ. He was not the locus of effective decision-making for those companies with respect to the sale; Mr De Bernardo [i.e. the appointed director of AIL and HNZ] undertook this role. The fact that Mr Grenfell had to approve the transaction, as the receiver of the sole shareholder, does not alter this. He did not give directions or instructions to Mr De Bernardo in relation to the sale process or the agreement for sale and purchase. Indeed, there was very little direct communication between them.*

3.18 Relevant factual findings leading to this conclusion were as follows:

(a) In practical terms the receivers of Hastie Holdings were always going to need have some direct involvement in the search for new owners of AIL and HNZ's profitable businesses both to approve a sale of their assets and to advise the security trustee.[48]

(b) Mr De Bernardo's primary concern was to look after the interests of staff and customers. At the commencement of the receivership both the receiver and the director issued separate statements to media and business customers that AIL and HNZ were not in receivership and would continue to be run by their

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[46] *Aquaheat*, at [20].

[47] Ibid., at [91].

[48] Ibid., at [81].

directors and managers.[49] At the director's request the receiver accompanied him on visits to key customers to reassure them of that.[50]

(c) The appointed director decided to remain as a director to see the sale through. He was confident during that process that the vendors could meet their obligations from trading profits or cash reserves pending completion of the sale.[51]

(d) The receiver took care to ensure that the appointed director understood that he remained responsible for all AIL and HNZ board decisions. He told the appointed director to seek independent advice if he thought that was necessary, which he did.[52]

(e) Although the receiver suggested that Grant Samuel be appointed to manage the sale process and suggested that certain solicitors should be engaged to provide legal advice, the director was comfortable with these appointments and signed the engagement letters that were addressed to him.[53]

(f) The director approved the final form of the Information Memorandum which described the sale process and timetable. He did not receive any directions or instructions regarding the sales process from the receiver.[54]

(g) The sales process revealed a clear "front runner" with no direction or instruction from the receiver in that regard.[55]

(h) Grant Samuel and the solicitors took the lead through the sales process. The director and the receiver were kept fully informed. They provided separate independent input. Although the receivers were treated as part of the vendor group, this made sense given the compressed timetable and the need for shareholder consent and a security release.[56]

(i) Although the receiver had been part of the vendor group consulted by Grant Samuels and the solicitors, the receiver's and the director's input were separate and independent. The receiver did not attend a meeting to negotiate the final terms of the SPA because he did not think it was appropriate for him to do so. The receiver attended a short break out session late in the negotiations at Grant Samuel's request. The receiver asked Grant Samuels to attempt to negotiate an increased price which they were able to do.

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49 Ibid., at [29]-[30].

50 Ibid., at [31].

51 *Aquaheat*, at [82].

52 Ibid., at [83].

53 Ibid., at [84].

54 Ibid., at [85].

55 Ibid., at [86].

56 Ibid., at [87].

(j) The amount of $250,000 to be held in escrow for the purposes of paying any working capital or outgoing shortfall was suggested by Grant Samuels. This suggestion attracted neither question nor comment from the director or the receiver. As such there could be no suggestion that the director acted under the receiver's direction or instruction in agreeing to this provision. There was some evidence that the receiver stated a preference for this matter to be dealt with in the agreement rather than in a side letter, but the Judge held that this was ultimately incidental to the critical issue concerning the amount to be held.[57]

(k) Although the receiver suggested that the director sign the agreement and hold it in escrow pending receipt of the shareholder's resolution approving the transaction, the Court held once again that this was only to accommodate a compressed timeframe. It remained the director's decision whether or not to sign the agreement. He made that decision exercising this own skill and judgment without influence from the receiver.

(l) The receiver and the director commented separately and independently on the draft SPA. The SPA was signed by the director with no evidence of any director or instruction from the receiver to do so.

Comment

3.19 Although in the end the Judge was able to dismiss the plaintiffs' claim in relatively short order, the case raises interesting factual and legal issues. The lending structure whereby a holding company borrows to fund its operating subsidiaries is relatively common. Equally, those operating subsidiaries may have businesses that remain financially viable – notwithstanding their inability to meet their shareholder's financing obligations. When that occurs, secured lenders, directors and insolvency practitioners will each need to make decisions as to how to achieve the best possible outcome for the relevant stakeholders, while complying with their statutory and other duties. To be effective in that they will to some degree need to work together closely towards shared goals (usually including maximising the sale price of secured assets). This case shows that notwithstanding the necessarily close arrangements that may follow, the Courts will still respect the corporate veil that separates the related companies, and the different duties and obligations incumbent on directors and receivers.

Contribution Orders

3.20 Conversely, *Lewis Holdings Limited & Ors v Steel & Tube Holdings Limited*[58] is a recent example of a case where the High Court was prepared to look beyond the corporate veil.

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57 *Aquaheat*, at [88] - Although the director said that he had "*no real input*" into the decision to accept the final indicative non-binding bid received from the ultimate purchaser, the Court found there was no suggestion that this was not the best option available; nor that the receiver ever requested the director to sign that agreement (let alone directing or instructing him to do so). As such the Court held that the director signed that agreement because he considered it was in the best interests of AIL and HNZ for him to do so. See [43].

58 [2014] NZHC 3311, [2015] 2 NZLR 831 (*Lewis*).

3.21 Section 271 of the Act allows the Court to look beyond the corporate veil and order that a company related to another company in liquidation must pay the whole or part of any or all of the claims in the liquidation. The section also enables the Court to order that the liquidation of two or more related companies proceed together.

3.22 Section 271 creates an obvious exception to the well-known common law principle in *Salomon v Salomon*[59] (and set out in s 15 of the Act) that a company has a separate legal identity to its shareholders. In certain circumstances it prevents companies (including parent companies) from relying on the separate legal existence of related companies (including subsidiaries) in liquidation to avoid liability for creditor claims. Although the provisions relating to contribution orders have not been commonly applied the essential facts of this case were perhaps not uncommon, so this case is of particular interest.

3.23 Section 271 provides that:

> *(1) On the application of the liquidator, or a creditor or shareholder, the Court, if satisfied that it is just and equitable to do so, may order that –*
>
> *a. a company that is, or has been, related to the company in liquidation must pay to the liquidator the whole or part of any or all of the claims made in the liquidation (contribution orders);*
>
> *b. where 2 or more related companies are in liquidation, the liquidations in respect of each company must proceed together as if they were 1 company to the extent that the court so orders and subject to such terms and conditions as the court may impose (pooling orders).*

3.24 Section 272(1) provides guidance as to when such an order should be made. In coming to its decision, the Court must have regard to the following matters:

(a) the extent to which the related company took a part in the management of the company in liquidation;

(b) the conduct of the related company towards the creditors of the company in liquidation;

(c) the extent to which the circumstances that gave rise to the liquidation of the company are attributable to the actions of the related company; and

(d) such other matters as the Court thinks fit.

3.25 In applying s 271, MacKenzie J bore expressly in mind the competing policy tensions in play: "*I must balance two policy considerations inherent in the legislation which weigh on different sides of the scales. The first is that the separate corporate identity of the company in liquidation is to be respected. The second is that s 271 is directed to the mischief that an overly strict application of that separate application may cause".*[60]

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[59] *Salomon v A Salomon & Co Ltd* [1897] AC 22 (HL), confirmed by *Lee v Lee's Air Farming Ltd* [1961] NZLR 325.

[60] *Lewis*, [19].

Facts

3.26 Lewis was the owner of a commercial property which had been occupied by Stube Industries Limited for a substantial period of time pursuant to a lease which was subject to the Public Bodies Leases Act 1969. Stube was a wholly owned subsidiary of Steel & Tube Holdings Limited (STH). The lease would automatically renew unless notice was given by the lessee of its intention not to. Unfortunately for Stube, the necessary notice of intention not to renew was overlooked and not given. This put Stube on the hook for an onerous lease for a period of 21 years.

3.27 In June 2013, Stube was placed into liquidation by a shareholder resolution. The liquidators disclaimed the lease shortly thereafter. Lewis filed a proof of debt in the liquidation for funds outstanding under the 21 year lease which had many years to run. The liquidators and Lewis applied for a contribution order under s 271(1)(a) requiring STH to be liable for Lewis' claim in liquidation of Stube.

3.28 The Court considered each of the factors set out in s 272.

Extent to which STH took part in the management of Stube

3.29 The Court held that in considering the extent to which STH took part in the management of Stube, it needs to look beyond the formal legal structure to determine what actually happened.

3.30 The Court found that Stube was effectively being run by STH. The directors of Stube were senior employees within STH. Although this is not uncommon the Court held that those individuals ran Stube's affairs as managers of STH rather than as directors of Stube. Although Stube's constitution provided that for the purposes of s 131 its directors could, in the execution of their duties, choose to act in the best interests of the parent company, the Court found that in fact those directors made no distinction at all between the interests of STH and those of Stube. The Court held that STH group was run as a single unit.

3.31 There were no board meetings for Stube. The directors considered the lease to be an asset of STH rather than Stube for tax purposes. Stube had no employees; any actions taken in relation to Stube were necessarily taken by STH's employees. Where STH employees did take actions in respect of Stube, correspondence was sent on STH letterhead with no reference to Stube at all. Rather than simply blurring the lines between the two companies, the evidence suggested that there was no line at all. For all intents and purposes, Stube was not treated as having its own distinct legal personality. By way of example the Judge noted that major remediation work to the leased property had been carried out by STH rather than Stube with contractors engaged and paid by STH. Stube had no bank account. Its rent was paid by STH. The rental invoices were addressed to STH.

3.32 One point considered was the extent of the tension between s 131(2) of the Act (which allows a subsidiary company's resolution to permit the directors of the subsidiary company to act in the best interests of the parent company) and s 271. In dealing with this, the Court pointed out that:

(a) s 131(2) of the Act is only an exception to s 131(1) (which requires the director to act in the best interests of the company) and not to any other director duties, including the duty in s 136 (that a director must not allow the company to incur obligations unless he reasonably believes that the company can perform those obligations); and

(b) on the evidence, the directors of Stube did not in fact distinguish the separate interests of the parent and subsidiary companies at all.[61]

3.33 The Court concluded that while s 131(2) might allow the parent's interests to be preferred over its subsidiaries, it does not enable the interests of the parent and subsidiary companies to be entirely conflated, or for the subsidiary companies' interests to be ignored.[62] They must conduct the affairs of the subsidiary as a separate board. Where the subsidiary is funded by the parent, legal arrangements are required to ensure that support. Where that is not done, orders may be made under s 271.

3.34 In the circumstances the judge rejected the submission that Stube was a shell company managed separately but as part of a group. He found that: [63]

> *Stube was not a shell company. It owned a significant property interest, which was both an asset and a liability. I find no evidence of any exercise of management functions concerning that property interest which was independent of STH, or to any material extent. The evidence, including, but not limited to the examples I have given, satisfies me that in the relevant period (…), STH took part in the management of Stube to an extent which was total in all essential respects. Mr Crossland describes Stube as a "slave" of STH. Another metaphor might be "puppet". The separate legal entity which was Stube was devoid of any capacity to conduct its own affairs.*

The conduct of STH towards the creditors of Stube

3.35 As to STH's conduct towards Lewis as a creditor of Stube, the Court found that although Lewis knew Stube was legally separate, STH had demonstrated to Lewis that STH was taking responsibility for the lease. Lewis was well aware that STH was behind Stube. In particular the Court found that by renewing the lease, and then continuing to pay the rent, STH had led Lewis to believe that Stube was not being treated as a separate legal entity to its parent company.

3.36 Lewis' submission was that there was a "stark contrast" in behaviour between STH's conduct prior to the renewal of the lease (where STH had stood behind Stube) and its behaviour subsequently. STH relied on the fact that it had always been up-front with Lewis during their dealings and that Lewis could not be confused as to which entity it contracted with.[64] It said further that it had shown "exemplary conduct" by continuing to fund Stube, and by making contributions to enable Stube to meet its contractual obligations. STH submitted that s 271 was designed to deal with circumstances where the subsidiary is deprived of assets by its parent to the detriment of creditors, and that in the current case, where the parent's dealings had

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[61] *Lewis* at [33], [39] and also [95].

[62] Ibid., at [33]

[63] Ibid., at [65].

[64] Ibid., at [66], [68].

been in good faith and transparent at all times, to make an order under s 271 would be unjust and inequitable.[65]

3.37 The Court held that while Lewis was not confused as to which entity it is dealing with, such confusion is not necessary for the purposes of s271. What was relevant was that all the dealings between STH and Lewis suggested that STH would support its subsidiary. The Judge found this weighed in favour of an order under s 271.

3.38 In looking at the substance of the dealings between the parties concerning the renewal of the lease, the Court found that Lewis had been negotiating with STH rather than Stube. Although the question of whether Lewis had changed its position in response to STH's conduct was considered, in the end the Court decided that the answer was irrelevant. The key factor in deciding whether to grant the order under s 271 was the conduct between the parties, and in this instance the evidence weighed in favour of the making of such an order.[66] Put another way, s 271 should be used to "convert STH's longstanding assumption of responsibility for the property into a legal obligation".[67]

3.39 In reaching the conclusion that STH was in reality the party taking all of the relevant actions, the Court noted two specific obligations that the directors of Stube should have complied with in deciding to renew the lease. First, s 136 requires that directors do no not allow the company to incur obligations that they know the company will not be able to perform. The Court held the Stube directors would not have complied with this duty because there were no enforceable financial arrangements in place for payment of the rent. Secondly, the transaction would have been a major transaction for the purposes of s 129 of the Act, and so should have been approved by special resolution of STH. Neither were complied with, when the lease was renewed and STH continued to pay rent. The Court found that this amounted to conduct by STH towards Lewis leading it to believe that Stube was not being treated as legally distinct.[68]

The extent to which the circumstances that gave rise to the liquidation of Stube are attributable to the actions of the STH

3.40 The Court did not hesitate in finding that the circumstances giving rise to the liquidation of Stube were directly attributable to STH. After all, the shareholder resolution to put it into liquidation was STH's resolution.

3.41 There was a submission by STH that an order under s 271 would effectively be to impose a parent company guarantee for the obligations of Stube in circumstances when all parties know there was no such guarantee. The Court did not accept that proposition. It held that "*the only potential relevance is that a guarantee would*

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65 Ibid., at [70].

66 *Lewis*, at [78].

67 Ibid., at [72].

68 Ibid., at [84]. The Court further noted that this is even more significant in circumstances where the parent company is a listed company (as STH was in this case).

obviate the need for an application under s 271. The absence of a guarantee is not a factor which weighs against an order under s 271".[69]

3.42 Finally, it is worth noting that the Court was asked, as something of a cross-check,[70] to consider whether the parent company was a shadow director in terms of s 126 of the Act. While the Judge concluded that it was not necessary to decide this point (on the basis that he was satisfied that there were sufficient factors weighing in favour of making an order under s 271), he indicated that a director who did not have regard to the interests of the subsidiary company, preferring only to act in the interests of the parent, may potentially be considered to be a shadow director.[71]

Conclusion

3.43 The result of the application can be summarised by the Judge's comments at paragraph 115:

"STH took part in the management of Stube to an extent which was, in essence, total. That justifies a total contribution under section 271. There is nothing in the other circumstances, which I have held also support an order, which justifies any proportionate reduction. I have determined that it is just and equitable that STH make a contribution to Lewis' claim. The circumstances as I have described them lead me to the conclusion that the contribution should be total, not partial."

3.44 This is a significant decision. Although in parts it turns on particular facts concerning negotiations leading up to the renewal of a Glasgow lease, in many respects the group structure and the administration of the companies within it are relatively common place. The parties (including Lewis) were commercially experienced and well aware that Stube not STH was party to the lease, but STH will be treated as though it had given a parent guarantee when it had not.

3.45 STH has filed an appeal which has been stayed pending determination of quantum pursuant to s 307 of the Act. Judgment on that application is due shortly, following which the appeal(s) will be heard. It will be interesting to observe the outcome.

4 FUNDING

Waterhouse v Contractors Bonding Ltd [2013] NZSC 89; [2014] 1 NZLR 91

4.1 The Waterhouses (a father and son) were associated with insurance businesses in Georgia, USA. The United States authorities arrested them on numerous fraud-related charges arising out of issuing policies in the name of a non-existent insurer. Their businesses failed.

4.2 The Waterhouses claimed to have been the innocent dupes of Contractors Bonding Limited (*Contractors Bonding*), who (they said) had made them believe that the policies they had brokered and issued were underwritten by a non-existent American

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[69] Ibid., at [103].

[70] Ibid., at [106].

[71] In terms of the description given by Millett J in *re Hydrodam (Corby) Limited* [1994] 2 BCLC 180 (Ch).

Samoan subsidiary. Aided by an independent litigation funder, they sued Contractors Bonding in deceit, negligent misstatement, and breach of fiduciary duty.

4.3 Contractors Bonding applied for a stay of proceedings pending disclosure by the Waterhouses of their agreement with the litigation funder. The issues of whether the Waterhouses should be ordered to disclose the litigation agreement, and if so on what terms, ultimately reached the Supreme Court.

4.4 The Court of Appeal allowed the defendant's appeal from the High Court; and the plaintiffs appeal to the Supreme Court was partly but not wholly successful. So the issues and various policy arguments behind those issues were thoroughly canvased along the way.

Court of Appeal Judgment

4.5 The Court of Appeal held that both the trial court and the non-funded party should be given formal notice that a litigation funder is involved when a proceeding is commenced.[72] The Court of Appeal held that the following details of the funding arrangements should then be disclosed to the non-funded party:

(a) The identity and location of the litigation funder;

(b) Its financial standing/viability;

(c) Its amenability to the jurisdiction of the New Zealand Courts; and

(d) The terms on which funding can be withdrawn and the consequences of withdrawal.[73]

4.6 The Court of Appeal said that these details were relevant to determining whether or not the agreement might amount to or be evidenced of an abuse of process. The Court also directed that a redacted copy of the agreement be provided to the defendants within 10 working days so as to enable the defendant to assist the High Court's assessment of the funding arrangements.

Supreme Court Judgment

4.7 The Supreme Court ultimately held that when a plaintiff issues proceedings funded by a third party funder with no prior interest in the proceedings and whose remuneration is tied to the success of the proceedings and/or who has the ability to exercise some form of control over the conduct of the proceeding, the plaintiffs should disclose:

(a) The identity and location of any such litigation funder; and

(b) Its amenability to the jurisdiction of the New Zealand Courts.

4.8 The Supreme Court disagreed with the Court of Appeal that the plaintiffs should also disclose information concerning the financial standing and viability of the funder, and

[72] *Contractors Bonding Limited v Waterhouse* [2012] 3 NZLR 826 (*Waterhouse CA*) at [67]. Cited in *Waterhouse v Contractors Bonding Limited* [2014] 1 NZLR 91 (*Waterhouse SC*) at [8].

[73] Ibid.

the terms upon which funding could be withdrawn and the consequences of that withdrawal.[74]

4.9 The Supreme Court held that where an application for stay is made on the grounds of an alleged abuse of process, the Courts may order disclosure of the litigation funding agreement subject to redactions relating to confidentiality, and litigation sensitive and privileged matters. This could also apply in relation to applications for costs awards against funders.[75] The Supreme Court also though it "strongly arguable" that the Courts could order disclosure of the relevant terms for the purposes of determining an application for security for costs.[76]

Reasons and rationale

4.10 The Supreme Court made the following findings and expressed the following views that may also be relevant in dealing with issues and applications that may arise in future cases where a litigation funder is involved.

Who is a funder?

4.11 The Supreme Court stressed that they were dealing with the situation of third party funders with no prior interest in the proceedings and whose remuneration is tied to the success of the proceeding and/or who have the ability to exercise some form of control over the conduct of the proceeding. The Court expressly noted that it was not addressing the position of relatives or associated bodies who might fund litigations; conditional fee arrangements by solicitors; or those who fund litigation for no more than a commercial rate of return on the money lent. Nor did the appeal concern litigation funded by insurance.[77]

Should the torts of maintenance and champerty be abolished?

4.12 The plaintiffs' counsel had submitted that these torts should be abolished as they have been in other jurisdictions. The Supreme Court expressed no view on this because the underlying proceeding was not an action in maintenance or champerty. There was no factual foundation on which to base a discussion of the relevant issues. As such they proceeded on the assumption that those torts continue to exist.

No general supervisory role over litigation funding

4.13 The Supreme Court did not accept that it is the role of the Court to scrutinise litigation funding agreements to ensure they do not raise issues of abuse of process or public policy concern. The Supreme Court held it was not the role of the Court to act as general regulators of litigation funding arrangements, or to give prior approval to such arrangements.[78]

What amounts to an "abuse of process" that might give rise to a stay?

4.14 The Supreme Court accepted that the power to stay a proceeding for abuse of process is not limited to the narrow tort of abuse of process (i.e. the bringing of

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[74] Waterhouse SC, at [76].

[75] Ibid., at [64].

[76] Ibid., at [63].

[77] Waterhouse SC, para [24].

[78] Ibid.,para [28].

proceedings for an ulterior purpose such as extortion or oppression or some collateral advantage for which the legal process is not designed).[79] Assignments of bare causes of action in tort and other personal actions are generally not permitted in New Zealand. As such, if a funding arrangement amounts to an impermissible assignment of a cause of action then this would be an abuse of process. In assessing whether the litigation funding arrangements effectively amount to such an assignment, the Court should have regard to the funding arrangements as a whole including the level of legal control able to be exercised by the funder and the profit share of the funder. The role of the lawyers acting may also be relevant.[80]

4.15 The Supreme Court did not accept the submission that it would be an abuse of process for a funder not to provide an indemnity for costs to a funded party. That was because the Court could in appropriate circumstances make cost orders against funders.[81] Nor did the Supreme Court accept that the terms upon which funding can be withdrawn may be a relevant factor to deciding if there is an abuse of process. In this regard counsel for Contractors Bonding had expressed concern that a defendant could be left "high and dry" to face an impecunious plaintiff. However, the Supreme Court considered that this was a risk that all defendants face, whether or not the plaintiff is funded by a third party. The Supreme Court also accepted the submission that disclosure of such information (e.g. the size of the "war chest") could give a tactical advantage to the non-funded party which could be put in a position to precipitate the withdrawal of funding.[82] However, as noted above, the Supreme Court expressly left open whether the terms of possible withdrawal might be relevant to an application for security for costs.[83]

Comments

4.16 This is a clear statement from the Supreme Court that although the torts against maintenance and champerty may well continue to exist in New Zealand, it does not follow that the Courts have a general role in regulating third-party funding. In the first instance, the plaintiffs need only disclose the existence of a third-party funding agreement and the location of the funder. Nor is there any automatic requirement for the plaintiff's funder to provide a costs indemnity.

4.17 That said, where a defendant does bring an application to stay the proceedings because of a perceived abuse of process, the funding agreement may well need to be disclosed, albeit on a redacted basis. In determining whether there is an abuse of process, the Court will need to determine whether the funding arrangements amount to bare assignment of the cause of action. The Court was not definitive at all about when that might occur, but did comment that the degree of control able to be exerted by the funder and their profit share might be relevant. However, the

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79 Ibid.,para [30], citing Stephen Todd "Abuse of Legal Procedure" in Stephen Todd (ED) The Law of Torts in New Zealand (6th PD, Brookers Limited, Wellington, 2013) chapter 18 at [18.4.01].

80 Waterhouse SC para [47], [57] and 76[e].

81 In that way the New Zealand Cost Regime is materially different to the position in New South Wales that was being considered in *Jeffery & Katauskas Pty Limited v SST Consulting Pty Limited* (2009) 239 CLR 75.

82 Ibid.,para [71].

83 Ibid.,para [71] –[72].

Court observed that "any consideration of control should be linked to potential legal control and not potential d-factor control of the litigation"[84]

Walker & Ors v Forbes & Ors [2015] NZHC 1730

4.18 The principles set out by the Supreme Court in Waterhouse have been considered most recently in Walker & Ors v Forbes & Ors [2015] NZHC 1730.

Facts

4.19 Property Ventures Limited (*Company*) was placed into receivership, and then into liquidation. In November 2012, the Company (by its liquidators) issued proceedings against its directors and its auditors. Allied Farms Investments Limited (*Allied*) had a first ranking GSA over the Company's assets (*GSA*).

4.20 The litigation was funded by SPF No. 10 Limited (*SPF*). The Funding Agreement entitled SPF to 42.5% of the judgment award. No challenge was made to the Funding Agreement "in isolation". However, it was a condition of the Funding Agreement that SPF and Allied enter into arrangements giving SPF a first ranking security interest over the Company's assets. This was to include arrangements as to "any assignment of the benefit of [Allied's] security". Significantly, the Funding Agreement provided that the Company was to use its reasonable endeavours to satisfy that condition. SPF could cancel the Funding Agreement if that did not happen by an agreed date.

4.21 In March 2013, Allied and SPF entered into a Deed of Assignment (*Assignment*) pursuant to which Allied assigned its debt and securities to SPF. By this time, following the realisation of secured assets the Company was indebted to Allied for tens of millions of dollars. The Company's only remaining assets were its claims against its directors and auditors. SPF paid Allied $100,000 and agreed to pay 5% of the net amount recovered in the proceedings.

4.22 The upshot of this was that SPF stood to benefit from the proceedings in two ways. First, as a litigation funder entitled to 42.5% of the judgment award. Secondly, as a creditor with security over the Company's claims. It was these "dual and coincident interests" that formed the basis of the auditor's application for a stay, rather than any particular complaint about either the GSA, or the Funding Agreement. In broad terms, the auditors argued that:

(a) the Assignment (in combination with the Funding Agreement) constituted trafficking in litigation with the result that the litigation pursued is an abuse of process on traditional grounds;

(b) the Funding Agreement (when viewed with the Deed of Assignment) amounted to an impermissible assignment of a cause of action which is contrary to public policy and/or a misuse of the liquidator's powers. The auditors argued that the Funding Agreement would improperly enrich SPF

[84] Ibid.,para [47].

which had become a secured creditor by a champertous assignment and failed to benefit unsecured creditors.[85]

4.23 To illustrate the point, the auditors showed that if the secured debt continued to accrue interest compounding monthly through to a June 2017 trial date the secured debt would be $188m with the result that the judgment of $334m would be required before the Company's unsecured creditor made any recovery.

Assignment/Funding Agreement

4.24 The plaintiffs argued that although the funding arrangements needed to be consider "as a whole" the Funding Agreement and the Assignment were entirely separate and should not be conflated for the purposes of determining whether or not there should be a stay for abuse of process. The Court did not agree that the Assignment could be ignored because the Funding Agreement was conditional on SPF being satisfied with the Assignment. So the issue became whether the Assignment infected the Funding Agreement sufficiently for the overall arrangement to warrant a stay of proceedings.

Abuse of process on traditional grounds?

4.25 The focus of the auditor's complaint was that the Assignment would give SPF a "second bite at the cherry" by virtue of the repayment of the secured debt over and above the 42.5% service fee. This was said to be a "collateral advantage" for SPF that amounted to using the Court for an improper purpose.

4.26 Brown J did not accept that SPF's "dual interest" in the proceeds of litigation amounted to a "collateral advantage" in the necessary way. In the proceedings the Company was seeking an orthodox remedy of damages for alleged breach of contract and tort. It was not seeking to secure any advantage outside that orthodox remedy. Moreover, the quantum of damages would not be affected by the fact of the Assignment.[86]

4.27 The auditors also argued that the liquidator had misused its powers under the Act to advance SPF's financial interests rather than those of the unsecured creditors. In particular, he had not taken steps under s305(8) to require Allied (or SPF) to realise its security, surrender it, or value it and claim as an unsecured creditor for any balance. On the contrary, the liquidator had caused the Company to agree to use its reasonable endeavours to facilitate the assignment of the security to SPF, and then issued proceedings knowing that they were unlikely to benefit unsecured creditors. The auditors alleged this was an improper use of the liquidators' powers.

4.28 Brown J accepted that the unsecured creditors may be aggrieved, and that the liquidator may have conflicted himself by contracting to endeavour to procure the Assignment. However, while this might raise issues concerning entitlement to the proceeds of litigation, it did not follow that the litigation itself was brought for an improper purpose. The Court held that if the claim against the auditors was sound,

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[85] At [7].

[86] At para [37]-[41].

the fact that the liquidators brought it for the intended benefit of the wrong party was (for present purposes) beside the point.[87]

Impermissible assignment of cause of action?

4.29 *Waterhouse* holds that in determining whether funding arrangements amount to an assignment, the Court should have regard to the funding arrangements as a whole, including the level of control able to be exercised by the funder and the funder's profit share. Conversely, no issue of maintenance or champerty arises if an assignment of a cause of action is incidental to a genuine commercial interest in the subject matter of the proceedings.88

4.30 In this case, the alleged "champertous assignment" was the Assignment, not the Funding Agreement. The Auditor argued that the Assignment was taken merely to enable SPF to take the benefit of the cause of action. Also, that there was no other "genuine commercial interest" in enforcing the cause of action in circumstances where SPF have only lent money for the purposes of funding for litigation.89

4.31 Brown J held that:

(a) The Assignment by Allied was of the debt owed to it by the Company, and the underlying security.[90] Debts are routinely assigned for value. An assignee does not need to have any prior interest in the debt.

(b) Provided the assignment of debt is genuine and does not have maintenance or champerty as its object, it does not matter that the underlying debt may be disputed and the assignee may need to sue to enforce it.[91]

(c) The Assignment was not a sham. It was taken in order for SPF to be the secured creditor in respect of the balance of the proceeds after payment of the amounts due under the Funding Agreement.[92] However, the proceeding was already on foot when the Assignment was taken.

(d) The total return to SPF is the fee under the (otherwise solid) Funding Agreement and any profit on the (otherwise valid) Assignment. But for the assignment, surplus proceeds would need to be paid to Allied. In those circumstances, the Court *"[did] not consider that it can fairly be said that excessive profit is derived from the Funding Agreement as such*."[93]

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[87] At para [51].

[88] *TrendtexTrading Corporation v Credit Suisse* [1982] AC 679 (HL); and *First City Corporation Ltd v Downsview Nominees Ltd* [1989] 3 NZLR 710.

[89] Relying on *Citic New Zealand Ltd v Fletcher Challenge Forests Industries Ltd,* HC Auckland, CP 583/SW/99, 1 March 2002 (Potter J).

[90] *Camdex International Ltd v Bank of Zambia* [1998] QB 22 (CA); *Body Corporate 16113 v Auckland City Council* [2008] 1 NZLR 838 (HC).

[91] Ibid.

[92] At para [85].

[93] At para [89]-[90].

(e) As such there was no traditional abuse of process and no impermissible assignment.

Comment

4.32 The Court held that the Assignment "*could not be ignored*" when analysing the funding arrangements "*as a whole*". This was unsurprising given that: the Funding Agreement was entirely conditional on SPF being satisfied with the terms of Assignment; and the Company (via its liquidators) had agreed to use reasonable endeavours to procure satisfaction of that condition. However, the Court went on to hold that the overall arrangement did not warrant a stay because each of the Funding Agreement and the Assignment were independently valid, and SPF's benefit did not exceed the sum of these two parts. Two rights cannot make a wrong.

4.33 The auditors will likely argue on appeal (amongst other things) that this final analysis understates the necessary link between the Funding Agreement and the Assignment arising out of the fact that the former was entirely conditional on the funder's satisfaction with the latter. They will say this is particularly relevant when the upshot is that almost all of the proceeds of the litigation will go to the funders and the liquidators. They will also rely on the High Court's finding that the liquidators may have conflicted themselves in the first place.

4.34 The plaintiffs will argue (amongst other things) that whatever is paid to SPF under the Assignment would have been paid to Allied in any event, and any issues arising out of s305 of the Act should not prevent an otherwise valid claim from being brought.

4.35 This case tests the limits of the law in this area and raises questions concerning the policies behind the law. It will be interesting to see what the Court of Appeal makes of it.

5 LEGAL UPDATE

IRD Priority / PAYE not held on trust for IRD

Jennings Roadfreight Limited (in liq) v Commissioner of Inland Revenue

5.1 The Supreme Court has recently considered the question of how to treat unpaid and overdue PAYE held in a company's account at the time of liquidation. Should a statutory trust in favour of the Commissioner of Inland Revenue apply to those funds, or should the unpaid PAYE be subject to the priority rules in Schedule 7 to the Companies Act 1993?

5.2 This was the question to be decided by the Supreme Court in *Jennings Roadfreight Limited (in liq) v Commissioner of Inland Revenue*.[94] The answer turned on the proper interpretation of s 167(1) and (2) of the Tax Administration Act 1994 (*the TAA*). Although the Supreme Court unanimously decided that Schedule 7 should prevail, in doing so it overturned the majority decision of the Court of Appeal. So the interpretation of this ostensibly practical piece of legislation is not as straightforward as ideally it would be.

[94] [2014] NZSC 160, [2015] 1 NZLR 573 (*Jennings SC*).

The facts

5.3 Jennings Roadfreight Limited (*Jennings*) was placed into liquidation on 24 March 2011. At the time of the liquidation, Jennings owed approximately $50,000 in PAYE for the month ending February 2011. It held $14,076.38 in its bank account at the point of liquidation. Following completion of the liquation, the bank paid the funds to the Commissioner.

5.4 The liquidators sought to recover the funds from the Commissioner.

The earlier decisions

5.5 At first instance, the High Court granted the orders sought by the liquidators that the funds should be repaid by the Commissioner.[95] The Court of Appeal by a majority (Wild and White JJ, with Ellen France J dissenting) overturned the High Court decision, finding that any credit balance in the company's account at the time of liquidation is held on trust for the Commissioner and is therefore not part of the estate in liquidation.[96] As such, the funds could not be repaid by the Commissioner.

The Supreme Court decision

5.6 The Supreme Court disagreed with the majority's interpretation of s 167 of the TAA. The Supreme Court found that the statutory trust in favour of the Commissioner will cease to exist in circumstances where the deducted PAYE had either not been treated in the way that s 167 envisaged or had not been dealt with in accordance with the PAYE rules.

5.7 The decision centred around the potential conflict between s 167(1) and 167(2), because both purport to apply in the event of liquidation (and bankruptcy and assignment for the benefit of creditors).[97] The relevant statutory text provides:

> *167 Recovery of tax and payments from employers or PAYE intermediaries*
>
> 1. Every amount of tax or combined tax and earner-related payment withheld or deducted under the PAYE rules […] shall be held in trust for the Crown, and any amount so held in trust shall not be property of the employer liable to execution, and, in the event of the bankruptcy or liquidation of the employer or of an assignment for the benefit of the employer's creditors, shall remain apart, and form no part of the estate in bankruptcy, liquidation, or assignment.
>
> 2. When an amount of tax or combined tax and earner-related payment has been withheld or deducted under the PAYE rules […] and the employer has failed to deal with the amount of the tax or payment withheld or deducted (or any part of it) in the manner required by subsection (1) or the PAYE rules, the amount of the tax or payment for the time being unpaid to the Commissioner shall, in the application of the assets of the employer, rank as follows:
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> […]

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95 [2012] NZHC 1681, Doogue AJ.

96 [2013] NZCA 455, [2014] 2 NZLR 569.

97 Jennings SC, at [13].

(b) where the employer is a company, upon the liquidation of the company, the amount of the tax or payment shall have the ranking provided for in Schedule 7 of the Companies Act 1993 […]

5.8 The Supreme Court found that s 167(2) was to be read as a specific qualification of the more general s 167(1), which it held could apply even where there was no insolvency.[98] The Judges held that this interpretation accorded with existing case law.[99] The Court also found that its interpretation of s 167 (namely that s 167(2) is a qualification on the general nature of s 167(1)) was also supported by the legislative scheme. To allow any credit balance in a company's bank account at the time of liquidation to be categorised as trust property (as contended by the Commissioner) would be to deny the priority scheme set out at Schedule 7, and to allow the Commissioner to 'leapfrog' other preferential creditors.[100]

5.9 The Court also considered the nature of the trust created by s167(1), and held that it was intended to be a notional statutory trust, not a "true" trust[101] which would prevent the assets held in it from being distributed to creditors. This notional trust is created over the employer's assets generally.[102]

5.10 Applying the analysis to the facts, the Court decided that the Commissioner was required to pay back the $14,076.38. Section 167(1) did not require the funds to be kept in a separate account (which they were not in this case in any event). The PAYE rules require that PAYE is paid on a particular due date. In Jennings' case, this did not happen. The funds in Jennings' account on liquidation therefore represented unpaid and overdue PAYE which ranked in accordance with the Schedule 7 priority.[103]

5.11 The result will have come as something of a relief to many in the insolvency industry, as it confirms the position that has been traditionally applied by banks and insolvency practitioners for some time.

Mortgagee sales, acceleration and Property Law Act 2007 notices
***ANZ v Boyce* [2014] NZHC 3185[104]**

5.12 This decision of the High Court in *ANZ v Boyce* challenged the traditionally held view that a notice issued under s 119 (*PLA Notice*) of the Property Law Act 2007 (*PLA*) could operate to accelerate amounts owing under the relevant mortgage. The position taken by the Court was that a PLA notice was not effective to accelerate all

98 Ibid., at [18]-[19].

99 *Re Westmoreland Box Co Ltd (in liquidation)* [1968] NZLR 826 (which had been cited in the dissenting judgment of Ellen France in the Court of Appeal), where the Court of Appeal agreed that the legislative intention was not to make unpaid tax deductions trust property [at 842]. Also *CIR v Smith* [2000] 2 NZLR 147 (CA), where the Court of Appeal found that the statutory trust comes to an end upon liquidation pursuant to s167(2) [at 13].

100 Jennings SC, at [27]-[29].

101 By use of the term 'true trust' we understand the Court to mean one with the three certainties of intention, subject matter and object.

102 Ibid., at [55] and [56].

103 Ibid., at [62].

104 12 December 2014.

amounts due and owing under a loan, in circumstances where the lender's loan and/or mortgage documentation required that acceleration was by notice or demand (described by the Judge as a "call-up acceleration clause"). Nevertheless the Court accepted that where loan and mortgage documentation *automatically* accelerated indebtedness on default, no issue arose.

5.13 The decision had consequences for mortgagees seeking to pursue shortfalls after sale. No issue arose in respect of a mortgagee's power of sale, or entitlement to apply the proceeds of sale to secured indebtedness. This was because the Judge accepted that s 185(i)(d) of the PLA entitled a mortgagee to recover all amounts secured by a mortgage, even if those amounts had not fallen due under a call-up acceleration clause as a consequence of a lender failing to issue demand accelerating the indebtedness following the expiry of the PLA notice.

5.14 The judgment was issued in relation to three separate undefended claims (by two banks) for the recovery of shortfall sums owing after the mortgagee sale of secured property. In each case, the bank had issued a PLA notice for outstanding arrears in the statutory prescribed form.

5.15 Section 119 of the PLA states:

> (1) No amounts secured by a mortgage over land are payable by any person under an acceleration clause, and no mortgagee or receiver may exercise a power specified in subsection (2), by reason of a default, unless
>
> a. A notice complying with section 120 has been served (whether by the mortgagee or receiver) on the person who, at the date of the service of the notice, is the current mortgagor; and
>
> b. On the expiry of the period specified in the notice, the default has not been remedied.
>
> (2) The powers are:
>
> a. The mortgagee's power to enter into possession of mortgaged land;
>
> b. The receiver's power to manage mortgaged land or demand and recover income from mortgaged land;
>
> c. The mortgagee's or receiver's power to sell mortgaged land.
>
> (…)

5.16 Section 120 of the PLA states:

> **120 Form of notice under section 119**
>
> (1) The notice required by section 119 must be in the prescribed form and must adequately inform the current mortgagor of—
>
> (a) the nature and extent of the default; and
>
> (b) the action required to remedy the default (if it can be remedied); and
>
> (c) the period within which the current mortgagor must remedy the default or cause it to be remedied, being not shorter than 20 working days after the date of service of the notice, or any longer period for the remedying of the default specified by any term that is expressed or implied in any instrument; and
>
> (d) the consequence that if, at the expiry of the period specified under paragraph (c), the default has not been, or cannot be, remedied,—

(i) the amounts secured by the mortgage and specified in the notice will become payable; or

(ii) the amounts secured by the mortgage and specified in the notice may be called up as becoming payable; or

(iii) the powers of the mortgagee or receiver specified in the notice will become exercisable; or

(iv) more than 1 of those things will occur.

5.17 In every case, the PLA notices expired unremedied. A further demand was not issued after the expiry of the PLA notices but prior to the settlement of sale of the property. The banks sold the properties, and issued proceedings for the shortfall after sale. The specific issue raised by the Judge (notwithstanding that the defendants themselves took no steps) was whether the underlying debts had been accelerated by the PLA notice in the absence of a further demand prior to settlement. The form of the PLA notices was in accordance with s 120(1)(d)(i) of the PLA; in other words, that the amounts secured "will become payable" upon expiry of the notice (cf "may be called up as becoming payable").

5.18 The Court found that, in relation to lending facilities with call-up acceleration clauses, a PLA notice in that form was ineffective to accelerate the indebtedness upon its expiry. In the Court's view, a further demand was required to be issued by lenders to effectively accelerate the indebtedness under the loan or mortgage documentation. The banks were therefore arguably recovering amounts at mortgagee sale that were not yet due and payable. In other words, as described by the judge at paragraph 24:

> *From the proceeds of sale the lenders recovered sums that had already fallen due and also other sums secured, that is, sums that had not yet fallen due because there had been no acceleration. The lenders therefore recovered pre-payments of instalments to fall due later. For some time following the sale, mortgagors were no longer in default because of these pre-payments…*

5.19 The Judge therefore declined to enter summary judgment in respect of one of the three proceedings, on the basis that it was arguable that the defendants were no longer in default under their loan because future instalments had been pre-paid out of the proceeds of sale received by the bank.[105] In the absence of a further default, the Judge said that the bank could not accelerate the indebtedness. No consideration was given to whether the material difference in the bank's security position (given the sale of its security) constituted a default under the loan and mortgage documentation.

5.20 The *ANZ v Boyce* judgment was not appealed, so the next expected step will be for the matter to go to trial in the High Court.

5.21 The Court subsequently followed its own decision on this point in the brief judgment issued on 7 April 2015 in *Debt Buyers Limited v Hancox* [2015] NZHC 668, also an undefended summary judgment proceeding.

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105 In the other two proceedings, the Judge accepted that the debt was automatically accelerated, and so the issue did not arise.

5.22 The decision has been widely criticised on the basis that the PLA had been misinterpreted by the Court; on a plain reading of the sections, the PLA notice itself can act to accelerate a loan under a call-up acceleration clause.

Koroniadis v BNZ [106]

5.23 The Court of Appeal has since considered the issue in an unrelated proceeding, and disagreed with the High Court's analysis in *ANZ v Boyce.* In its judgment released on 28 July 2015, the Court of Appeal found that: [107]

> *there is no reason in principle why a notice issued under s 119 to comply with s 120 of the Act cannot also satisfy the requirement for a demand to call up the principal under the term loan, provided it has that effect. Section 120(1)(d) confirms that the notice can address various consequences.*

5.24 In this case, Koroniadis appealed the entry of summary judgment against him on the ground that, among other things, the principal indebtedness had not been properly accelerated against the principal debtor following the expiry of a PLA notice. Koroniadis guaranteed the principal debtor's obligations. The Court of Appeal disagreed and upheld the lower court's summary judgment.

5.25 The Court of Appeal found that, on the facts, the PLA notice issued by the mortgagee both satisfied the requirements of s 120 of the PLA and was effective to accelerate the indebtedness under the terms of the loan and GSA documents.[108]

5.26 The consequence of the judgment is that lenders are not required to issue further demand on a mortgagor following the expiry of a PLA notice, provided the wording of the PLA notice satisfies the acceleration requirements in the underlying loan and mortgage documentation. In most cases, the broad wording proscribed in the PLA should be sufficient for this purpose (and historically has been assumed to do so). To the extent that there is any doubt, a further demand prior to the settlement of the mortgagee sale would be prudent to avoid any challenge by the mortgagor or guarantor.

Burgess v TSB Bank[109]

5.27 A further recent Court of Appeal decision (issued 10 August 2015) highlights the importance to satisfying the technical requirements of the PLA.

5.28 In *Burgess*, TSB Bank loaned money to Mr Burgess, who had provided a mortgage over his property as security for loan. Mr Burgess fell into arrears, and the Bank served a PLA notice, giving notice of its intention to exercise its power of sale over the secured property if the default was not remedied within the requisite period. The default was not remedied, the property was sold by mortgagee sale. After applying the proceeds of sale to the debt owed by Mr Burgess, a shortfall remained owing to the bank.

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[106] [2015] NZCA 337

[107] Ibid., at [38].

[108] Ibid., at [42].

[109] [2015] NZCA 361 (*Burgess*)

5.29 The bank obtained summary judgment for the shortfall in the High Court. Mr Burgess appealed on various grounds, but the most significant for present purposes can be summarised as follows:

(a) The notice did not adequately advise of the action required by Mr Burgess to remedy the default. Mr Burgess complained that the notice did not make clear exactly how much he owed to the Bank, particularly because the disbursements detailed on the notice were approximated;

(b) The notice required payment of interest which was not yet due as at the date of the notice;

(c) The notice did not advise the consequences of remedying the default (i.e. that the Bank would accelerate the loan as well as seek to recover the arrears).

5.30 At first instance, the High Court held that despite having only given approximate figures for disbursements incurred in respect of the preparation and service of the notice (which were later confirmed in correspondence as being significantly higher), the notice was valid. The Court found that the relevant sections of the PLA do not require an absolute standard, but do require *"an element of reasonableness and proportionality"*. The High Court also considered that no prejudice would have been suffered by the debtor because he would not have been able to pay the sums due under the loan in any event. The High Court judge also found that the demand for interest accruing to the date of payment did not invalidate the notice. While the sum of future interest was not specified, it could be calculated on the basis of the information in the notice.

5.31 The Court of Appeal disagreed with parts of the High Court's reasoning, but reached the same result. The Appeal judges considered that "*if the action required to remedy the default involves payment of a sum of money, we consider the Act and Regulations*[110] *require the notice to state the sum that must be paid",*[111] so an approximation is not good enough. Detail of the sum payable is necessary to inform not only the debtor, but also any covenantors (including, in this case, caveators) who must be served with a copy of the notice under s 121 of the PLA. In the Court of Appeal's view, the suggestion that a debtor would not be able to pay the debt in any event was not good reason to exclude the full detail of the sum payable.

5.32 Despite the criticism, however, the Court of Appeal did find that the debtor had been adequately informed of the action required to remedy the default. On the subject of the approximate disbursement figures, the Court of Appeal suggested that had the debtor paid the approximate sums, no mortgagee sale could have taken place. But taken together, the information supplied in the notice was sufficient to adequately inform the debtor of what he needed to do to avoid his property being sold, without being misleading. Equally, the future interest sums detailed in the notice did not form part of the demand. Rather they were set out in a separate section of the PLA notice, and were described as payments that would subsequently fall due. The

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[110] Property Law (Mortgagees' Sales Forms) Regulations 2007, which prescribe the form of the PLA notices.

[111] *Burgess*, at [36].

Court of Appeal was satisfied that this did not invalidate the notice or mislead the debtor.

5.33 Finally, on the question of whether the bank had accelerated the loan without giving notice to the debtor, the Court of Appeal agreed with the High Court that the Bank was not purporting to call up the loan in the PLA notice. The PLA notice was notice of the Bank's intention to exercise its power of sale, not to accelerate the loan. Despite the fact that the loan was on demand, the notice only made demand for sums in default – not the full amount of the loans. Once the bank had exercised its power of sale, it then was obliged to apply the proceeds in a particular order pursuant to the terms of the mortgage, which it did. Both the High Court and Court of Appeal were satisfied that it was entitled to do so under the PLA notice served. The appeal was dismissed.

5.34 The *Burgess* decision is a timely reminder of the necessity for precision when drafting PLA notices.

Liquidators' powers to disclaim leases – *Willmott Forests*

5.35 The powers of liquidators to disclaim "onerous property" in Australian recently faced some controversy, due to the High Court of Australia's approach in *Willmott Growers Group Inc v Willmott Forests Ltd* (*Willmott*).[112]

5.36 Under s 269 of the New Zealand Companies Act, liquidators have similar powers. Onerous property can include unprofitable contracts, unsaleable property and litigation rights having no reasonable prospect of success – in effect, any property which subjects the company to a liability rather than granting it a benefit. Where a liquidator disclaims onerous property, the disclaimer ends all the company's rights and liabilities in relation to that property. Any disadvantaged party must then claim as a creditor.

5.37 Prior to *Willmott*, disclaimers did not traditionally affect leases in cases where the insolvent company was the lessor – that is, the rights of lessees could not be dismantled by s 269.[113] In New Zealand, some authorities had deviated from that precedent, arguing (albeit in obiter) that leases could sometimes be onerous property, even where the company was the lessor.[114] However, that more open conception of s 269 had not received appellate approval.

5.38 *Willmott* substantially changed that position. In *Willmott*, a company went into liquidation being the lessor of major, long-term forestry leases. The land was unsaleable with the leases in force, so the liquidators applied to disclaim the leases. Though the tenants submitted that the lease was the property of the lessee, not the lessor, the majority of the High Court agreed that the leases were onerous property. On the wording of the provisions (which were very similar to New Zealand's), leases

112 *Willmott Growers Group Inc v Willmott Forests Ltd* [2013] HCA 51.

113 *Re Bastable, ex parte The Trustee* [1901] 2 KB 518 (CA); *Hindcastle Ltd v Barbara Attenborough Associates Ltd* [1997] AC 70 (HL).

114 *Re Richmond Commercial Developments Ltd* (1990) 5 NZ, CLC 66,336; *Capital + Merchant Investments Ltd (in rec) v Russell Management Ltd* (2009) 10 NZCPR 199.

were clearly contracts which conferred rights on the lessor; as such, they were open to being disclaimed.

5.39 As a result, *Willmott* significantly strengthened liquidators' powers while diminishing the certainty of tenants' titles. By expanding the scope of onerous property, the High Court of Australia effectively prioritised liquidators' powers to disclaim property over tenants' indefeasible interests in land. An obvious consequence for tenants is that the term of their lease is no longer certain and may depend on the landlord's solvency.

5.40 The New Zealand High Court has since suggested that it will adopt the broader s 269 powers described in *Willmott*. In *Hoole v Pickens*, the High Court held that a disclaimer by a lessor was capable of bringing the lease to an end, extinguishing the rights of the lessee and any sub-lessees.[115] Though that principle was not necessary for the findings in *Hoole*, it suggests that the New Zealand courts are willing to follow *Willmott* in determining the scope of s 269.

Construction Contracts Act 2002 – retentions

5.41 The Construction Contracts Act 2002 (*CCA*) has, since its inception, played a substantial role in regulating the legal function of the construction industry. The latest amendment to that key legislation – the Construction Contracts Amendment Bill – might now dramatically alter the way that retention money is handled.[116]

5.42 Generally speaking, the Bill is designed to streamline the CCA, extending its scope to cover design, engineering and quantity surveying work, dismantling distinctions between the treatment of residential and commercial contracts, and simplifying enforcement.

5.43 Under the status quo, retention money usually forms part of a business' normal working capital – once a job is finished and they are required to pay it out, it comes out of normal business funds. However, the aftermath of the Mainzeal collapse showed how that system can go awry: there, subcontractors lost out on retention money which was part of Mainzeal's general accounts when the company became insolvent.

5.44 Adding to that list, the Bill's most recent Supplementary Order Paper proposes to avoid the Mainzeal problem by requiring the principal (party A) to keep retention money on trust for the relevant contractor or subcontractor (party B). While held on trust, the retention money must not be used by party A, and cannot be used to pay debts owed to any other party.[117] Though party A is entitled to invest the money and accrue interest, they must repay the amount if the investment fails.[118]

5.45 In spite of those requirements, party A is allowed to comingle the trust money with general funds – contrary to the usual trustee obligation to hold trust assets

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[115] *Hoole v Pickens* [2014] NZHC 620.

[116] Construction Contracts Amendment Bill (Government Bill 97-2).

[117] Construction Contracts Amendment Bill, ss 18C, 18H (as per SOP 52, 11 March 2015).

[118] Ibid., s 18F (as per SOP 52, 11 March 2015).

separately.[119] Retention money must also be paid out immediately on completion and can only be withheld on the basis of non-completion.[120]

5.46 As currently framed, the Bill would achieve its objective in protecting retention money from being consumed in a liquidation – however, other consequences of the trust structures have not necessarily been addressed. In particular:

(a) because each party in the chain (principal, contractor, subcontractor and so on) must hold retention money on trust, a very large amount of capital ends up being "frozen" which might otherwise be used to fund building work; and

(b) the tolerance of commingled trust and non-trust money seems an invitation to confusion and error, particularly in an industry unaccustomed to managing trust obligations.

5.47 These issues have been highlighted by a number of commentators and industry participants, while others (such as the Specialist Trade Contractors Federation) have embraced the increased security the changes give subcontractors. Whether that affects the Government's drafting of the Bill is yet to be seen. The Bill underwent its second reading in Parliament in mid-March.

KiwiSaver balances and bankruptcy

5.48 Ordinarily, the Insolvency Act 2006 prescribes that when a person goes bankrupt, their assets are all vested in the Official Assignee.[121] However, the Court of Appeal recently dealt with an irregular carve-out – KiwiSaver accounts.

5.49 KiwiSaver accounts, governed by the KiwiSaver Act 2006, are the New Zealand Government's response to the rising cost of public superannuation. KiwiSaver is effectively a private pension fund: employers, employees and the Government pay into the fund, which cannot be accessed until a person retires, buys their first home, or suffers "significant financial hardship". As part of those limitations, s 127 KiwiSaver Act prohibits the assignment or transfer of any part of an individual's KiwiSaver fund.

5.50 In *Trustees Executors Ltd v Official Assignee*, the Court of Appeal considered an application by the Official Assignee to seize a bankrupt's KiwiSaver account.[122] The Official Assignee had applied to exercise their powers under s 7 Insolvency Act – that is, to have the bankrupt's property vest in the Assignee. The Court addressed two main questions:

(c) whether the Official Assignee's rights under s 7 Insolvency Act should trump the prohibition on assignments under s 127 KiwiSaver Act 2006; and

[119] Ibid., s 18E (as per SOP 52, 11 March 2015).

[120] Ibid., s 18I (as per SOP 52, 11 March 2015).

[121] Insolvency Act 2006, s 7.

[122] *Trustee Executors Ltd v Official Assignee* [2015] NZCA 118.

(d) whether becoming bankrupt means a person automatically satisfies the "significant financial hardship" test which allows for the early withdrawal of KiwiSaver funds.

5.51 The Court of Appeal answered "no" to both questions. On the first point, the Court said that the emphatic language of s 127 KiwiSaver Act expressly prohibited *any* assignment, including under any statutory powers.[123] Extending that prohibition to cover the Official Assignee's powers was a logical extension of the purpose of the KiwiSaver Act – that is, to encourage and protect long-term savings.[124]

5.52 On the second issue, the Court confirmed the High Court's findings that bankruptcy alone would not always constitute significant financial hardship.[125]

5.53 The major consequence of the Court of Appeal's decision is greater certainty, both for potential bankrupts and the Official Assignee. Though it raises the risk that debtors will try to lock funds away in KiwiSaver in the lead-up to bankruptcy, the decision aligns neatly with international norms – for example, both Australia's Bankruptcy Act 1966 and the United States' Bankruptcy Code exempt pension schemes from funds available to creditors on bankruptcy.[126]

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123 Ibid., at [51]-[52].

124 Ibid., at [54]-[57].

125 Ibid., at [80]-[81].

126 Bankruptcy Act 1966 (Aus), s 116.