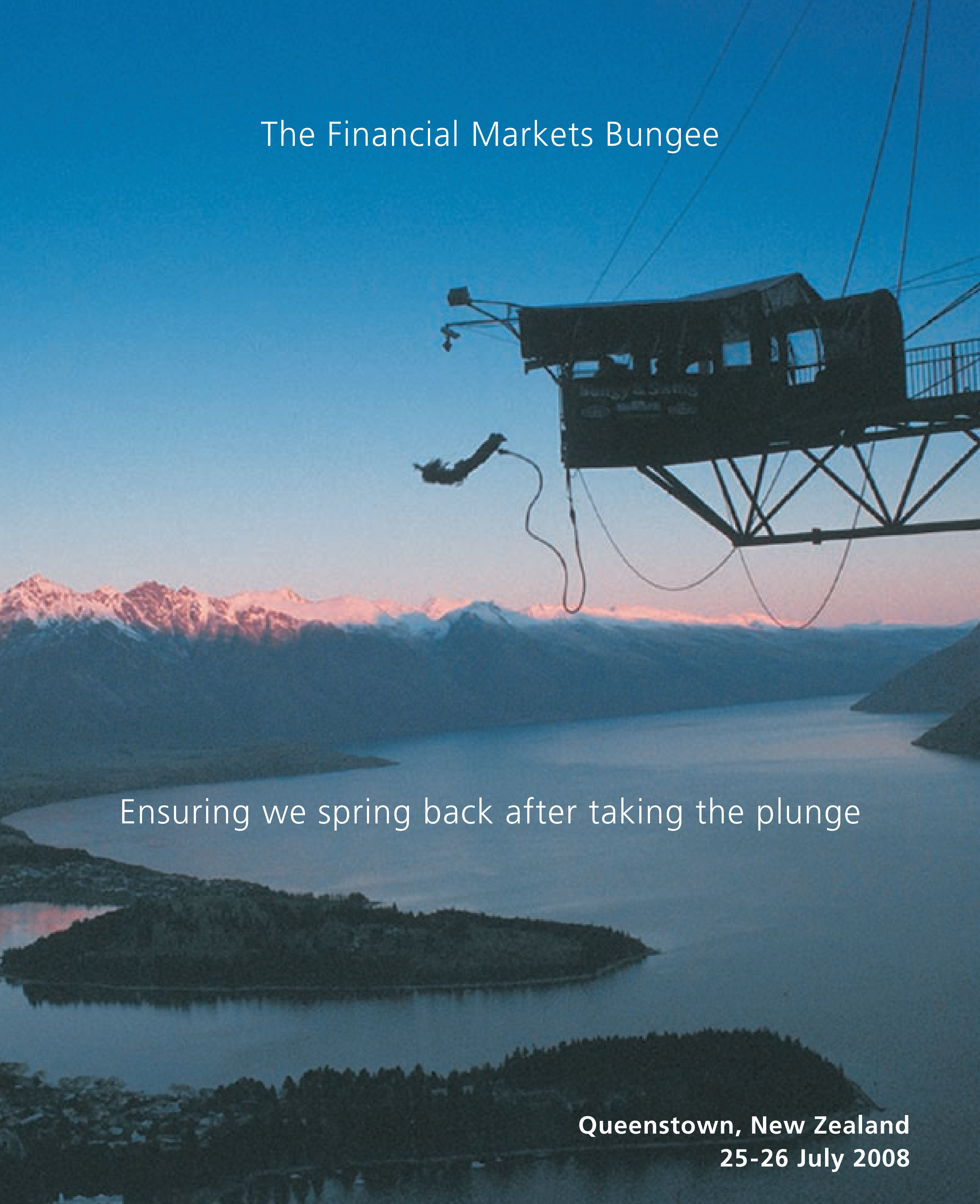

The Financial Markets Bungee

Ensuring we spring back after taking the plunge

Queenstown, New Zealand
25-26 July 2008

Conference Programme & Registration Booklet

25th Annual Banking & Financial Services Law & Practice Conference

Presented by

BFSLA
Banking & Financial Services Law Association

President's Message

Dear Colleagues

I am delighted to invite you to our Annual Conference.

This will be our 25th. Our conferences have established a high standard, and this year will be no excepton.

We are adding even greater 'grunt', and increasing the length, breadth and depth of the conference: we have extended it to two full days; and we are increasing our focus on the technical and academic content, while still keeping firmly in touch with the practical. We have assembled an outstanding panel of speakers, including Professor Philip Wood from the University of Oxford, Justices Barrett, Finn and Chambers and Professors John Carter, Bob Baxt, John Stumbles and James O'Donovan.

Areas we will examine include the judicial and regulatory response to riskier lending and the responsibility of lenders to their borrowers; international developments in taking security, lessons learned from the impact of the credit crunch on structured finance; workouts in the era of secondary debt trading and credit derivatives; the insolvency of trusts and collective investment vehicles; and conflicts of interest in financial services firms. In addition we examine carbon trading and an issue which often generates a great deal of heat but little light in negotiations: what is the effect of an indemnity?

We are returning to beautiful Queenstown, the site of our very successful 20th Conference in 2003. Prue Flacks and Alan A'Court are again very generously making their house available for the welcoming cocktail reception. That will be the first of a number of opportunities to enjoy one of the great benefits of the conference, to get to know in a relaxed atmosphere colleagues and those with whom we deal.

As always partners are welcome and the full array of scenic, adventure and gastronomic delights of the region await those who wish to stay after the conference.

I look forward to seeing you there.

Diccon Loxton
President

Programme

THURSDAY 24TH JULY, 2008

4.30pm	**Registration**
6.30pm	**Welcome Reception** at the house of Prue Flacks and Alan A'Court sponsored by Russell McVeagh, Buddle Findlay and Chapman Tripp

FRIDAY 25TH JULY, 2008

8.45am	**Opening and Maori Welcome**
9.00am	**Plenary session** **A little knowledge is a dangerous thing. Recipient and accessory liability - constructive trusts. What degree of knowledge is necessary?** *Chair* — *Mariette van Ryn, General Manager Regulatory Affairs and General Counsel, Westpac New Zealand* *Speakers:* — *Justice Paul Finn, Federal Court of Australia* *Justice Robert Chambers, New Zealand Court of Appeal*
10.20am	**Morning break**
11.10am	**Concurrent Sessions** **Concurrent Session 1a - Predatory Lending: From the sub-prime to the ridiculous.** Examining judicial and legislative responses in terms of their effect on lenders, mortgage brokers, borrowers and guarantors *Chair:* — *Elisabeth Wentworth, Barrister, Victorian Bar, Melbourne* *Speaker:* — *Prof. Jim O'Donovan, University of Western Australia, Perth* *Comments:* — *Philip Trinca, Partner, Blake Dawson, Melbourne* Concurrent Session 1b - **Sale in New Zealand and Australia of International Capital Markets Instruments** *Chair:* — *Graham Mouat, Special Counsel, Minter Ellison, Brisbane* *Speakers:* — *Ross Pennington, Partner, Russell McVeagh, Auckland* *Patrick Mullins, Head Capital Markets Origination, Bank of New Zealand, Auckland* *John Elias, Partner, Minter Ellison, Sydney*
12.30pm	**Lunch Break**
1.30pm	**Concurrent Session 2a - Prudent? Imprudent?? Predatory???: Lender liability for riskier lending-the developing regulatory responses to it.** **Can we avoid collateral damage? Examining regulatory responses.** *Chair:* — *Graham Curd, Senior Counsel Legal Services, Westpac Banking Corporation, Sydney* *Speakers:* — *Graham Gill, Fair Trading Manager, New Zealand Commerce Commission, Auckland* *Karen Cox, Co-ordinator, Consumer Credit Legal Centre, Sydney* *Narelle Smythe, Partner, Clayton Utz, Sydney* **Concurrent Session 2b - Workouts – What lurks beneath:** **The Impact of Credit Derivatives, Credit Default Swaps and Debt Trading** *Chair:* — *Richard Fawcett, Blake Dawson, Sydney* *Speakers:* — *Rick Drury, Director, Credit Restructuring, National Australia Bank, Melbourne* *Prof. John Stumbles, University of Technology, Sydney*
3.00pm	**Afternoon Break**
3.30pm	**Concurrent Session 3a - The credit crunch, securitisation and structured finance: lessons learned and the future.** *Chair:* — *Glen Smith, Special Counsel, Corrs Chambers Westgarth, Brisbane* *Speakers:* — *Matthew Allchurch, Partner, Allens Arthur Robinson, Sydney* *Alistair Jeffrey, Chairman, Bluestone Mortgage Group* *Lyn Cobley, Group Treasurer, Commonwealth Bank of Australia*

	Concurrent Session 3b - Carbon Trading and Carbon Credits *Chair:* *Angela Flannery, Clayton Utz, Sydney* *Speakers:* *Karen Price, Director, New Zealand Carbon Exchange, Auckland* *Ashley Stafford, Baker and McKenzie, Sydney* *Karel Nolles, Macquarie Group*
7.00pm	**Pre dinner drinks and dinner** Speaker: Prof. Philip Wood
5.15pm	**Annual General Meeting of the Banking & Financial Services Law Association** **Followed by a meeting of all Committee Members. Followed by a meeting of all Board Members**

SATURDAY 26TH JULY, 2008

9.00am	**Opening Plenary – Day two** **International Developments in the Law of Security** *Chair:* *Diccon Loxton, Partner, Allens Arthur Robinson, Sydney* *Speaker:* *Prof. Philip Wood, Visiting Professor in International Financial Law, Oxford University, UK* *(Special Global Counsel, Allen & Overy LLP; Yorke Distinguished Visiting Fellow, University of Cambridge; Visiting Professor, Queen Mary College, University of London)*
10.20am	**Morning break**
10.50am	**Concurrent sessions** **Concurrent Session 4a - Conflicts of Interest in Financial Services Firms** *Chair:* *Paul Rogerson, Head of Legal, St George Bank, Sydney* *Speakers:* *Prof. Bob Baxt, Partner, Competition Law Group, Freehills, Melbourne* *John O'Sullivan, Chair, Australian Investment Banking Division, Credit Suisse, Sydney* *Comments:* *Paul Rogerson, Head of Legal, St George Bank, Sydney* **Concurrent Session 4b - New New Zealand Voluntary Administrators Regime and the Australian Experience** *Chair:* *Michael Robinson, Partner, Simpson Grierson, Auckland* *Speakers:* *Michael Harper, Partner, Chapman Tripp, Auckland Kerryn Downey, Managing Partner, McGrathNicol, Auckland* *Colin Nicol, Partner, McGrathNicol, Melbourne*
12.20pm	**Lunch Break**
1.20pm	**Plenary sessions** **Indemnities More than meets the eye?:** Lawyers spend hours drafting and negotiating indemnities, when surprisingly little of their true effect is known or understood. Are those hours well spent? Issues include the nature of the obligation, the nature of the remedies and questions of mitigation and remoteness. *Chair:* *Nuncio D'Angelo, Partner, Mallesons Stephen Jaques, Sydney* *Speaker:* *Prof. John Carter, University of Sydney* *Comments:* *Nuncio D'Angelo*
2.35pm	**30 mins** **Afternoon break**
3.05pm	**Collapsing collective investment vehicles: Insolvency of Trusts & Managed Investment Schemes – uncertain territory for lenders and lawyers** *Chair:* *John Evans, Partner, Henry Davis York, Sydney* *Speakers:* *Justice Reg Barrett, Supreme Court NSW, Sydney Michael Dineen, Partner, Buddle Findlay, Auckland* *Roger Dobson, Partner, Henry Davis York, Sydney*
4.30pm	**Closing Panel: Lessons from the 'school of hard knocks' from a panel of battle scarred veterans** *Convenor:* *Diccon Loxton*
5.30pm	**Closing** **Winetasting**

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BFSLA
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Friday 25th July, 2008
Opening Plenary

9.00am – 10.20am

Chair:
Mariette van Ryn
Westpac New Zealand
General Manager, Regulatory Affairs, Customer Advocacy
& General Counsel NZ, Auckland

Speakers:
Justice Paul Finn
Federal Court of Australia

Justice Robert Chambers
New Zealand Court of Appeal

A little knowledge is a dangerous thing.
Recipient and accessory liability constructive trusts.
What degree of knowledge is necessary?

Justice Paul Finn, Federal Court of Australia
Knowing Receipt and Knowing Assistance: Balkanising Equity

KNOWING RECEIPT AND KNOWING ASSISTANCE:
Balkanising Equity

I need to begin with several explanatory comments. First, when I accepted Mariette's generous invitation to address you, it was to be on a completely different topic – that of mortgage indefeasibility. Necessarily I would have mentioned that aspect of *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* (2007) 230 CLR 89, but not its treatment of *Barnes v Addy* (1874) LR 9 Ch App 244. Now all is changed.

This brings me to the second matter. I have persistently refused to accept invitations to speak about *Farah*. I should indicate why. *Farah* obviously represents Australian law at the moment on third party liability both for knowing assistance in a breach of trust or of fiduciary duty and for knowing receipt of property consequent upon a breach of trust or of fiduciary duty. I say "at the moment" for this reason. The High Court acknowledged the radical difference between the decision of the Privy Council in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378 and the earlier decision of the High Court in *Consul Development Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373 on the knowing assistance limb of *Barnes v Addy*. In *Royal Brunei* it was indicated that, provided the third party was acting dishonestly, it mattered not whether the trustee or fiduciary committing the breach of trust or of fiduciary duty was also acting dishonestly or fraudulently. In contrast, *Consul* was said to have accepted that there must be a dishonest or fraudulent design on the part of the defaulting trustee or fiduciary. As I will later indicate, the distinction is not unimportant.

While not discountenancing that it might revisit *Consul* in light of *Royal Brunei*, the High Court indicated that (at [163]):

> *Until such an occasion arises in this Court, Australian courts should continue to observe the [Consul] distinction mentioned above and, in particular, apply the formulation in the second limb of* Barnes v Addy.

We now live in consequence with settled, but lame, law. What makes this situation regrettable is that it simply accentuates the vice in the case law identified by Lord Nicholls in *Royal Brunei* which is implicit in the title to this session. His Lordship said (at 386):

> *… there has been a tendency to cite and interpret and apply Lord Selborne L.C.'s formulation in* Barnes v Addy, *L.R. 9 Ch.App. 244, 251-252, as though it were a statute. This has particularly been so with the accessory limb of Lord Selborne L.C.'s apothegm. This approach has been inimical to analysis of the underlying concept. Working within this constraint, the courts have found themselves wrestling with the interpretation of the individual ingredients, especially "knowingly" but also "dishonest and fraudulent design on the part of the trustees," without examining the underlying reason why a third party who has received no trust property is being made liable at all.*

For the moment we have to continue to engage in the illusion that we can solve problems by formulae, although it was acknowledged almost 25 years ago that the law in this area "suffers from over much classification at the expense of sound underlying principle"[1].

In this state of affairs there is not much, in my view, that can profitably be said about *Farah's* treatment of *Barnes v Addy*. In Australia it is simply "business as usual".

Not that it is of any significance or consequence at all[2], I nonetheless should indicate that I consider that, based on the trial judge's findings, the actual conclusion reached in *Farah* is immune to criticism. I equally consider that the ultimate rejection of a restitution based, strict liability alternative to the knowing receipt limb of *Barnes v Addy* was entirely appropriate. My reasons for so thinking, as will be seen, are somewhat different from those of the Court. Finally, I should add that this is not the place to express views on those aspects of what I might euphemistically describe as the High Court's methodology in *Farah* which have attracted responses, most notably from Keith Mason, the recently retired President of the New South Wales Court of Appeal. I would say, though, that it was that unworthy dimension of *Farah* more than anything that had till now disinclined me to comment on the case at all.

Now let me turn to what I will talk about and it will not be an analysis of Australian – or for that matter comparative – case law as such. Rather it will be about the factors which at the moment make the case law so problematic[3]. I would preface what I have to say with the comment that if you think the reasons are self-evident why and when we should impose personal liability on a third party who is implicated in another's breach of fiduciary duty or breach of trust, I would suggest you think again. If you survey the *Barnes v Addy* case law in the UK, Canada, New Zealand and Australia you will find the judicial equivalent of Babel.

Having said I will not talk about case law, I should indicate I have appended to the CD version of my paper a lengthy research memoranda prepared by my associate. It compares and contrasts the various national responses to themes in the case law.

BACKGROUND

Simply to set the scene I should indicate that the type of situation with which we are generally concerned is that where A commits an equitable wrong on B and X (a third party) participates in, or is otherwise implicated in, the commission of that wrong. In such circumstances B will ordinarily be entitled to equitable relief against A – the award of compensation, an account of profits, the avoidance of a dealing, etc. But often enough relief against A will be illusory. And thus the questions arise whether, when and why relief of some sort (but usually for compensation) can be sought against X. I will for convenience refer to X's potential liability here as "participatory liability" – a neutral description.

The major point of which we should never lose sight is that where participatory liability arises, it is a pendant liability in the sense that it is predicated upon the primary wrong of another, i.e. of A to B. One would have thought that if X was to be held severally liable for participation in that primary wrong it should only be because X was itself, in the

1 See Sir Anthony Mason in Finn (ed), *Essays in Equity* (1985) at 247.
2 Cf the comments of P Young J in (2008) 82 ALJ 349.
3 For a now dated foray into this see Finn, "The Liability of Third Parties for Knowing Recept or Assistance" in Waters (ed), *Equity, Fiduciaries and Trusts* (1993) at 195.

circumstances, also a wrongdoer to B, i.e. X's liability would not be a secondary liability[4] and would be fault based. I will return to this issue.

Now let me begin to catalogue the complications and incoherences in *Barnes v Addy* jurisprudence.

EQUITABLE WRONGS

The first relates to equitable wrongs. One can envisage a considerable range of equitable wrongs in which a third party is implicated and in which the issue of participatory liability could arise. A simple example is that of a third party purchaser who is complicit in a mortgagee's abuse of its power of sale. Assume that the purchaser has resold the property. Can it be sued for compensation by the mortgagor for its complicity in the mortgagee's breach of its equitable duty of good faith to the mortgagor[5]? I do not pause to answer that question because what is clear is that the species of equitable wrong that potentially attract the *Barnes v Addy* style liabilities are limited to breaches of trust and breaches of fiduciary duty.

What in consequence is clear is that there is a range of situations in which third party participatory liabilities can arise but which are not conventionally analysed in *Barnes v Addy* terms. Simple examples are the possible liabilities of third parties who knowingly receive and use information obtained in breach of confidence[6] and the bank that seeks to take advantage of a security given in favour of the dominant party to a relationship of undue influence[7].

I need hardly add that there is wide disagreement between Commonwealth common law countries as to whether relationships of confidence or of influence are fiduciary ones. I long ago expressed the view that they were and cannot understand the argument to the contrary[8].

DERIVING A BENEFIT FROM THE TRUSTEE'S OR FIDUCIARY'S WRONG: PRIVILEGING PROPERTY

A common reason for a third party's implication in a breach of fiduciary duty or breach of trust is that that third party has sought to derive or has derived a tangible benefit in consequence of the breach – e.g. the receipt or purchase of property, the exploitation of a business opportunity, a contract entered into, etc. But for historical reasons[9], the third party's receipt of "trust" property from the defaulting fiduciary or trustee has been given a privileged and, I would suggest, an increasingly anomalous position in *Barnes v Addy* jurisprudence.

It is appropriate at this point to refer at last to what Lord Selbourne LC actually said on this matter in *Barnes v Addy*[10]:

> *Now in this case we have to deal with certain persons who are trustees, and with certain other persons who are not trustees. That is a distinction to be borne in mind throughout the case. Those who create a trust clothe the trustee with a legal power and control over the trust property, imposing on him a corresponding responsibility.*

4 See Ridge "Justifying the Remedies for Dishonest Assistance" (2008) 124 LQR 445 at 446 ff.
5 Cf *Downsview Nominees Ltd v First City Corporation Ltd* [1993] AC 295.
6 Cf Meagher Gummow & Lehane's *Equity Doctrines and Remedies* (4th ed) at [41-110] which advocates resort to the *Barnes v Addy* **analogy** in this context.
7 *Bank of New South Wales v Rogers* (1941) 65 CLR 42.
8 *Fiduciary Obligations* (1977) chs 16 and 19.
9 Related to participatory liability's provenance in the law of trusts.
10 LR 9 Ch App at 251-252.

> *That responsibility may no doubt be extended in equity to others who are not properly trustees, if they are found either making themselves trustees* de son tort*, or actually participating in any fraudulent conduct of the trustee to the injury of the* cestui que trust*. But, on the other hand, strangers are not to be made constructive trustees merely because they act as the agents of trustees in transactions within their legal powers, transactions, perhaps of which a Court of Equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on the part of the trustees.*

I should make the following comments immediately. *First*, Lord Selbourne did not speak of knowing receipt of trust property but rather of becoming "chargeable with trust property". The former we take to be the modern expression of the latter. *Secondly*, the responsibility as a constructive trustee of which he spoke is, put shortly, to be equated with the liabilities to which the recipient would be exposed as if he or she was in fact a trustee and most particularly liability to pay compensation for loss of trust property. *Thirdly*, despite the hares set running by the High Court in *Farah* (at [120]), it is well accepted from long standing authority that "trust property" extends to property possessed, held or controlled by a person in a fiduciary capacity as, for example, corporate property subject to the control of corporate directors[11]. *Fourthly*, it is also well accepted that for there to be a "receipt" for *Barnes v Addy* purposes, the recipient third party must receive the trust property for his or her own benefit or else appropriate it to his or her own benefit. Importantly for banks, it is insufficient to receive and deal with trust property as a mere depository or a channel for transmission to others[12]. The four Commonwealth countries to which I have been making reference, acknowledge this own benefit vs agency distinction.

Now let me return to the trust property - other benefit distinction. With a distinct rule of participatory liability being formulated for "trust property" (in the extended sense I have noted above), participatory liability for other types of benefit acquired by a third party in consequence of a breach of fiduciary duty, e.g. the exploitation of an opportunity, seemingly required a different explanation. This, as I will indicate, was to be found, but only partially, in the knowing assistance limb of *Barnes v Addy*.

A SEPARATE RATIONALE FOR THE TRUST PROPERTY LIMB OF *BARNES v ADDY*?

The differentiation of the factually distinct phenomena of receipt of trust property and of participating in a breach of fiduciary duty or breach of trust without such a receipt tends to suggest that there are at least two distinct participatory liability rules at play here with differing rationales and different incidents, most notably in relation to the level of knowledge of the trustee's or fiduciary's wrongdoing and/or of its character which is required to attract liability.

It was on this question that Stephen J commented (at 410) in *Consul*:

> *It is not clear to me why there should exist this distinction between the case where trust property is received and dealt with by the defendant and where it is not; perhaps its origin lies in equitable doctrines of tracing, perhaps in equity's concern for the*

11 See *Kalls Enterprises Pty Ltd (in liq) v Baloglow* (2007) 63 ACSR 557 at [152] ff.
12 See *Robb Evans of Robb Evans & Associates v European Bank Ltd* (2004) 61 NSWLR 75 at [159] ff.

> *protection of equitable estates and interests in property which comes into the hands of purchasers for value.*

I would have to admit to the same difficulty.

Yet all four jurisdictions acknowledge that there is a difference between trust property receipt cases and other cases of participatory liability and this justifies differing requirements for each. But the rationales for the differences vary between countries, as do the respective requirements for liability for knowing receipt. In making this comment I include Australia, although with our preoccupation with the theology of doctrine, little has been said by the courts here about the underlying reasons why a third party recipient or for that matter a third party who has received no trust property is being made liable at all: cf *Royal Brunei* at 386.

Historically, the rationale of protecting the wronged beneficiary's property interest about which Stephen J speculated has loomed large in the shaping of the requirements for participatory liability in property receipt cases. Influenced significantly by the doctrine of bona fide purchaser for value without notice all four countries did – and most still do – adhere to a liability rule concerned with the protection of equitable estates and interests and not with any question whether the recipient was guilty of such fault in the matter as would warrant the imposition of not merely proprietary but also personal liability on him. The recipient's constructive knowledge (in Australia) or constructive notice (in New Zealand and Canada) of a breach of trust or of fiduciary duty would suffice to attract participatory liability[13].

The property protection concern has led to some flirtation with the imposition of strict liability subject to defences on a third party recipient (i.e. a restitution/unjust enrichment rationale). Though some lip service to unjust enrichment has been paid in Canada[14], strict liability has made no headway in any of the four countries as its rejection in *Farah* attests, although it has had some notable proponents in the UK and particularly Lord Nicholls. My own view is that strict liability would result in the wholly unappetising consequence of making a third party recipient the insurer for the beneficiary of the defaulting fiduciary's or trustee's probity and, often, competence. It is difficult, with respect, to see what could justify such a perverse risk allocation[15].

There are three comments I would like to make about the knowledge/notice requirement in receipt cases. First, I earlier referred to the illusion of solving problems by formula and to Lord Nicholls' comment on "wrestling with the interpretation" of the knowledge requirement in knowing assistance cases. It is now appropriate to refer to the decision of Peter Gibson J in *Baden's* case ([1993] 1 WLR 509 at 582) on the refined distinctions possible in the degrees of knowledge or notice. The schemata propounded there attained what the authors of *Jacobs' Law of Trusts* (7th ed) (at [1335]) have described as the "zenith of complexity". It had five categories:

(i) "actual" knowledge;

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13 In the UK see the discussion in *BCCI (Overseas) Ltd v Akindele* [2001] Ch 437; in New Zealand see *Westpac Banking Corporation v Savin* [1985] 2 NZLR 41 but note the reservation of Richardson J at 53; in Canada see *Gold v Rosenberg* [1997] 3 SCR 767 and *Citadel General Assurance Co v Lloyds Bank Canada* [1997] 3 SCR 805; in Australia this issue was not addressed in *Farah* but in *United States Surgical Corporation v Hospital Products International Pty Ltd* [1983] 2 NSWLR 157 which accepts a watered down version of constructive notice.

14 See *Citadel General Assurance* at [51].

15 See generally Dietrich and Ridge, "The Receipt of What?: Questions Concerning Third Party Recipient Liability in Equity etc" (2007) 31 MULR 47.

(ii) the wilful shutting of one's eyes to the obvious;
(iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make;
(iv) knowledge of circumstances which would indicate the facts to an honest and reasonable man (constructive knowledge); and
(v) knowledge of circumstances which would put a reasonable man on inquiry (constructive notice).

I should note in passing that for Australian purposes *Consul* mandates categories (i) to (iv) but not category (v).

Secondly, whether or not one stops at category (iv) or category (v), it cannot in my view be said convincingly that the type of liability being imposed on the third party recipient is fault based in the equitable sense that the recipient's conscience is in the circumstances so affected that his or her receipt is knowingly wrongful. As Megarry V-C noted in *In Re Montagu's Settlement Trusts* [1987] Ch 264 at 285, the carelessness involved in categories (iv) and (v) would "not normally amount to a want of probility".

Thirdly, after considerable indecision in the case law, the UK courts have abandoned at least a simple constructive notice basis for liability. In *BCCI (Overseas) Ltd v Akindele* [2001] Ch 437 at 455 it was held that there ought to be a single test of knowledge for knowing receipt. It was that –

> *"The recipient's state of knowledge must be such as to make it unconscionable for him to retain the benefit of the receipt."*

Of this it was said:

> *"A test in that form, though it cannot, any more than any other, avoid difficulties of application, ought to avoid those of definition and allocation to which the previous categorisations have led. Moreover, it should better enable the courts to give commonsense decisions in the commercial context in which claims in knowing receipt are now frequently made …"*

The final comment I want to make about having a separate liability rule for receipt cases which, seemingly, has its own rationale is this. I would not wish to be taken as suggesting that the non-receipt cases similarly have their own distinct rationale and incidents. The contrary is the case.

KNOWING RECEIPT'S COUNTERPOINT: KNOWING ASSISTANCE

I have already indicated that not all cases of participatory liability not involving a property receipt fall potentially within the second limb of *Barnes v Addy* for the reason that they do not involve a breach of fiduciary duty or breach of trust.

Now for two further complications. The first is a product of the knowing assistance formula used by Lord Selbourne in *Barnes v Addy*. This was of agents "assist[ing] with knowledge in a dishonest and fraudulent design on the part of the trustees". Both Australia (because of *Farah*) and Canada[16] adhere literally and dogmatically to this formula in its

[16] See *Air Canada v M & L Travel* [1993] 3 SCR 787.

requirement of a dishonest and fraudulent design. Subject to what I will say below, knowledge of simply a breach of fiduciary duty or breach of trust as such will not suffice. *Farah* has seen to that. And neither would a dishonest or fraudulent design on the part of the third party alone.

For the sake of completeness – and to compound the confusion – the required knowledge of the relevant design differs as between Australia and Canada. Again in consequence of *Farah* constructive knowledge (*Baden* category (iv)) will suffice. In Canada, which has a truly fault based liability for knowing assistance, what is required is actual knowledge or else reckless or wilful blindness to the circumstances[17].

I earlier said that there was an exception to the proposition that knowledge of a breach of fiduciary duty or a breach of trust would not suffice for participatory liability purposes. The exception, which was acknowledged in *Farah* (at [161]-[162]), is that a third party who knowingly induces or immediately procures a breach of trust or of fiduciary duty is liable therefore to the wronged beneficiary: see *Elders Trustee and Executor Co Ltd v E G Reeves Pty Ltd* (1987) 78 ALR 193 at 238. This exception goes far to undermine the knowing assistance limb of *Barnes v Addy*. It appears, properly in my view, to have a more intense knowledge requirement than is permitted by *Consul*. Equally importantly, though, it embraces potentially two of the largest and most practically significant classes of case: (i) that of company directors whose decisions cause a corporate trustee to commit a breach of trust or of fiduciary duty; and (ii) advisers, be they solicitors, financial advisers or otherwise, who aid, abet, counsel or procure breaches of fiduciary duty or of trust.

What should be borne in mind in relation to this "exception", if I can so call it, is that, though it does not fall under the *Barnes v Addy* rubric, what differentiates it from "knowing assistance" is the different and more damning character of the third party's participatory role in the fiduciary's or trustee's own wrong. And when one puts it alongside the type of case with which the *Barnes v Addy* formulation was concerned, i.e. the agent who assists in a breach of trust or of fiduciary duty, what seems to be suggested is that there are three variables at play in the shaping of third party liability. These are (i) the actual manner of participation by the third party in the fiduciary's or trustee's wrong; (ii) the character of that wrong, i.e. was it fraudulent or innocent; and (iii), to use a neutral term, the extent of the third party's "appreciation" of the likelihood of a wrong being committed by the trustee or fiduciary.

To digress slightly, in my 1993 paper, I ventured to suggest that an overarching principle of third party liability in equity could be distilled from the cocktail of those factors. But that's another story.

What is not another story is the radical departure first in the UK – and then in New Zealand[18] – from the traditional understanding of the second limb of *Barnes v Addy*. *Royal Brunei*, as far as it goes, represents a real attempt to put accessorial liability in equity on a principled and coherent footing. The hallmark of accessorial liability is the third party's dishonest participation in a breach of fiduciary duty or breach of trust.

For the moment in this setting *Royal Brunei*'s burden is something for New Zealanders to ponder. For Australians, it is a distant prospect.

17 Ibid.

18 See *US International Marketing Ltd v National Bank of New Zealand Ltd* [2004] 1 NZLR 589.

CONCLUSION

I earlier referred to Sir Anthony Mason's comment that the law as it presently stands in Australia suffers from overmuch classification at the expense of sound underlying principle. In my view this does us little credit. Much of the difficulty lies in *Barnes v Addy* itself and in its skewed focus on trust property and agents. It was a most imperfect progenitor for a coherent body of principle concerned with participatory liability. First, its focus on trusts and trust property was understandable enough for its time. But it predates the rise of the fiduciary relationship and the remedial constructive trust. Fiduciary wrongdoing – and I include undue influence and breach of confidence in this – now looms large in commerce. The accessory question is becoming increasingly a fiduciary related one.

Secondly, the agent assisting in a breach of trust or breach of fiduciary duty is in a sense the atypical type of accessory which raises quite unique issues. These result from the agency relationship itself and from its demands such as carrying out the principal's instructions, etc. Contrast the person who induces, procures, or facilitates such breaches or who takes advantage of them. Such are strangers to the knowing assistance limb of *Barnes v Addy*. Yet we see them daily in corporate collapses, financial scams and the like and they are fitting targets for a principled, accessorial liability regime.

This leads me to my final observation. Today *Barnes v Addy*, I would suggest, is a distraction.

Justice Robert Chambers, New Zealand Court of Appeal
Dishonest Assistance

**DISHONEST
ASSISTANCE**

Robert Chambers

(A judge of the Court of Appeal of New Zealand)

with

Colin Fife

(Judge's clerk, Court of Appeal of New Zealand)[*]

PRELIMINARY DRAFT: NOT AVAILABLE FOR CITATION UNLESS APPROVED IN WRITING BY CHAMBERS J

Introduction

In 1995, Lord Nicholls of Birkenhead, delivering the Privy Council's advice in *Royal Brunei Airlines Sdn Bhd v Tan* [1] began his judgment as follows:[2]

[*]This is very much a joint paper, but, in view of the imbalance of power in the authors' relationship, the former has magnanimously agreed to take responsibility for any errors or deficiencies in it.
[1] [1995] 2 AC 378 (PC).
[2] Ibid at 381.

The proper role of equity in commercial transactions is a topical question.

> Increasingly plaintiffs have recourse to equity for an effective remedy when the person in default, typically a company, is insolvent. Plaintiffs seek to obtain relief from others who were involved in the transaction, such as directors of the company, or its bankers, or its legal or other advisers. They seek to fasten fiduciary obligations directly on to a company's officers or agents or advisers, or to have them held personally liable for assisting the company in breaches of trust or fiduciary obligations.

Royal Brunei was such a case. An insolvent travel agent company owed money to an airline. The airline sought a remedy against the travel agent's principal director and shareholder. The claim was based on the famous dictum of Lord Selborne LC in *Barnes v Addy.*[3] Under that dictum, there were two circumstances in which third parties (non-trustees) could become liable to account in equity. The first circumstance is generally referred to by the shorthand title "knowing receipt". The second circumstance is where liability arises from "knowing assistance". Lord Nicholls summarised the two limbs of Lord Selborne's formulation as follows:[4]

> The first limb … is concerned with the liability of a person as a *recipient* of trust property or its traceable proceeds. The second limb is concerned with what, for want of a better compendious description, can be called the liability of an *accessory* to a trustee's breach of trust. Liability as an accessory is not dependent upon receipt of trust property. It arises even though no trust property has reached the hands of the accessory. It is a form of secondary liability in the sense that it only arises where there has been a breach of trust.

Unfortunately, like most areas of judge-made law, these heads of equitable liability have become suffused with difficulties. That is amply demonstrated in the extremely useful compendium of English, Canadian, Australian, and New Zealand authorities summarised in David Ananian-Cooper's research memorandum, appended to Finn J's own illuminating paper. The divergence of authority is much to be regretted. Bankers and their lawyers – and I focus on them, given the audience for this conference – ought to be able to ascertain with reasonable certainty exactly what the relevant principles for knowing receipt and dishonest assistance are, particularly given that decisions in this area often have to made quickly.[5] Whatever one thinks of the High Court of Australia's decision in *Farah Constructions Pty Ltd*

[3] (1874) LR 9 Ch App 244 at 251-252.
[4] [1995] 2 AC 378 at 382.
[5] See for example the facts in *US International Marketing Ltd v National Bank of New Zealand Ltd* [2004] 1 NZLR 589 (CA).

v Say-Dee Pty Ltd,[6] one can at least agree with the proposition[7] that the New South Wales Court of Appeal's new approach had caused "great confusion" in Australia; new approaches in an area of this kind are not steps for intermediate courts of appeal. In *US International Marketing Ltd v National Bank of New Zealand Ltd*,[8] Tipping J referred to the obligation on the courts to respond to the "no win situation" in which banks often find themselves by stating rules that are "as clear and as straightforward to apply as possible".[9] We are, I think, still some distance away from achieving that laudatory aim.

The aim of this paper is to try to predict the principles that the Supreme Court of New Zealand might adopt when the first of these cases hits its docket. (None has so far.) I am not going to waste time in speculating on the course the New Zealand Court of Appeal is likely to take, as it remains bound by decisions of the Privy Council (here, *Royal Brunei*[10]) and by its own previous decisions (here, *US International Marketing*): see *R v Chilton*.[11] The Supreme Court, however, is bound by no one! No doubt relevant Privy Council decisions will be persuasive, but probably no more persuasive than relevant decisions from other superior courts elsewhere in the Commonwealth. In this paper, I concentrate on the "knowing assistance" limb, simply because of the time limitations.

It would be presumptuous of me to speculate whether the High Court of Australia will move from the position it reached in *Farah*. That decision was, with respect, surprising in two regards. First, its attack on the New South Wales Court of Appeal's reasoning was extravagant by Commonwealth standards.[12] Secondly, its decision was surprisingly reactionary in simply reiterating the continued applicability of its own 1975 decision, *Consul Development Pty Ltd v DPC Estates Pty Ltd*.[13] Notwithstanding the significant developments in this area of law by the Privy Council, the House of Lords, and the Supreme Court of Canada since *Consul* was decided, the High Court did not take the opportunity to re-evaluate it. Rather, their concern was simply to confirm *Consul* as "the law in Australia", to "be

[6] (2007) 230 CLR 89.
[7] Ibid at [134]-[135].
[8] [2004] 1 NZLR 589 (CA).
[9] Ibid at [6].
[10] But not *Barlow Clowes International Ltd (In Liqn) v Eurotrust International Ltd* [2006] 1 WLR 1476, which was decided after the Privy Council ceased to be part of New Zealand's appellate structure.
[11] [2006] 2 NZLR 341 at [83]-[92] and [111]-[114].
[12] Its effect may perhaps be seen in Mason P's address to the Judicial Council of Australia conference in October 2007: see "Throwing Stones: Cost/benefit analysis of judges being offensive to each other" (2008) 82 ALJ 260. Mason P was a member of the panel determining *Farah* at Court of Appeal level.
[13] 132 CLR 373.

followed by Australian courts, unless and until departed from by decision of [the High Court]".[14] Finn J is in a much better position than I to assess likely Australian developments in light of *Farah*. Australian bankers and their lawyers need to keep reading, however, as they need to be aware their New Zealand subsidiaries and branches may have to make decisions utilising at least slightly different equitable principles.

In light of the time available, I intend to evaluate what I think will be the five most influential decisions, assuming this question comes before the Supreme Court within the next couple of years. Having discussed those cases, I shall try to predict what course the Supreme Court may take on this issue.

The five key cases

Royal Brunei Airlines v Tan

Royal Brunei was a case in which an insolvent travel agent owed money to an airline. The airline appointed a company, Borneo Leisure Travel (BLT), to act as its general agent for the sale of passenger and cargo transport. BLT was required to account to the airline for all amounts received from sales of tickets. The agency contract expressly provided that BLT would hold ticket money on trust for the airline and account to the airline for such money. In practice the money received by BLT on behalf of the airline was not paid into a separate account, but was paid into BLT's ordinary operating account and used to pay salaries and other expenses. Mr Tan was the principal shareholder and managing director of BLT (in effect, its alter ego) although he had signed all contracts as agent for BLT and not in his personal capacity. The airline claimed that Mr Tan was liable as a constructive trustee under the second limb of *Barnes v Addy*, on the basis that he had knowingly assisted BLT in a breach of trust.

The trial judge found Mr Tan was liable for knowingly assisting the breach of trust, as he had known BLT held the money on trust and he had authorised its use for purposes other than repaying the airline. He ordered Mr Tan to pay damages of B$335,000. The Court of Appeal of Brunei Darussalam allowed Mr Tan's appeal. The court held there had been no dishonest

[14] Ibid at [178].

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and fraudulent design on the part of BLT. Accordingly, Mr Tan could not be liable, even though it was conceded he had assisted with actual knowledge of BLT's breach of trust.[15] The issue on appeal to the Privy Council was the circumstances in which a third party can be liable for knowingly assisting such a breach.

Lord Nicholls said it was necessary to take an overall look at the accessory liability principle, in particular at the state of mind of the third party.[16] The breach of trust by the trustee may be entirely inadvertent or innocent, although of course a trustee's liability is strict. Generally a person will be liable for assisting a breach of trust only if his or her conduct, when assessed objectively and in light of the surrounding circumstances, is dishonest. Telltale signs of dishonesty, Lord Nicholls said, might include acting in reckless disregard of others' rights, or becoming or staying involved where an honest person would flatly decline to become involved or would ask further questions.[17]

Lord Nicholls summarised the position as follows:

> Drawing the threads together, their Lordships' overall conclusion is that dishonesty is a necessary ingredient of accessory liability. It is also a sufficient ingredient. A liability in equity to make good resulting loss attaches to a person who dishonestly procures or assists in a breach of trust or fiduciary obligation. It is not necessary that, in addition, the trustee or fiduciary was acting dishonestly, although this will usually be so where the third party who is assisting him is acting dishonestly. "Knowingly" is better avoided as a defining ingredient of the principle, and in the context of this principle the *Baden* [[1993] 1 WLR 509] scale of knowledge is best forgotten.[18]

The Privy Council held Mr Tan had assisted in a breach of trust because he caused his company to apply airline money in a way which he knew was dishonest. No doubt he hoped the airline would be repaid, but that was beside the point: he had no right to use the money for his business expenses. He was accordingly required to make good the airline's loss. The damages award was reinstated.

[15] [1995] 2 AC 378 at 383.
[16] Ibid at 386.
[17] Ibid at 390-391.
[18] For this reason, I have taken the liberty of changing the title of this address from that provided by the organisers!

Twinsectra v Yardley

Twinsectra Ltd v Yardley[19] was a case about a dishonest property developer, Mr Yardley. He negotiated a loan of £1m from Twinsectra for the purposes of buying property. The money was paid to a law firm (Sims) on its written undertaking that the money would only be released to Mr Yardley for the sole purpose of buying property. It was to be used for no other purpose. Sims did not honour its undertaking; on an assurance from Mr Yardley it paid the money to another solicitor, Mr Leach, who simply paid the money out on Mr Yardley's instructions. £358,000 was used by Mr Yardley for purposes other than buying property and the loan was not repaid. Twinsectra sued all the parties involved. The question for the House of Lords was whether Mr Leach's conduct, in receiving the money and paying it out without regard to whether it would be used to purchase property, could be said to have dishonestly assisted a breach of trust. The trial judge found that his conduct was "misguided" but not dishonest. The Court of Appeal reversed this finding and found Mr Leach had been dishonest and was thus liable for assisting a breach of trust.

Lord Hoffmann and Lord Hutton (with whom Lord Slynn of Hadley and Lord Steyn joined) agreed that the case required application of the principles set out in *Royal Brunei*. The question was whether Mr Leach's liability as an accessory to a breach of trust required it to be shown that he had acted dishonestly. In particular, in order for Mr Leach to be liable, did it need to be shown he had a conscious appreciation that his actions were dishonest? Lord Hoffmann characterised the test in *Royal Brunei* as requiring a "dishonest state of mind" and a "consciousness that one is transgressing ordinary standards of honest behaviour".[20] His Lordship was of the view that, because Mr Leach believed (albeit wrongly) that any undertaking was a matter purely between Sims and Mr Yardley and that the money was at Mr Yardley's disposal, it could be said he was misguided and had taken a blinkered approach to a lawyer's professional obligations, but it could not be said he was dishonest in terms of the *Royal Brunei* test.

Lord Hutton noted the distinction between subjective and objective dishonesty. He considered *Royal Brunei* required it to be shown that the third party knew that what he or she

[19] [2002] 2 AC 164 (HL).
[20] Ibid at [20].

was doing would be regarded as dishonest by honest people.[21] (The third party will not escape liability by the "Robin Hood" defence - that is, by setting his or her own standards of honesty.) Lord Hutton described this as a "combined test" for accessory liability, incorporating both subjective knowledge and objective standards of dishonesty. The question in this case, Lord Hutton said, was whether Mr Leach realised his action was dishonest by the standards of responsible and honest solicitors.[22] There was no evidence, in Lord Hutton's view, to justify the Court of Appeal substituting its own finding of dishonesty and Mr Leach was not liable for dishonestly assisting a breach of trust. The House of Lords restored the judgment of the trial judge.

Lord Millett dissented. He first distinguished between knowing assistance and knowing receipt. Recipient liability, Lord Millett said, does not depend on fault because it is a restitutionary cause of action. There will be no need to show the recipient had knowledge of the breach of trust, let alone dishonesty.[23] Liability as an assistant or accessory to a breach of trust, on the other hand, has an additional requirement of dishonesty. The decision of the Privy Council in *Royal Brunei*, Lord Millett said, firmly rejected negligence as a sufficient condition of accessory liability.[24] Dishonesty is required, or, in some rare cases, deliberately shutting one's eyes to facts which one would prefer not to know.[25] In Lord Millett's view, however, Lord Nicholls's judgment in *Royal Brunei* firmly rejected the requirement for a dishonest state of mind as a condition for assistant liability. There is "no trace in Lord Nicholls' opinion", Lord Millett said, "that the defendant should have been aware he was acting contrary to objective standards of dishonesty."[26] Lord Millett considered that the test was whether a defendant has attained that standard which would be observed by a honest person in similar circumstances, having regard to subjective considerations such as the defendant's experience and intelligence, and his or her actual knowledge [of the material facts] at the relevant time.[27] It is an almost entirely objective standard.[28] It will not be necessary, Lord Millett would have held, for the third party to know the details of the trust or

[21] Ibid at [35].
[22] Ibid at [49].
[23] Ibid at [105].
[24] Ibid at [113].
[25] Sometimes referred to as "Nelsonian knowledge", because Admiral Nelson is famously (albeit inaccurately) believed to have disobeyed Admiral Sir Hyde Parker's order of recall, during the battle of Copenhagen in April 1801, by holding his telescope to his blind eye and claiming to not see the signal: see *Baden v Société Générale SA* [1993] 1 WLR 509 at 576 (Ch) per Peter Gibson J.
[26] [2002] 2 AC 164 at [118] (HL).
[27] Ibid at [121].
[28] Ibid at [122] and [127].

even the identity of the beneficiary: it is enough that he or she knows the money is not at the free disposal of the principal.[29]

US International Marketing v National Bank

US International Marketing Ltd v National Bank of New Zealand Ltd[30] was a case about the duty of a banker faced with a demand for payment in circumstances where the bank was aware that a third party had a claim to the money. US International had two accounts with the respondent bank. The sole director of US International (a Mr Singh) purchased, using funds in one of the accounts, a bank cheque for $15,073 payable to the High Court. Mr Singh offered the bank cheque to counsel appearing in liquidation proceedings against a third company (PE). Mr Singh was apparently anxious to stave off liquidation of PE and so offered the cheque in court as a means to pay off creditors of PE. An order for liquidation of PE was nevertheless made; the bank cheque was no longer required and it was resold by Mr Singh to the bank on 2 December 1997. At this point in time the account was $17,905 in credit. On 3 December 1997 the manager of the bank branch at which US International's accounts were held received a fax from a firm of solicitors acting for PE's liquidators. The fax indicated that PE had said during the High Court hearings that it held a bank cheque for $15,073 and that such funds belonged to PE. The solicitors then said "urgent application will be made to the High Court to secure those funds and we formally ask that those funds be frozen by the Bank in the interim."

The bank, acting on legal advice, froze the funds in US International's account and when Mr Singh and other family members attempted to withdraw money on 4 and 5 December 1997 they were told the account was frozen. Despite Mr Singh's remonstrations with the branch manager on 8 December, and a fax sent by Mr Singh to the bank on 10 December demanding the release of money from the account, no transactions were permitted. A preservation order was made in the High Court on 10 December and the funds were paid into Court in accordance with terms of the order. US International sued and alleged that because the bank had not paid on demand, it had lost $731,000 in respect of a land contract in India on

[29] Ibid at [135]
[30] [2004] 1 NZLR 589 (CA).

which a deposit was due.[31] The High Court held that the bank had acted honestly and reasonably in declining to release the funds until it knew the outcome of the liquidators' application for a preservation order. US International appealed to the Court of Appeal.

The Court of Appeal allowed the appeal. On the morning of 10 December 1997, the court held, there was no basis on which the bank should have known it might have been dishonest to meet US International's demand. The starting point, the court said, is that a bank has a clear duty to its customer to allow immediate access for whatever purpose the customer may wish to apply them. If the courts were too willing to undermine that relationship, third parties might too readily intervene in the banker/customer relationship for undeserving reasons.[32] A bank may only refuse to meet its customer's demand if to do so would, in all the circumstances, provide dishonest assistance. Each member of the court gave separate reasons.

Tipping J referred with approval to the decisions of the Privy Council in *Royal Brunei* and the House of Lords in *Twinsectra*. Dishonesty has both objective and subjective elements, and the person concerned must appreciate that their conduct is transgressing ordinary standards of honest behaviour.[33] Tipping J considered it helpful to introduce the concept of a reasonable banker and "look at the circumstances known to the bank in question through those objective eyes".[34] Tipping J's "reasonable banker" would only be entitled to freeze an account in circumstances where (1) in all the circumstances known to the bank, (2) a reasonable banker would know it was dishonest to pay the funds to or on the order of its customer, and (3) if the bank itself appreciates that to be the case.

In "relatively rare" cases, Tipping J said, a reasonable banker might realise without any further inquiry that it would be dishonest to meet a customer's demand. More often, further inquiry will be required and it should be made in an appropriate and timely manner. Tipping J considered that a failure to make such further inquiry would give rise to liability only if the failure was dishonest: in most cases this will be a deliberate closing of the eyes or not asking questions about a transaction.[35] In Tipping J's view such a test satisfactorily

[31] US International's claim was for losses caused by a breach of contract by the bank in failing to pay on demand. In this regard the case was about "dishonest assistance" only in so far as the bank sought to use the doctrine as an excuse for freezing US International's account.
[32] Ibid at [6] per Tipping J.
[33] Ibid at [7].
[34] Ibid at [9].
[35] Ibid at [10].

reconciled the competing factors in the banker/customer relationship. Finally, Tipping J noted that freezing a customer's account ahead of any actual demand by the customer for payment of funds might well amount to an anticipatory breach of contract, although no loss would ensue unless a subsequent actual demand was received by the bank and not met. Tipping J then turned to the facts in this case. His essential reasoning merits reproduction in full:[36]

> To this point I do not consider the solicitor's letter gave any basis for the bank pro tanto to freeze US International's account. Nor do I consider the circumstances were such that a reasonable banker should have felt obliged to make further inquiry to avoid being at risk of being regarded as dishonest if it met a demand by its customer in relation to the funds in question. The fact that an urgent application to the High Court to secure the funds was foreshadowed cannot, in my view, make any difference. A sufficient factual foundation must be laid for the contention that the funds concerned are trust funds. It follows that the bank acted at least in anticipatory breach of its contract with US International when it agreed to freeze the funds at the solicitor's request.

Anderson J commenced his discussion with a summary of Lord Nicholls's judgment in *Royal Brunei*. He expressed reservations about the requirement for actual knowledge by a defendant that his or her conduct was dishonest by the ordinary standards of reasonable people. Anderson J was of the view that in circumstances where it would be dishonest for a bank to pay on a customer's demand, the test should not be complicated by a consideration of whether a reasonable banker would know this.[37] Anderson J was "diffident" about equity recognising conduct as dishonest only if the defendant knew his conduct to be wrong. The better approach, in Anderson J's view, was that conduct by a banker which was unreasonable having regard to banking standards might in some circumstances suggest dishonesty. The nature of a customer's dealings and his or her business practices would be relevant, because an honest person would not ignore evidence of a breach of trust by the customer. Anderson J expressed the central issue as being whether in all the circumstances it would have been dishonest for the bank to meet its customer's demand.

Glazebrook J expressed herself as being in substantial agreement with Anderson and Tipping JJ. She indicated it was not necessary to decide on all the subjective elements of the test for dishonest assistance, although she considered Tipping J's "reasonable banker" concept

[36] Ibid at [15].
[37] Ibid at [68].

reinforced the objective elements of the test while recognising that subjective concepts, such as experience and knowledge, might also be relevant. Glazebrook J had some reservations about whether the final subjective element from *Twinsectra* (Tipping J's third element) is necessary in New Zealand.

Barlow Clowes v Eurotrust

Barlow Clowes International Ltd (In Liqn) v Eurotrust International Ltd[38] was a case about a fraudulent offshore investment scheme. Mr Clowes incorporated a company in Gibraltar (Barlow Clowes) which purported to offer high investment returns. He attracted £140m from small UK investors, but rather than investing the money he spent it on extravagant living and personal business ventures. Mr Cramer was an associate of Mr Clowes. Mr Cramer instructed an independent company (ITC) in the Isle of Man to form a number of offshore companies which ITC was to administer on his behalf. In mid-1987 Messrs Clowes and Cramer decided to engineer a "reverse takeover" of Barlow Clowes using one of Mr Cramer's companies (JFH). To execute these plans, JFH needed working capital. Investor money was transferred out of Barlow Clowes (through the ITC client account) to a Cramer company called Ryeman Ltd in two steps, £1.9m on 3 March 1987 and £7m on 22 June 1987. Of this money, £6.6m was later transferred to Mr Cramer's personal account or paid by ITC on his order.

Unsurprisingly, the whole scheme collapsed. Barlow Clowes' liquidators sued ITC's directors, in particular a Mr Henwood, and alleged he had dishonestly assisted Mr Cramer to misappropriate investors' funds. The trial judge applied the test in *Royal Brunei* and found Mr Henwood liable for dishonestly assisting the misappropriation of the £6.6m paid to Mr Cramer's personal account or to his businesses. Mr Henwood appealed on the ground that a finding of dishonest assistance was not supported by the evidence. The intermediate appellate court of the Isle of Man allowed Mr Henwood's appeal. Barlow Clowes appealed to the Privy Council. The essential issue for the Privy Council was whether it had to be shown that Mr Henwood was not only dishonest but also "was aware that [his actions] would by ordinary standards be regarded as dishonest".[39]

[38] [2006] 1 WLR 1476 (PC).
[39] Ibid at [12]-[13].

Lord Hoffmann gave the judgment of a unanimous Privy Council.[40] He referred to the speech of Lord Hutton in *Twinsectra*, and in particular the part of Lord Hutton's judgment where the subjective knowledge requirement was emphasised: "dishonesty requires knowledge by the defendant that what he was doing would be regarded as dishonest by honest people."[41] Lord Hoffmann firmly rejected counsel's suggestion that this pointed to an additional subjective requirement on the part of the defendant. "There is an element of ambiguity in [Lord Hutton's remarks]", Lord Hoffmann conceded, but the Privy Council in *Twinsectra* did not depart from the law as previously understood.[42] There is no additional subjective element of dishonesty. The only knowledge required for dishonest assistance, the Privy Council held in *Barlow Clowes*, is "knowledge of the transaction…such as to render his participation contrary to normally acceptable standards of honest conduct. It [does] not require that he should have had reflections about what those normally acceptable standards were."[43]

On the facts of *Barlow Clowes*, the Privy Council had no doubt that Mr Henwood was liable for dishonestly assisting a breach of trust. There was clear evidence to support this finding. Mr Henwood had entertained a clear suspicion that the transfers to Mr Cramer and his companies were of moneys held in trust, and it would be "quite unreal" to suppose that Mr Henwood would have to know every detail of the transactions before he suspected that Messrs Clowes and Cramer were misappropriating investors' money.[44] Lord Hoffmann said that someone can know, and certainly suspect, that he or she is assisting in the misappropriation of money without knowing the money is held on trust or even what a trust means.[45]

The decision of the first instance judge was restored. This meant Mr Henwood was liable for the misappropriation of money in which he had dishonestly assisted.

[40] The committee which heard *Barlow Clowes* included Lord Nicholls, who gave the judgment in *Royal Brunei*.
[41] *Barlow Clowes v Eurotrust* [2006] 1 WLR 1476 at [14], citing *Twinsectra Ltd v Yardley* [2002] 2 AC 164 at [36].
[42] Ibid at [15].
[43] Ibid at [15].
[44] Ibid at [28].
[45] Ibid at [28].

Farah v Say-Dee

The two protagonists in *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* were development companies controlled by different families. They entered a contract to purchase a property at 11 Deane Street in Sydney as tenants in common in equal shares, with the intention of redeveloping the site as joint venturers. Mr Elias (a director of Farah) lodged a development application with the council, but was advised that the site was too narrow to develop without amalgamation with neighbouring sites. Mr Elias and members of his family then purchased some of the nearby properties, without Say-Dee's knowledge. He then withdrew the planning application in respect of no. 11, and made a concealed offer to purchase no. 11 in such a way that his identity remained secret.[46]

Say-Dee sued Farah and alleged that it and the Elias family had acquired the neighbouring properties in breach of fiduciary duties owed to the joint venture. Say-Dee contended that Mr Elias's wife and daughters (through another family company, Lesmint Ltd) had known of Farah's breach of trust, and that accordingly they held any interest in the properties acquired by themselves or Lesmint as constructive trustees for Say-Dee. Say-Dee alleged that Mr Elias's family were liable under the first limb of *Barnes v Addy* as recipients of trust property. The New South Wales Court of Appeal found that Mrs Elias and her daughters were liable as knowing recipients of the property and held it, and any profits, on a constructive trust for Say-Dee. Farah and the Elias family appealed.

The High Court of Australia unanimously allowed Farah's appeal. It firmly rejected the Court of Appeal's finding that the Elias family were liable as recipients of trust property under the first limb of *Barnes v Addy*.[47] There was no relevant receipt in this case because the "trust property" alleged to have been received by the Elias family, namely confidential information about the planning approval process for the Deane St properties and about what terms the local council was likely to require, was nothing of the sort. It was, the High Court held, public information and not trust property held by Mr Elias or Farah for the partnership.

The High Court emphasised that the first limb of *Barnes* (recipient liability) continues to apply in Australia. Recipient liability requires (i) receipt of trust property by a third party and

[46] 230 CLR 89 at [20].
[47] Ibid at [115].

(ii) notice to the third party of the breach of trust.[48] In this case the Elias family members were separate individuals and could not be fixed with constructive knowledge of Farah's breach.

The High Court went on to discuss liability for assisting a breach of trust under the second limb of *Barnes v Addy*. The Court stated that a defendant will be liable if he or she "assists a trustee or fiduciary with knowledge of a dishonest and fraudulent design on the part of the trustee or fiduciary".[49] The High Court noted that the statement of accessory liability in *Barnes* is not exhaustive, and it is possible that a third party may be liable in circumstances where the trustee does not act for an improper or fraudulent purpose but the third party dishonestly procures a dishonest breach of trust: these cases are to be distinguished from the second limb of *Barnes*, which contemplates dishonesty on the part of the trustee and assistance by the third party.[50] The Court also noted that *Royal Brunei* appears to displace the rule in *Barnes* and instead substitutes a general principle of "accessory liability". The High Court was diffident about adopting *Royal Brunei* in Australia. On the facts in *Say-Dee* the High Court was not required to consider whether *Royal Brunei* had modified or restated the second limb of *Barnes*.[51]

The High Court then surveyed the requirements for a third party's knowledge of the dishonesty and fraudulent design on the part of the trustee. It expressly affirmed its earlier 1975 decision in *Consul*.[52] The Court said with reference to *Consul* that, "as a matter of ordinary understanding", an act may be dishonest without a person appreciating the act in question was dishonest by the standards of ordinary decent people.[53] This suggests the test in Australia for third party knowledge is an objective one. The Court then referred with approval to the *Baden* categories of knowledge:[54] the five categories, the Court said, provide "authoritative guidance" on the question of knowledge for the second limb of *Barnes*. Any of

[48] Ibid at [122].
[49] Ibid at [160].
[50] Ibid at [161] and [163].
[51] Ibid at [164].
[52] 132 CLR 373.
[53] Ibid at [173].
[54] The five categories are (i) actual knowledge; (ii) wilfully shutting one's eyes to the obvious; (iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make; (iv) knowledge of circumstances which would indicate the facts to an honest and reasonable man; (v) knowledge of circumstances which would put an honest and reasonable man on inquiry. See *Baden v Société Générale SA* [1993] 1 WLR 509 at 575-6 per Peter Gibson J.

the categories would suffice except for category (v), namely, circumstances which would put an honest and reasonable person on inquiry.

The High Court concluded that, as stated in its judgment in *Consul*, liability for assisting a breach of trust under the rule in *Barnes v Addy* will arise only where the breach of trust or fiduciary duty is "dishonest and fraudulent."[55] Not all breaches of trust will be deemed dishonest or fraudulent: some are well intentioned, and some are trivial.[56] In particular, where a trustee acts honestly and reasonably, then a breach might fairly be excused. It appears from the judgment in *Say-Dee* that the High Court considers assistant liability will arise under *Barnes v Addy* only where there is dishonesty and/or fraud on the part of the trustee. Where an innocent breach is procured by a dishonest third party, the third party may well be liable but not under the second limb of *Barnes v Addy*.[57] The High Court did not decide whether *Royal Brunei*, if adopted in Australia, would encompass both situations.

The likely course our Supreme Court will adopt

Having set out what I consider to be the five cases most likely to influence our Supreme Court,[58] I now turn to consider what course our Supreme Court is likely to chart in these waters. Predictions such as these come with all the normal caveats!

1. The two heads of liability enunciated by Lord Selborne in *Barnes v Addy* are likely to remain distinct. The doctrines of receipt of trust property and dishonestly assisting a breach of trust or fiduciary duty, while both equitable doctrines, are distinct and almost certainly will be kept separate. Different considerations apply to each doctrine, as was noted by Lord Nicholls in *Royal Brunei*.[59]

2. The approach taken in *Royal Brunei* is likely to be followed here. The case was strongly relied on by the Court of Appeal in *US International Marketing*, in which Tipping J delivered the leading judgment. The short history of our Supreme Court and its current complement would suggest that Tipping J is likely to be a key member of

[55] 230 CLR 89 at [179].
[56] Ibid at [184].
[57] Ibid at [161].
[58] Assuming a "dishonest assistance" case reaches the Supreme Court in, say, the next five years.
[59] [1995] 2 AC 378 at 386.

the court in this area, provided a case reaches the Supreme Court before August 2012.[60] It is unlikely our Supreme Court will move in a radical new direction, for the reasons given by the High Court of Australia in *Farah*: "change [in this area] would call for very careful examination of the possible consequences."[61]

3. Assisting a breach of trust or other fiduciary obligation will be actionable by the beneficiary only if the assister's conduct, when assessed objectively and in light of the surrounding circumstances, is dishonest. Knowing assistance is no longer an apt description of this head of liability.

4. An assister is dishonest if he or she had knowledge of the transaction such as to render his or her participation contrary to normally acceptable standards of honest conduct. That is judged objectively; it is not necessary for a claimant to prove that the assister had thought about what those normally acceptable standards are. The well known categories of knowledge set out in the *Baden* case are almost certainly no longer relevant in this area of New Zealand law. New Zealand law has probably diverged from Australia in this regard.[62]

5. Telltale signs of dishonesty include acting in reckless disregard of other's rights, or becoming or staying involved in circumstances where an honest person would flatly decline to become involved or would ask further questions.[63]

6. The assister does not need to know that the money is trust money, the terms on which it is held, or even what a trust is.[64] All that is required is that the assister know, or suspect, that he or she is assisting in the misappropriation of money.[65] Knowledge of the facts of a particular transaction or circumstances will generally suffice.[66] In rare cases, a failure to inquire into the source of the money when an honest person would have asked questions will suffice.

[60] Tipping J's retirement date!
[61] 230 CLR 89 at [121].
[62] As noted above, the High Court of Australia expressly affirmed the utility of the *Baden* scale in respect of the knowing assistance limb of *Barnes v Addy*: at [175].
[63] *Royal Brunei* at 390-391.
[64] *Barlow Clowes v Eurotrust* at [28]
[65] *Barlow Clowes*, ibid.
[66] Ibid. In *Twinsectra Ltd v Yardley* [2002] 2 AC 164, Lord Millett at [135] characterised dishonesty as "knowing the money is not at the free disposal of the principal", which may mean the same thing.

7. In relation to dishonesty in cases involving banks, Tipping J's concept of a reasonable banker will be informative. Future dishonest assistance claims involving banks will likely require a focus on what inquiries a reasonable banker ought to have made. This may encompass such information as expert evidence about banking best practice, statutory reporting requirements,[67] and the knowledge of the particular bank about a customer's business practices.[68]

8. The nature of the remedies for dishonest assistance remains very uncertain. Is the assister's liability a form of civil secondary liability analogous to common law secondary liability or is the assister's liability a primary liability? There has been much academic writing on this topic.[69] The answer to that question can have a bearing on types and quantum of remedies, causation and remoteness of damage, and also on possible defences, eg limitation.[70]

In my view, New Zealand law is likely to adopt a model of primary liability, leading principally to a compensatory remedy.[71] In most cases the compensation will be to the beneficiaries and will require the restoration of lost trust property. Given, however, this country's tendency since the 1980s to permit mingling of equitable and common law remedies,[72] I do not rule out the prospect that assisters could, in appropriate circumstances, be liable to account to the plaintiff for profits the assister may have made. Court of Appeal authority supports a distinction between a conventional approach to causation for breaches of a duty of care by a trustee, and a more stringent approach for breaches of fiduciary duty which involve an element of infidelity or

[67] For example, the reporting requirements for suspicious transactions contained in the Financial Transactions Reporting Act 1996, s 11(2).
[68] *US International* at [69] per Anderson J.
[69] See, for example, Elliott and Mitchell "Remedies for Dishonest Assistance" (2004) 67 MLR 16 and Ridge "Justifying the Remedies for Dishonest Assistance" (2008) 124 LQR 445.
[70] Mitchell "Dishonest Assistance, Knowing Receipt, and the Law of Limitation" (2008) 72 Conv 226.
[71] Notwithstanding his comments in *Royal Brunei*, Lord Nicholls now appears to accept that both knowing receipt and dishonest assistance are two types of *primary* equitable wrong: Lord Nicholls "Knowing Receipt: The Need for a New Landmark" in Cornish and others (eds.) *Restitution: Past, Present and Future: Essays in Honour of Gareth Jones* (1998) at 244.
[72] See, for example, *Aquaculture Corporation v NZ Green Mussel Co* [1990] 3 NZLR 299 at 301 (CA) per Cooke P, emphasising that a full range of remedies (including monetary compensation) are available as appropriate, no matter whether the obligation is one of common law, equity or statute.

disloyalty engaging the trustee's or fiduciary's conscience.[73] In the latter type of case, gain-based or restitutionary remedies may well be appropriate. While the assister has not given an undertaking of loyalty, he or she has dishonestly interfered with the trust or fiduciary relationship for profit, thereby exploiting the claimant's vulnerability, and this may suggest that a gain-based remedy should be available to the claimant.[74]

[73] *Bank of New Zealand v New Zealand Guardian Trust Co Ltd* [1999] 1 NZLR 664 (CA), and see in particular
at 687 per Tipping J.

[74] Ridge at 451; *Consul* 132 CLR 373 at 397; *Zhu v Treasurer (New South Wales)* (2004) 218 CLR 530 at 571.

Friday 25th July, 2008

Concurrent 1a
Millennium Hotel

11.10am – 12.30pm

Chair:
Elisabeth Wentworth
Barrister, Victorian Bar
Melbourne

Speakers:
Prof. Jim O'Donovan
University of Western Australia
Perth

Philip Trinca
Partner, Blake Dawson
Melbourne

Predatory Lending:
From the sub-prime to the ridiculous

Prof. Jim O'Donovan, University of Western Australia, Perth

"Lenders Behaving Badly"

"LENDERS BEHAVING BADLY"
by
Professor James O'Donovan
Barrister-at -Law
Law School Chambers
The University of Western Australia
Crawley WA

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1. INTRODUCTION

(i) Definitions

The book of *Ecclesiastes*(1:1-3) tells us that there is nothing new under the sun. This is certainly true of predatory lending which has existed for centuries.

Predatory lending is a pejorative term used to describe abusive lending practices. It involves "imposing unfair and abusive loan terms on borrowers often through aggressive sales tactics, taking advantage of borrowers' lack of understanding of extremely complicated transactions, and outright deception."[1] The term predatory lending may extend to payday loans, credit cards and other forms of consumer debt, and even overdrafts, involving unreasonably high interest rates or exorbitant fees.[2] Sub-prime lending in the United States does not necessarily involve predatory lending but there are often predatory features in their Australian counterpart: low doc loans.

(ii) The Targets of Predatory Lenders

The targets of predatory lenders are usually the less educated, racial or ethnic minorities and the elderly, but predatory lending is not confined to any socio-economic group.[3] A study of 26,000 households by the management consultancy firm, Fujitsu, found that disadvantaged borrowers living on the fringes of Australia's capital cities had been heavily targeted by predatory home loan brokers.[4] Females were overrepresented in the "disadvantaged fringe" category, with 13000 women falling victim to predatory lending, compared with 8500 men.[5] Consumers in the "battling urban" category were twice as likely to fall victim to predatory lenders, while there were few victims in the "exclusive/professional"category.[6] Borrowers in the "disadvantaged fringe" category were four times more likely to be victims of predatory lending than the broader population.[7]

While there are many reputable non-bank lenders, predatory lending is generally conducted by non-bank lenders who have different initial credit assessment guidelines from bank lenders and more aggressive repossession strategies[8]. Non-bank lenders provide only about 20 per cent of housing loans but they are responsible for 80 per cent of home repossessions.[9]

(iii) Forms of Predatory Loans

Predatory lending can occur in many different forms: low-doc loans; "Ponzi" loans; pay day loans; and even reverse mortgages.

A low-doc loan is a loan where the borrowers themselves or their agents verify their income, assets and liabilities in the loan application process.[10] Australia does not have a sub-prime lending market comparable to the United States. Indeed, it is estimated that only 1% of Australian borrowers fall in the sub-prime category, compared with 13% in the United States.[11] Nevertheless, it is estimated that around $10 billion has been borrowed in Australia's low-doc home loan industry,[12] and non-conforming loans account for about 6% of all housing loan arrears in Australia.[13] More importantly, unlike US sub-prime borrowers, Australian borrowers will be liable under the personal covenants in their mortgages. They cannot simply walk away from their properties.[14]

A "Ponzi" loan is a loan which can only be repaid by either taking out a larger subsequent loan, or by selling the asset that was purchased or financed using the loan.[15] Ponzi loans are often used in pyramid schemes.

A pay day loan is a high-cost, short –term loan which allows a borrower to discharge an immediate financial burden.[16] If the borrowers are unable to repay the loans on their pay day – usually pension day – they will be charged an expensive late fee and another fee for an extension of the loan for another few weeks. These loans enmesh borrowers in a poverty trap, exacerbating their financial stress and placing their assets such as their house or car in jeopardy.

The growth of pay day lending has been phenomenal. It is estimated that Australia will have 800 outlets offering pay day loans by 2010.[17] In 2002 Victoria's Consumer Law Action Centre estimated that the size of the pay day lending sector's turnover at $200 million, with a customer base of 100,000 to 150,000 users.[18] More recent estimates suggest that pay day lenders turn over $80-100 million in Queensland alone.[19] In 2006-2007 Cash Converters made a net $11.5 million profit from a mix of commission payments and a $124.6 million loan book.[20] In an attempt to under-cut pay day lenders such as Cash Converters, Money 3 and Amazing Loans, Radio Rentals has introduced a trial cash-loan fringe lending scheme directed at an estimated

2 million Australian households that are "cash constrained" in the sense that they are generally reliant on welfare or a very small income.[21]

Reverse mortgages enable retirees to take advantage of the equity in their homes without reducing their pension benefits. Reverse mortgage borrowers can gain access to the equity in their homes without having to sell and without the demands of regular payments. In return for a lump sum or a regular payment from the lender, the borrowers agree to hand over a portion of their homes, including interest payments, when they die or when the property is sold.[22]

The size of outstanding reverse mortgage loan balances grew by 67% to $1.18 billion in the 12 months to June 2007; the number of loans grew by 13% to 31, 544 in the 6 months to June 2007.[23] This growth is likely to continue with improved product feasibility and wider distribution channels. The average reverse mortgage loan size is about $52,000 and the average age of borrowers is 73.[24] However, 23% of borrowers had borrowed additional funds in the 6 months to June 2007, adding an average of $10,500 to their loan facilities.[25] On the other hand, on average, borrowers draw only 75% of the maximum loan amount available and 10% of borrowers each year choose to pay back their loans in full.[26]

It is expected that there will be a growing demand for shared-equity mortgages under which the borrowers, (usually first home buyers, someone upgrading their home or cash-poor retirees) can borrow 10 to 20% of the value of property interest-free.[27] In return, the borrowers may be required to surrender up to 40% of any capital gain. Sometimes 20% of a loan will be funded by a shared-equity loan and the balance by a traditional mortgage. While there is no evidence of abuses in relation to shared equity loans, this sector may require close monitoring.[28] Falling house values may leave banks with little or nothing to collect if borrowers default on a home-equity loan.[29] In the United States delinquent home-equity loans amounted to $A16.6 billion by the end of September 2007. In a US study of 640,000 first mortgages with piggyback shared-equity loans attached it was found that those loans were 43% more likely to go into default than stand alone mortgages.[30]

(iv) Consequences of Sub-Prime and Predatory Lending

Problems in the US sub-prime lending sector have sparked a global financial crisis which has increased the cost of wholesale finance and prompted a significant repricing of credit risk. The price of credit default swaps has surged[31] and there will be a severe strain on the commercial mortgage-backed securities market when $6 billion in these securities mature later this year and in 2009.[32] Banks are attempting to absorb higher wholesale funding costs[33] but some have recently decided to pass these costs on to their borrowers. While it is expected that Australian banks will weather the storm,[34] many of their borrowers will struggle with their loan commitments and consumer credit obligations. It is estimated that there is an increased risk of default with 700,000 households coming under some form of mortgage stress in the first half of 2008[35] and 300,000 households under severe financial stress.[36] This stress is not confined to first home buyers who may find that the combination of increasing interest rates and falling house process produce a negative equity in their homes.[37] Even middle-class households are suffering financial stress,[38] which is often concealed by using credit cards to pay mortgage instalments[39]Credit card fees and penalties for late payment exacerbate the problem.[40] Indeed, some borrowers are resorting to their superannuation to service their mortgage repayments and credit card debts.[41] Predatory lending is often supported by collateral security over a car or house so that if the borrower defaults, the lender can repossess, foreclose or exercise a power of sale.[42]

Predatory lending in Australia cannot be blamed for the global financial crisis. But there is no doubt that sub-prime lending in the United States contributed to the global credit squeeze. Moreover, in Australia it has been estimated that 90% of the 40,000 households that were victims of predatory lending are in “severe housing stress”.[43] Defaults on loans from non-bank lenders are expected to rise by a third to almost 3 per cent of borrowers, more than triple the rate of major banks.[44] It should not be thought, however, that predatory lending is the exclusive domain of non-bank lenders. The Commonwealth Bank of Australia recently admitted to giving unaffordable personal loans to Sudanese refugees some of whom had no job, and no grasp of finance or English.[45] Under pressure from consumer advocates, the bank has waived most of these outstanding debts and introduced an internal investigation into the 18 loans to these families in southeast Melbourne.[46] Moreover, a former employee of the National Australia Bank Ltd interviewed in a recent *Four Corners* program claimed that he was pressured into talking people into bigger loans than they wanted. The bank responded that it had “strict credit policies, processes and controls.”[47] One wonders how these allegations of predatory conduct by the Australian banks square with their obligations under clause 2.2 of the Code of Banking Practice (12 August 2002) to act fairly and reasonably towards their customers.

(v) Abusive Lending Practices

Common features of predatory lending include: frequent refinancing or loan flipping, with new fees included in the loan balances; financing of unnecessary products, for example single-premium credit life insurance with the premiums added to the loan balance; excessive prepayment penalties; balloon payments where substantial instalments are payable towards the end of the loan period; excessive fees and high interest rates; failures to disclose that the loan price is negotiable; unaffordable loans that the borrowers have no ability to repay; risk-based pricing; and misleading marketing and sales practices.[48] We shall examine the fragmented response of the legal system to some of these practices as they have developed in Australia.

Predatory lending practices can be divided into two categories: procedural unfairness and substantive unfairness.

2. PROCEDURAL UNFAIRNESS

(i) No Advice about Chapter Loans and Risk of Default

An American court has held that a lender's failure to advise a borrower of a cheaper loan alternative amounted to procedural unconscionability because the alternative loan had a shorter term, lower monthly repayments and incurred less interest over the term of the loan.[49] The lender had initiated discussions with the borrower and had taken unnecessary security for a loan which the court described as "exorbitantly expensive".[50]

In Australia, it is doubtful whether a mere failure to advise a customer of a more advantageous loan alternative would render a lender liable in negligence for economic loss. There is no implied duty to inform a customer of a new account or facility which would benefit the customer. This would impose an onerous and time-consuming burden on lenders to review all their existing facilities with their customers whenever they introduced a new facility.[51] Hence, lender should not incur any liability from a simple failure to advise its customer how to structure a loan so as to minimise interest and bank charges, even where it is alleged that the lender acted as the borrower's trusted adviser.[52]

A lender is generally entitled to seek and obtain the best terms it can in negotiating a commercial loan with its customers.[53] It may have regard solely to its own commercial interest. It is not the lender's obligation to ensure that the borrower has made a correct or wise commercial decision based on a full understanding of all risks,[54] unless the borrower has specifically sought the lender's advice.[55] If the customer approaches the lender merely for a loan to purchase a business, as distinct from investment advice, the lender will not be liable for a failure to disclose that another customer had failed in the same business.[56] Even if the borrower has little understanding of how the Australian financial system works and the consequences of default, the lender is under no duty to explain these matters to a commercial borrower.[57] Nor is the lender generally obliged to provide a guarantor or third party mortgagor with any commercial advice, although if such advice is proffered, the lender may become subject to a duty of care.[58]

Against this background, *Beneficial Finance Corporation v Karavas*[59] can be seen as an exceptional case decided under the *Contracts Review Act* 1980 (NSW). In that case the New South Wales Court of Appeal held that third party mortgages obtained from guarantors were "unjust" within s7(1) of the Act. The mortgages were given to secure a loan of $564,000 to Socair Pty Ltd to enable it to purchase the business of Murray Valley Airlines Pty Ltd (in receivership). They were held to be unjust because it was, or should have been, obvious to the lender, Beneficial Finance Corporation, that the mortgagors had insufficient knowledge of the risks they were incurring by mortgaging their residences to secure the loan. President Kirby (as he then was) issued this clear warning:

> "Where the borrowers, or their guarantors and mortgagors are ill-educated, inexperienced in business, related to those principally involved by blood or affection and involved in the purchase of a business with some apparent risks, the lesson of this case may indeed that the guarantors and mortgagors receive effective independent financial advice on the risks they are running."[60]

At the trial Giles J identified numerous factors which the mortgagors needed to understand to gain a proper appreciation of their risk, in particular that there was a real prospect of the business failing and that they might not simply lose their residences but also incur a personal liability for the whole of the sum borrowed. Giles J concluded that the mortgages were unjust contracts because the lender's decision to finance the transaction could not properly have been made "on the basis of the capacity of the airline to generate income, and can only have been made on the basis of the security offered."[61] His decision was unanimously upheld by the New South Wales Court of Appeal. [62]

(ii) Aggressive Marketing

Lenders can be held liable for making negligent, reckless or fraudulent misrepresentations to customers in relation to approval of their loan applications. [63] For example, a false assurance that the customer will qualify for a government-subsidised or government-guaranteed loan for the purchase of real estate may render a lender liable for the tort of deceit, negligent misstatement or misleading or deceptive conduct if the customer relies on the assurance to his or her detriment. [64]

In the majority of predatory lending cases, a mortgage broker has been involved. The Mortgage Industry Association of Australasia estimates that brokers will originate up to 50% of home loans in the future. [65] As lenders become more reliant on mortgage brokers to introduce new business, their potential exposure through s12GH of the *Australian Securities and Investments Commission Act* 2001 (Cth) will be tested. However, a lender will not be liable under s12GH for misleading or deceptive statements made by mortgage brokers unless the brokers were acting "on behalf of" the lender. [66] Persons who merely "introduce business" to lenders are not their agents and are not acting on their behalf. [67] A finance broker will rarely be the agent of the lender even if the broker receives a commission from the lender[68] because of the clear conflict of interest that would arise in the broker's dealings with the borrower. [69]

(iii) Inspections, Valuations and Two-Tier Marketing

In the absence of a special or extended duty assumed by the lender, inspections are intended merely to satisfy the lender that the security is adequate for the loan. [70] The inspection does not, in itself, impose any duty on the lender to the borrower to take reasonable care in carrying out the inspection. [71] Nor will a lender be liable for a negligent valuation which was undertaken by the lender for its own purposes, even if the borrower paid for the cost of valuation. [72] It is immaterial whether the valuation was done by one of the lender's employees[73] or by an independent valuer. [74]

On the other hand, a lender can be liable for a negligent valuation where it knows that the purchasers intend to rely on the valuation to validate their decision to enter into the transaction. [75] Lenders can also be liable to purchasers where they negligently endorse a property as a good buy or a sound investment. [76]

A lenders who is guilty of misleading or deceptive conduct or a breach of fiduciary duty in inducing one of its customers to enter into a transaction with another customer on the basis of an inflated valuation could be liable to the purchaser, particularly where the vendor is in financial difficulties. [77] Indeed, it has been suggested that the lender can be liable for a borrower's losses even if the lender's valuation is not disclosed to the borrower. [78] However, before a lender can be fixed with liability for a negligent or false valuation, which is not disclosed to the borrower, it must be clear that the borrower was relying on the lender not to overvalue the property. [79] Such cases are rare.

In *Commonwealth Bank of Australia v Finding*[80] the Supreme Court of Queensland confirmed that a lender, which has not undertaken to provide investment or financial advice, is under no obligation to disclose a valuation of a hotel property which it sells as mortgagee to one of its long-standing customers at a price substantially higher than the assessed value. Nor is the lender required to disclose information about the doubtful viability of the hotel business, as operated by the mortgagor, when the customers apply for finance to complete the purchase. [81]

Where non-disclosure alone is relied on as constituting misleading or deceptive conduct under s12DA of the *Australian Securities and Investments Commission Act* 2001 (Cth), it is necessary to prove that the failure to disclose was deliberate.[82] However, where the misleading or deceptive conduct takes the form of both representations and non-disclosure, the respondent's intention or knowledge will merely be a relevant, but not a decisive, factor in determining whether a contravention by non-disclosure has occurred. [83] The question is not whether the lender was under a duty to speak out but rather whether, having regard to all the relevant circumstances, there has been conduct that is misleading or deceptive or that is likely to mislead or deceive.[84]

These principles will determine the liability of lenders who finance property investments, knowing that their customers are paying substantially more for their properties as a result a two-tier marketing scheme preying on interstate or overseas borrowers. Lenders who fail to advise their borrowers of their relationship with the developers or the inflated prices listed for unwary interstate or overseas purchasers may be liable for unconscionable conduct or misleading or deceptive conduct.[85]

(iv) Misleading Loan Applications

Mortgage brokers who make false statements in completing loan applications, such as inflating the borrower's assets or income[86] or misrepresenting that the borrowers or the guarantors have obtained independent advice,[87] can be personally liable for misleading or deceptive conduct or unconscionable conduct.[88] While the brokerage company who engaged the mortgage broker may be held liable for the broker's conduct,[89] it is unlikely that the lender will be deemed to be liable for misleading or deceptive conduct or unconscionable conduct as a result of the mortgage broker's actions.[90]

This is not to say that the lender will be able to enforce the loan agreement or mortgage with impunity. A lender who fails to follow its own internal lending guidelines in assessing a loan application or recommending that certain borrowers or guarantors receive independent legal or accounting advice may find that its security is held to be an "unjust contract" within s7 of the *Contracts Review Act* 1980 (NSW).[91] In determining whether a contract is "unjust" in the circumstances pertaining to the contract at the time it was made, the court must have regard to the public interest and all the circumstances of the case.[92] The court can take into account the commercial or other setting and effect of the contract.[93] In *Perpetual Trustee Company Ltd v Khoshaba*[94] the court found that the lender's failure to follow its own internal guidelines relating to verification of the loan applicants' employment and income, the ascertainment of the true purpose of the loan and proper checks on the execution of the loan documents rendered the contract "unjust"[95]. The fact that the lending guidelines were devised for the lender's own protection did not prevent them from being taken into account in determining whether the contract was unjust. If the guidelines had been followed, the lender would not have made the loan to the borrowers. The lender's failure to follow the guidelines meant that the lender was content to lend on the value of the security provided by the borrowers who were a low income earner and a pensioner. In the result, the lender lost its right to repayment of the loan.

There are similar provisions in s70 of the *Consumer Credit Code*. While business and investment loans are expressly excluded from the operation of the Code, the court can go behind false declarations that the loan is not to be applied wholly or predominantly for business or investment purposes (or for both purposes).[96] Indeed, in *Permanent Mortgages Pty Ltd v Cook*[97] the court held that a mortgage was unjust despite false statements by the borrowers in the loan documentation because the lender was aware, or ought to have been aware, that the borrowers were not capable of servicing the loan. The court conducted a balancing exercise. The defendants spoke English, were experienced borrowers, engaged a solicitor, were anxious to obtain the loan and were prepared to make false declarations in the loan application. On the other hand, they were poorly educated and unsophisticated and the court concluded that they were the type of people that the Code was intended to protect "from their own foolishness."[98] In essence, the court in *Permanent Mortgages Pty Ltd v Cook* extended the reasoning in *Perpetual Trustees v Khoshaba* to the *Consumer Credit Code*.[99]

The relief available under s71 of the *Consumer Credit Code* should be directed to returning the claimants to the position they were in before the unjust contract. For example, in *Permanent Mortgages Pty Ltd v Cook*[100] the court relieved the defendants of the costs and expenses incurred in respect of the credit provided by the plaintiff, reduced the principal to the sum that was actually applied for the benefit of the defendants in discharging their outstanding debts and relieved the defendants from the payment of interest at a rate exceeding simple interest of 8.8% per annum. This decision was in large part affirmed on appeal,[101] but the Court of Appeal ordered the plaintiff to pay ninety per cent of the defendants' costs of the proceedings.

SUBSTANTIVE UNFAIRNESS

(i) No General Duty to Lend Prudently

Predatory lending involves not just abusive practices but also harsh and oppressive terms in loan contracts and mortgages. Before we examine the legal response to substantive unfairness it may be convenient to consider whether lenders have a duty not to lend excessively or imprudently.

A publican owes a duty to his patrons to take reasonable care to ensure that they are not exposed to injury as a result of their intoxication.[102] If it is reasonably foreseeable that a patron or a third party could suffer harm as a result of the publican serving too much alcohol, then the publican can be liable for the damage caused by his breach of duty.[103]

On the other hand, it is established that a casino or registered club does not owe a duty of care to a person who it knew, or ought to have known, to be a problem gambler to protect the person against financial loss.[104] Only in extraordinary cases will the law allow recovery of economic loss occasioned by gambling.[105] Such losses are an inherent risk of the activity, and individuals must accept personal responsibility for their own actions.[106] Nor is there any no unconscionable conduct where a casino or registered club fails to prevent gambling by refusing a gambler's request to cash cheques.[107]

In a similar vein, a lender does not owe a borrower a general law duty of care to refrain from excessive lending. In *National Australia Bank v Lekais (No 2)*[108] the defendants attempted to raise a counterclaim alleging misrepresentation, misleading or deceptive conduct, unconscionable conduct and breach of duty by the plaintiff because it lent to the defendants a sum of money, knowing that they could not afford to repay the loan. The defendants alleged that their damages were at least commensurate with the amount of the loan. Judge Burley, Supreme Court Master, rejected the counterclaim because of defects in the pleading:

> "…the defendants have not sought to establish damages which are referable to losses that they may have sustained as a result of the allegedly wrongful conduct on the part of the plaintiff prior to and at the time of lending monies to the defendants and their associated companies. In other words, it has not been put that the plaintiff lent money to the defendants and their associated companies, that either or both of the defendants and their associated companies entered into a business venture which failed, that the failure of the business was referable to the conduct of the plaintiff in such a manner that a cause of action arose entitling the defendants to sue the plaintiff for damages, and that the measure of damages exceeded the indebtedness under the mortgages at the time that action was taken to enforce them."[109]

The defendants also raised an equitable set-off but Judge Burley held that "a set off of any description does not arise because damages of the type sought by the defendants are not recoverable as a *matter of law*…"[110]

It is now becoming accepted that lenders owe borrowers a duty of good faith and reasonableness in the performance of contractual obligations,[111] although the content of this duty is difficult to determine. In another context, namely a mortgagee's equitable duty of good faith in exercising its powers, the courts have stated that a mortgagee must not "recklessly sacrifice" the interests of the mortgagor.[112] This may be an appropriate test to apply to lenders' duty of good faith to other borrowers. Yet even if this standard applied, a lender would not necessarily breach its duty of good faith by lending excessively or imprudently.

While it is clear that lenders do not owe any general law duty to borrowers to refrain from lending excessively or imprudently, their obligations to guarantors may be different.
The traditional view is that a lender is under no general duty to disclose to guarantors the borrower's past indebtedness[113] or the outstanding balance of his overdraft.[114] Indeed, in the absence of an express condition in the guarantee, a guarantor has no defence if the lender advances the borrower sums in excess of an agreed limit.[115]

Nor is there any continuing duty to disclose to guarantors features of the principal transaction after the guarantee is executed.[116] American courts have, however, recognised a continuing duty of disclosure. In *Georgia Pacific Corp v Levitz*[117] the Arizona Court of Appeal held that a surety had a defence to an action to enforce a continuing guarantee where the creditor failed to disclose to the surety that the principal debtor was clearly insolvent before it extended further credit to the debtor. It is unlikely that Australian courts would follow this view.

In *Black v Ottoman Bank*[118] the Privy Council stated a general principle that a guarantor would be discharged if there has been:

> "some positive act done by [the creditor] to the prejudice of the surety, or such degree of negligence, as in the language of Vice-Chancellor Wood in *Dawson v Lawes* (1854) 23 LJ Ch 434 at 441," to imply connivance and amount to fraud.[119]

Fraud, in this context, has been defined as conduct that is unfair to a surety.[120] However, it is difficult to find cases where a guarantor has been discharged simply because the creditor acted to his prejudice. All the cases which pay-lip service to the principle can be explained on the basis of the more traditional grounds of discharging guarantors, such as loss or impairment of collateral securities or variation of the principal contract.[121]

Perhaps the first glimpse of new hope for guarantors lies in the suggestion of the Court in *Credit Lyonnais Bank Nederland v Export Credit Guarantee Department*[122] that a lender who does not act as a prudent lender in its dealings with the borrower may give the court grounds for setting aside a guarantee of the borrower's debts. This radical suggestion cannot, however, be regarded as an established principle.

Lending too much is not in itself a form of predatory lending. On the contrary, some of the most egregious examples of predatory lending involve relatively small advances, albeit with excessive interest and exorbitant fees and charges.[123]

(ii) Excessive Interest Fees and Charges

Loan agreements and mortgages commonly stipulate a higher rate of interest in the event of default by the borrower or mortgagor. Alternatively, they provide that the higher rate of interest is the standard rate but that a lower rate will be charged if the borrower or mortgagor is not in default. [124]

Where the default interest clause merely provides for a reduction of the rate if interest be paid punctually, it operates as an incentive to punctual payment and it will not be set aside as a penalty.[125] But a default rate of interest can be challenged as a penalty if the amount payable under the stipulated rate is extravagant and unconscionable in comparison with the greatest loss that could conceivably be proved to have resulted from the breach.[126] Moreover, the amount payable will be set aside as a penalty if the breach is merely a failure to pay a sum of money, and the amount payable is greater than the sum which ought to have been paid.[127] According to the High Court in *Ringrow Pty Ltd v BP Australia Pty Ltd*[128] a payment will be considered to be a penalty if it is extravagant, unconscionable and out of all proportion to a genuine pre-estimate of the damage caused by the breach.[129] On this basis a default rate of interest 9% higher than the standard compliance rate was held to be a penalty in *Beil v Pacific View (Qld) Pty Ltd*.[130]

(a) <u>Interest rate caps</u>

In most jurisdictions a credit contract (and any mortgage given to a credit provider in relation to that contract) is unenforceable where the annual interest percentage rate in respect of the contract exceeds 48.[131] It is also an offence for a credit provider to enter into a credit contract where the annual percentage rate is respect of the contract exceeds 48.[132] Hence, the interest rate is capped in relation to most consumer credit contracts at 48 per cent.

(b) <u>Caps on Fees and Charges</u>

In New South Wales and the Australian Capital Territory the cap applies to all charges in the nature of the interest.[133] These provisions were originally intended to apply to fringe or pay-day lenders who impose flat fees in lieu of interest and to credit contracts of under 62 days duration.[134] However, they have applied to all regulated credit contracts from 1 March 2006.[135] These changes have not yet been introduced in the other jurisdictions, although the legislation contacts a mechanism to do so.[136]

In its current form, s 72 of the *Consumer Credit Code* allows a court to review interest rate changes, an establishment fee or charge, an early termination fee or charge or a prepayment fee or charge, and the court may reduce or annul the change, fee or charge if it finds it "unconscionable".[137] Other fees and charges are not regulated.

Under s 70 of the *Consumer Credit Code*, a debtor, mortgagor or guarantor can apply to the court to "re-open" an unjust transaction. In determining whether the transaction is unjust, the court must have regard to the public interest and all the circumstances of the case. Under this provision, the court can set aside fees or charges that had not been properly imposed[138] or unjust terms as to price,[139] for example, where the price charged for insurance is exorbitant compared with the market price or the expected cost. Similarly, the court can reopen transactions which are structured in such a way that the borrower has no capacity to repay the debt according to its terms or transactions[140] or transactions on terms that are not reasonably necessary to protect the legitimate interests of the lender.[141]

In theory, these provisions can be used to curb fees and charges by predatory lenders but they can easily be avoided by forcing borrowers to sign a declaration that the transaction is for the purposes of a business or investment, thereby excluding the operation of the *Consumer Credit Code*.[142] Similarly, the prohibition in s12CB of the *Australian Securities and Investments Commission Act* 2001 (Cth) only applies to unconscionable conduct in the supply or possible supply of financial services of a kind ordinarily acquired for personal, domestic or household use.[143]

(c) The Prohibition of Unconscionable Conduct

One of the principal forms of protection available to business borrowers against excessive interest and exorbitant fees and charges is the statutory prohibition on unconscionable conduct. The equitable doctrine of unconscionable conduct is now enshrined in s 12CA of the *Australian Securities and Investment Commission Act* 2001 (Cth) in the following terms:

> "A corporation must not, in trade or commerce, engage in conduct in relation to financial services if the conduct is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories."

The important advantage of s12CA over the equitable doctrine of unconscionable conduct is that it gives litigants access to the wider range of remedies available under the Act, including damages and injunctive or tailored relief.[144] However, the section does not apply to financial corporations in their dealings with borrowers who are broadly classified as "consumers" or small business enterprises or "business consumers".[145]

A separate regime in s51AC of the *Trade Practices Act* 1974 (Cth) prohibits unconscionable conduct in connection with the supply of financial services to another person or corporation (other than a listed public company)[146]. However, this regime does not apply where the price of the financial services is in excess of $3 million, or such a higher amount as is prescribed. [147] The price for the supply of financial services is taken to include the capital value of a loan or a loan facility. [148] The price is not, therefore, confined to the lender's fees, interests and charges.

In determining whether the lender or other supplier of financial services has engaged in unconscionable conduct in its dealings with business consumers, the court may have regard to a catalogue of factors listed in s51AC. Some of these factors mirror the general law of unconscionability but others have no direct counterparts in the equitable doctrine.

In *Asia Pacific International Pty Ltd as Trustee for Planet Securities Unit Trust v Dalrymple*[149] the plaintiff claimed around $210,000 as moneys allegedly owing under a loan agreement, whereby the defendants borrowed $70,588. It also claimed interest at a rate of 20 per cent per calendar month from 9 June 1998 pursuant to a clause in the loan agreement which provided for the capitalisation of interest monthly. Over a 21 month period the original loan of $70,588 grew to a debt in excess of $3M.

The defendants alleged unconscionable conduct in breach of s 51AA of the *Trade Practices Act* 1974 (Cth), which applied to financial services before s 12CA of the *Australian Securities and Investments Act* 2001 (Cth) came into operation. The basis of their allegation of unconscionable conduct was that the plaintiff had taken advantage of them and inserted clauses in the loan agreement that were not reasonable for the protection of its legitimate interest and that allowed for grossly excessive interest.

Shepherson J found that the transaction was not illegal;[150] it was between parties at arm's length and the plaintiff's solicitors were at pains to ensure that the defendants were properly advised as to the terms of the loan and understood the consequences of default. [151] His Honour also found that the defendants urgently needed a loan of $60,000 for a term of one month and that they were prepared to pay $9,000 interest in return for that loan, a rate of 15 per cent. [152] However, his Honour found that the provision in the loan agreement allowing the plaintiff to capitalise interest at the rate of 20% per month in the event of default was oppressive and unreasonable. [153] His Honour concluded:

> I realise that it is important that courts do not as a general rule interfere in transactions entered into at arms length between men of commerce. Nevertheless, in the circumstances of this particular case I feel very strongly that there has been unconscionable conduct on the part of the plaintiff by the insertion in the Deed of Loan of provisions enabling unpaid interest to be capitalised and then bear further interest at the rate of 20 per cent per month. This case shows that a lender can be extremely careful to ensure, as far as he can, that the borrower has competent independent advice and understands well the nature of the obligation, yet the contract of loan may amount to an unconscionable dealing. [154]

It should be noted that at the time of the loan the defendants did not appear to be in a desperate financial position, that they received independent legal advice and that at least one of the defendants was experienced in the world of commerce.

Shepherdson J did not set aside the loan agreement. Rather his Honour held the defendants liable for the original advance, plus compound interest at 15% per annum but without capitalising unpaid interest. In the result, his Honour gave judgment for the plaintiff in the sum of $292,936. His Honour based his decision on the equitable doctrine of unconscionability without a detailed analysis of s51AA of the *Trade Practices Act* 1974 (Cth). [155]

Asia Pacific International Pty as Trustee for Planet Securities Unit Trust v Dalrymple[156] has been cited with apparent approval in *Multiplan Constructions No 1 Pty Ltd v 14 Portland Street Pty Ltd (No 2)* [157] and *Guardian Mortgages Pty Ltd v Miller*. [158] In the first case it was distinguished on the ground that it involved excessive interest. In the second case a default interest rate of 14.5% for one month was not found to be excessive in the absence of evidence showing the prevailing rate for short term bridging loans secured by second mortgage. However, Wood CJ in CL found that another provision was an unjust penalty because it required the mortgagor to pay the mortgagee all of the costs and expenses incurred by it as a result of any default, including administration and legal costs upon an indemnity basis, as well as interest upon those costs and expenses until their payment at the default rate, and it also permitted the mortgagee, upon default, to take a charge over any property owned by the defendant. [159] By contrast, there is no unconscionable conduct, and no illegitimate economic pressure or economic duress, where a lender seeks further security with cross-collateralisation clauses as a condition of providing additional finance to a borrower in strained financial circumstances and requires these documents to be signed before making copies available to the borrowers to obtain legal advice. [160]

It appears that the trend of recent authorities is to expand the realm of the unconscionability doctrine to cover the area once served by the doctrine of clogging the equity of redemption.[161] Cases where the mortgagee purports to charge excessive interest or exorbitant fees or obtain a collateral advantage such as an option to purchase the mortgaged property are now more likely to be brought along the battlelines of unconscionability,[162] rather than as a clog on the equity of redemption. Perhaps the only residual significance of a clog on the equity of redemption is where the limitation period for an action based on unconscionable conduct has expired.[163]

4. LIABILITY FOR REPACKAGING SUB-PRIME LOANS

Some predatory lenders do not simply exploit vulnerable borrowers, they compound their misconduct by repackaging these loans as tradeable securities known as asset-based securities or collateralised debt obligations for unsuspecting investors. Indeed, sub-prime loans in the United States became so "sliced and diced" through inter-bank trading that it is difficult to determine who "owned" the loans, and the value of the securities deteriorated. In Ohio, courts have refused to grant foreclosure orders in favour of parties who alleged that they were the owners of sub-prime mortgages.[164]

When the sub-prime crisis hit the capital markets in the United States parties were scrambling to find defendants to blame for their losses. It was recently reported that mid-size German lender, HSH Nordbank, has sued Swiss banking grant ,UBS, alleging that UBS sold it $US500 million in complex investments in UBS's now-defunct hedge fund, Dillon Read Capital Management , which was later used as a receptacle for troubled sub-prime mortgage securities. The German bank alleges that UBS exploited the structure for its own ends at HSH's expense in breach of its contractual and fiduciary duties. It is claiming a loss of at least US$275 million.[165]

As a general rule, Australian banks do not owe fiduciary duties to their borrowers or customers.[166] However, in exceptional circumstances, banks can attract fiduciary obligations if they assume the role of investment adviser.[167]

In the United States investors were comforted by the fact that the sub-prime investments they acquired were guaranteed by monoline insurers with AAA credit ratings. [168] Some of these credit ratings have proved to be unjustified.[169] However, the rating agencies are protected by the First Amendment to the *United States Constitution* which guarantees free speech and protects such evaluations. [170] In the result, what appeared to be solid bricks and mortar investments turned into a house of cards.

Fortunately the direct fallout from the sub-prime crisis does not appear to have had a major long term impact on Australian banks. On the other hand, the 152 municipal councils in New South Wales that could have lost up to A$400 million from their investments in sub-prime securities will follow the UBS litigation with keen interest.[171]

5. REFORM PROPOSALS

Australia's fragmentary response to predatory lending has relied a panoply of different regimes with varying degrees of effectiveness. Any reform agenda must incorporate certain key features:

(1) Education of borrowers, consumers and guarantors with "health warnings".[172]

(2) Increased disclosure to consumers.[173]

(3) Compulsory independent legal and financial advice for borrowers and guarantors involved in heavily-geared transactions.

(4) A national system for licensing mortgage brokers and providing professional indemnity and fidelity insurance; [174]

(5) National regulation of consumer credit.[175]

(6) Statutory presumptions that certain terms dealing with excessive interest and exorbitant fees and charges are substantively unfair and invalid.[176]

(7) Relaxation of privacy constraints to allow credit providers more access to the credit history of borrowers.[177] Lenders should then be required to document that a borrower has a reasonable ability to repay based on income, credit history and references.

(8) Increases to APRA's powers to take over distressed financial institutions.[178]

(9) Preventing avoidance of consumer credit obligations through false declarations of business or investment purposes.

(10) Increased resources allocated to ACCC to enable test cases to be run against predatory lenders.

(11) Supporting community-based lending and housing schemes for disadvantaged groups to enable them to avoid the poverty spiral.[179]

(12) Industry Codes of Conduct that could be given the force of law.[180]

(13) While debt forgiveness has an ancient history,[181] it is unlikely to solve the current housing crisis.[182]

The *Mortgage Reform and Anti-Predatory Lending Act* 2007 (HR 3915):[183]

(i) prohibits individuals from becoming loan originators unless they can obtain and maintain registration or a licence under State legislation and an identification number assigned by the federal registry (s 103);

(ii) requires anyone applying for registration as a State-licensed loan originator to supply information for a background check ,undergo at least 20 hours of approved education, and pass a test developed by the Nationwide Mortgage Licensing System and Registry (s 104);

(iii) prohibits the issue of a licence to a loan originator who has had a similar licence revoked in the previous five years or if the applicant has been found guilty or pleaded no contest to a felony in the past seven years (s 104);

(iv) requires regulations to be devised to prohibit mortgage lenders from steering borrowers to loans:

  (a) that the borrowers lack the capacity to repay;
  (b) that include equity stripping or excessive fees; or
  (c) in cases of residential mortgage refinance, that do not provide the borrowers with a net tangible benefit (s 123).

(v) allows civil action to be taken against mortgages for rescission of residential mortgage loans that violate the *Truth in Lending Act*, unless the mortgage corrects the violation within 90 days of notification (s 204);

(vi) requires mortgage contracts to state the maximum amount of any payments and the additional amount required every month to cover taxes or insurance (s 213); and

(vi) establishes the universal mortgage disclosure requirement of good faith estimates, which must disclose:

  (a) the total loan amount;
  (b) the type of loan;

(c) the length of the loan period;
(d) the estimated interest rate;
(e) the maximum interest rate;
(f) the total monthly estimated repayment;
(g) the percentage of the borrower's monthly income required to service the loan;
(h) the period to lock in an interest rate;
(i) any prepayment penalties;
(j) any increased final payment;
(k) any settlement charges; and
(l) the estimated cast need to close the loan(s 501).[184]

It remains to be seen whether this Act will be passed by the US Senate but even if it is not passed it could serve as a possible blueprint for a more comprehensive approach to predatory lending in Australia.

The problems posed by predatory lending will not be solved by competition or market forces.[185] By the same token, any increased regulation must be rational and focused so that it does not exclude vulnerable groups from access to credit.[186] It must be remembered that one of the side effects of deregulation of the banking and financial services industry was to increase competition and allow many borrowers the chance to get ahead. The fact that predatory lenders have taken advantage of vulnerable borrowers is no reason for turning back the clock. In the face of the threat from predatory lending the courts have shown themselves to be surprisingly adaptable and flexible in their application of legal principles. They have moved a long way from a rigid public policy of holding borrowers to their credit bargains. But there is still a long way to go before all consumers will be able to enjoy the benefits of a credit society without falling into a poverty trap.

1. This definition is provided by Acorn, the Association of Community Organisations for Reform Now at www.acorn.org.

2. Credit card fees have increased by 73% since the Reserve Bank introduced its card payment reforms in 2003, and the amount earned by Australian banks from their household credit card operations now exceeds $1 billion in fees alone: K Jiminez, "Reserve eyes soaring fees on fantastic plastic" *The Australian* 31 May 2007, p 23. Moreover, it has been reported that Australians paid out about $90M to banks in 2006 in credit card "penalty fees": P Maley, "Banks net $90M in credit penalties" *The Australian* 5 September 2007, p 3. It will be interesting to see whether Family First's proposed *Fair Bank and Credit Card Fees Bill* 2008 can overcome these problems. The bill has attracted a storm of criticism from the Australian Bankers' Association. See D Bell, " Proposed bank fees bill hurts consumers" *The Australian Financial Review* 2 May 2008, p79.

3. See J Malbon, Predatory Lending (2005) 33 ABLR 224 at 231.

4. A Klan, "Predatory loans sting 40,000" *The Australian* 14 September 2007, p 5.

5. Ibid.

6. Ibid.

7. Ibid.

8. Caitlin O'Toole "Banks: super lifts rates" *The Australian Financial Review* 3 April 2008, p.7.

9. Ibid.

10. *Permanent Mortgages Pty Ltd v Cook* [2006] NSWSC 1104 at [82-84] and [85]. See generally ASIC's Report on Low-Doc Loans at www.fidogov.au

11. See Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia on 27 March 2008 and S Murdoch, "Banks 'strong enough to weather the storm" *The Australian* 28 March 2008, p 2. It is estimated that home repossessions in the United States have doubled in the past year. See Bloomberg, "Home repossessions double" *The Australian* 18 May 2008, p76.

12. R Gluyas, "Oz low-doc loans safe, say lenders" *The Australian* 14 March 2007, p 34.

13. See C Hart, "Borrowers offered 'too much' for loans" *The Weekend Australian* 11-12 August 2007, p 6 and "Stopping 'equity skimmers' *The Australian Financial Review* 5 September 2007, p 55.

14. See T Blue, "Battling the mortgage squeeze" *The Australian* 5 March 2008, p 5.

15. *Permanent Mortgages Pty Ltd v Cook* [2006] NSWSC 1104 at [82]-[85].

16. See generally C Field, "Pay Day Lending – an exploitative market practice" (2002) 27 (1) *Alternative Law Journal* 36.

17. See T Boreham, "The poor prove profitable prey for lenders" *The Weekend Australian* 24-25 November 2006, p 40.

18. Ibid.

19. Ibid.

20. Ibid.

21. See T Boreham, "The poor prove profitable prey for lenders" *The Australian* 24-25 November 2006, pp 33 and 40. Ironically, it now appears that Amazing Loans' own access to finance is under threat. See R Urban, "Patday lender's credit under review" *The Weekend Australian* 31 May-1 June 2008, p31.

22. See Jonathan Garforth, "Reverse Mortgages" (2006) 22 (1) BLB 12 and J Pascoe, "Reverse Mortgages some regulatory issues and developments" (2008) 23(9) BLB 130.

23. G Newman, "Reverse mortgages getting into top gear" *The Australian* 24 September 2007, p. 31. See also "Demand for reverse mortgages leaps 65 pc" *The West Australian* 30 April 2007, p.33.

24. Ibid.

25. Ibid.

26. Ibid.

27. See Anna French, "Shared-equity loan boom" *The Australian* 14 March 2007, p 34.

28. For useful guidelines for solicitors advising on these products, see the Victorian Legal Practitioners' Liability Committee, "Advising on Reverse Mortgages and Other Release Products"

29. Mara Der Hovanesian, "Home-equity loans squeeze credit crisis" *The Weekend Financial Review* 19-20 June 2008, p 30.

30. Ibid.

31. Patrick Cummins "Cost of default protection soars to record" *The Australian Financial Review* 18 March 2008, p 27. It may well be that the estimated

US$1 trillion cost of the global financial crisis is overstated. See D Uren,"IMF's sub-prime crisis prediction out by 50 pc, according to OECD" *The Australian* 16 April 2008, p33. See also N Tabakoff, "Debt faculty will cost Ten more interest" *The Australian* 29 April 2008, p 23.

32. Florence Chong, "Maturing securities a property time bomb" *The Australian* 14 March 2008, p 26. Even large conglomerates such as Westfarmers are finding the cost of finance has increased dramatically. See M Sainsbury, "Westfarmers to frefinance Coles buy with $4bn war chest" *The Australian* 22 April 2008, p23. See also N Tabakoff, " Debt facility will cost Ten more interest" *The Australian* 29 April 2008, p23.

33. See R Gluyas "Analysts says banks still bear funding cost" *The Australian* 27 March 2008, p 23. Banks normally borrow at 15 basis points over the cash rate but on 18 March 2008 it was 60 basis points over the cost rate: ANZ Blomberg quoted in Patrick Cummins, "Cost of default protection soars to record" *The Australian Financial Review* 18 March 2008, p 27. The current margin is even higher.

34. See S Murdoch, "Banks strong enough to weather the storm" *The Australian* 28 March 2008, p. 2 quoting from an address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia. See also K Jimenez, "Aussie banking sector a top performer in the sub-prime crisis" *The Australian* 2 April 2008, p29 and "Westpac beats credit squeeze with profit" *The Australian Financial Review* 2 May 2008, pp1 and 72.

35. See D Gibson, "Mortgage defaults tipped to rise" *The West Australian* 21 January 2008, p 11 and "Defaults soar 30 pc in rising debt stress" *The Weekend Australian* 15-16 September 2007, p. 35.

36. Katherine Jimenez, "Mortgage pain spreading to affluent families" *The Australian* 14 March 2008, p. 21. The rate of repossessions is increasing in most States. See J Wiseman, "Battlers' super pays mortgages" *The Weekend Australian* 22-23 September 2007, p.11.

37. Adrian Rollins "Most first-home buyers suffering stress" *The Australian Financial Review* 18 March 2008, p. 9 and Sid Marris, "Recent first-home buyers pay dearly" *The Australian* 18 March 2008, p 6.

38. See Majella Corrigan, "Interest-rate pain finally hits the affluent set" *The Weekend Australian* 22-23 March 2008, p 36 and Katherine Jimenez, "Mortgage pain spreading to affluent families" *The Australian* 14 March 2008, pp. 21-22. The numbers of borrowers with mortgage debts is increasing. See Nicola Berkovic and Siobhan Ryan, "More city-dwellers with mortgages" *The Australian* 18 March 2008, p.6.

39. Anthony Klan, "Credit cards hide mortgage pressures" *The Australian* 19 September 2007, p 6.

40. See above n 2.

41. John Wiseman & Jamie Walker, "Battlers' super pays mortgages" *The Weekend Australian* 22-23 September 2007, p 11. In 2006 APRA approved 13,871 applications for home owners to access superannuation funds in a final effort to save their homes, an increase of 30% over the previous year. The value of the superannuation bailouts more than doubled from $64 million to $135 million in the period 2004-2007: Ibid. This is an unfortunate trend because some commentators believe that Australians do not generally have sufficient superannuation and will need to supplement it by their home equity: See James Dunn "Home holds the key to super shortfall" *The Australian* 18 September 2007, p 37.

42. See "Predatory lending" in http://en.wikipedia.org/wiki/Predatory_lending.

43. Anthony Klan, "Predatory loans sting 40,000" *The Australian* 14 September 2007, p 5.

44. Ibid. It appears that 65-86% of applications for repossession come from non-bank lenders. See Katherine Jimenez, "Banks have a choice about lifting rates: NAB" *The Weekend Australian* 25-26 August 2007, p 36.

45. "Spotlight on loans" *The Australian* 31 March 2008, p 31.

46. Ibid.

47. Ibid. See also R Kerbaj, " Escape from the mire" *The Australian* 16 April 2008, p 13 and Four Corners program transcript, "Debtland" 31 March 2008 at www.abc.net.au/4 corners/content/2008/s2203896.htm

48. See Patricia E Obara, "Predatory Lending" (2001) 118 BLJ 541 at 550.

49. *Besta v Beneficial Loan Co* 855 F 2d 532 (8th Cir, 1988); Yen, "Failure to Advise a Loan Applicant of a Less Expensive Loan Alternative May Constitute Procedural Unconscionability" (1989) 106 BLJ 274. See also DR Cassling, "A Bank Was Liable for Beach of Contract and Breach of Good Faith as a Result of its Conduct in Negotiating a Loan Application" (2003) 120 BLJ 762.

50. *Besta v Beneficial Loan Co* 855 F 2d 532 (8th Cir 1988) at 536.

51. See *Suriya & Douglas (a Firm) v Midland Bank Plc* (1999) 3 Lloyd's Rep Bank 103 (CA).

52. *Murphy v HSBC Plc* [2004] EWHC 467; 2004 WL 413037.

53. *Metha v Commonwalth Bank of Australia* (unreported, Sup Ct, Comm D, NSW Rogers CJ, 7 June 1990). Compare Fischel, "The Economics of Lender Liability" (1989) 99 Yale LJ 131; *Lam v Ausintel Investments Australia Pty Ltd* (1990) 97 FLR 458; [1990] ATPR 40-990 at 50, 880.

54. *Ralik Pty Ltd v Commonwealth Bank of Australia* (unreported, Sup Ct, NSW Cole J, 14 August 1990). See also *State Bank of New South Wales v Chia* [2000] NSWSC 552 and *National Australia Bank Ltd v Mullins* [2006] ACTSC 116.

55. *Redmond v Allied Irish Banks Plc* [1987] FLR 307.

56. *Commonwealth Bank of Australia v Bryant* (unreported, Sup Ct NSW, Levine J, 27 October 1993). See also *Commonwealth Bank of Australia v Gatto* (unreported, Sup CT Vic, Beach J, 9 August 1996) and *Mahlo v Westpac Banking Corp* (unreported, Sup Ct, NSW Santow J, 6 February 1998 (where a lender was not held liable simply because it enthusiastically concurred in the borrower's decision to purchase additional farming properties).

57. *Warner v Elders Rural Finance Ltd* (1993) 41 FCR 399; [1993] ATPR 41-238 (lender was not liable for misleading or deceptive conduct for failing to explain system and risks).

58. *Metha v Commonwealth Bank of Australia* (unreported, Court of Appeal NSW, 29 March 1991); *Stanton v Australia and New Zealand Banking Group Ltd* [1987] ATPR 40-755; *Cornish v Midland Bank Plc* [1985] 3 All ER 513; *Bankers Trust International Plc v PT Dharmala Sakti Sejahtera* (unreported, High Court of Justice, Mance J, 1 December 1995).

59. (1991) 23 NSWLR 256; [1991] ASC 56-062.

60. Ibid at 56, 764.

61. Ibid at 56, 761.

62. (1991) 23 NSWLR 256; [1991] ASC 56-062.

63. *Box v Midland Bank Ltd* [1979] 2 Lloyd's Rep 391; *First Federal Savings & Loan Association of Hamilton v Candle* 425 So 2 d 1050 (Ala, 1982); *Brandriet v Northwest Bank of South Dakota* NA 499 NW2d 613 (SD, 1993).

64. Compare annotation "Banks Liability to Real Estate Purchaser for Misrepresentation Respecting Purchaser's Obtaining Government Guaranteed or Subsidized Loan" 37 ALR 4th 773 (1993).

65. Se J Moullakis, "Credit unions weigh odds of mortgage broking" *The Australian Financial Review* 27 May 2002, p. 49.

66. *NMFM Property Ltd v Citibank Ltd* [2000] FCA 1558; BC 20006827 (unreported, Fed Ct, Lindgren J, 10 November 2000).

67. Ibid. The phrase "on behalf of" in s 12GH suggests some involvement by the brokers with the activities of the lender. The phrase has a similar meaning to the phrase "in the course of the" lender's affairs and activities, without being

confined to any notion of master and servant": *Walplan Pty Ltd v Wallace* (1985) 8 FCR 27 at 37.

68. *Esanda Finance Corporation Ltd v Spence Financial Group Ltd* [2006] WASC 177 at [37]; *Custom Credit Corporation Ltd v Lynch* [1993] 2 VR 469 and *Octapon Pty Ltd v Esanda Finance Corporation Ltd* (unreported, Sup Ct NSW Cole J, 3 February 1989) at 27-28.

69. See *Con-Stan Industries of Australia Pty Ltd v Norwich Winterthur (Insurance) Australia Ltd* (1986) 160 CLR 226 at 234; *Octapon Pty Ltd v Esanda Finance Corporation Ltd* (unreported, Sup Ct, NSW, Cole J, 3 February 1989) at 27 28; *Custom Credit Corporation Ltd v Lynch* [1993] 2 VR 469 at 486 and *Esanda Finance Corporation Ltd v Spence Financial Group Pty Ltd* [2006] WASC 777 at [37]. See also *Branwhite v Worcester Works Finance Ltd* [1969] AC 552 at 577-578.

70. *Henry v First Federal Savings & Loan Association* 459 A2d 772 (Pa. 1982); *Hughes v Holt* 435A 2d 687 (1981); Hiller, "Mortgagee Liability for Defective Construction and Negligent Appraisals" (1991) 108 BLJ 386 at 391.

71. See note "Mortgage Lender Liability to the Purchaser of New or Existing Homes" (1988) U.Ill LR 215; *Henry v First Federal Savings & Loan Association* 459A 2d 772 (Pa. 1982). The guarantors of the borrower's debt will not be discharged simply because the lender was careless in failing to verify progress payments on a construction project: *Modderno v Australia and New Zealand Banking Group Ltd* (unreported, NSW Court of Appeal, 15 February 1999); *Fidgeon v Westpac Banking Corporation* [2002] VSC 85; BC 200201250 (Special leave to appeal to the High Court was refused: [2003] HCA Transcript 532)

72. *ACCC v Oceana Commercial Pty Ltd* [2003] FCA 1516 at [339]. Compare *Curran v Northern Ireland Co-ownership Housing Association Ltd* (unreported, CA, Northern Ireland, Gibson J, 9 May 1986), where a lender was not held liable for a loss caused by a negligent valuation because the purchaser had not paid for the valuation. See Jones, "Lender Liability for Negligent Building Valuations" (1999) 10 JBFLP 228 at 235.

73. *Westlake v Bracknell District Council* (1987) 282 EG 868.

74. *Davis v Idris Parry* (1988) 20 EG 92; *Roberts v J Hampon & Co* (1988) NLJ 166. By the same token, in exceptional circumstances a lender can be liable for a negligent valuation even if it was done by an independent valuer: *Smith v Commonwealth Bank of Australia* (unreported, Fed Ct of Aust, von Doussa J, 11 March 1991), affirmed: (1991) 42 FCR 390; (1991) 102 ALR 453.

75. *Westlake v Bracknell District Council* (1987) 282 EG 868. No duty of care will arise where a borrower does not disclose to the lender that he is looking for development finance in addition to the finance required to purchase a property. See *Plum v Commonwealth Bank of Australia* [2005] FCA 790 (unreported, Fed Ct, Wilcox J, 15 June 2005) at [137].

76. See *Verity v Lloyd's Bank* (unreported, QB, Robert Taylor J, 4 September 1995); *Contractors Supplies Pty Ltd v Esanda Finance Corporation Ltd* (unreported, Fed Ct FC, 30 September 1991), affirmed (1991) 42 FCR 390; *Smith v Commonwealth Bank of Australia* (unreported, Fed Ct, von Doussa J, 11 March 1991), affirmed: *Commonwealth Bank of Australia v Smith* (1991) 102 ALR 453. Compare *Timms v Commonwealth Bank of Australia* [2004] NSWSC 76 where the bank was not liable because it did not represent that the business was a sound investment.

77. *Commonwealth Bank of Australia v Smith* (1991) 102 ALR 453; *Loyola Federal Savings & Loan Association v Galanes* 33 Md App 559; 365A 2d 580 (1976); *Contractors Services Pty Ltd v Esanda Finance Corporation Ltd* (unreported, Fed Ct, FC, 30 September 1991).

78. Jones, "Lender Liability for Negligent Building Valuations" (1991) 10 JBFLP 228 at 234-235.

79. See *Australia Breeders Co-operative Society v Jones* (1997) 150 ALR 488 and O'Donovan, *Lender Liability On-Line* (2007), para [4.120]. Compare *ACCC v Oceana Commercial Pty Ltd* [2003] FCA 1516 at [339].

80. *Commonwealth Bank of Australia v Finding* (unreported, Sup Ct Qld de Jersey CJ 23 April 1998), on appeal: *Finding v Commonwealth Bank of Australia* [1999] Q Conv R 60, 370 at para 54-533.

81. Ibid. Contrast *Hong Kong Bank of Canada v Phillips* (unreported, QB Manitoba, Clearwater J, 24 March 1997 (bank should have advised borrowers to obtain independent advice).

82. *Johnson Tiles Pty Ltd v Esso Australia Ltd* [1999] ATPR 41-696 at 42 888; [1999] FCA 569 at [2]-[4]; *Costa Vraca Pty Ltd v Berrigan Weed and Pest Control Pty Ltd* (1998) 154 ALR 714 at 722.

83. C Lockhart, *The Law of Misleading or Deceptive Conduct* (2nd ed, Butterworths, 2003), para [5.3], cited with approval in *Noor Al Honda Islamic College Pty Ltd v Bankstown Airport Ltd* [2005] NSWSC 20 at [189].

84. *Demangogue v Ramensky* (1992) 39 FCR 31 at 32. See also *Kimberly NZI Finance Ltd v Torero Pty Ltd* (1989) ASC 55-943; (1989) ATPR (Digest) 46-054.

85. See A Fraser, "All eyes on two-tier sales" *The Australian* 20 March 2003, Primespace, p 3 and O'Donovan, *Lender Liability On-Line* (2007), para [4.151].

86. *Australian Securities and Investments Commission v Skeers* [2007] FCA 1551; BC 200708620. As to the dangers of low-doc loans involving loan applications that allegedly contain substantially false information about the borrower's income and assets, see A Klan, "Homeless man's loan" *The*

Australian 31 August 2007, p 25. In the United States the FBI is investigating the no-doc loans made by Countrywide Financial because of allegations that the company deliberately overlooked inflated income figures for many borrowers. See G R Simpson & J R Hagerty, " Countrywide suffers $1bn loss as FBI probes no-doc loans" *The Australian* 1 May 2008, p26.

87. ASIC may prosecute a bank for unconscionable conduct if it falsely states that guarantors received independent legal advice. See R Gluyas, "ASIC pursues bank's "false" declaration" *The Australian* 6 September 2007, p 21.

88. *Australian Securities and Investments Commission v Skeers* [2007] FCA 1551; BC 200708620. It has also been reported that a Newcastle broker has been convicted of two counts of fraud under the *Crimes Act* 1900 (NSW) for arranging a low-doc loan with false documentation. See ASIC Media Release "Former director of Newcastle-based investment company found guilty" 12 October 2007 <www.asic.gov.au/asic/asic.nsf/byhead/ine/07-268+Former+director+of Newcastl ebased+investment+company+found+guilty?open document > at 19 October 2007 and J Mc Sweeney, "Low-doc loans:broker conduct impact"(2007) 23 (6) BLB 85 at 86.

89. *Australian Securities and Investments Commission v Skeers* [2007] FCA 1551; BC 200708620.

90. See above n.66.

91. *Perpetual Trustee Company Ltd v Khoshaba* [2006] NSWCA 41; BC 200602108.

92. *Contracts Review Act* 1980 (NSW), s 9.

93. Section 9 (2) (l).

94. [2006] NSWCA 41; BC 200602108.

95. Lending on the basis of the security provided rather than the borrower's ability to repay the loan can result in a declaration that the mortgage is an "unjust contract" s 7 of the *Contracts Review Act* 1980 (NSW) and an adjustment of the mortgagee's rights and remedies. See *King Mortgages Pty Ltd v Satchithanantham* [2006] NSWSC 1303; BC 2006 102 34 and David Richardson, "Asset lending foils financier" (2007) 22 (8) BLB 104.

96. *Permanent Mortgages Pty Ltd v Cook* [2006] NSWSC 1104; BC 200608529.

97. Ibid.

98. [2006] NSWSC 1104 at [95].

99. See *Graeme Howatson & Dioni Perera*, "Court finds mortgage unjust despite false statements by borrowers" (2007) 22 (8) BLB102 at 103.

100. [2006] NSWSC 1104 at [95]; [2006] ASC 155-082.

101. See *Cook v Permanent Mortgages Pty Ltd* [2007] NSWCA 219 at [24].

102. *Chordas v Bryant (Wellington) Pty Ltd* (1988) 20 FCR 91; *Hay v Sheargold* (unreported, Sup Ct NSW, 18 April 1996); *Munro v Park Holiday Estates Ltd* [1984] TLR 138; *Mayfield Investments Ltd v Stewart* (1995) 121 DLR (4th) 222; *Jordan House Ltd v Menow* (1973) 38 DLR (3d) 105. See also Marcus Hoyne, "One for the Road – Liability of Servers of Alcohol" (1998) 72 (4) LIJ 46.

103. See *Johns v Cosgrove* (unreported Sup Ct, Qld, Derrington J, 12 December 1997) reversed *Cosgrove v Johns* [2001] QCA 157. See also *Desmond v Cullen* (2001) 34 MVR 186; [2001 NSWCA 238 (no breach of duty where publican relied on assistance proffered by patron's friends who told hotel staff they would look after him) and *Soutter v P & O Resorts Pty Ltd* [1999] Qd R 106 (as to whether a publican owed a duty of care to ensure that an intoxicated patron did not cause injury by dancing wildly). See also "Impaired Judgements? Alcohol Server Liability and "Personal Responsibility" after Cole v South Tweed Heads Rugby Leagues Football Club Ltd" (2005) 13 TLJ 103.

104. *Foroughi v Star City Pty Ltd* [2007] FCA 1503; *Reynolds v Katoomba RSL All Services Club Ltd* (2001) 53 NSWLR 43.

105. *Reynolds v Katoomba RSL All Services Club Ltd* (2001) 53 NSWLR 43 at [27].

106. *Reynolds v Katoomba RSL All Services Club Ltd* (2001) 53 NSWLR 43 at [27]. See also *Perre v Apand Pty Ltd* (1999) 198 CLR 180 and *Agar v Hyde* (2000) 201 CLR 552.

107. *Reynolds v Katoomba RSL All Services Club Ltd* (2001) 53 NSWLR 43 at [49].

108. [2004] SASC 103 (unreported, Sup Ct, SA, Judge Burley Supreme Court Master, 25 April 2004).

109. Ibid at [15].

110. Ibid at [20]. (emphasis added). Note the recent allegation against Wespac that the "negligent handling of our loans have caused a significant exacerbation of my gambling habits and was the catalyst for my loss of my employment and future earning potential": J Roberts, "Gambler sues Westpac for his addiction" *The Australian* 2 June 2008, p5.

111. See *Commonwealth Bank of Australia v Spira* (2002) 174 FLR 274; [2002] NSWSC 905; appeal dismissed *Spira v Commonwealth Bank of Australia* (2003) 57 NSWLR 544; [2003] ATPR (Digest) 46-237; special leave refused:

Spira v Commonwealth Bank of Australia [2004] HCA Trans 465. See also *Varangian Pty Ltd v OFM Capital Ltd* [2003] VSC 444 (on the importation of a duty of good faith in the enforcement of commercial loan agreements). See too *Roselle Enterprises Pty Ltd v Morris* [2003] WASCA 277; *Burger King Corporation v Hungry Jacks Pty Ltd* [2001] NSWCA 187 at [159] and [164] and *Vodaphone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 12 at [125].

112. See *Expo International Pty Ltd v Chant* (No 2) [1979] 2 NSWLR 820; (1979) 4 ACLR 679; *Australia & New Zealand Banking Group Ltd v Carnegie* (unreported, Sup Ct Vic Crockett J, 16 June 1987,

113. *National Provincial Bank of England Ltd v Glanusk* [1913] 3KB 335; *Midland Bank v Kidwai The Independent* 5 June 1995. The creditor has a wider duty of disclosure to guarantors who are individuals or small business customers under the Code of Banking Practice, cl 28.4.

114. *Kelly v ANZ Banking Group Ltd* (unreported, Qld Sup Ct, Demack J, 31 March 1993); *Commercial Bank of Australia Ltd v Amadio* (1983) 151 C.L.R. 447 at 463 and O'Donovan & Phillips *The Modern Contract of Guarantee,* [para 4.220].

115. *Gordon v Rae* (1858) 8 E & B 1065; 120 ER 396.

116. O'Donovan & Phillips, *The Modern Contract of Guarantee*, para [4.210]. Compare *Toronto Dominion Bank v Rooke* (1983) 3 DLR (4th) 715.

117. 716 P 2d 1057 (1986).

118. (1862) 15 Moo PC 472; 15 ER 573.

119. (1862) 15 Moo PC 472 at 483; 15 ER 573 at 577.

120. *Mayor of Durham v Fowler* (1889) 22 QBD 394 at 419 per Denman J.

121. See O'Donovan & Phillips, *The Modern Contract of Guarantee* (Looseleaf ed, Thomson, Lawbook Co Ltd, 2004), para [8.1100].

122. [1996] 1 Lloyd's Rep 200. See also *Bank of Baroda v Patel* [1996] 1 Lloyd's Rep 391.

123. See C Field, "Pay Day Lending – an exploitation market practice" (2002) 27 (1) *Alternative Law Journal* 36. and Therese Wilson, "The inadequacy of the current regulatory response to payday lending" (2004) 32(3) ABLR 193.

124. In *Beil v Pacific View (Qld) Pty Ltd* [2006] QSC 199 at [32] Chesterman J noted that there are many cases that have upheld the payment of a higher rate of interest on default even though the mortgage did not stipulate that the higher rate of interest applied at all times but a lower rate would be charged

for punctual payment. Compare *David Securities Pty Ltd v Commonwealth Bank of Australia* (199) 23 FCR 1 at 29.

125. *Gibbons v Pozzan* [2007] SASC 99; *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 23 FCR 1 at 29. See also Meredith, "A nicety in the Law of Mortgage" (1916) 32 LQR 420.

126. *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79; [1914-15] All ER 739.

127. *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79; [1914-15] All ER 739. See also *Kostopoulos v GE Commercial Finance* [2005] QCA 311.

128. (2005) 224 CLR 656; 222 ALR 306.

129. Whether any particular provision represents a genuine pre-estimate of the loss from the breach must be decided as a matter of substance rather than form: *O'Dea Allstates Leasing System (WA) Pty Ltd* (1982-83) 152 CLR 539; *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 at 185 and 197; *AMEV Finance Ltd v Artes Studios Thoroughbreds Pty Ltd* (1989) 15 NSWLR 564 at 572.

130. [2006] QSC 199 (unreported, Sup Ct Qld, Chesterman J, 18 August 2006).

131. See eg *Consumer Credit (Victoria) Act* 1995 (Vic), s 39 (1).

132. See eg *Consumer Credit (Victoria) Act* 1995 (Vic), s 39(3).

133. See *Consumer Credit (New South Wales) Amendment (Maximum Annual Percentage Rate) Act* 2005 (NSW); *Consumer Credit (NSW) Act* 1995, s 10B and *Consumer Credit Act* 1995 (ACT), s 8C. See also A Galvin, "NSW and ACT Amendments to the Consumer Credit Code – the unintended consequences" (2006) 22(1) BLB1.

134. C Nguyen, "Fees in consumer credit: regulatory rumblings" (2007) 23(6) BLB 87 at 89.

135. Ibid.

136. See *Consumer Credit Code*, s 72 and C. Nguyen, opcit, n 134, p. 89.

137. Under a proposed change to s 72 of the *Consumer Credit Code* the word "unreasonable" will be substituted for the word "unconscionable". This is intended to introduce a broad and flexible test for the court following the decision in *Director of Consumer Affairs Victoria v City Finance Loans and Cash Solutions* [2005] VCAT 1989. See R Dennings, S Klimt, M Sneedon and N Smythe, "Proposed changes for Consumer Credit Code" (2007) 23(4) BLB 62.

138. See *McKenzie v Smith* [1998] ASC 55-025; *McNally v Australia and New Zealand Banking Group* [2001] ASC 155-047 and Nicola Howell, "Catching up with consumer realities: The need for legislation prohibiting unfair terms in consumer contracts" (2006) 34 ABLR 447 at 453.

139. *Dale v Niochols Constructions Pty Ltd* [2003] QDC 453; *Espiritu v Australian Guarantee Corporation Ltd* [1997] ASC 155-004 and Nicola Howell, opcit, p. 452.

140. *McKenzie v Smith* [1998] ASC 155-025 *Elders Rural Finance Ltd v Smith* (1996) 41 NSWLR 296; *Goldsborough v Form Credit Aust Ltd* [1989] ASC 55-946 and Howell, opcit, pp 453-454.

141. *Esanda Finance Corporation Ltd v Tong* (1997) 41 NSWLR 482; *Australia and New Zealand Banking Group Ltd v Volemsky* (unreported, Sup Ct NSW, Spender AJ, 14 December 2004).

142. See generally O'Donovan, *Lender Liability On-Line* (2007), para. [5.395].

143. *Australian Securities and Investments Commission Act* 2001 (Cth), s 12CB(5).

144. See *Australian Securities and Investments Commission Act* 2001 (Cth), ss 12GF, 12GD and 12GM.

145. "Consumers" are covered by s 12CB of the *Australian Securities and Investments Commission Act* 2001 (Cth); small business consumers are protected by s 51AC of the *Trade Practices Act* 1974 (Cth). See O'Donovan, *Lender Liability* (2000) paras [5.265]-[5.285].

146. See O'Donovan, *Lender Liability On-Line*, para [5.270].

147. *Trade Practices Act* 1974 (Cth), s 51AC (11)(e).

148. See O'Donovan, *Lender Liability* (2000), para [5.275].

149. (unreported, Sup Ct Qld, Shepherdson J, 31 August 1999).

150. Ibid at [36].

151. Ibid at [57].

152. Ibid at [57].

153. Ibid at [57].

154. *Asia Pacific International Pty Ltd as Trustee for Planet Securities Unit Trust v Dalrymple* (unreported, Sup Ct Qld, Shepherdson J, 31 August 1999) at [58].

155. Ibid at [68] and [69].

156. (unreported, Sup Ct Qld, Shepherdson J, 31 August 1999). Compare *Greenbank New Zealand Ltd v Haas* [2000] 3 NZLR 341.

157. [2001] NSWSC 1047.

158. [2004] NSWSC 1236.

159. Ibid at [110].

160. *Karam v Australia & New Zealand Banking Group Ltd* [2005] NSWCA 344 at [96]. See also Lee Aitken, A "duty to lend reasonably – new terror for lenders in a consumer world" (2007) 18 JBFLP 18 at 25-26.

161. See *Guardian Mortgages Pty Ltd v Miller* [2004] NSWSC 1236 at [114] and Lindy Willmot and Bill Duncan, "Clogging the Equity of Redemption: An Outmoded Concept?" (2002) 2(1) QUTLJ 35.

162. See Lindy Willmott and Bill Duncan, "Clogging the Equity of Redemption…" opcit, pp. 43-49.

163. See *Australian Securities and Investments Commission Act* 2001 (Cth), s 12GM(5).

164. See Lita Epstein, "Ohio court gives victory to homeowners facing foreclosure" http://www.bloggingstocks.com/2007/11/15 and David Nason, "Home owners give thanks to Ohio judiciary" *The Australian* 19 November 2007. Australian lenders are not immune from this type of problem. See Angela Flammery, "Loan agreements and mortgages. What is the effect of a transfer of a mortgage?" (2007) 22(9) BLB 119.

165. See Carrick Mollenkamp, "UBS sued for offloading sub-prime assets" *The Australian* 28 February 2008, p 26 and R Simon, "Mortgage lenders face ire of investors" *The Australian* 29 May 2008, p. 26.

166. *Williams and Glyn's Bank Ltd v Barnes* (181) Con LR 205; *James v Australia & New Zealand Banking Group Ltd* (1985) 64 ALR 347 at 391; *Commonwealth Bank of Australia v Grubic* (unreported, Sup Ct FC, SA 27 August 1993) and O'Donovan, *Lender Liability* (2000), para [4.160].

167. See *Commonwealth Bank of Australia v Smith* (1991) 102 ALR 453, affirming *Smith v Commonwealth Bank of Australia* (unreported, Fed Ct, von Doussa J, 11 March 1991), O'Donovan, *Lender Liability* (2000), Ch 4 and *Lender Liability On-Line*, (2007) Ch 4.

168. The bond issuers only provided guarantees in respect of asset backed securities or collateralised debt obligations. See generally Karen Richardson, "Credit rating affirmed for top bond insurer" *The Australian* 28 February 2008, p 56 and A Lucchetti, "Embattled Moody's boss falls on sword" *The Australian* 9 May 2008, p. 23.

169. US monoline insurer, ACA, has been downgraded to junk status. See S Murdock & R Callick, "ANZ's $1bn for loan debts as defaults rise" *The Australian* 8 April 2008, p 27. A monoline insurer is, in effect, a AAA-guarantor that wraps its own credit rating around a debt obligation and guarantees its timely payment of principal and interest in return for a fee.

170. See Frank Pasquale Concurring Opinions: From First Amendment to Financial Meltdown? 22 August 2007 at http://www.concurringopinions.com/archives/2007/08/from_first_amen_html. The ratings agencies, such as Standard & Poor's and Moody's, are considered members of the media: *Jefferson City School v Moody's* (PC No 95-WY-2649-40 (US Court of Appeals, Tenth Circuit, 4 May 1999). This view will be tested by the *US Mortgage Reform and Anti- Predatory Lending Act* 2007 if it is passed by the US Senate.

171. Imre Salucinzky, "Sub-prime hit for ratepayers" *The Australian* 3 April 2008, p2 and S Moran, "Council to sue Lehman" The Australian 22 April 2008, p.22.

172. See Gary Becker, "Should have thought of that before you bought the house" at www.becker_posner_blog.com; S Wright, "Borrowers to blame for homes crisis, says Symond" *The West Australian* 8 May 2008, p 17 and B Salt, "How to keep our consumerist society ticking" *The Australian* 22 May 2008, p. 24. Education should be directed not merely at financial literacy but also risk appreciation. Disclosure without sufficient education to guard against predatory practices will not be effective. See Jean M Lown "Educating and Empowering consumers to Avoid Bankruptcy" (2005) 29(5) *International Journal of Consumer Studies* 401 at 406. But, to be successful, education programs must be tailored and targeted, such as an extended period of one-on-one counselling. See J Malbon, "Predatory Lending" (2005) 33 ABLR 224.

173. See A Hepworth, "States target consumer credit disclosure" *The Australian Financial Review* 28 April 2008, pp 1 and 8.

174. See generally Graeme Howatson, "National regulation of finance brokers" (2008) 23(7) BLB 101 and L Wright, "Tough laws shield loans" *The Sunday Times* 19 August 2007, p 15. The national licensing system should require a maximum level of education and experience, a compulsory dispute resolution system, probity checks, disclosure of commissions and disclosure of the brokers' panel of lenders. The Finance Brokers' Association of Australia has itself called for an overhaul of the laws regulating mortgage brokers: A Klan, "Call for national licensing system to end mortgage broking fraud" *The Weekend Australian* 15-16 September 2007, p 37. This call for a national licensing system is a continuing saga. The States have agreed to transfer power to the Commonwealth to regulate credit. The Federal Government's "Green Paper on Financial Services and Credit Reform" (3 June 2008) proposes a national system for regulating mortgages and mortgage broking advice. For an evaluation of US statutes regulating mortgage brokers, see Lloyd T Wilson Jr, "A Taxonomic Analysis of Mortgage Broker Licensing

Statutes: Devising a Programmic Response to Predatory Lending" (2006) 36(2) *New Mexico Law Review* 297.

175. Ros Grady, "Should credit go to the Commonwealth? Yes!" (2007) 23(6) BLB 82. However, it appears that regulation of consumer credit, as distinct from mortgage lending, may be left to the States. See the Federal Governments "Green Paper on Financial Services and Credit Reform" (3 June 2008)

176. See Nicola Howell, "Catching up with consumer realities: The need for legislation prohibiting unfair terms in consumer contracts" (2006) 34 ABLR 469. See also R Nickless, "Gym offered members unfair contracts" *The Australian Financial Review* 28 April 2008, p. 9.

177. See generally O'Donovan, *Lender Liability* (2000), Ch 3.

178. See Richard Gluyas, "Regulator may get sweeping powers to deal with distressed banks" *The Australian* 28 March 2008, p. 22.

179. See J Malbon, "Predatory Lending" (2005) 33(3) ABLR 224 at 227 for a discussion of Community Development Finance programs.

180. See *Corporations Act* 2001 (Cth), s 1011A and ASIC Policy Statement 103, *Approval of Financial Codes of Conduct* (2005). For an example of a voluntary code of conduct relating to reverse mortgages, see *The Senior Australian Equity Release Association of Lenders (SEQUAL) Code of Conduct* (August 2007) at www.sequal.com.au and A Fenech "Seniors protected in reverse mortgages" *The Weekend Australian* 25-26 August 2007, p 27. Section 51AE of the *Trade Practices Act* 1974 (Cth) provides that regulations may prescribe an Industry Code and declare it to be mandatory. A contract that directly contravenes a provision of an Industry Code is rendered unenforceable by the common law. See *Ketchell v Master of Education Services Pty Ltd* [2007] NSWCA 161 at [27]. Cf *The Cheesecake Shop v A & A Shah Enterprises* [2004] NSWSC 625.

181. Debt amnesties were granted by Sumerian and Babylonian kings. See CL Peterson, "Truth, Understanding and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act" (2003) 55 *Florida Law Review* 807 at 820.

182. See Greg Ip, "Bernanake calls for mortgage forgiveness" *The Australian* 6 March 2008, p 26. See also Stephen Ellis, "Fed's suggestion that lenders take a haircut reflects depth of the US crisis" *The Australian* 6 March 2008 p 30.

183. This Act was passed by the US House of Representatives on 15 November 2007. Law reformers will also pay close attention to the *Consumer Credit Act* 2006 (UK) which introduced a new "unfair credit relationship test" in place of the "extortionate credit bargain" provisions of the *Consumer Credit Act* 1974. The *Consumer Credit Act* 2006 (UK) received Royal Assent on 30 March 2006 but it is thought that the new test may bring more uncertainty to the

debtor/creditor relationship. See Lorna Cromar, “Consumer Credit Bill” (2006) 156 NLJ 662

184. This section draws heavily on the summary of the Act provided by Project Vote Smart. See HR 3915: Mortgage Reform and Anti-Predatory Lending Act of 2007 (GovTrack.us) at http://www.govtrack.us/congresbill.xpd?tab=summary&bill= h110-3915.

185. See Joshua S Gans, “Protecting consumers by protecting competition, Does behavioural economics support this contention?” (2005) 13 *Competition and Consumer Law Journal* 40. Contrast S Sedwick, “Solution to housing affordability ‘crisis’ is to help the market work better” *The Australian* 13 March 2008, p 30. See also D Wessel, “Learning our sub-prime lessons: we must prevent lenders competing their way to disaster” *The Australian* 30 May 2008, p. 26. If anything, the global credit crisis is destroying competition in the home-lending market. See David Uren, “Call to support mortgage lenders” *The Australian* 28 March 2008, p 2 and “Bank raises broker ire with commission cuts” *The Australian* 15 April 2008, p 21. On the other hand, one Australian bank wants to broaden the role of mortgage brokers. See T Boreham, “NAB seeks broker-advisers” *The Australian* 28 April 2008, p. 29.

186. See Sinclair Davidson, “Let banks and instos make own credit decisions” *The Australian* 22 February 2008, p 28.

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Predatory Lending - Responding To "Lenders Behaving Badly"

PREDATORY LENDING - RESPONDING TO "LENDERS BEHAVING BADLY"

By Philip Trinca, Partner, Blake Dawson, Melbourne

14 July 2008

In his paper "Lenders Behaving Badly", Professor O'Donovan has given us an excellent overview of the general circumstances in which predatory lending may arise. In addition, he has noted and examined "the fragmented response of the Australian legal system" to many of these predatory practices. It is this fragmentation of response on which I intend to focus my own comments.

That we have inherited a fragmented response to this age old problem is not something that should really surprise us. Predatory lending has been a scourge to commercial societies for millennia, and the responses to those charged with controlling it have never been entirely successful. To be fair, the regulation of commerce, even undesirable commerce, is a balancing act. It needs to balance the protection of the vulnerable against the encouragement of enterprise and competition. This is not an easy task, in any field of commerce.

The real difficulty in framing an appropriate response, however, is that the causes and opportunities for predatory lending are varied and complex. In addition, the opportunities to engage in predatory practices continue to expand. The ever increasing range and complexity of financial products is seeing to that. A further difficulty is that the regulation of undesirable practices is mostly responsive, while human ingenuity for maximising personal profit is often "ahead of the game".

Accordingly, there are likely to be some good reasons for why our responses to date can be accused of being fragmented. The trick, as we try to do better, will be to imagine the best framework upon which to continue to build and develop our response to the problem. In my view, we need to pursue a layered and flexible approach – even if this does continue to run the risk of being seen to be fragmented.

If we try to imagine and implement a single or "one size fits all" approach, we will fail. The complexities of the modern world will quickly see to that. Just as there is not a single problem to address, there is not a single or universal solution to be applied. That is not to say, however, that some regulatory restraints ought not to be universally applied. These universal restraints could be viewed as the base layer of the response.

The application of caps on interest rates and the regulation of unfair contract terms, would be a couple of good examples of where a base form of universal regulation might be continued to be applied. The harder task is the formulation and application of the more targeted responses to the particular predatory practices, as they arise. These responses will fall into two parts: the application of industry knowledge to understand the issues of today and tomorrow and the effective enforcement of the envisaged solutions. A cap on interest rates, for example, is of no value if it is not strictly enforced. That requires money and the will to apply the law. The regulation and control of other (often less obvious) predatory practices requires:

- the industry knowledge to identify the current and developing predatory strategies;

- the application of judgement as to how they might best be regulated, or otherwise controlled;
- the legislative flexibility to respond to new predatory practices as they arise; and
- the commitment and financial resources to back up and enforce the legislative response.

Despite the apparent difficulties of the task, there does seem to be a general acceptance that something more needs to be done to control unfair or predatory practices.

Not coincidentally, in Australia we are currently poised on an opportunity to re-evaluate the manner in which consumer lending is regulated. We have been examining and preparing for a range of regulatory changes that were to be implemented at the State level. Now, consequent upon the decisions of COAG[19] in March and early July 2008 to transfer regulatory power for consumer lending to the Commonwealth, we have an opportunity to re-assess and re-evaluate the existing levers of regulation as well as those which might be imagined and brought to bear.

Our current fragmented history of regulation is both a legacy of past endeavours to regulate unacceptable practices as they arise, together with the fragmentation of regulation which has arisen from our historical circumstance of having eight separate jurisdictions regulating the same sphere of commercial activity. By moving to a single Commonwealth regulator we have the opportunity to considerably improve the focus of our response to any predatory behaviour by lenders. Whether this opportunity will be used for maximum advantage, however, is still very much open to question. A chief concern is that those who will have responsibility for formulating and giving substance to our new grand scheme, are being given very little time to envisage and implement the right balance of regulation and control.

Their task is not an easy one and, as usual, the lessons of history will be difficult to adapt and apply. Time constraints, or other factors, may well mean that the initial outcome is simply a Commonwealth version of our currently State based Uniform Consumer Credit Code (**UCCC**). We can, however, probably expect to have one or two "add ons" that have been extracted and copied from the most recent individual legislative attempts of some States to address particular needs that have arisen.

In the context of these general comments, I would now like to make some more specific comments on some of the regulatory options that are available for consideration or are current features of our existing approach to regulating consumer credit. I should emphasise that these are largely personal views.

1. Is the value of truth in lending overstated?

One of the key principles that underlies much of the recent regulation of consumer lending is the concept of truth in lending. The idea is that if borrowers are provided with ready access to relevant information, they will be better able to compare and decide upon credit terms that may be offered to them by one or more credit providers. While this is a worthy aim, and has a logical appeal at an intellectual level, truth in lending as a means of redressing the balance is subject to a number of limitations.

The first concern I have is that consumers are rarely in a position to conduct an objective comparison of competing financial products. There are many reasons for this. Often, there is not a choice of products offered at the point of sale, or there may be a range of commercially self-interested reasons why a consumer is directed to, or offered only, one product.

Even where there is a choice, unless the product is one of particular simplicity, the making of useful and informative comparisons between the full range of features and risks offered by the available products is likely to be beyond most consumers.

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19 The Council of Australian Governments.

Separately, there does not appear to be much evidence that the disclosure of all fees and charges will necessarily influence the behaviour or risk appetite of borrowers. The legislative requirement to disclose key features of a loan in a schedule, such as the interest charges and fees, remains a potentially valuable strategy. Nevertheless, it is liable to be considerably diluted by the volume of the disclosures, where numerous fees are listed, or numerous interest rate options are listed and explained. It might be concluded that truth is only valuable where it is brief. Too much truth runs the danger of losing the message. Additionally, the increasing complexity of financial products on offer also works against the ideal of allowing key features of a product to be compared with other products. We are seeing the same problems in the regulation of financial products under Chapter 7 of the Australian Corporations Law. There, there are detailed and apparently sensible disclosure requirements that must be made within a Product Disclosure Statement (**PDS**). As a recent example, I drafted a PDS which I thought was bursting with clarity, plain English and full disclosure. It took me two hours to conduct my final read through, and I knew what it said!

In the context of the format for the disclosure of key features of a loan, an interesting survey was conducted a few years ago in Queensland by Paul O'Shea. It is described in his paper entitled "Consumer Credit Code Disclosure: Does it Work?".[20] The paper describes an experiment that was conducted to determine whether disclosure of key financial details in the financial table in accordance with the UCCC increased the comprehension of relevant terms over disclosure of the same information, where it is embedded within the body of the contract. The results achieved suggest that our perceptions about the value of financial tables may well be overrated. Paul O'Shea reported that:

> "… there was a barely statistically significant improvement in the mean [for comprehension of the selected information] for the Code-compliant …contracts over the embedded contracts, [and that] only 2.9% of this variance is explained by the difference in the documents. The rest is attributable to other factors."

If we are to persist with "scheduled" disclosures, it suggests to me that the disclosures should be limited to a few compulsory headline items that require no more than a page to disclose.

Even if we are fully informed, that does not mean that we will make our choices accordingly.

The free will of the prospective borrower is considerably diminished by the fact that the finance is, in most cases, simply a means to an end. The finance may be required to fund a purchase that the borrower has already decided to make. For example, in-store finance allows a customer to purchase the plasma TV of their dreams, or the washing machine of their needs. In many respects, the finance contract and its particular terms are secondary to the main objective (the purchase) and the main objective cannot be achieved without the finance. The purchase decision will already have been made. It is likely that the borrower will not have the opportunity, the desire, or even the skills to consider competing finance products (even if we assume that they have knowledge of the availability of alternative finance options).

At a consumer level, we also need to bear in mind that consumers rarely, if ever, have the opportunity to negotiate the terms of an offered credit contract. This is particularly so in the case of mortgages, credit cards and finance in stores and car yards. In a housing context, few of us would read the detailed terms and conditions, even if we are lawyers. We know that if we want the money, we sign the mortgage.

Even as "educated" borrowers with some degree of choice, our response may be to choose to rely on our perception of the reputation of the lender as our primary form of

[20] (2005) 16(1) JBFLP5.

protection. We concern ourselves, therefore, with headline items, such as the applicable interest rate and the establishment costs. This has resulted in an opportunity for lenders who have devised and applied an increasingly varied range of fees and charges that are used to generate a very significant portion of the lender's return. A particular community concern at present is that some of these fees and charges fall on those most vulnerable, for example, in the form of default or exception fees applied when the borrower runs into financial difficulty and misses payments.

What this suggests to me is that relying on the borrowers to protect themselves, even where the relevant financial information has been required to be presented in the most comprehensible terms, is not the best way to address or control predatory practices.

2. Regulation of fees and charges

At present in Australia, we are in the midst of re-evaluating the means and degree to which credit fees and charges should be regulated. The present position under the UCCC is that only a very few fee types are regulated, and principally, only subject to attack where they are unconscionable within the meaning of the common law. Effectively, this means the fees have to be pretty outrageous before they are vulnerable. Further, any remediation requires court action to establish the unconscionability. In 2007, following a review of the UCCC at various levels of government, the Ministerial Counsel on Consumer Affairs issued a Consultation Package which, through a draft Consumer Credit Code Amendment Bill 2007, proposed that all fees be subject to challenge in circumstances where they are "unreasonable". This proposal raised considerable concern amongst lenders, particularly where they were required to demonstrate reasonableness by reference to underlying cost. Of course, not all fees have an underlying cost. Separately, establishing average costs of providing a particular service is not only difficult, but often too simplistic as an approach.

Following industry consultation, it is understood that the re-drafting of the proposed reform package has been moving towards a proposal under which fees would be subject to challenge where they are "unfair". It is understood that the determination of what is unfair would be left to the Court, rather than prescribed by Regulation. Now, following the COAG decision in July, we have the proposal to move the regulation of all consumer credit to the Commonwealth sphere and we are, to a large extent, left to imagine the degree to which the Commonwealth will elect to regulate fees. A significant starting clue, however, was contained within the green paper which preceded COAG's decision. In the green paper, it was stated that:

> "It is important to note that the government does not intend to regulate bank fees and charges... Regulation of bank fees and charges discourages new investment and innovation, increases compliance costs for industry and may eventually lead to an increase in prices for consumers. The government considers a competitive market to be a more effective mechanism for driving down fees and charges."[21]

Whether this market driven philosophy will prevail in the drafting of the new Commonwealth laws is yet to be seen. My personal view is that relying on the market to regulate fees and charges is not likely to have any significant impact on predatory lending practices.

That leaves the difficult question of the extent to which, and the manner in which fees might otherwise be regulated. There are some existing regulations that are achieving their purpose, such as section 30 of the UCCC – which limits a credit provider's recovery of the third party expenses it incurs to the net final cost of that expense. A move beyond this point requires a decision as to whether we should:

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21 Green Paper June 2008 – Financial Services and Credit Reform, Improving, Simplifying and Standardising Financial Services and Credit Regulation, page 15.

- return to the days of the Credit Acts' approach to regulation; or
- stick with the market control approach that is permitted under the UCCC.

The better option, it seems to me, is to stick with the UCCC's approach, but to monitor the effectiveness of that form of control on different fee types. Where the market control is not working, as some would say is currently the case with exception fees, and where regulation will not stifle competition and innovation, there would be a case for imposing limits on the amounts that may be charged for specific fee types. This might be more effectively done by imposing direct price control caps on certain types of fees, but that is not a solution that many would favour.

3. **Unfairness and the public interest**

As a separate comment, it is worth drawing attention to the New South Wales decision of *Permanent Mortgages Pty Ltd v Cook*[22], to which Professor O'Donovan has referred. It involved a Ponzi Loan. In that case, the Court was required by the terms of section 70 of the UCCC to consider whether a mortgage was unjust. Evidence had been given by Associate Professor Keen that the loan approved by the lender exceeded the capacity of the Cooks to service the loan by around $100,000 (based on the credit assessment models utilised by a number of major banks). Under section 70, the court was required to consider the public interest, before deciding whether the mortgage was unjust. The evidence of Professor Keen was that:

> "… were the practice of Ponzi Lending to become widespread, it would substantially increase the tendency of the Australian financial system to asset bubbles and subsequent financial crisis …".[23]

The view of Professor Keen was that Ponzi Loans thus have an adverse economic consequence that extends well beyond the immediate parties to the loan agreement.

The court, however, concluded that against any public interest in discouraging loans of this type, there is a public interest in the enforcement of contractual obligations freely entered into. Patten AJ concluded:

> "In the result, I do not regard the public interest as of much significance in resolving this case. Rather, I think the greater focus should be upon factors personal to the Defendants, or more directly concerned with the particular transaction."[24]

One might be forgiven for concluding that the Court effectively dismissed the relevance of the public interest consideration in the context of an individual loan.

4. Interest rate caps

Caps on interest rates are one of the oldest, if not the oldest, forms of regulating predatory lending. Interest rate caps have been applied for millennia.

They remain a key means by which some control over the worst excesses of predatory lending can be applied. The real issue with interest rate caps, however, is not the imposition of the cap itself, but the diligence with which it is enforced.

Currently in Australia, New South Wales and the ACT seek to go one step further by combining fees and interest within the maximum interest rate cap.

5. Information, positive credit reporting, low doc loans and liars

The rules that make the most sense to me are those that are imposed on the person best able to control the outcome. Problems arise, however, where inaccurate or

22 [2006] NSWCA 41.
23 [2006] NSWCA 41 at paragraph 81.
24 [2006] NSWCA 41 at paragraph 85.

misleading information is being given to the person making the relevant decisions and exercising the relevant control – typically the lender.

As a general proposition, accurate and more detailed information should reduce the circumstances in which inappropriate loans are made. Accordingly, most credit providers are strongly in favour of allowing positive credit reporting in the sense that such reporting will allow them to have access to wider verifiable information, such as information about existing loans (both disclosed and undisclosed), the repayment performance of borrowers under those loans and the amounts then borrowed. In particular, lenders wish to know whether a borrower has the capacity to repay a requested loan. Ultimately, they should be the person responsible for making the assessment as to whether and how much to lend.

The concerns against allowing lenders access to so called "positive credit information" centre on privacy concerns and the protection of the rights of the individual.

There seems little doubt, however, that manipulation of the truth does occur in the lending environment. Borrowers under low doc loans can overstate their income and financial capacity. Brokers, for their own selfish reasons, may be tempted to bend the truth when putting forward a loan applicant for a loan. At the other end of the scale, financiers who are planning to have no long term interest in the loan may be less inclined to check various claims. The quality of many of the loans written in the US at the bottom end of the market is ample illustration of this point.

A good example of what we should not do, however, was illustrated by the recent draft National Finance Broking legislation. Under the original draft legislation, it was proposed to make all "brokers" responsible for checking and assuring the financial capacity of the borrower. This might be appropriate in some real property mortgage situations, but as soon as a broker is widely defined, it becomes an entirely different proposition. Is a car salesperson or a shop assistant really capable of making such an assessment? As a consumer, would you want to give them the required financial information to establish your capacity to repay?

6. Fear

There is no doubt that active Regulators are more likely to drive proper behaviour than inactive ones. Nevertheless, the extent to which they can be effective is dependant upon the powers they have, the financial resources at their disposal and the consequences applicable to lenders who transgress.

While no-one would wish for a return of the days of the Credit Act, when interest rights were automatically forfeited for the most trivial disclosure breaches, the almost voluntary breach disclosure regime that applies under the UCCC has arguably led lenders to a false sense of security about the risks of prosecution or examination.

There have been very few prosecutions by Regulators, and where Regulators have become visibly active, there has often been little political choice about their doing so. This has meant that a number of practices have remained untested and a degree of complacency has, one might suggest, settled in.

If one thing is clear, it seems that clear guidelines and guidance of what is and is not acceptable on the one hand, combined with rigorous oversight and enforcement on the other, is the most likely means by which effective regulation can be administered.

7. Concluding comments

There is no one or single solution to the issues we have discussed today. As financial products become more complex, the regulation of these products through a single means has an increasingly diminished value. Against that, a plethora of regulatory approaches or a "global" approach accompanied by a diverse and complex scheme of exceptions, such as that we are experiencing under Chapter 7 of the Corporations Law, is also undesirable.

There are a number of possible ways forward. They range from limiting regulation to basic products with defined but limited features, to placing more complex conditions upon access to positive credit information, or upon the provision of the more complicated financial products. Such conditions may include the requirement on the lender to do something in justification of its lending decisions. For example, if positive credit reporting information is to be provided, a lender might be required to document and record the basis on which it decided that the borrower had the capacity to repay it.

The regulation of brokers, as currently proposed in Australia, so as to require them to effectively assess and be responsible for the credit capacity of a borrower, seems to me to be a less obviously desirable approach. At the end of the day, it is the lender that lends the money and takes the risk. It is the lender that should have the experience to measure credit capacity and to test the information provided to it by the applicant and/or the borrower.
Nevertheless, I do think that our ongoing response needs to continue to test new regulatory models and to be flexible and adaptable to changing circumstances. While this will impose an ongoing cost at both industry and government level, it is something that seems to me to have the best prospect of improving the focus and implementation of the regulatory response.

Friday 25th July, 2008

Concurrent 1b
Copthorne Hotel

11.10am – 12.30pm

Chair:
Graham Mouat
Special Counsel
Clayton Utz
Brisbane

Speakers:
Ross Pennington
Partner
Russell McVeagh
Auckland

Patrick Mullins
Head Capital Markets Origination
Bank of New Zealand
Auckland

John Elias
Partner, Minter Ellison
Sydney

Sale in New Zealand & Australia of International Capital Markets Instruments

Ross Pennington, Partner, Russell McVeagh, Auckland

International Debt Offerings In New Zealand and The Wider Context Of The Global Eurokiwi Market

INTERNATIONAL DEBT OFFERINGS IN NEW ZEALAND

AND THE WIDER CONTEXT OF THE GLOBAL EUROKIWI MARKET

Ross Pennington

RUSSELL McVEAGH

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INTRODUCTION AND COVERAGE

The New Zealand debt capital market has recently surged, more than trebling in a two-year period. This has occurred in close alignment with milestone international retail issues and the emergence of the Kauri Bond market. These issues have put strains on a regulatory framework designed in the 1970s around local productive enterprises of the time and against a dramatically different market framework.

The focus of this paper is the domestic debt capital market and the emerging contribution of international issuers to that market. It seeks to place this market in the wider context of the obscure colossus of global New Zealand dollar issuance and describes the emergence of the Kauri bond, an instrument that has a footprint in each of these markets. It also explores some of the dynamics that shape these markets and the derivative markets that have grown in concert with them.

There has been a growing recognition of the critical importance a vibrant and credible domestic capital market places in keeping our economy one in which the international community of issuers and investors has confidence. This paper concludes with suggestions of some matters requiring attention in our securities laws if we are to encourage both confidence and high quality and diverse issuance, whether local or international.

The structure of this paper is as follows:

- The recent expansion of the New Zealand corporate bond market and the basic features of the wholesale and retail Kiwi debt capital markets.

- The steps required for retail issuance, the roles the various participants play in the process and the steps that they should take to minimise their respective risks.

- Regulation of information flows in a retail context: who can say what, to whom, and when.

- Lessons to be drawn from recent international issues, including the Rabobank Nederland and Crédit Agricole issues Tier 1 issues and the World Bank retail Kauri issue.

- The emergence of the Kauri bond market and legal and operational aspects of those offerings.

- The wider context of New Zealand Dollar issuance, including the New Zealand government, Uridashi and Eurokiwi bond markets, and the dynamics that shape all those markets.

- General exemptions available to facilitate international issuance of debt securities, the limitations of the same, and the process for obtaining issuer-specific exemptions, including Trans-Tasman harmonisation and the new mutual recognition regime.

- Liability and risk management in the context of international offerings.

- Reform initiatives, including the Review of Financial Products and Providers and tax reforms, including some suggestions as to aspects of the securities laws requiring urgent attention if high quality issuance is to be encouraged in this market.

DEVELOPMENT AND SHAPE OF NEW ZEALAND'S DEBT CAPITAL MARKETS

New Zealand's corporate bond market is a recent phenomenon, having begun to develop in the late 1980s, stimulated by the floating of the exchange rate in 1985 and the corporatisation or privatisation of significant state-owned enterprises.[25] Those SOEs were among the first issuers of corporate bonds in New Zealand, which is unsurprising given their size, the creditworthy nature of their financial structure and activities and their need for finance.

Until the past couple of years, the growth of the domestic debt capital market was incremental at best. Since then it has been explosive:

Much of what accounts for the steep trajectory of recent growth is international issuance. However, despite this recent growth New Zealand's capital markets are smaller than most OECD countries relative to GDP — in fact they are the smallest among all developed countries.[26]

Less well known were developments in New Zealand dollar issuance taking place at the same time around the globe and the financial innovations that accompanied them. In particular, the mid-1980s saw the birth of the Eurokiwi and Uridashi markets and the swap market that now forms the basis for New Zealand's most ubiquitous financial

[25] See generally Simon Tyler "The New Zealand Corporate Bond Market" (BIS Papers, No 26, 2005).
[26] "Deepening Financial Markets" (*OECD Economic Surveys*), Paris, April 2007, pg 79 at pg 80. New Zealand's domestic corporate bond market is less than 5% of GDP compared with an OECD average of 39% (2005 figures).

instrument — the fixed rate mortgage. This market has had a recent resurgence to hit a new peak of almost $60 billion, a fact which has attracted international attention.[27]

The New Zealand corporate bond market at its inception was, and still remains, very undiversified by sector. Domestic issuance is dominated by financial, utilities and primary goods companies, which make up more than three-quarters of the market. This feature of the market amplifies the importance of international issuance, in terms of supplying much-needed diversification and credit quality.[28]

Liquidity is also a perennial concern in New Zealand, which has only a small and shallow secondary market for corporate bonds. There are a number of reasons for this, including the small stock of issuance, the fact that many issues are wholesale and thus restricted in distribution, the lack of clear benchmarks on which to base pricing, the persistence of paper based trading for securities that are neither listed nor held in Austraclear New Zealand, and the small institutional dealer pool.

Forms of issuance

The primary classification of the debt issuance is based on tenor, constituting the money market for terms of up to one year and the bond or medium term note market for longer terms. The commercial paper market has been particularly affected by the credit crunch, particularly in terms of conduit issuance.

The term debt capital markets break down into two basic components: the retail market (listed and unlisted) and the wholesale medium term note market. Another way to categorise the market is into investment grade issuers (primarily the banks and utilities) and sub-investment grade (of whom the most regular and prominent are debentures issued by finance companies, a market that has proved extremely problematic in recent times). The New Zealand listed debt market (NZDX) currently has a market capitalisation of $12.5 billion.[29]

Most New Zealand corporate investment grade issuance is conducted in the offshore — particularly the US private placement and Euro MTN markets — and in the domestic wholesale medium term note markets. It is therefore unavailable, at least on a direct basis, to local retail investors.

Against this context, international securities offerings offer a significant opportunity for a number of reasons. First, they will invariably be undertaken by an investment grade name as there would be no prospect of clearing an offering for an issuer who is both unfamiliar and of uncertain credit. Second, in order to make offering in this jurisdiction worthwhile, the tranches offered are likely to be of a size that gives scope for a liquid secondary market to develop, particularly where the securities are listed. Third, they offer at least geographic, if not sectoral, diversity.

Regulatory capital offerings

A major development in New Zealand in the past year has been the tapping of this market by international banks for their Tier 1 capital raisings. In a sense these too are "Kauri" issues but they are sometimes treated separately, as Kauri bond issuance is

[27] Peter Garnham, Gillian Tett and David Turner "Carried Away? Why the yen borrowing game could end in players taking a tumble" (*Financial Times*) London, 15 February 2008.
[28] See generally "Deepening Financial Markets" (*OECD Economic Surveys*), Paris, April 2007, pg 79.
[29] A further level of categorisation would carve out the asset-backed markets (particularly RMBS and ABS) and the structured product market, including CDO and capital guaranteed products. The former have been a significant part of the wholesale market and the latter have comprised a comparatively substantial part of the retail market. These are outside the scope of this paper, as is the money market.

often viewed as involving senior-ranking fixed or floating rate debt securities with a fixed maturity.

This market was initiated by Rabobank Nederland in a deal led by Credit Suisse, and locally by First NZ Capital and ASB Securities. This listed deal exceeded all expectations, being more than two-times over-subscribed and breaking local records for a corporate bond issue of this sort.

The Rabobank Nederland deal was followed closely by a similar Tier 1 offering by Crédit Agricole. Although on the surface these transactions were similar, Crédit Agricole did not enjoy the benefit of the class exemption notice for registered banks in New Zealand so its offering exposed more of the intricacies of New Zealand's securities laws.

In similar vein but in a wholesale context, IAG undertook a regulatory offering under the capital adequacy rules applying in Australia to insurance companies (and which soon may be required of such companies in New Zealand).

Wholesale issuance

From a legal and operational perspective, wholesale offers in New Zealand are very straightforward. There is no stamp duty in New Zealand, nor are there any foreign exchange restrictions. In the great majority of cases, there are no regulatory consents or filings required.[30]

Where the offer is made only into the wholesale market or to investor under a $500,000 minimum subscription, legal compliance is restricted to not being misleading or deceptive. There are no positive disclosure obligations nor any general market expectation for a formal and specific information memorandum. Freedom of contract is respected, leaving issuers and arrangers to frame their transaction and offering documents as they see fit.

The disadvantages of a wholesale issue are the liquidity limitations and the fact that the issuer foregoes the opportunity to widely publicise its offering.

Until recently, all Kauri bonds had been wholesale offers, available only to institutional investors or to subscribers for at least $500,000 of bonds. This changed with the World Bank retail Kauri bond offer launched in June of this year, which is described later in this paper.

RETAIL ISSUES — CORE REQUIREMENTS AND MARKET NORMS

Opting for a retail issue

The advantages of a retail issue, of course, are in opening up the liquidity of the issue. This factor may become increasingly significant in current market conditions, where wholesale spreads have blown out considerably and liquidity has become a highly sought after feature of interest rate securities.

The liquidity advantages have a price in terms of higher upfront and ongoing costs. The primary cost differential between wholesale and legal offerings come in the form of audit, registry and trustee fees, printing and public marketing costs, and the increased legal

[30] For issuers with the word "bank" (or derivations thereof) in their names, consideration would need to be given to the restrictions on the use of such term contained in section 64 of the Reserve Bank of New Zealand Act 1989. The regulators, however, have typically had no objection to the use of the word "bank" in a name in wholesale or one-off transactions.

costs that the additional documentation and due diligence for a public issue require. It also exposes the issuer and any "promoter" of the issue to potential liabilities for breach of securities laws, the management of which is primarily the responsibility of issuer's counsel.

Core legal requirements for a retail offer

In the absence of an exemption, an offer of debt securities to the public in New Zealand can only be made under the following documentation in terms of the applicable securities legislation (primarily the Securities Act 1978 and the Securities Regulations 1983):

- **Investment Statement**: An Investment Statement must be provided to each investor before they invest. An Investment Statement is similar to a prospectus but is aimed at providing key information in a way understandable to the prudent but non-expert investor. It is a combined marketing and legal compliance document in the sense that it must contain specified disclosures (but no detailed financial information, MD&A and the like) but the issuer generally speaking is not restricted in how it is formatted or what additional information it contains.

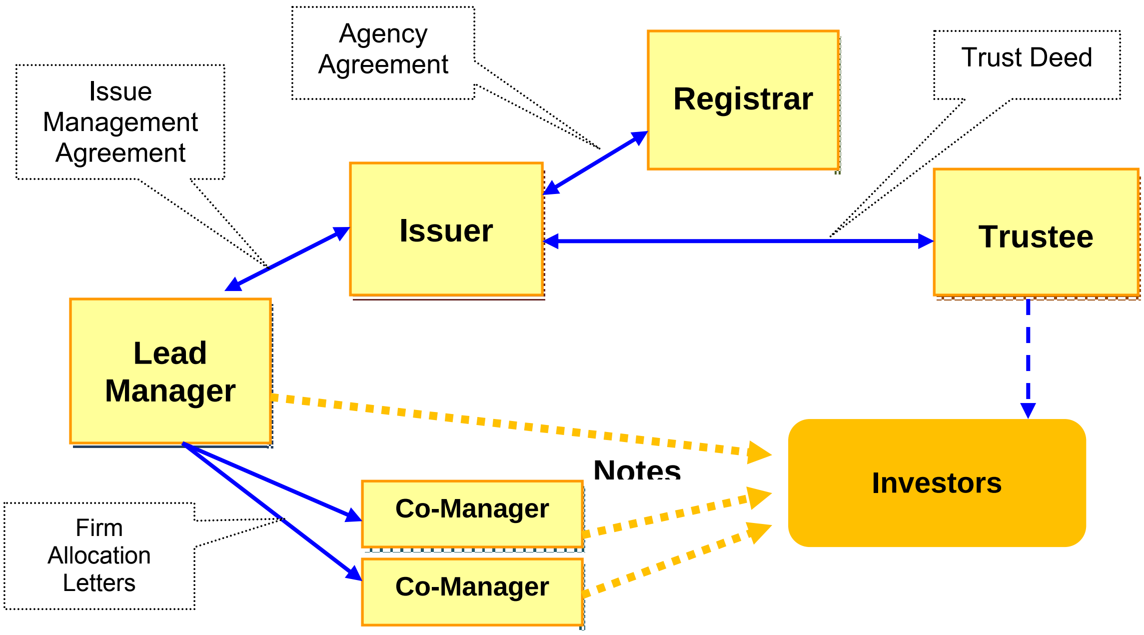
- **Prospectus**: A prospectus must be publicly registered with the Registrar of Companies but need not be provided to investors unless they request it. This document (unlike the Investment Statement) contains or incorporates by reference financial statements of the issuer and is also generally seen as containing more detailed and technical disclosures.

- **Trustee**: A statutory trustee must be appointed, whose primary role is to monitor the issuer's ability to comply with its obligations. It must be one of the authorised trustee companies in New Zealand.

- **Trust Deed**: A trust deed must be signed by the issuer and the trustee and a copy of it must be registered with the Registrar of Companies. This document is a combination of the normal constitutive document for the securities (usually a deed poll in wholesale issues) and a document setting out the rights and obligations of the statutory trustee.

In addition to these statutory requirements, contractual arrangements will need to be made for the distribution of the bonds and paying and registry functions in relation to them (unless these can be performed by the issuer). The following diagram sets out the relevant parties and documents in almost any retail transaction.

Fig. 1 - Transaction documents and parties for a retail transaction



Distribution arrangements for retail issues

The distribution arrangements for retail bonds depends on the relevant sector of the market. For example, finance company debentures tend to be distributed on a tap basis via retail brokers and financial advisers. Listed issues, on the other hand, require the formal appointment of an Organising Participant to coordinate the issue and take responsibility for compliance with Listing Rules.

Beyond that, the New Zealand market is relatively unusual in lacking a systematic set of market norms and documentation for underwriting and distribution arrangements. This is by contrast, for example, to the U.S. securities market, which has a standard Agreement Among Underwriters entered into by the dealer group by way of a confirmation telex and an only slightly less Underwriting Agreement entered into with the issuer. Similarly, in the Euromarkets the distribution arrangements are recorded in standard form terms or subscription agreements included in the programme documentation and increasingly the offer itself is (at least in theory) conducted according to formally documented operating procedures.

In New Zealand, commonly one or more lead managers will be mandated to undertake the issue under an engagement letter, providing for the basic terms of the offering, scope of the engagement, exclusivity and clear market undertakings, arrangement fees and brokerage, undertakings and indemnities.

In the lead-up to the launch of the offer, the lead manager(s) will conduct a book-build that will normally involve a road show to institutional investors and other financial intermediaries. This process customarily will lead to various dealers and brokers entering into firm allocation letters, where they agree to "bid firm" for a specific allocation of the bonds at the agreed pricing. For a sufficiently significant allocation, those intermediaries may be invited to be co-managers of the offering.

Beyond this, market standard documentation in the retail market in relation to either the primary lead manager role or the subsidiary co-manager roles has yet to fully emerge. The various interests of the parties in undertaking a successful issue that complies with applicable laws, and allocating the risks of this not being the case, mean that the market is evolving toward issue management agreements specifying the issuer's and lead/co-managers' respective obligations in relation to the offer, based on their roles in the offering and their responsibilities under the securities laws (as outlined later in this paper). Such documents had been a standard feature of the wholesale debt capital markets and were normally contained in a "dealer agreement".

Underwriting in the New Zealand corporate bond market exhibits unusual characteristics as it is ordinarily on a "best endeavours" basis — that is, it is not a true underwriting in the sense that the dealers agree to purchase a specific allocation of bonds and take the risk of their on-sale. This contrasts to major overseas markets where the dealer panel will acquire bonds from the issuer and will then make their arrangements with investors. This distinction, however, can sometimes be more apparent than real, as the "true" underwriting agreements customarily have detailed conditions precedent (including company and market MAC clauses) and the New Zealand "best endeavours" underwritings are often seen by arrangers as a morally binding commitment.

Similarly, there is rarely any explicit obligation in relation to later support of an issue. It is usually expected of lead managers, however, that they will maintain a two-way market in securities for which they arranged the primary issuance and will otherwise facilitate a secondary market. Failure to do so can be a factor against dealers in pitching for future primary issuance. This is particularly important for unlisted securities, for which there is a unlikely to be a regularly published market price or benchmark and paper-based trading is still the norm.

REGULATORY REQUIREMENTS FOR RETAIL ISSUES

Content of investment Statements

Where an investment statement is required under the Act (which will be the case in respect of debt securities unless an exemption applies or is obtained), the investor must receive a copy of the investment statement before subscribing for the security. If an investor does not receive a copy of the investment statement, the allotment is voidable at the instance of the investor. The investment statement does not have to be registered or to be updated or renewed provided its contents have not become misleading as a result of adverse circumstances prior to allotment.

The detailed requirements in respect of the content of investment statements are set out in Schedule 3D to the Securities Regulations. Apart from those requirements, there are no limits on the content of advertisements provided that the investment statement is not likely to deceive, mislead or confuse potential investors. Accordingly, in general terms, the issuer is entitled to use the investment statement as a marketing document with whatever content and in whatever style it chooses.

The directors of the issuer are not required to sign the Investment Statement itself, but must sign a certificate which confirms that the advertisement is not likely to deceive, mislead or confuse prior to the advertisement being distributed to the public.

Requirements in relation to prospectuses

A prospectus needs to be prepared which gives certain details about the issuer and has the issuer's audited financial statements included in or attached to it, but does not need to be given to investors unless they ask for it. Therefore, to reduce costs, it may be just a "word-processed" document, rather than a marketing document.

The Securities Regulations contain rules about the financial statements to be included or referred to in a prospectus which, as discussed below, can provide particular headaches for international issuers.

There are also rules as to how much time can lapse after the date to which those financial statements were prepared. Specifically, securities cannot be offered if the date of allotment would be more than 9 months after the date of the statement of financial position or interim statement of financial position contained or referred to in the prospectus. If the issue is being kept open or further securities are being issued under it, is it also possible to extend the life of the prospectus by a further nine months by registering of a director's certificate containing certain representations and accompanied by interim accounts.

Thus the prospectus effectively has to be rolled over at 9 month intervals, with new accounts prepared. This will need to be considered well in advance and taking account of the time taken to prepare the offering and distribute the securities. For example, if it seems that the issuer might run close counting back to the audited annual financial statements, then it will be necessary to engage the auditors to perform an audit of the interim financial statements. As noted above, however, this only applies during the period that securities are being offered. There is no need to update the prospectus merely because securities are outstanding.

Unlike the investment statement, the prospectus needs to be signed by directors of the issuer and any promoters and registered at the Companies Office.

Other certifications

A certificate, known as a Reg 17 certificate, must be prepared and signed by at least two directors of the issuer for all advertisements (which includes the investment statement but not the prospectus), but need not be registered or delivered to any person. This certificate states that the relevant offer documents comply with law and are not likely to mislead, deceive or confuse. A similar certificate must be completed for each advertisement released in relation to the offer (including oral presentations).

Audit and financial information requirements

Unless the issuer has the benefit of an exemption from the requirement for a prospectus altogether, it is important to engage audit assistance at the outset of the offering process. If financial statements are required to be included or incorporated by reference in the prospectus, then there will need to an audit sign-off that all the requirements of the relevant schedule to the Securities Regulations are met. Time will need to be set aside for this, as this is more than a simple sign-off as to compliance with generally accepted accounting practice, which is International Financial Reporting Standards (IFRS) since its adoption by New Zealand from 1 January 2007.

After an overseas company issues securities to the public in New Zealand, it will be required to register its audited annual financial statements in New Zealand under the Financial Reporting Act 1993, which contains New Zealand's financial reporting requirements.

The financial requirements in the Securities Regulations are quite specific and are not restricted to IFRS even where it is possible to incorporate by reference financial statements that are required to be registered under the Financial Reporting Act. Most relevantly, in the case of debt securities, the auditors will need to attest to compliance with clauses 16 to 32 of Schedule 2 to the Securities Regulations. At a general level, these requirements should not yield any difficulties. They call for inclusion of the standard suite of financial statements, being statements of financial position (balance sheet), financial performance (P&L), cash flows, and movements in equity.

The devil, regrettably, is in the detail. For instance, a number of international issuers could have problems with requirements of the following sort: liabilities and assets must be presented as current and non-current; fixed assets on the balance sheet need to be classified into land, buildings, machinery and other fixed assets and include details of valuations and depreciation; a detailed maturity profile is needed for issuers whose monetary assets exceed two-thirds of their total tangible assets; and the equity method of accounting may not be used in respect of any amounts.

Overall, the requirements yield an impression of being frozen in time and contemplating productive enterprises that would have predominated in New Zealand at the time the regulations were conceived, more than 20 years ago. They certainly do not contemplate modern multinational financial institutions with predominantly financial assets and whose balance sheet can, in the case of Crédit Agricole for example, exceed €1 trillion. Nor do they incorporate full flexibility for changes in accounting standards either in general or as applied by the auditors in relation to a particular entity or class of entities.

This is not an issue at all for those entities which have an exemption from the prospectus requirements, notably registered banks. This was the case with the offer made by Rabobank Nederland but not with that of Crédit Agricole. In the case of the latter, it was therefore necessary to obtain an exemption from the relevant requirements of the regulations, subject to the conditions that Crédit Agricole's audited financial statements published in France accompany the prospectus and contain a description of the differences between IFRS as applied in France and as applied in New Zealand. It is reasonably likely that similarly placed issuers would need to consider obtaining similar exemptions for offerings in the New Zealand market.

Other administrative requirements

Aside from the above requirements, the Securities Act also imposes various administrative obligations on issuers including:

- keeping and maintaining of registers of securities;
- opening registers for inspection;
- keeping proper accounting records;
- issuing certificates evidencing securities;
- having accounts audited at least annually by a "qualified auditor";
- sending documents and other information prescribed by regulation to security holders; and
- sending a copy of the registered prospectus, financial statements, and other information to security holders or prospective investors on request.

The majority of these requirements should present no real difficulties for international issuers because matters relating to the securities register and making documents and information available may be delegated to the New Zealand registrar and paying agent for the securities. This is not to say that the provisions of the Securities Act with respect to the maintenance of accounting records make any sense. In view of that all entities which issue securities to the public thereby become subject to the requirements of the

Financial Reporting Act, they have no proper place in the Securities Act and should be repealed.[31]

Two requirements of this little-explored part of the Securities Act that could be problematical for international issuers, however, are the stipulations that:

- The accounting records be "kept either in written form in the English language or so as to enable the accounting records to be readily accessible and readily convertible into written form in the English language" (section 53B) and that they are kept at the registered office of the issuer, provided that, under section 53A(2):

  > The accounting records may be kept at a place outside New Zealand only if there is sent to, and kept at a place in, New Zealand such documents in respect of the business dealt with in those accounting records as will disclose with reasonable accuracy the financial position of that business at intervals not exceeding 6 months and will enable to be prepared the financial statements of the issuer or scheme, and any document annexed to any of those documents giving information that is required by any enactment.

- The financial statements of the issuer are audited at least annually by a "qualified auditor" (section 53E).

Recalling that the "accounting records" as defined in section 53 include all invoices issued for goods or services, this would pose substantial difficulties if it were applied at face value. For all enterprises of greater sophistication than the corner dairy, however, the relevant accounting records will be maintained electronically and backed up under relevant business continuity and document retention policies. Are these records taken to be "at the place" where the relevant server is housed? Surely not.

Of more meaningful difficulty is the requirement for a "qualified auditor". In any sensible world that would be a person qualified by applicable GAAP to audit the accounts of a public issuer. However, this is not yet such a world, and the requirements essentially are for a New Zealand chartered accountant or another person specifically authorised in this capacity by the Securities Commission. Since this is matter properly regulated under the Financial Reporting Act, to which all public issuers are automatically subject and which (by recent innovation) has exemption provisions specifically relevant to international enterprises, this requirement should be repealed. Until it is, however, international issuers will need to obtain an exemption under the Securities Act in addition to that they will likely seek under the Financial Reporting Act.

UNDERTAKING AN OFFERING

Regulatory approval process

In New Zealand, the Securities Act requires the prospectus for an offer to be registered with the Companies Office, but not the investment statement, unless combined with the prospectus. In practice, this means that the prospectus should be pre-vetted by the staff of the Registrar of Companies, whose focus tends to be on technical compliance issues, particularly around the detailed requirements of the relevant schedules to the Securities Regulations. Following the approval of the prospectus it must then be signed by all of the

[31] For example, the "accounting records" as defined in section 53 include all invoices relating to either goods or services and must be kept at the registered office of the issuer and retained for at least 7 years. There is no conceivable justification for such a requirement.

directors of the issuer, and all of the directors of any promoter, and delivered to the Companies Office for registration.

For listed issues, the NZX Listing Rules require both the draft investment statement and prospectus, and all other advertisements to be used in connection with the offer, to be reviewed by NZX staff before distribution. The offer documents must be submitted to NZX in draft form for approval at least 10 business days before the they are intended to be circulated, executed or printing is intended to commence. The NZX approval is also a standard condition of the Companies Office before they will accept the prospectus for registration.

The actual registration process can take some time, but the document in normal circumstances is treated as having been registered from the date of submission. This is the effective date which brings an end to the pre-offering "quiet period" and allows the marketing of the offer to commence.

Project management and anticipation of regulatory roadblocks

Timing is important to capital markets offerings anywhere and particularly so in New Zealand conditions, where supply and demand factors in terms of redemptions and competing offers can make the difference between the success or failure of an issue. In addition, the coupon that can be offered will be sensitive to movements in the swap rate and, for international issuers, the basis swap.

For wholesale offers, this is both less significant, because of the different investor base, and easier to manage. Retail offers, on the other hand, have many more moving parts; particularly where the issuer needs to complete a prospectus and comply with related financial schedules (ie does not have an exemption from this requirement, such as that applicable to registered banks). In addition, there are aspects of the process over which neither the issuer nor the arranger will have complete control. These include:

- **Regulatory approvals**: As discussed above, this process should be manageable so long as no unexpected issues arise. The key, then, is to identify at an early stage any matter that could present issues for the Registrar of Companies in relation to the prospectus or related signing and submission requirements and, for listed issues, for NZX in relation to any of the offering documents.

- **Exemptions and waivers**: Attention needs to be given at the earliest possible stage to any exemptions from the Securities Act and Financial Reporting Act and (for listed issues) any waivers of the NZX Listing Rules that may be required. Some of these matters are routine, for example the technical waivers that invariably must be given to customary minimum subscription amounts as transfer restrictions for the purposes of the Listing Rules. Others may not be so obvious, particularly for the circumstances of an issue or an issuer that is new in the market.

- **Preparation of audited financial statements**. Because of the "life of prospectus" rules in section 37A of the Securities Act, it is important to be aware of any significant deadlines in terms of the age of the accounts and whether, for example, an audit of interim financial statements may need to be planned for.

As a result of these factors as well as the general due diligence requirements in relation to all offering materials, project management of a securities offering assumes great importance. This is especially important in relation to offerings by international issuers, who cannot be assumed to have any familiarity with local processes and laws. It will therefore be beneficial at an early stage to prepare a detailed week-by-week timetable for the steps that will be required in the lead up to the launch of the offer and then the closing and issuance that will take place after the offering period has concluded.

Signing by directors and its direct relation to liability

Certain documents (prospectus, certificates relating to advertisements and investment statements, listing agreement with New Zealand's main stock exchange, NZX) are required to be signed by the directors of an issuer. These requirements, which are generally viewed as appropriate for New Zealand companies (i.e., relatively small with a high degree of director involvement by international standards) may cause difficulty where top level governors of an issuer are not accustomed to, or may not have the ability to, sign such documents, this being left largely to the executive management. This may especially be the case where governors reside in different cities or countries. This issue may have to be addressed through an exemptions from the New Zealand regulators (Securities Commission, Companies Office and NZX).

A more conceptual aspect of this issue is that the individual accountability and liability aspects of New Zealand's securities law regime are triggered by the relevant person (being directors of the issuer and any promoter and any person making statements as an "expert" in the offering documents) signing the prospectus. This tends to focus the attention of senior governors of large corporations on these matters, even if the risk is more theoretical than real in the light of the degree of due diligence and scrutiny that takes place in producing compliant offering documents. This contrasts to the situation obtaining in, for example, the United Kingdom and the United States, where directorial liability is a feature of the securities laws but is not directly tied to the signing of any document and is also subject to certain formal defence mechanisms that has led to well understood legal and due diligence requirements (such as the provision of "10b-5 opinions" and comfort letters).

ROLES AND RESPONSIBILITIES OF THE VARIOUS PARTICIPANTS

A wholesale issue is straightforward in terms of participants, generally involving only the issuer and relevant lead manager(s), and their counsel. By contrast, retail issues involve the coordination of a large team with various roles and responsibilities, typically including some or all of the following:

- **Issuer**: The issuer is ultimately responsible for all aspects of the offering, because it is the only person who will not have any defence at all under the liability provisions of the Securities Act if there is a breach and will most directly suffer any resultant reputational consequences. It therefore bears the responsibility, but it is the nature of the offering process that much of the implementation will be carried out by other people (most notably in the distribution of the securities). Accordingly, the issuer will generally wish to bind the dealers and other relevant parties to enforceable agreements related to compliance with applicable laws and will also wish to closely manage all aspects of the due diligence and compliance process, particularly in view of the potential directorial liability if this is not managed properly.

- **Intermediaries**: For a significant securities offering there will normally be an investment bank appointed as lead managers (one or more of whom may also be anointed as arrangers — although there is not much practical relevance to the particular terminology). They will be closely involved in the preparation of offering documents in particular and in managing the book build / price discovery process and ultimately the distribution of the bonds, although the latter will likely also involve other intermediaries with wide retail distribution capacity. There may also be one or more co-managers appointed to the offer, although this may not occur until during the book build as it may be based on the level of bonds at which relevant institutions are prepared to bid firm.

- **Trustee**: Unless an exemption is available (as for example is the case for registered banks) the Securities Act requires a qualified trustee company to be appointed under a trust deed if the offer of the bonds is made to members of the public. The trustee represents the interests of the bondholders and allows the issuer to deal with one person on behalf of the bondholders. Its main role is in the negotiation of the trust instrument, in particular to provide for the reporting obligations that will enable it to fulfil its role, and which recently have been augmented by statute in relation to finance companies.[32] The trustee is also required to provide a statement for inclusion in the prospectus pursuant to clause 13(3) of the Second Schedule to the Securities Regulations confirming that the offer complies with relevant provisions of the Trust Deed.

- **Registrar**: Most issuers will wish to appoint a registrar and paying agent in relation to the relevant securities. Due to the way the offering process is conducted in New Zealand, this person will likely have a key part to play in the implementation of the offering process and in allotting the securities. Specifically, it is normally the case that applications will be sent by individual subscribers, or by brokers on their behalf, to the Agent, who will then need to bank the subscription cheques into a trust account (as required by section 36A of the Securities Act). The Agent will also be responsible for organising the applications into those stamped by brokers and clean-skins, for the purpose of calculating any brokerage that is payable. Following the closing of the offer, the Agent may need to organise the payment of any "early bird interest" that is payable following close or on the first interest payment date. Thereafter they will be responsible for all payments and fiscal requirements, including withholding of resident and non-resident withholding taxes, conducting transfers, sending information to investors, and otherwise administering the offering.

- **Auditors**: The role of auditors will be significant if there is no exemption from the prospectus requirements. Aside from practical questions of producing relevant audited financial statements, clause 36 of the Second Schedule to the Securities Regulations requires an opinion from qualified auditors that the financial statements contained or referred to in the prospectus comply with clauses 16 to 32 of the Second Schedule, that amounts used in the 5-year summary financial table are correctly taken from audited accounts of the issuer and that the statement about the ranking of the securities under clause 12 of the Second Schedule similarly is correctly taken from audited accounts of the issuer. These matters all require a specific engagement in addition to the normal audit duties performed in respect of the company.

- **Lawyers**: The issuer, lead managers and trustee are all likely to be represented by legal counsel. The key role is assigned to the issuer's counsel, which generally will draft the offering documents and will be responsible for the issuer's compliance with all the various requirements (including signing of Reg 17 certificates and other documents). They will also need to coordinate the meeting of the registration requirements in relation to the prospectus under section 41 and 42 of the Securities Act, which is not always straightforward. In international offerings, the issuer is also likely to be represented by counsel in its home jurisdiction and/or in the place where its programme is listed.

Each of these parties (other than the lawyers and (other than through their engagement letter) the auditors) is likely to be tied contractually to the issuer by various documents:

[32] Securities Amendment Regulations 2007.

the trust deed in the case of the trustee, an issue management agreement and/or co-managers' appointment letters in the case of the various intermediaries, and an agency agreement with the registrar. These comprise the primary transaction documents for an offering, that need to be prepared in addition to the offering documents. Where the issue is listed, there is substantial additional documentation that needs to be agreed with NZX, including the Listing Agreement.

Arranger's and dealers' liability in relation to retail offerings

The appointed dealers or joint lead managers on a transaction will have the most immediate connection with subscribers and generally will have responsibility (implicit or explicit) to ensure that investors receive a copy of the investment statement before investing. The question of the extent of their responsibilities under or stemming from the Securities Act will depend on:

(a) whether or not the arranger in particular (and its directors) is a "promoter" of the securities (discussed below);

(b) the contractual obligations and indemnities it may have assumed under any Issue Management or Dealer Agreement entered into with the issuer;

(c) to the extent investment advice is being provided (which will not be the case if the lead managers and dealers are merely transmitting information received from the issuer), disclosure statements will need to be provided under Part 4 of the Securities Markets Act 1988;

(d) potential responsibility in tort to investors (eg for negligence or misrepresentation), eg in relation to the suitability of the product for the particular investor;

(e) in certain specific circumstances, whether they could be construed as an "expert" making statements.

That aside, in general the obligations in the Securities Act apply only to the issuer of the securities, that is, the person on whose behalf any money paid in consideration of the allotment of the securities is received.

Promoters and their liability

A promoter is defined in the Securities Act as a person who is instrumental in the formulation of a plan or programme pursuant to which securities are offered to the public, and includes directors of that person, but excludes persons who act solely in a professional capacity.

This creates a particular issue in the case of offerings by international issuers because the unfamiliarity of those issuers with this market increases their reliance on arrangers in structuring and implementing an issue. As against this, they will generally be sophisticated institutions who are often continuously issuing in various jurisdictions around the world.

For offerings by international issuers or otherwise, an issue that therefore needs to be managed by arrangers of retail securities offerings in New Zealand is to avoid being seen as so influential in the offer process or structuring as to be a "promoter". If that is the case, both the arranger itself and its directors will be required to sign the prospectus and will be liable for its contents. Although the considerations around this issue can be complex, particularly in relation to structured securities offerings that may be proprietary to the arranger, for most securities offerings the arranger will be viewed as acting solely in a professional capacity in relation to the offering, which will disqualify the arranger from any possibility of being a promoter.[33]

Beyond this, the main compliance issues for the arranger and dealers to manage relate to ensuring that all advertising material or information of any sort in relation to the offering is appropriately vetted and formally signed off by the issuer through the Reg 17 certificate previously described and that traders stick to the script in relation to the offering document disclosures. The reason (as discussed further below) is that the issuer is exposed to civil and criminal liability on such communications.

REGULATION OF INFORMATION FLOWS IN A RETAIL CONTEXT

One of the core issues in any retail offer in New Zealand is that the flow of information is a heavily regulated matter — indeed, this is the *raison d'être* of New Zealand's disclosure-based securities laws. The two main guiding principles (subject to exceptions and other details discussed below) are that:

- communication about an offering cannot begin before the prospectus is registered; and
- thereafter, all marketing is to be driven through the investment statement, which must be received by all investors, and through authorised advertisements[34].

There will always be a tension between the desire of the lead manager(s) to publicise the offer as early and as widely as possible, in order to determine basic issue parameters of offering size and margin-setting, and the need to manage securities law risk on behalf of the issuer (and, by statutory or contractual extension, the offeror).

The issues in this regard fall into two main categories:

- **Pre-prospectus publicity**: What can be said, and to whom, before the official marketing period commences (following the registration of the prospectus, if there is one).
- **Control of advertisements**: What materials can be distributed or otherwise communicated to investors during the offering period and meeting of the various (and comparatively stringent) regulatory requirements in relation to these.

QUIET PERIODS AND PRE-PROSPECTUS PUBLICITY

When can marketing commence?

Where a prospectus is required for an offering, the position is straightforward. You can commence marketing (using the investment statement and authorised advertisements) when the prospectus in the form agreed with the Companies Office and including the agreed and sign-off attachments is submitted to the Companies Office for registration. The prospectus is not actually registered until the certificate of registration is received under section 42(5) of the Securities Act, but this is effectively back-dated to the time of submission. (Section 42(4)(b) of the Act expressly permits the Registrar to register a prospectus that does not comply with the formal requirements in section 41 of the Act if

[33] For structured offerings conducted through an SPV incorporated by the arranger, it (or at least some substantial company in its group) will almost inevitably be a promoter of those offerings.

[34] That is, advertisements , that refer to that investment statement, are consistent with the investment statement and prospectus and meet other detailed rules discussed below.

the Registrar is satisfied that it otherwise complies with all provisions of the Act and is a satisfactory prospectus.)

Where no prospectus is required (for example an issue by a registered bank or one of the overseas companies exemption notices), the marketing can begin when the investment is made available (normally in printed form) and authorised by the issuer for release.

Communication with and involvement of the issuer

The question of how the issuer should be involved in communications depends on the business understanding with the particular issuer. Some wish to defer all matters to the lead managers and others insist on being more hands-on.

Regardless of the issuer's preferences, however, the issuer should be kept closely involved in all matters relating to:

(a) Registration of the prospectus, commencement of the offering and any changes to the offering timetable.

(b) Any advertisements or roadshow materials to be distributed in connection with the offering. Amongst other things, the issuer will be exposed to civil and potentially criminal liability on such communications and will likely need to prepare a Reg 17 certificate for them and (if listed) submit them to NZX for approval.

Permitted communications during the pre-registration "quiet period"

In relation to pre-prospectus publicity, there are two main exceptions on the face of the Securities Act and some argue that a third should be implied. These exceptions (each of which is discussed in more detail below) are:

(a) **"Tombstone" exception under s 5(2CA)**: Advertisements containing **only** certain specified information are exempted under section 5(2CA) of the Securities Act from the prohibition on pre-prospectus publicity. This exception has the advantage that it can be distributed to all clients. The disadvantage is that it is restrictive in terms of information and any information that is given that isn't among the listed types will render it non-compliant.

(b) **"Underwriting" exception under s 3(2)(b)**: An invitation to a person to enter into a bona fide underwriting or sub-underwriting agreement with respect to an offer of securities is not an offer of securities to the public. This is generally interpreted as permitting Lead Managers for an offer to undertake their book-build with institutional intermediaries and brokers.

(c) **Implied "Wholesale investors" exception**: It is argued by some that there is an implied exception from the Securities Act for communications made only with institutional and other wholesale investors (ie communications that, if they were an offer of securities, would be exempted under section 3(2)(a) of the Securities Act).

In summary overall, the Tombstone exception involves narrow information but a wide audience and the Underwriting and Wholesale exceptions involve a narrow audience but wide information.

Tombstone exception (5(2CA))

Generally, the Securities Act prohibits advertising before an investment statement is distributed or prospectus is registered, where the Act requires such registration for an offer of securities. However, there is a limited exception to this under section 5(2CA) of the Securities Act, commonly referred to as the "tombstone" exception. Advertisements made under this must state that:

(a) the issuer is considering making an offer of securities to the public; and

(b) no money is currently being sought and that no applications for securities will be accepted or money received unless the subscriber has received an investment statement.

The advertisement then may state any or all of the information specified under section 5(2CA) (and nothing else). There is reasonable scope for communication under the stated matters, which for example include " a description of the securities intended to be offered" and "the terms of the intended offer", the interest rate, and the date at which the issuer expects that the offer will be made. The quoted paragraphs in particular permit a wider range of information than is sometimes appreciated.

The advertisement may also state that the issuer is seeking preliminary indications of interest and, if so, must state how indications of interest may be made and that no indication of interest will involve an obligation or commitment of any kind.

The advertisement must not contain any other information about the proposed offer and must strictly conform with the above. In particular, we note that no mention may be made of listing of the securities by NZX due to the strict wording requirements of regulation 23 of the Securities Regulations 1983 and there is also no room to mention any rating or indicative rating for the issuer or the securities (unless, for example, the obtaining of a minimum rating is a condition to the offer being made and thus a "term of the offer").

It is important to note that the pre-prospectus publicity is not limited to communications in any particular medium, and can include spoken presentations or audio-visual communications, to the extent such communications are authorised or instigated by, or on behalf of the issuer or prepared with its co-operation. As a result, the Tombstone exception can also be used for phone arounds, so long as the statutory statement is read and the dealer sticks closely to the script.

Bona fide underwriting exception — Book-build process

Section 3(2)(b) of the Securities Act provides that the following shall not constitute an offer of securities to the public:

> An invitation to a person to enter into a bona fide underwriting or sub-underwriting agreement with respect to an offer of securities.

This section provides the basis for Lead Managers in the New Zealand market to undertake their pre-launch book-build activities (including, but not necessarily limited to, the roadshow).

The key issue in applying the section is what is meant by the entry into a bona fide "underwriting or sub-underwriting agreement". It is likely that this concept would include standard firm allocation arrangements, since the intent and effect of those is to bind the relevant broker or dealer to acquire the securities for which it has bid.

Implied wholesale investors exception

Prudence would dictate not going beyond the explicit pre-prospectus exceptions discussed above. The implied wholesale investors exception, if it truly exists, is more difficult to rely on because it results from an interpretation of the Securities Act that not necessarily all even knowledgeable securities law advisers would agree with, whereas the other exceptions are clearly available on the face of the Act.

Caution about use of the exceptions in unison

The final point is that the various exceptions cannot be seen in isolation, as there is potential for an exception of one sort to taint the application of another. In this regard, section 2A(6) of the Securities Act provides:

> Where—
>
> (a) An advertisement within the meaning of this section appears in association with another advertisement that is not an advertisement within the meaning of this section; and
>
> (b) Both advertisements are authorised or instigated by, or on behalf of, the same person or prepared with the co-operation of, or by arrangement with, the same person,—
>
> those advertisements are deemed to be a single advertisement within the meaning of this section.

In particular, there can be a fundamental inconsistency between invoking the tombstone exception and the underwriting (or the wholesale) exceptions at the same time, particularly to an audience that might crossover (ie where it is possible that members of the wholesale audience may have clients who would receive the tombstone ads). The issue is that the natural tendency in such cases would be for the retail clients to make inquiries of the wholesale independent financial advisers, and (even in spite of confidentiality undertakings) the latter may be tempted to share information from the wholesale presentation. Any information imparted in this fashion would mean that communications have been made to retail investors outside the bounds of section 5(2CA) of the Securities Act. As a result, there would then be a non-complying offering of securities to the public, in addition to a breach of the advertising rules.

The key point is that there can be no leakage of any wholesale information to retail investors or any framework which would encourage or enable the same.

CONTROL OF THE CONTENT AND DISTRIBUTION OF ADVERTISEMENTS

One of the most difficult issues to manage in relation to a retail offering of debt securities relates to the controls tight imposed on all forms of communications in relation to the offering and the resultant compliance procedures that need to be implemented.

The Securities Regulations continue the historic antipathy of New Zealand regulators toward public advertising of securities by imposing a number of requirements that go well beyond the need not to mislead and by requiring formal issuer sign-off in the form of a "Reg 17" certificate.

It is an area that, because of the breadth of the definition of "advertisement", can lead to frustration on the lead manager and others responsible for marketing the bonds. Equally, because of the severe consequences potentially attached to non-compliance (including civil and criminal penalties and directorial liability) it is an area where there is no reasonable alternative to applying a cautious and meticulous approach. In practical terms this is exacerbated because advertisements are "low hanging fruit" when it comes to enforcement, as by nature they are in the public domain and readily accessible. As a result the Securities Commission can, and does, review them, with what appears to be a fine tooth comb.

Another factor that needs to be stressed is that the Commission is entitled to, and does, look beyond the detailed words of the advertisement to its overall impact in determining whether it may be unbalanced or otherwise misleading. In this connection, section 55 of the Securities Act defines "untrue" for the purposes of the liability sections in a way that indicates that provides some justification for this approach. Specifically, section 55 of the Securities Act provides that a statement included in an advertisement or registered prospectus is deemed to be untrue if—

> (i) It is misleading **in the form and context in which it is included**; or
>
> (ii) It is misleading by reason of the omission of a particular which is material to the statement **in the form and context in which it is included**. (Emphasis added.)

Meaning of advertisement

Section 2A(1) of the Securities Act defines "advertisement" as follows:

> In this Act, unless the context otherwise requires, advertisement means a form of communication—
>
> (a) That—
>
> (i) Contains or refers to an offer of securities to the public for subscription; **or**
>
> (ii) Is reasonably likely to induce persons to subscribe for securities of an issuer, being securities to which the communication relates and that have been, or are to be, offered to the public for subscription; and
>
> (b) That is authorised or instigated by, or on behalf of, the issuer of the securities or prepared with the co-operation of, or by arrangement with, the issuer of the securities; and
>
> (c) That is to be, or has been, distributed to a person.

This is a very inclusive definition that goes well beyond the notion of an advertisement as used in common parlance. It covers all forms of communication and extends to anything that "encourages the acceptance of an offer".[35] This would include audiovisual advertisements and oral presentations. The issuer's website, if it refers to an offer, will also be an advertisement for the purposes of the Securities Act.[36]

The Securities Act provides a list of things that are not advertisements. These are:

[35] Refer *Securities Commission Bulletin* No.2, 1 May 1984.
[36] Refer Securities Commission News Release, 29 May 2001.

(a) A registered prospectus;

(b) A statement made to or for the purposes of a general meeting of the members of the issuer, or a report of such a meeting;

(c) A statement relating to the affairs of the issuer made to any stock exchange for the purpose of complying with the listing requirements of that stock exchange;

(d) A disclosure statement published by a registered bank (under section 81 of the Reserve Bank of New Zealand Act 1989).

When a lead manager or arranger make communications in relation to an offering, it is highly likely that the issuer will need to prepare a Reg 17 certificate for them and (if listed) submit them to NZX for approval. The Issuer will also be exposed to civil and potentially criminal liability on such communications. As a result, it is crucial to ensure that all communication in relation to a public offering is tightly managed and subject to appropriate due diligence and legal compliance checks.

Issues commonly arising from the regulatory restrictions

The nature of the restrictions on advertisements contained in the Securities Act and, in particular, in Parts 2 and 3 of the Securities Regulations is such that, as suggested above, there is little alternative to implementing a compliance procedure which involves every published communication relating to the offer to be scrutinised against the relevant rules (preferably by way of a detailed checklist).

Among the issues in relation to advertisements from these requirements, the following tend to crop up regularly:

- **Investment statement**: It is mandatory in all advertisements (other than the investment statement itself) to refer to the investment statement (section 38 of the Securities Act).

- **Guarantees**: If an advertisement states or implies securities are guaranteed, advertisement must state nature and amount of guarantee; name of guarantor; and whether or not guarantee secured and if so, nature and extent of security (Reg 11).

- **Assets**: An advertisement must not state any persons assets without also stating their liabilities (Reg 13).

- **Ranking**: An advertisement may not refer to debt securities without stating they are unsecured or nature and ranking of security if they are (Reg 14).

- **Shareholders**: An advertisement must not state that a person is a shareholder of the issuer without also stating whether or not the securities are guaranteed by that person (which then invokes Reg 11) (Reg 18).

- **Safety**: An advertisement must not state that the investment is safe or free from risk (Reg 20). (This particularly rankles with ad executives and marketing departments who appear to share an almost irresistible urge to insist that their securities are "as safe (or safer) than houses".)

- **Interest rates**: An advertisement cannot refer to the interest rates unless it also states the minimum amount of securities that have to be held (ie the minimum subscription amount), and minimum periods for which securities to be held (which would be the relevant interest payment dates), to earn the interest rate (Reg 21(1)).

- **Impact of tax**: An advertisement cannot state a rate of interest adjusted for taxation or otherwise refer to taxation of interest; but it can contain a statement regarding tax advantages if there is a full description of those in prospectus (Reg 21(2)). This is particularly relevant in the current context of the PIE regime.

- **Listing**: There cannot be any mention at all of listing other than the relevant prescribed "Reg 23" statement (Reg 23).

The above requirements will often result in sub-optimal changes having to be made to the wording of advertisements and/or the inclusion of fine print statements of seeming insignificance. It is important, of course, also to ensure that the marketing message does not get lost in the compliance process.

Issuer sign-off — when a Regulation 17 certificate is required

Regulation 17 provides that no advertisement may be distributed unless a certificate that complies with the Regulation has been signed by at least directors of the issuer. The general rule is that all advertisements must have a Regulation 17 certificate prepared for them, however Regulation 17(3) states that a certificate is not required if the advertisement contains no information other than the following matters (which are similar to the matters permitted to be disclosed under the "tombstone" exception referred to previously):

(a) name and contact details;

(b) description of securities and terms;

(c) rates of interest that may be earned;

(d) matters specified in Regulation 11 (guarantees), Regulation 14 (secured and unsecured securities), Regulation 21 (interest rates);

(e) names of principal stockbroker and underwriters;

(f) description of fees and charges payable to the subscriber; and

(g) a statement that an investment statement has been prepared and is available.

Every certificate must be held by the issuer for at least 12 months from the date of the last distribution of any advertisement to which it relates. Failure to comply with this is an offence under the Securities Act. If the advertisement is distributed without a complying certificate the party that distributed the advertisement will be committing an offence. The issuer (including its directors and principal officers) of the securities that the advertisement relates to will also be committing an offence. Any party committing such offence may be liable on summary conviction for a fine of up to $5,000.

Consequences of non-compliance with the advertising provisions

Section 38(b) of the Securities Act deals with the prohibition of advertisements. Under section 38(b)(1), the Securities Commission may order the prohibition of distribution of an advertisement or of any other advertisement which relates to the same offer of securities if the Securities Commission believes that the advertisement:

(a) is likely to deceive, mislead or confuse with regard to any particular that is material to the offer of securities; or

(b) is inconsistent with any registered prospectus referred to in it; or

(c) does not comply with the Securities Act or the Regulations.

It is an offence to ignore such an order made by the Securities Commission under section 38(b) and the party committing the offence may be liable on summary conviction for a fine of up to $5,000.

Section 56 deals with civil liability from the statements in an advertisement. Where an advertisement contains a statement that is untrue and someone suffers loss or damage as a result, the directors of the issuer and the promoter of the securities may be liable for such a loss. The aggrieved party must prove that the untrue statement induced them to subscribe and that the subsequent loss was related to that statement. However, section 56(3) provides a defence if the directors of the issuer or the promoter believed on reasonable grounds that the statement made was true.

Section 58 deals with criminal liability for misstatements in an advertisement or distributing an advertisement that does not comply with the Securities Act or Regulations. Again, where an advertisement includes any untrue statement or is non-compliant and is distributed, every director of the issuer commits an offence. Under section 58(5) every person who commits an offence under the section may be liable for

(a) on conviction on indictment to -

(i) imprisonment for up to five years; or

(ii) a fine up to $300,000;

(b) on summary conviction to -

(i) imprisonment for a term not exceeding three months; or

(ii) a fine not exceeding $300,000.

However, similar to the civil liability section, each director of the issuer has a defence if they can prove that they believed on reasonable grounds that the statement was true, or that the contravention was immaterial.

SOME LESSONS FROM RECENT INTERNATIONAL RETAIL OFFERS

Rabobank Nederland Capital Securities offer

The Rabobank Nederland was launched in September 2007. It was an offer of Capital Securities qualifying as Tier 1 capital for the issuer in the Netherlands. The offer raised $900 million, making it the largest unwrapped corporate bond issue in New Zealand.

Rabobank Nederland is a registered bank in New Zealand so had the benefit of the exemption under section 5(2C) of the Securities Act applicable to debt securities issued by registered banks. This is particularly advantageous in a retail offering where a substantial part of the compliance costs come from the requirement to produce a prospectus.

The governing law of the Capital Securities was the law of the Netherlands, which (like New Zealand law) recognises registered, book entry only securities. As such the terms and conditions for the Notes could simply be included within the Investment Statement (no trust deed being required as a result of the exemption just mentioned). However, for reasons relating to the regulatory capital treatment of the notes and the need for a "trust deed" under the Listing Rules, the terms and conditions of the Notes were appended to the Agency Agreement entered into with the New Zealand registrar.

Crédit Agricole Perpetual Deeply Subordinated Notes offer

This was another listed offer of notes counting as Tier 1 regulatory capital for the issuer in its home jurisdiction (France). This offer was launched in November 2007 and raised $250 million.

There were two primary challenges in relation to the Crédit Agricole offering, by contrast to the earlier Rabobank Nederland Capital Securities Offcer. First, Crédit Agricole is not a registered bank in New Zealand so did not enjoy an exception to the requirements for a prospectus and a to appoint an authorised trustee under a trust deed. Secondly, the offering took place against a backdrop of an emerging financial crisis that has since become known as the "credit crunch".

In relation to the New Zealand prospectus requirements, the primary issue that the Crédit Agricole transaction brought out was the inflexible nature of the detailed financial reporting requirements of clauses 16 to 32 of Schedule 2 to the Securities Regulations, as previously mentioned in this paper. This resulted in the need for an exemption from the Securities Commission, subject to the condition of describing the differences between IFRS as applied in the European Union and IFRS as applied in New Zealand. These differences would strike all but the most ardent financial statements reader as somewhat esoteric and it seems at odds with the policy behind the implementation of "international financial reporting standards" that such would be required. At a deeper level, it is not clear in policy terms why there should be any requirements in relation to audited financial statements other than compliance with GAAP and relevant legislation (most notably that the financial statements "give a true and fair view" of the financial performance and position of the issuer).

One of the parameters of the issuer was to undertake the offering as much as possible in accordance with its underlying EMTN programme documentation, in part in order to facilitate obtaining the desired regulatory treatment from the French banking authority. As a result, the Trust Deed entered into was governed by English law.

World Bank retail Kauri bond offer

Until recently, all "vanilla" Kauri bonds had been issued only into the wholesale market. This changed with the launch on 23 June 2008 of the International Bank for Reconstruction and Development (World Bank) retail medium term note offer.

This offer was facilitated by exemptions obtained from the Securities and Financial Reporting Acts. The Securities Act (World Bank) Exemption Notice 2007 permitted the World Bank to offer debt securities under its global debt issuance facility to New Zealand retail investors under an investment statement, but without a prospectus or New Zealand trustee (that is, it is substantively similar to the exemption for registered banks). The conditions for the exemption included that the World Bank would make available to New Zealand investors its most recent prospectus for its global programme and the most recent Information Statement that it prepares annually in accordance with its charter.

The policy reasons underlying the exemption included the very high credit quality of the World Bank (which has maintained a AAA rating continuously since 1959), the fact that

New Zealand is a member of the organisation, and the high quality of the information that the World Bank regularly publishes about its operations and financial condition.

The World Bank also obtained an exemption from the requirements of the Financial Reporting Act on the condition that it submit audited annual financial statements in accordance with US GAAP.

Some general observations

Offerings from international issuers, whether Kauri bond issues or retail issues, throw up a number of challenges and issues in addition to those for a purely domestic offering. These include:

- **Time differences**: In so far as debt capital markets issuance is concerned, New Zealand is alone on its latitude, so there will always be a time difference to factor in, both when putting deals together and when administering them (particularly by way of making payments on issue, interest payment dates and maturity). In many cases (notably Europe), there will be no business day cross-over at all and there are two days per week when it is a business day in one place and not in the other. This all gives rise to a new concept of the working day / week, particularly for the legal advisers.

- **Legal documentation**: The legal documentation for securities offerings around the world has developed a much more standardised framework for bond offerings than is apparent in New Zealand. It will often be expected by issuers, and in particular their home jurisdiction counsel, that documentation of this nature will be entered into in a substantially consistent manner wherever they offer securities. This will sometimes create problems in New Zealand either because market norms are different (for example in relation to distribution arrangements, closing conditions or due diligence requirements) or because institutional and legal forms differ (eg the legal form of notes).

- **Unfamiliar laws**: In an international offering, it is never safe to assume that local laws will be familiar to the international counterparties and their counsel. There is a great deal more educating that therefore needs to take place about basic regulatory and compliance requirements. It is also important for New Zealand counsel to be alert to local requirements that could cause difficulties for overseas entities, such as requirements as to signing and audit related matters.

- **Institutional differences**: New Zealand lacks a custodial sector dominated by large banks and trust institutions such as Bank of New York, Citibank and JPMorgan Chase. Instead, there are only local registry institutions, of whom Computershare Investor Services Limited has undertaken the registrar and paying agency role in relation to debt capital markets offerings by international issuers. This can lead to issues in terms of approved credit exposures for payment flows and the need to build a framework that can replicate the custodial relations that are a customary part of the Euromarkets.

- **Settlement mechanics**: Because of time zone differences, clearing and settlement of international bond issues cannot take place using customary delivery-versus-payment (DVP) mechanics, which operates to eliminate settlement and credit risk in normal trades conducted via clearing systems. As a result, Kauri bonds transactions need to be subscribed for by means of a funding method referred to as a "MT103" instruction, which is an authenticated and unconditional transfer of funds among international correspondent banks.[37]

- **Clearing systems**: The primary clearing systems for international offerings are Euroclear and Clearstream in the Euromarkets and DTC in the United States and most institutional holdings are through these systems. There is no direct access to Euroclear and Clearstream for issues cleared through Austraclear New Zealand — rather than system operates through a one-way sub-custodial "bridge" system (one way because issues cleared initially through Austraclear can trade through Euroclear and Clearstream, but not vice versa). There is no bridge between Austraclear New Zealand and DTC at all.

- **Form of Note holdings**: Most international offerings will take place using Global Notes, as opposed to the almost universal framework now adopted in New Zealand of issuing book-entry notes under a deed poll. This has implications both in terms of the legal documentation for offers and operational considerations, as physical notes cannot be held within the Austraclear New Zealand System. Other issues that can arise in this regard relate to transfer restrictions applicable in the international capital markets to securities that can be initially sold into the U.S. institutional market (Rule 144A issues) and ones that may be distributed to U.S. persons only after the expiry of a restricted period (Reg S Notes). In practice this invokes some very arcane and technical securities and tax rules (notably the so-called TEFRA rules[38]). Specific procedures need to be undertaken to issue Rule 144A notes in a Kauri format.

- **Culture and expectations**: Since international offerings in New Zealand are by definition done across different markets, they run up against different conventions and expectations in those markets. It therefore becomes important to explain the operational features of this market in a way that would not be expected for a domestic offering. It is also important to maintain a flexibility in undertaking offerings of this type with a view to keeping all sides as happy as the circumstances will allow.

THE EMERGENCE OF KAURI BONDS

Kauri bonds are New Zealand dollar denominated bonds issues by overseas issuers and cleared through Austraclear New Zealand.

The Kauri bond market is new, having started in 2004 with debut issues by Telstra, Morgan Stanley and Merrill Lynch. It has quickly become the largest corporate bond market in New Zealand. It has also proved to be very resilient through the credit crunch — for example, in July and August of 2007, the New Zealand market was one of the very few markets around the world seeing more than a trickle of new deal flow.[39]

New Zealand's debt capital markets in 2007 were dominated by Kauri bond issuance, particularly since July when the Reserve Bank opened up its repo-eligibility window to

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[37] MT103 is a SWIFT message type (hence "MT") and is a format commonly banks use when they effect a wire transfer.
[38] Which rolls off the tongue somewhat better than their real name, being section 1.163-5(c)(2)(i)(D)(3)(i)(C)(iii)(B) of the U.S. Treasury Regulations.
[39] "After the Gold Rush" *Kanga News* (March 2008) pg 6.

supranational, sovereign / semi-governmental and agency issuers (referred to in this market as "SSAs") who meet its criteria.[40]

Against a backdrop of annual issuance typically in the range of $2 - 3 billion, in 2007 there was total debt capital market issuance of $10.8 billion, of which $6.3 billion comprised Kauri bond issuance and, in all, more than three-quarters was from international issuers. To date 2008 the New Zealand market has seen a further $6.2 billion of issuance, dominated by financial institutions (59%) and Kauri bonds (35%), with local authority issues making up the remainder.[41]

In addition to the four issuers who had initiated the Kauri bond market from 2004, in the past year fifteen new issuers have tapped this market and many others have made enhancements to their Australian or Euro MTN programmes to facilitate this.

There have been four significant developments recently in the Kauri bond market:

- First, it has proved possible to undertake Kauri issues from the full range of major international bond programmes — EMTN, Australian MTN (AMTN) and Global Programmes — and the initial bias in favour of AMTNs because of execution preference resulting from the book entry clearing framework shared by Australia and New Zealand has subsided. The question of which programme to use is now almost always straightforwardly one of issuer preference.

- Second, once an issuer has undertaken its debut issue, execution of subsequent trades is something that can be done with relative ease and with as little as a few working days turnaround.

- Third, of particular importance to generating a sound international investor base, an issue by Queensland Treasury Corporation laid the groundwork for initial issuance into the United States institutional market through Rule 144A issuance, cleared through Euroclear and Clearstream Luxembourg, via the bridge operating with Austraclear New Zealand.

- Fourth, the market has had its debut retail issue, with the $100 million World Bank medium term notes launched on 23 June 2008 (lead manager Westpac Institutional Bank with ANZ National Bank and Bank of New Zealand as co-managers).

Repo eligibility under the Reserve Bank's liquidity facilities

The most significant breakthrough in the Kauri Bond market came with the announcement by the Reserve Bank on 17 July 2007 that it will accept SSA bonds meeting specified criteria into its Overnight Reverse Repo Facility ("**ORRF**"). This change was part of the Reserve Bank's efforts to reliquefy the banking system, which have resulted in settlement cash in the banking system being increased from $20 million in 2006 to its current level of $7 billion. Although many banks have taken the opportunity to have Kauri bonds in their liquidity books, none have yet used those securities to raise cash.[42]

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40 Both the criteria and the process for obtaining repo-eligibility have proved reasonably straightforward. The criteria are published on the Reserve Bank's website (www.rbnz.govt.nz/finmarkets/liquiditymanagement).

41 The United States bond market, by way of comparison, currently stands at US$30.5 trillion (ref sifma.org). As the New Zealand corporate bond market is less than 5% of GDP compared with an OECD average of 39%, this implies there is plenty of growth potential yet.

42 Reserve Bank *Financial Stability Report* (May 2008), pg 13.

The requirements for this are discretionary, and application must be made for acceptance prior to the securities being lodged in Austraclear New Zealand.[43] The primary criteria are that (in summary):

(a) The issuer and issue have a long term AAA rating from at least two acceptable ratings agencies.

(b) The issuer (other than supranationals) must be domiciled in one of the following jurisdictions: Austria, Australia, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Hong Kong, Hungary, Ireland, Italy, Japan, Luxembourg, Malta, Netherlands, New Zealand, Norway, Singapore, Slovenia, Spain, Sweden, Switzerland, United Kingdom and United States.

(c) The issuer is an institution with which the Reserve Bank has no supervisory conflict (i.e., restricted to supranational, foreign sovereign, “agencies” and semi-government issuers).

(d) The issue is plain vanilla (e.g., a bond with no optionality and not subordinated).

(e) The issue’s pricing convention follows price and yield formulae as used by the Reserve Bank — in particular bonds should have a semi-annual coupon.

(f) The issue must be denominated in New Zealand dollars.

(g) The security is not already on issue in Austraclear.

(h) The issue will be lodged in Austraclear. Eligibility criteria for lodgement into Austraclear include having a suitable New Zealand-based registrar, and a paying agent (not the Reserve Bank) who must be an Austraclear member.

(i) The issue has more than three days to maturity.

Recent changes to the repo eligibility regime

On 7 May 2008 the Reserve Bank announced that it is abandoning its current exposure limits on the amount of SSA securities it will accept for repo purposes. Instead, SSA Kauri bonds are accepted by the Reserve Bank under a graduated haircut regime involving a 3% "haircut" for AAA securities having a maturity of up to 3 years and 5% on longer dated securities. This haircut is a risk margin, whereby securities offered in a repurchase transaction are required to have a market value greater than the cash or other securities supplied. The varies depending on the type of security, its credit quality and tenure.[44]

The removal of the caps is a positive step for a number of SSAs who had already issued to their limit and would otherwise have needed a fresh authorisation to tap this market. In a wider sense, it removes a barrier for the Kauri market to compete with the Eurokiwi market as the preferred format for New Zealand Dollar issuance.

At the same time the Reserve Bank also announced that from 3 June 2008 it will accept domestic bank, local authority and state-owned enterprise securities rated AA- or above (being the New Zealand Government's credit rating outside New Zealand) and from 31 July 2008 will accept New Zealand dollar denominated Residential Mortgage-Backed Securities rated AAA. It is yet to be seen what influence the freeing up of the repo-eligibility rules will have on the Kauri market, although clearly issuers and arrangers

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43 Refer to the guidelines at http://www.rbnz.govt.nz/finmarkets/liquiditymanagement/3067314.html.

44 Reserve Bank *Financial Stability Report* (May 2008) pg 38.

already need to look outside of bank liquidity books for demand. In addition, a similar move by the Reserve Bank of Australia in 2007 had little impact on demand for SSA Kangaroo bonds.[45]

Some of these changes may prove to be a temporary response to the current conditions of strained liquidity and pressure on financial institutions, as the Reserve Bank is to review the new repo-eligibility regime in July 2009.

Benchmarking issues and new indices

New Zealand fund managers have traditionally used a government bond only benchmark, leading to tracking error and under-performance, particularly given the lack of supply and illiquidity in the NZ government bond market.[46] This has led to a search for alternative benchmarks, including a developing trend for using the NZD Swap index, which has the disadvantage that it incorporates credit risk.[47] Partly because of the recent elevated swap spreads and the lack of clarity about their cause, the OECD in its recent economic survey of New Zealand questioned whether the swap market is able to provide a sufficient benchmark yield for the economy as a whole.

This factor is important to the development of the Kauri bond market because the benchmark indices influence the demand for Kauri Bonds among fund managers. The issue is that SSA Kauri Bonds usually offer a significant yield pick up over benchmark government bonds (usually of the order of 70 to 100 basis points) but equally trade through swap (usually by between 15 and 30 basis points).

The surge in SSA issuance has spurred the creation of two new indices, developed by ANZ and NZX. The NZX Kauri Bond Index and the NZX Composite AAA Bond Index (which is a composite of SSA and New Zealand government bonds) were launched on 2 May 2008.[48] As of 30 April 2008, the NZX Kauri Bond Index had a market value of $5.3 billion and the NZX Composite AAA Bond Index had a market value of $31.5 billion.

The development of appropriate indices has been a significant development in both the Canadian Maple and the Australian Kangaroo markets. It is too early to predict what sort of impact it might have on the development of the Kauri bond market.

Incentives for Kauri bond issuers

For the Kauri bond market to succeed, there needs to be willing issuers and willing investors. In relation to the former, ultimately to achieve issuance, local arrangers need to be able to deliver issuance at the issuer's funding targets, which are almost universally on the basis of a margin under USD Libor or Euribor benchmarks. Accordingly, Kauri bond transactions are priced below (or "through" in market parlance) swap and are swapped back into the relevant funding benchmark through basis swaps (as described in the next section of this paper).

The issuers who have chosen to access the Kauri market are in a diverse range. Initially the market was dominated by financial institutions — investment banks, including Merrill Lynch and Morgan Stanley, and overseas banking groups including HBOS, Rabobank, Citigroup and Bank of America. Since the credit crunch and repo eligibility changes (both beginning in July 2007), the predominant issuers have been SSAs, including:

[45] "RBNZ repo changes are positive, triple-As say" *Kanga News* (June 2008) pg 6.
[46] "New Indices are first to include SSA Kauris" *Kanga News* (June 2008) pg 5. See also "Assessing the Indices" *Kanga News* (April 2008), pg 26..
[47] The spread between swap and government bonds widened even prior to the credit crunch to 88 basis points on average in 2006 — refer OECD Economic Survey *Deepening Financial Markets* at pg 86-87.
[48] Refer http://www.nzx.com/markets/nzdx/nzx_debt_indices/nzx_nz_kauri_bond_indices.

- supranational development agencies such as the World Bank, European Investment Bank, Nordic Investment Bank and African Development Bank;

- agency issuers (who undertake borrowing on behalf of municipalities or utilities) such as BNG and Rentenbank; and

- semi-governmental issuers, such as Queensland Treasury Corporation.

SSA issuers typically have very large annual funding targets (eg the World Bank has a target of between US$10-15 billion in each year) and therefore are almost continually issuing in a number of separate markets. For sustainability and liquidity, the larger issuers will endeavour to "build a curve" by having tranches of bonds at differing maturities across the yield curve (which, in the Kauri bond market as it stands means tenors of between 2 and 10 years) as part of their benchmark programmes.

Part of the attraction of a market such as the Kauri bond market is that it expands and diversifies the investment base for the SSA issuers. Although this is not necessarily the case where Kauri bonds are issued to overseas investors, issuers equally recognise that the latter investment base is important to liquidity in the market and its vitality generally. Where issues are done on a retail basis (such as the World Bank issue launched in June of this year) it can also increase the profile of the institution in member country markets.

Investor base for Kauri bonds

The initial investor base for Kauri bonds was focused on bank liquidity managers, as the new repo eligibility rules allowed banks to meet their requirements for holding repo-eligibility securities while getting a significant yield pick-up over New Zealand government bonds. There has also been some uptake from New Zealand fund managers, but demand from such "real money" investors has thus far been constrained by a combination of mandate restrictions, benchmarking issues, and a "wait and see" approach in terms of how liquidity will develop in the market.

In line with the experience in the Kangaroo bond market, a large part of the investor base for Kauri bonds has been drawn from overseas institutional buyers, particularly from central banks and Asian sovereign funds. This is significant because the further development of the Kauri bond market requires a broadening of the investor base to include more investors who have traditionally had an appetite for Eurokiwi issuance (a potentially massive market by comparison to the New Zealand domestic capital market).

LEGAL AND OPERATIONAL CONSIDERATIONS FOR KAURI BOND ISSUES

The Kauri bond market is characterised by a relative ease of execution because issuers can utilise their Global, Euro MTN or Australian MTN programmes with minimal need for specific New Zealand documentation. It has this in common with the Canadian Maple bond market, but in other markets this has not been possible for tax, operational or legal reasons. Notably to access the Kangaroo bond market, issuers typically will have to enter into a full suite of Australian law governed programme documents and prepare an Australian information memorandum.

Initially, the majority of Kauri issues were undertaken pursuant to Australian MTN programmes. The advantages of using such programmes are that Australia and New Zealand have very similar legal documentation and operational processes. Specifically, both jurisdictions employ a fully dematerialised book entry system for both wholesale and retail note offerings. However, an issue that commonly arose with Australian programmes is that they were commonly restricted to issuance in Australian dollars and/or Australian domestic issuance, making them unsuitable for Kauri issuance without amendment. This issue has abated as many SSA issuers have modified their AMTN programmes in the past year to provide explicitly for Kauri bond issuances as part of their routine re-documentation processes.

Alternatively, Euro or Global Medium Term Note Programme documentation can form the basis for a Kauri issue. These programmes are very unlikely to be restricted in terms of currency or territory of issue, but are often subject to operational issues that will need to be worked through depending on the particular documentation. In particular, there may be inflexibility about the form of global notes that must be used in offerings (bearer and not registered), the use of alternative clearing systems or registrars, or operational procedures more generally.

Regardless of whether AMTN, EMTN or Global Programmes are utilised for a Kauri bond issue, the documentation generally consists of the following:

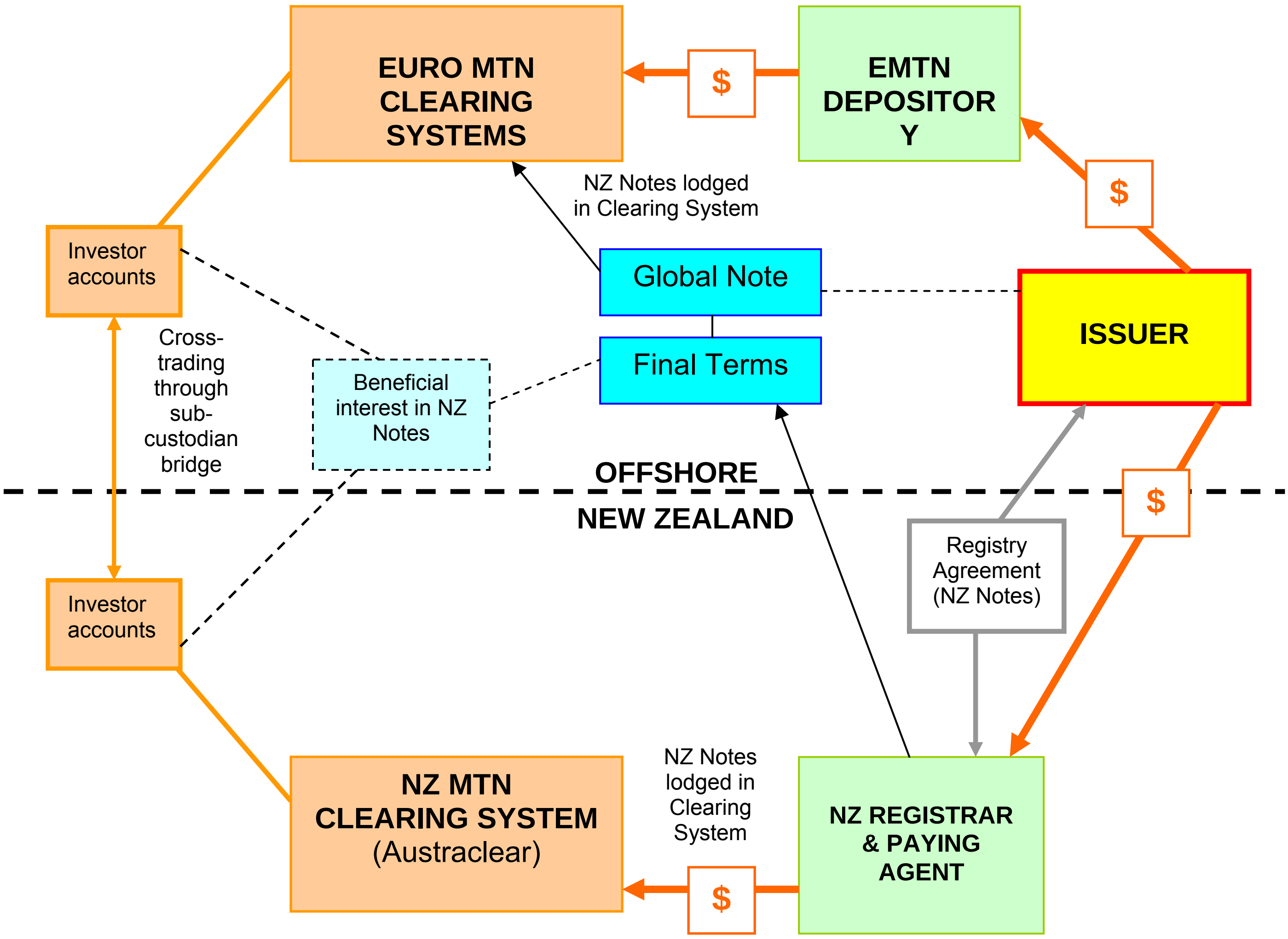
- **Pricing Supplement/Final Terms:** A pricing supplement or final terms document in the customary form, setting out the terms and conditions of the notes by way of supplementing, modifying or replacing the terms and conditions as contained in the underlying deed poll or fiscal agency agreement. This document for a Kauri bond will incorporate a "wrap" by having appended to it amending provisions or supplemental information.

- **Subscription/Terms Agreement or Dealer Accession Letter**. The lead manager(s) for the offering will become dealers-for-a-day under the programme (if they are not already programme dealers) by executing the relevant accession documentation (normally either a Subscription Agreement or a Dealer Accession Letter). The Terms or Subscription Agreement will also provide for the subscription of the bonds at the relevant all-in pricing, conditions precedent and distribution provisions, usually by reference to an underlying Programme or Dealer Agreement.

- **NZ Agency agreement:** The appointment of a New Zealand registrar and paying agent will be undertaken under an agency agreement, which is normally the only document that will be governed by New Zealand law. In addition to providing for normal roles such as keeping the register and making payments, this agreement may also provide for the New Zealand registrar to meet any other requirements in relation to the issue, such as collecting and holding U.S. tax forms, acting as the custodian for any required global note, or making floating rate or other calculations

A deal (in this case based on an EMTN programme) is structured as follows in terms of the relevant clearing arrangements:

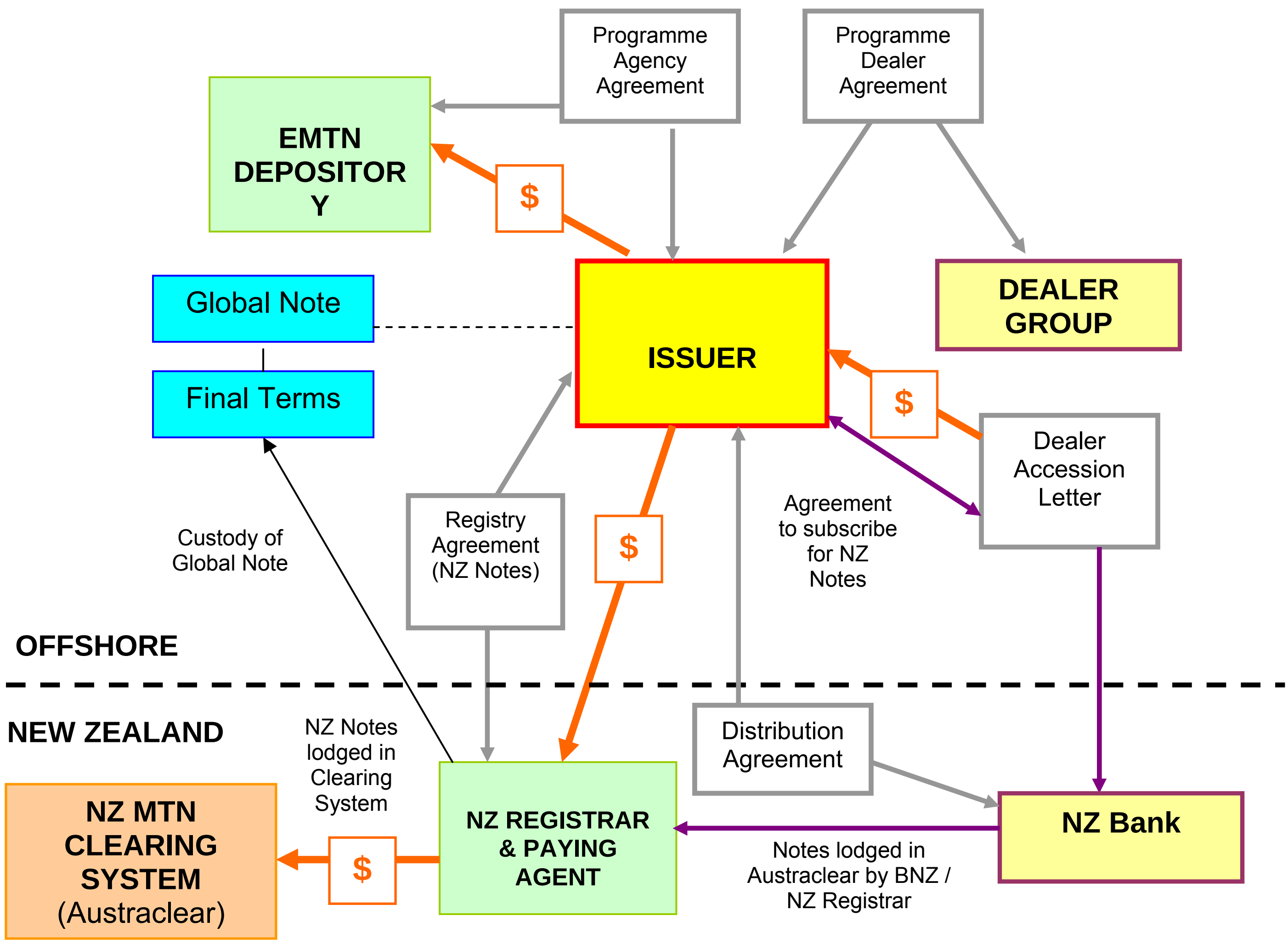
Fig. 2 - Kauri Bond clearing and settlement arrangements



In relation to the respective clearing systems, where bonds are cleared initially through Austraclear New Zealand (which is the case with Kauri bonds but not with Eurokiwis or Uridashis) there is full cross-trading available among the Austraclear, Euroclear and Clearstream systems through the sub-custodian bridge described on the left hand side of the above charts. In these cases, the trading through Euroclear and Clearstream is on the basis of the beneficial interests in the bonds held by the relevant sub-custodians in their Austraclear accounts (ANZ Nominees Limited for Clearstream and HSBC Nominees Limited for Euroclear). While the mechanics of this are quite complex, it appears to be robust, and does allow for normal DVP trading within the respective systems.

In terms of the distribution arrangements for Kauri bonds, these are as follows:

Fig. 3 - Kauri Bond distribution arrangements



Holding and trading of Notes

The usual position in the New Zealand wholesale capital markets is that notes may be held and traded through Austraclear NZ, but are not required to be — that is, the investor has a choice as to whether to hold through its own or a custodian's Austraclear NZ security account or to be recorded directly on the Register for the not (either as principal or through a custodian). This position has also been the starting point for Kauri Bond issues, but has been modified for some issues where it was stipulated that notes must be held within Austraclear NZ.

It is crucial to a Kauri bond issue that the relevant notes upon issue will be "acceptable securities" that are capable of being cleared and settled through the Austraclear NZ System. The policy of the Reserve Bank of New Zealand as operator of the Austraclear New Zealand system is that not all securities will be accepted into the Austraclear New Zealand system — the operator essentially has discretion as to which securities will be accepted as suitable.

The principal criteria considered by the operator are:

- **Registry arrangements:** A register for the Notes must be maintained in New Zealand.

- **Paying agency:** A New Zealand paying agent who is a member of Austraclear New Zealand must be appointed who undertakes to pay the beneficial holders directly in irrevocable funds through the Austraclear New Zealand system.

- **General characteristics:** The characteristics of the security must be able to be accommodated in Austraclear New Zealand. In practice this means that the New Zealand Paying Agent must be satisfied as to the compatibility of the payment mechanics on the Note with the Austraclear New Zealand system.

In common with Australia, the New Zealand capital markets employ a book entry system for both wholesale (including Kauri) and retail bond issues. Austraclear NZ is an electronic system only. It does not cater for the physical custody of, or settlement of transactions involving, paper securities (refer clause 2.1 of the Austraclear New Zealand System Rules). Lodging of securities into Austraclear NZ is effected by transfer of the securities into the name of the depository, New Zealand Central Securities Depository Limited (NZCSD), on the Register. Where there is an EMTN issue with a registered global note, this will be held by the NZ Agent as custodian for NZCSD.

Cross-trading between Austraclear, Euroclear and Clearstream

Where the securities are initially lodged in the Austraclear New Zealand system, it is possible to use the pooling accounts (via Austraclear New Zealand's sub-custodians) to have a New Zealand dollar bond that can trade and settle in both Austraclear NZ and in Euroclear and Clearstream. These trades are conducted DVP in these respective systems among the buying/selling institutional members and the relevant nominee with payments and instructions passing through SWIFT or other payment systems on an overnight basis because of the time zone differences.

There is no bridge between Austraclear NZ and the United States Depository Trust Corporation (DTC). Where Bonds are to be issued into the U.S. market under Rule 144A, these will be held through Euroclear or Clearstream by the relevant investors.

THE WIDER CONTEXT OF NEW ZEALAND DOLLAR DEBT ISSUANCE

The New Zealand domestic debt capital markets comprise only a small part of New Zealand dollar issuance. The New Zealand currency is one of the most widely issued and widely swapped currencies around the globe.

Such offshore New Zealand dollar issuance (which is often referred to collectively as the "Eurokiwi" market)[49] can be broken down more specifically by reference to the capital market into which it is issued:

- **Global Kiwi** (for bonds that are issued off U.S.-based global debt facilities providing for offering in more than one market and capable of clearance through the Depository Trust Corporation (DTC);

- **Uridashi** (and more rarely, Samurai[50]) bonds which are foreign-denominated bonds issued into the Japanese retail market; and

[49] Which is accurate since the "euro" epithet used accurately does not relate to securities issued in Europe but to any issuance of currency outside its home jurisdiction.
[50] Samurai bonds are also foreign-denominated bonds offered to Japanese retail investors but they have higher administrative costs as a result of a continuous disclosure regime and the fact that all documents

- **Eurokiwi**, which are issued into the Euro MTN market and cleared through Euroclear and Clearstream, Luxembourg.

The Kauri bond, in effect, complements or competes with these forms of issuance.

The other major New Zealand dollar market is the New Zealand government bond market, which performs an important benchmarking role in relation to other issues. The next section of this paper briefly describes these markets and the economic influence that shape (and are shaped by) them.

New Zealand government bond Market

As at 31 May 2008, there were $26.3 billion of New Zealand government bonds on issue, of which around $20 billion is available to the market.[51] However, this amount considerably overstates the amounts available to New Zealand fund managers and other local investors, as more than 70% of government bonds are currently held offshore and rarely traded.[52]

In order to create transparency and an orderly market, the New Zealand Government announces its bond programme annually in advance at the time of the Budget, and the bonds are then issued in periodic tenders organised into benchmark maturities in order to enhance liquidity. Thus, on 22 May 2008 the New Zealand Debt Management Office (NZDMO), which manages the government bond programme, announced that it intends to issue up to $3.4 billion of bonds in 2008/09, an amount which falls short of covering maturities for that period — a continuation of the gradual shrinkage of the government bond market that has been the product of consistent fiscal surpluses in recent years.

The NZDMO endeavours to maintain a relatively even maturity profile across the yield curve, but maturities and issuance of government bonds can still be lumpy. For example, on 15 July 2008 $3.8 billion of New Zealand government bonds matures, accounting for almost 15% of total government debt.

There have been persistent criticisms of the illiquidity of the New Zealand government bond market and its resulting impact on both price and benchmarking for fixed interest managers. This is despite the fact that average monthly turnover is nearly three times the amount of bonds on issue, of which around four-fifths comprises repo transactions.[53] The NZDMO has recognised this and responded by announcing in May 2008 that it will attempt to address this in part by introducing tap and reverse tap tenders. However, there is no current prospect of this market being increased to any meaningful extent (indeed, as mentioned above, it is continuing to shrink). In addition to that, daily turnover in New Zealand government bonds has been in steep decline since 2006.

Eurokiwi and Uridashi markets

As noted above, Eurokiwis are defined most broadly as New Zealand dollar bonds issued (in general) by non-New Zealand borrowers to investors offshore. In this regard, a Kauri bond offer is exactly the same, with the key distinguishing feature that it is cleared initially through the Austraclear New Zealand system.

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need to be translated into Japanese. This market has had something of a comeback recently with Westpac, ANZ and NAB undertaking issues in 2008 for a total of ¥303 billion (around A$3.3 billion).

[51] $3 billion were within the Earthquake Commission and $4.3 billion were held by the Reserve Bank (including bonds on repo as part of the Bank's liquidity management).

[52] The amount of New Zealand government bonds held offshore has fluctuated in recent times between 20% and 70% depending on economic conditions, including the level and direction of the exchange rate.

[53] John Farrell "Facing Challenges to Bond Market Development - Lessons from the New Zealand Experience" (2005) Asian Development Bank Institute.

Because it is impractical for New Zealand households to borrow offshore directly[54] and there is insufficient local saving to fund the mortgage market domestically, the Eurokiwi and Uridashi markets essentially provide an intermediation channel through which offshore investors can access the high yields available in the New Zealand market and domestic borrowers can obtain New Zealand dollar funding.[55]

Eurokiwi and Uridashi issuance fluctuates markedly in its levels from year to year. It is driven by three main factors, being the yield differential, currency level and direction, and swap spreads. Issuance is currently at very high levels, with the New Zealand dollar accounting for half of all new Uridashi issuance since the beginning of the year.[56]

Eurokiwi and Uridashi bonds usually have two- to three-year maturities, and are issued mainly by internationally known overseas institutions (such as the World Bank), and sold to overseas investors, particularly in the Benelux and Japan. At the same time, many New Zealand corporates and banks have found it more efficient to raise funds in the offshore capital markets (mainly in US dollars) — principally because offshore markets can provide greater volumes of longer-term funding than the domestic markets can — and swap these funds back into NZD.

A practical aspect of the arbitrage results from the fact that New Zealand banks (who need New Zealand dollars) have more limited access to the NZD market than do AAA rated supranational issuers such as the World Bank (who generally have little or no "natural" need for New Zealand dollar funding). Accordingly an organisation such as the World Bank can, through the swap market, raise and on-lend New Zealand dollars to a New Zealand bank, which raises and on-lends the currency required by the SSA (usually USD or Euro). As described by Kelly Eckhold:

> What is happening here is that the World Bank and the New Zealand bank each borrow in the market in which they have a **comparative** advantage, and share the net benefit. Even if, as generally will be the case, the New Zealand bank can access US dollars only at a margin above the World Bank's cost of borrowing USDs, so long as this margin is less than the advantage the World Bank enjoys in the offshore NZD market, there exists an opportunity for both to 'gain from trade'. The end result is that each ends up with the currency they need, and at a lower all-up funding cost than if they each borrowed the currencies they require directly.

Essentially the arbitrage results from the fact that the Eurokiwi market allows the issuer to separate currency risk from credit and country risk.[57] As a result, the Eurokiwi and Uridashi issues have provided New Zealand issuers with a cost-effective mechanism for converting (ie swapping, and thus hedging) their overseas borrowings into New Zealand dollars. In effect the New Zealand market has evolved to enable domestic and global participants to exploit their respective niches, which has improved the overall access to capital.

[54] Although this has happened before, for example the Swiss franc loans that enjoyed a brief period of popularity in the 1980s, but ended in disaster for a lot of those borrowers as a result of adverse exchange rate movements. It is currently, also, a popular practice in Hungary, Latvia and Romania.

[55] David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 30.

[56] *Kanga News* (February 2008), pg 26 and Reserve Bank *Financial Stability Report* (May 2008), pg 12.

[57] David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 31.

Backdrop of New Zealand's deficit financing requirements

New Zealand is heavily indebted.[58] The value of what we buy from the world exceeds the value of what we sell to it. As a result, we have run current account deficits extending continuously back to 1973. This shortfall has to be financed somehow and, with the fall-off in the comparatively stable funding channel of foreign direct investment, that collective shortfall is overwhelmingly funded by debt. Since 1998, New Zealand banks have taken on $73 billion in net funding from offshore markets, almost exactly matching the accumulated deficits over the same period. Our cumulative current account deficits and "dis-saving" (the Reserve Bank's term) have resulted in net international liabilities of around 80% of gross domestic product — making New Zealand one of the most indebted nations in the world on that measure.

At around 8% of GDP, New Zealand's current account deficit is also among the highest in the OECD. The public sector has been running a surplus for some years and the excess of investment over savings in the economy reflects the decisions of the private sector to borrow to finance activity or transactions. In particular, it reflects consumption decisions from the household sector and the favourite national pastime with buying and doing up houses. According to a report by the Reserve Bank:[59]

> New Zealand's dependence on international capital (both debt and equity) has increased substantially, to the point that New Zealand is more dependent on net external capital than any other developed country is currently, or probably has been at any time in recent decades. … Households' appetite for debt has been the largest single factor in our increased need for foreign capital – and, with few exceptions, households cannot directly borrow from abroad.

To reduce exposure to exchange rate risk, the Government's net foreign currency debt position was reduced to zero more than a decade ago and has been maintained at that since. Similarly a very high percentage of private sector borrowings are hedged, with the Eurokiwi market providing much of this need.

Between 1990 and 1997, offshore funding doubled, to constitute 30% of total bank borrowing. Foreign borrowing then underwent a further major expansion, reach 50% of total bank borrowing in 2000. New Zealand's reliance on foreign capital is by some margin the greatest among developed countries.[60] The fact that a substantial proportion of local banks' funding is drawn from offshore and in foreign currency, but without exposing banks for exchange rate risk, is a product of financial innovation — particularly the growth of the swap market.

On the investment side of the equation, around 50% of household funds available for investment in New Zealand are held in bank deposits, which is a high percentage by OECD comparisons. For many New Zealanders, the need to consider an investment strategy for their new Kiwisaver schemes will be their first foray into more complex financial assets. This in turn invokes one of the most significant issues facing the New Zealand savings market in general, which is the low level of financial literacy among the New Zealand public. This is a theme which is at the heart of the Government's systematic Review of Financial Products and Providers, although it has comes too late to

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[58] The total value of outstanding mortgages in New Zealand reached $155 billion by December 2007, more than double the level as recently as 2002, and the ratio of household debt to income is now 160%: Bank *Financial Stability Report* (May 2008), pg 16.

[59] Ian Woolford, Michael Reddel and Sean Comber "International Capital Flows, External Debt, and New Zealand Financial Stability" (*Reserve Bank Bulletin*, Vol 64, No.4) pg 4 at pg 6.

[60] Figures as at 2001, Woolford, Reddel and Comber (*Reserve Bank Bulletin*, Vol 64, No.4) pg 4 at pg 12.

save many investors from their disastrous decisions to concentrate their savings on speculative grade debenture issuers.

How the New Zealand dollar debt markets work and why it matters

Regardless of the form that non-government New Zealand dollar debt issuance takes, it will tend to result in the following investment flows and related impacts for the various participants (and, vicariously, the New Zealand householder):[61]

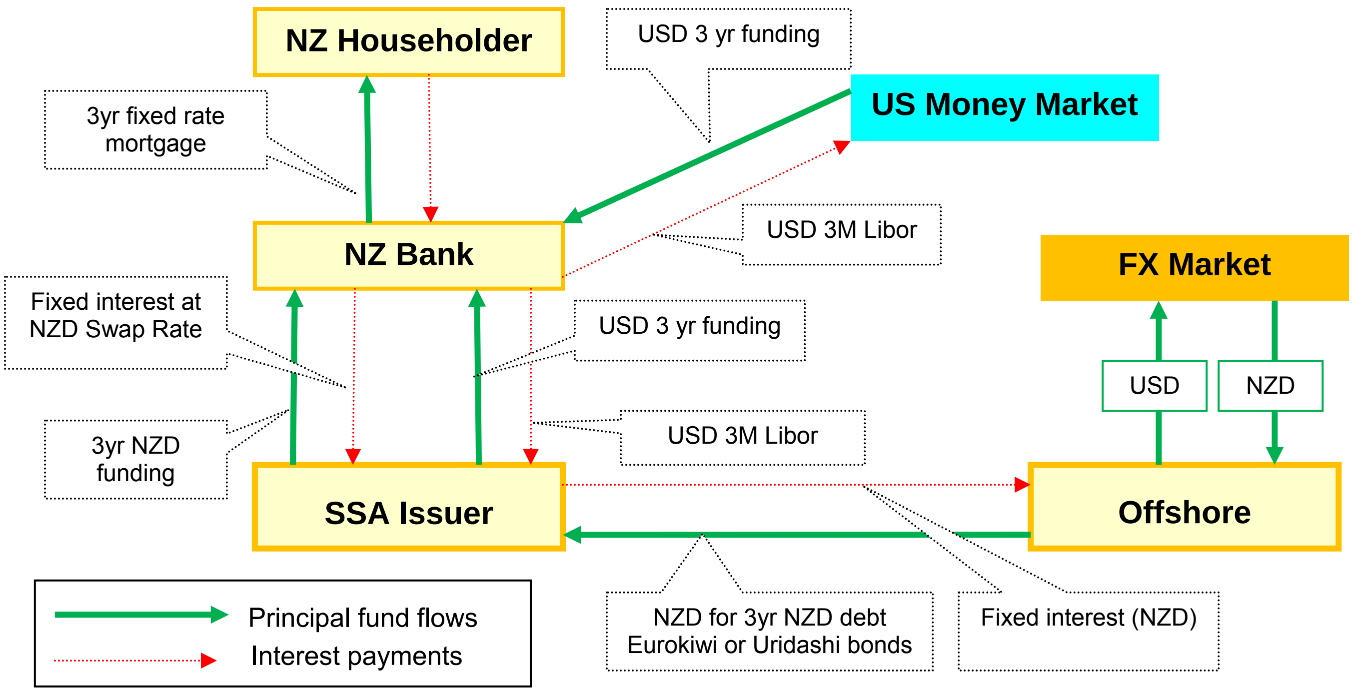
- **NZ Householder** borrows a 3-year fixed rate mortgage from NZ Bank.
- **NZ Bank** borrows NZD at a fixed rate in the interest rate swap market and funds USD in the short term floating rate US inter-bank market.
- **SSA Issuer** issues fixed rate NZD bonds under a Eurokiwi or Uridashi issue and "lends" the NZD to NZ Bank via an interest rate swap in exchange for US dollars or euros at a margin to (or under) 3-month USD Libor or Euribor. The NZD interest rate swap plus the USD floating rate swap is known as a cross-currency swap.
- **Offshore retail investors** (the colloquial Belgian dentists and Japanese housewives), attracted by the NZD yields and strong brand and credit of the SSA Issuer, purchase New Zealand dollars and subscribe for the Eurokiwi or Uridashi securities.

In essence, NZ Bank and SSA Issuer each borrows the currency required by the other and exchange the proceeds through a swap. The swap is a combined interest rate and currency (cross-currency) swap and involves the exchange of both funding and associated interest streams (see Figs 4 and 6).

This activity is normally organised by an international investment bank, which brings the parties together, underwrites the issue and organises the sale of the bonds in the relevant market.

[61] This discussion and the related flow charts draw heavily on an excellent article by Kelly Eckhold of the Financial Markets Depart of the Reserve Bank of New Zealand, "Developments in the Eurokiwi bond market" (*Reserve Bank Bulletin*, Vol 61, No 2), as updated by David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28.

Fig. 4 - Stylised Eurokiwi transaction flows



As a result of all this:

- **NZ Householder** gets a fixed rate mortgage loan at a lower rate than would be possible without the Eurokiwi market.

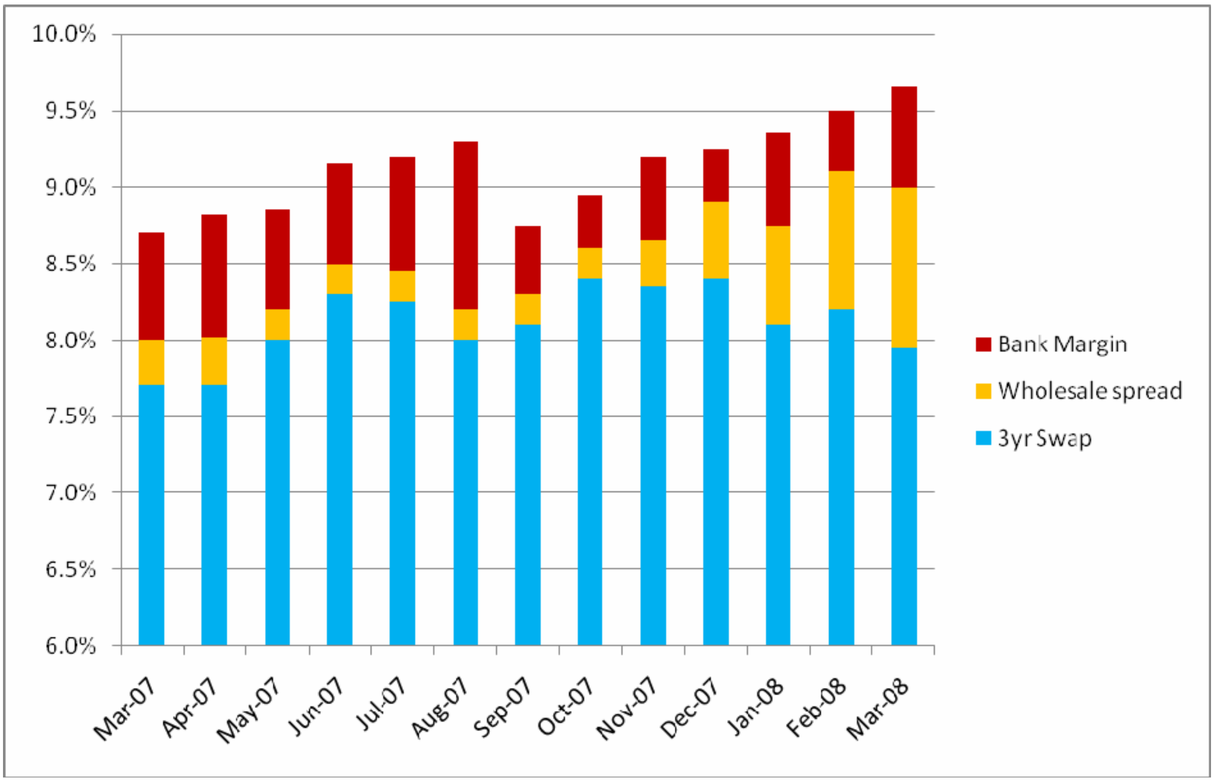
- **NZ Bank** makes a gross margin on the mortgage loan at the difference between its wholesale cost of funds (the swap rate) and the retail mortgage rate. This margin fluctuates according to competitive conditions.

- **SSA Issuer** obtains funding for its development or agency purposes in its preferred currency (USD or Euro) and at its desired cost of funds against the relevant benchmark (eg 3M USD-Libor / Euribor).

- **Offshore retail investors** gets a high-yield low risk investment and in return for this assumes the currency risk (of a depreciation in NZD such that they will obtain a lower return on exchange back into the home currency — of course the opposite is also true: if the NZD appreciates the return will be increased).

One of the prime regulatory consequences of this manner of funding New Zealand's mortgage market is that the Reserve Bank's primary tool for implementing monetary policy — changes in the Overnight Cash Rate or OCR — only have an indirect impact on key borrowing and consumption decisions. In fact, the credit crunch and the resultant blowout in wholesale interest rate spreads has had far more impact for those facing fixed rate resets, as indicated by the chart below.

Fig. 5 - Impact of wholesale interest rate spreads on mortgage rates



One impact that the firm monetary policy stance has had is that the yield curve is sharply inverse so that floating rate mortgages have generally had much higher rates than fixed rate mortgages.

Incentives for offshore investors in investing in New Zealand dollar debt

The high yields on New Zealand dollar denominated assets have made NZD investment very popular with global investors. Both the level of Eurokiwi issuance and of offshore holdings of New Zealand government bonds are closely correlated to the bond yield differential.[62]

There are two elements to the total return that an offshore investor receives from an investment in a Eurokiwi bond held to maturity:

- The yield differential between the Eurokiwi bond and other fixed income investments available to that investor.
- The movement in the value of the New Zealand dollar relative to the investor's home currency between the date of subscription and the maturity date (if the NZD depreciates, this reduces the return, and if it appreciates the total return increases).

The Reserve Bank conducted an analysis of effective returns on Eurokiwi bonds in the period from 1996 to 2005, assuming that investors exchanged Euros for NZD at the spot rate on issue and converted their returns back into Euro on maturity, again at spot.[63] On this basis, NZD/EUR exchange rate movements resulted in considerable volatility of

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62 Drage, Munro and Sleeman at pg 33.
63 David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 34.

returns (-5% to 24%) and the average return of 4.11% was only marginally higher than German bonds for the period. However, the Reserve Bank itself noted that the sample period is brief and their analysis does not take account of the fact that (for example) the investors could have hedged the currency by purchasing NZD at a forward rate. In addition, there are other ways to deal with long positions in depreciated currencies, such as ski holidays and coastal real estate.

Partly as a result of increasing monetary policy divergence, the current differentials between New Zealand and other countries is very significant. For example, the spread between the New Zealand Overnight Cash Rate and the US Fed Funds Rate is the highest it has been since OCR was introduced in 1999.[64] In part it is a product of very strong credit growth (approximately 15% year-on-year), which drives up interest rates directly through demand and supply mechanics and indirectly through putting pressure on inflation which in turn leads to tighter monetary policy.[65]

Of course it is impossible for an offshore investor (or anyone else) to know with certainty at the time of subscription what direction the currency is going to travel in over the term of the relevant bonds. (This may be more easy in other jurisdictions which have a pegged or otherwise managed exchange rate — a factor that encourages participation in the "carry trade".)

Relationship between the swap (wholesale funding) and Eurokiwi markets

The growth in fixed rate mortgage lending thus has given rise to an increased fixed rate NZD funding requirement for the New Zealand banking sector and has fuelled an expansion in the interest rate swaps market (which in essence is a wholesale market for borrowing and lending at fixed rates).

The swap spread provides an indication of the funding advantage of the Eurokiwi market. A widening of these spreads makes offering of Eurokiwi bonds more attractive to issuers because it indicates a wider margin between their cost of borrower (from offshore retail investors) and on-lending, via a cross-currency swap, with a New Zealand bank. From the perspective of investors, a wider margin can also be appealing because it gives rise to a potential increase in the value of the bonds if the swap spreads contract.[66] Accordingly, Eurokiwi, Uridashi and Kauri bond issuance tends to increase as the swap spreads widen.

In addition, the Eurokiwi markets assist the New Zealand banking sector in resolving potential maturity mismatches that could result from the significant demand for fixed rate mortgages (which demand itself is partly a result of the inverse yield curve). By swapping the NZ Bank's short term foreign currency and floating obligations for longer term New Zealand dollar funding and fixed interest rate obligations, the banks are better able to manage interest rate risk.[67]

Basis swaps

Basis swaps are an important factor in Kauri bond issuance because SSA issuers in particular are driven by funding targets such that (as is usually the case) where the basis swap is positive this improves the yield that can be provided to investors while enabling

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[64] Reserve Bank *Financial Stability Report* (May 2008), pg 11.

[65] David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 29-30.

[66] Kelly Eckhold "Developments in the Eurokiwi bond market" (*Reserve Bank Bulletin*, Vol 61, No 2), pg 100 at pg 104; see also David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 30.

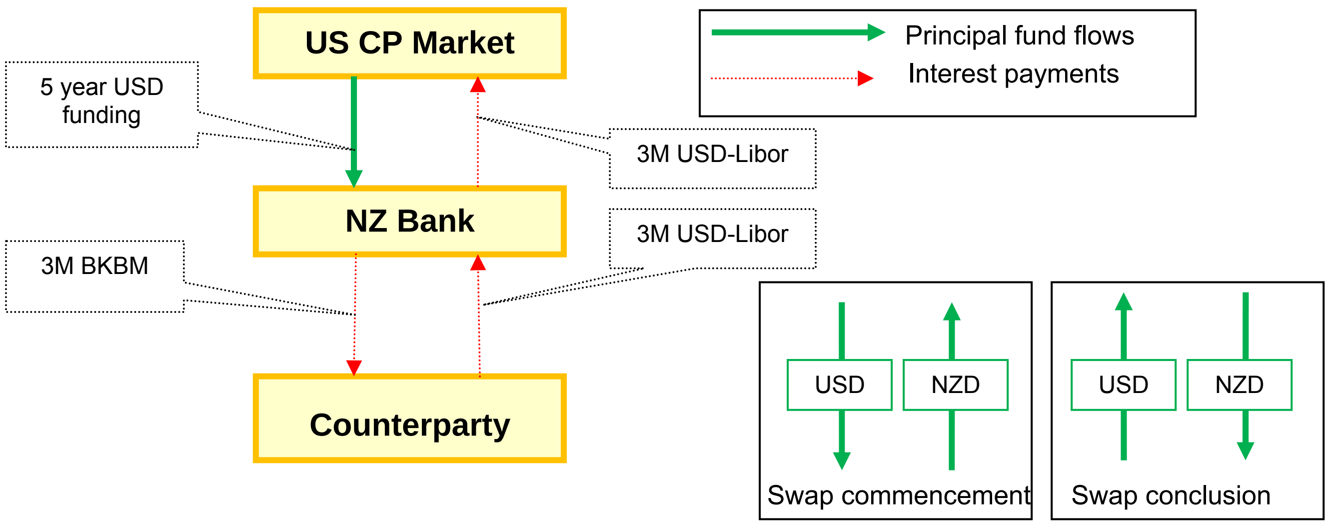
[67] David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 32.

the issuers to meet their USD-Libor or Euribor funding targets. The reason the basis swap is normally positive (typically between around 5 to 8 basis points) is that, particularly in the two to three year part of the curve, the weight of Uridashi, Eurokiwi and Kauri issuance offsets domestic bank and corporate offshore funding.[68]

A basis swap is floating-floating interest rate swap, ie a swap which involves the exchange of two floating rate instruments denominated in the same or different currencies. Essentially this form of basis swap exchanges one reference rate for another.[69] A basis swap is generally entered into in order to limit the interest rate risk that arises from having differing lending and borrowing rates. For example, if a bank lends at a floating rate that is tied to LIBOR but borrows money based on the New Zealand bank bill rate (BKBM), the difference between these borrowing and lending rates (the spread) leads to interest rate risk which can be eliminated by into a BKBM-for-LIBOR basis swap.

In this context, basis swaps are significant in that they facilitate New Zealand banks' avoidance of the exchange rate risk they would otherwise have on their foreign currency liabilities:

Fig. 6 - Basis swap cash flows



Here, NZ Bank is seeking to fund NZD floating assets, for example loans to New Zealand corporate borrowers with interest payable at the prevailing New Zealand bank bill rate. It does this by borrowing term debt in the US or Euro markets at the relevant floating rate prevailing in those markets (3-month USD-Libor in the US example used here or Euribor in the Euromarket). This achieves the required funding and the remainder of the steps in the basis swap involve avoiding foreign exchange and basis risk.

NZ Bank "lends" its US dollars or Euros to the Swap Counterparty by way of an initial exchange of the notional amounts respectively of USD/EUR for NZD at the pre-determined exchange rate. NZ Bank pays 3-month BKBM + the basis swap premium and receives 3-month USD-Libor or Euribor (as applicable). Thus NZ Bank has:

[68] "Watching the Basis Swap" *Kanga News* (April 2008), pg 12.
[69] This is not their only use, for example they can also be used to change exposures to different points on the yield curve (eg swap 3-month USD Libor for 6-month USD Libor).

- swapped the currency of its funding (it receives New Zealand dollars in the initial exchange and pays New Zealand dollars in the final exchange at the pre-agreed exchange rate); and

- swapped the reference rate basis for its funding from USD-Libor / Euribor to BKBM (hence "basis swap"), in order to match the basis for its assets (in the form of loans to New Zealand corporates).

NZ Bank benefits by funding its borrowings without exchange or basis risk and the Swap Counterparty benefits by achieving a higher interest rate than they would otherwise on their New Zealand dollars by virtue of the basis swap premium.

Size of the Eurokiwi market

The amount of annual Eurokiwi issuance varies considerably depending on economic conditions affecting the flow of international capital. Since the market began in the mid-1980s, issuance in any one year can vary from almost nil during trough times (for example 1994 and 1995) to tens of billions.[70] Eurokiwi and Uridashi instruments reached peaks in 1985 to 1987 (peaking at around $10 billion total outstandings), 1996 to 2000 (peaking at around $20 billion total outstandings), and 2004 to 2008 (peaking recently at around $57 billion total outstandings and currently just over $50 billion). In that latter period, Kauri bonds have also come into the mix and, if added to the other international NZD issuance, bring the overall market to $59 billion, almost 500% growth in the six years since the last trough in the market.

This, of course, all makes for some very large maturities coming up over the next five years, for example almost $5 billion in one month alone in 2009, something that has periodically caused consternation in the past but did not in those cases cause any material dislocation in the interest or exchange rate markets.

Economic causes and effects of the Eurokiwi market

The relationship of this market to the housing boom / bubble in New Zealand is dramatic. The total outstanding issuance of New Zealand dollar debt in offshore markets (including Kauri bonds) almost exactly tracks the surge in the New Zealand median house price from the late 1990s to the present, raising interesting questions about cause and effect.[71]

New Zealand dollar issuance internationally is heavily influenced by the high demand for credit in New Zealand, which pushes up interest rates and for the substantial interest rate differential between New Zealand and other countries (especially Europe and Asia, though more recently the United States too as a result of their post-credit crunch monetary policy easing).

Investors in low interest rate markets tend to look for higher yielding investments. This demand for New Zealand dollar debt creates the potential for borrowers to borrow New Zealand dollars more cheaply than if they were constrained to the New Zealand market alone, as the foreign investors effectively expand the supply of New Zealand dollar funding available.[72] There is little "natural" demand for New Zealand dollar assets internationally, so the main reason for continued demand for them is the relatively high yields offered on those assets in comparison to other developed countries.

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[70] Kelly Eckhold "Developments in the Eurokiwi bond market" (*Reserve Bank Bulletin*, Vol 61, No 2).
[71] OECD Survey "Deepening Financial Markets", April 2007, pg 87.
[72] Simon Tyler "The New Zealand Corporate Bond Market" (BIS Papers, No 26, 2005), pg 129 at pg 134, Kelly Eckhold "Developments in the Eurokiwi bond market" (*Reserve Bank Bulletin*, Vol 61, No 2).

This reliance on international capital raises questions about what the impact would be if offshore appetite for NZ dollar investments were to suddenly dissipate — a question that is periodically raised as we approach major maturities in the Eurokiwi and Uridashi markets.

There are a number of reasons in theory that this could occur, including:[73]

- A decline in terms of economic fundamentals (for example as the result of a significant change in monetary or wider economic policy or a sustained recession adversely impacting on the quality of bank assets and corporate balance sheets generally).

- A significant exchange rate depreciation resulting in investors in existing Eurokiwi issues experiencing disappointing returns (this factor has caused a dampening of the market following past periods of NZD depreciation).

- A sharp increase in risk aversion with respect to peripheral indebted countries, particularly those with large current account deficits.

- A reduction in the differential between interest rates in New Zealand and overseas, for example resulting from easing monetary policy in New Zealand at the same time as tightening in other countries (currently the opposite is true).

- A general retreat in cross-border capital flows for whatever reason.

This vulnerability is a matter of concern for New Zealand because of the degree of reliance on international debt capital markets and the relatively sharp increase in that reliance over a short period. However, the experience of the past has demonstrated that the invisible hand is working well as such changes have tended to take place in a measured and orderly fashion, permitting smooth adjustments to the new conditions. The Reserve Bank certainly has not been alarmist on such issues:[74]

> It is perhaps worth stressing that, since capital account liberalisation 17 years ago, the increasingly large external financing requirement has been met remarkably smoothly, and in a series of different forms, through a variety of international crises and changing domestic economic conditions.

In summary, the Reserve Bank notes that this vulnerability highlights the continued need for a stable and transparent macro-economic framework and strong risk management among New Zealand's banking and corporate sectors.

Macro-economic impacts of Eurokiwi issuance

Eurokiwi issuance has macro-economic impacts on New Zealand interest rates, the exchange rate and the current account. In terms of capital flows, Eurokiwi issuance is treated analytically as a hedge rather than as a capital inflow. Thus, offshore bond issues do not increase the current account deficit directly, but they do increase the available supply of credit and let the demand and supply of credit clear at a lower interest rate, implying a higher level of borrowing and spending by New Zealanders than would otherwise be the case.[75]

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[73] Ian Woolford, Michael Reddel and Sean Comber "International Capital Flows, External Debt, and New Zealand Financial Stability" (*Reserve Bank Bulletin*, Vol 64, No.4) pg 4 at pg 15 and Kelly Eckhold (*Reserve Bank Bulletin*, Vol 61, No 2) pg 100 at 109.

[74] Woolford, Reddell and Comber, at pg 14.

[75] Drage, Munro and Sleeman at pg 35.

All other things being equal, a rise in demand for borrowing should require an increase in interest rates to entice investors to supply the marginal credit demand. The existence of the Eurokiwi market operates to reduce overall interest rates on the supply side of the equation by expanding the pool of investors in New Zealand dollar assets. Essentially Eurokiwi and Uridashi issuance are a means of providing an exposure to New Zealand dollars for offshore retail investors who would otherwise have no easy way of doing so.[76] This provides another means for New Zealand banks to hedge their substantial foreign currency borrowings.

Another macro-economic impact of the Eurokiwi market is on exchange rates. Because Eurokiwi and Uridashi issues expand the demand for New Zealand dollars (which the investors have to acquire in order to subscribe for those bonds), this tends to apply upward pressure on the New Zealand exchange rate.[77]

Conventional economic theory suggests that the currencies of economies with large current account deficits should depreciate relative to those of countries with surpluses. However, recent experience has been the exact opposite. For example, despite a current account surplus of 4.9% of GDP, Japan's trade-weighted exchange rate depreciated 13% between 2002 and 2007. In the same period, New Zealand, with a current account deficit of 8% of GDP, experienced a 28% gain in the trade-weighted value of the New Zealand dollar over the same period.[78]

The reasons for this include the "carry trade", where hedge funds and other investors borrow cheaply in Yen (for example) and invest in high-yielding currencies such as the New Zealand dollar, and the continued popularity of Eurokiwis and Uridashis, which involve the purchase of New Zealand dollars. Notably, however, the volume of selling Yen to buy overseas currencies for Uridashi and similar issuance far exceeds the flows relating to the carry trade (¥30 trillion versus ¥10 trillion).[79]

This phenomenon, however, appears to be on the wane, as the carry trade is being unwound and "surplus country" currencies such as the Yen and Swiss franc have been appreciating while deficit country currencies (including the New Zealand dollar) are losing ground. It is difficult to predict whether this will have a dislocative effect, however, as there are a large number of factors in play. In relation to the Uridashi market, for example, Japanese interest rates are still only around half to 1 per cent and, despite the size of the Uridashi market, it represents only about 1% of Japanese financial assets.[80] The current experience is that Uridashi issuance is ongoing even though the carry trade is being unwound and the Yen is appreciating.

EXEMPTIONS — BY CLASS AND ISSUER-SPECIFIC

There is a process under which the Securities Commission can (and regularly does) grant to particular issuers or kinds of issuers exemptions from various aspects of the Securities Act. Exemptions may be of a class nature or may be specific to the issuer.

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[76] Refer Woolford, Reddell and Comber, cited previously.

[77] International trade for goods and services accounts for less than 2% of foreign exchange turnover: Anella Munro "What Drives the New Zealand Dollar" *Reserve Bank Bulletin* Vol 67, No. 2, pg 21 at 22.

[78] "The Domino Effect" *The Economist* 5 July 2008, pg 82. See generally Anella Munro "What Drives the New Zealand Dollar" *Reserve Bank Bulletin* Vol 67, No. 2, pg 21.

[79] Peter Garnham, Gillian Tett and David Turner "Carried Away: Why the Yen Borrowing Game Could End in Players Taking a Tumble" *Financial Times* (London, 15 February 2007).

[80] Peter Alford "Cash-rich Japanese Funds Eying Australia as Investment Destination" *The Australian*, 26 March 2008. Japanese household financial assets currently stand at ¥1,545 trillion, or US$14.7 trillion.

The basis for these exemptions is section 5(5) of the Securities Act, which confers upon the Securities Commission the power to exempt any person or class of persons or any transaction or class of transactions from any provisions of Part 2 of the Securities Act (which contains the substantive disclosure and other obligations for retail securities offerings) or from the Securities Regulations. This power is at the Commission's discretion and may be granted subject to such terms and conditions as it sees fit.

Class exemptions relevant to overseas issuers

Examples of class exemption notices that may be applicable to international securities offerings are the Overseas Companies, Overseas Listed Issues, Australian Issuers and Australian Registered Management Schemes (ARMIS) Exemption Notices. These class exemption notices, however, have requirements or conditions attaching to them that can restrict their application in particular cases. For example, they may be restricted to offers made only to existing holders of listed securities on specified exchanges, or the securities at the relevant time are also open for acceptance in the relevant overseas country.

In addition, Part 5 of the Securities Act provides a statutory basis for "recognition regimes", whereby (where relevant empowering regulations have been promulgated) issuers can offer securities in New Zealand in accordance with the securities laws of their home country. This Part was enacted in 2002 and has been inactive until this year, when regulations were put forward for a debut recognition regime allowing simultaneous New Zealand and Australian offers under Australian offering documents (discussed below under "Trans-Tasman Mutual Recognition Regime").

Specific exemptions

In relation to specific offerings, the requirements in relation to obtaining exemptions are published by the Securities Commission, to whom essentially a case needs to be made that the requested exemption is appropriate. In practice, it is very useful to have a precedent exemption notice from a similar situation that can be adapted. A case will also need to be made for the exemption in policy terms, generally on the basis that compliance would be disproportionately costly for the issuer and that the interests of investors may be served by other means, for example by making available financial or other disclosures from the issuer's home jurisdiction.

For the reasons previously given, exemptions from the requirements for prospectuses and as to audit and other financial requirements are often requested. The following are some of the provisions of Part 2 of the Securities Act and the Securities Regulations which are commonly the subject of exemptions:

- **Section 33(2)**: No debt security can be offered unless a New Zealand trustee has been appointed and a complying trust deed has been entered into and registered.
- **Section 37**: No allotment of a security can be made unless a prospectus has been prepared and registered in relation to the security. (There are also requirements as to minimum subscriptions etc.)
- **Section 37A**: No allotment of a security can be made if the subscriber did not receive an investment statement before subscribing (subsection (1)(a)), the date of allotment restrictions are breached or the total issue exceeds any specified maximum amount.
- **Section 38**: Meaning of authorised investment (generally an investment statement or an advertisement that refers to an investment statement).

- **Sections 51-54**: Miscellaneous obligations of issuers, including in relation to the keeping of a register of securities and proper accounting records and issuing of security certificates.

- **Section 53E**: Requirement for an annual audit of accounts by a "qualified auditor".

- **Section 54B**: Requirements for information that must be disclosed to investors on request.

- **Regulation 17**: Requirements for signing of certificates in relation to advertisements.

Conversely, it is regularly the case that general exemptions will be subject to the continued application of one of more of the following: **section 38B** (relating to misleading advertisements), **section 58** (criminal liability for untrue statements in an advertisement or prospectus), and **regulation 8**, which prohibits misleading information in an advertisement.

Financial Reporting Act

A separate process is in place for requirements under the Financial Reporting Act 1993, most particularly from the requirement to produce separate financial statements compliance with New Zealand IFRS and audited in New Zealand. This exemption is also to be obtained from the Securities Commission, and would permit the issuer to file its annual accounts that conform to either US GAAP or IFRS in place of NZ GAAP-compliant annual audited accounts otherwise required to be filed annually pursuant to the Financial Reporting Act. It is often filed in tandem with any exemption that may need to be sought under the Securities Act.

Using the powers in section 35A of the Financial Reporting Act, the Commission has granted a class exemption to issuers relying on the Securities Act (Overseas Companies) Exemption Notice 2002 and its precursors. Accordingly, pursuant to the Financial Reporting Act (Overseas Companies) Exemption Notice 2007 issuers can register audited financial statements that comply with their home country's laws and public filing requirements provided that the GAAP in relation to those accounts is either US GAAP or EU-IFRS.

Process and timing for exemptions

Exemptions to be obtained from the Securities Act through the Securities Commission generally take between four and six weeks; however, in exceptional circumstances this time may be reduced. Equally, if the proposed exemption notice is novel or raises material policy issues, the process can take a lot longer. (It is for this reason that it is prudent not to ask for too much and to carefully couch the exemption application in conventional policy terms.) There is no immediate time pressure regarding a Financial Reporting Act exemption as the requirement to report does not begin until five months after the close of the first financial year post issue; however, as noted above it is useful to file this in tandem with the Securities Act exemption and the issuer will generally wish to be sure of the position before offering.

Where listing is sought for a retail offer, NZX will review all offer documentation and process any exemption applications within ten business days. However, an issue may also be dealt with urgently.

TRANS-TASMAN MUTUAL RECOGNITION REGIME

Trans-Tasman harmonisation of securities offerings has long been on the agenda for ministerial and official working groups. These efforts at last have borne fruit with the joint announcement on 13 June 2008 by ASIC and the Securities Commission of a new regime for Trans-Tasman securities offerings.

Background

In February 2006, the governments of Australia and New Zealand signed a treaty entitled "Agreement between the Government of Australia and the Government of New Zealand in relation to the Mutual Recognition of Securities Offerings". The intent of the treaty is to establish a regime that will enable an issuer in either Australia or New Zealand to extend an offer of securities lawfully made in that country to investors in the other country, without that issuer being required to comply with most of the substantive requirements of the other country's securities laws.

The establishment of such a regime required legislation or regulations on both sides of the Tasman. These have now been enacted under the Securities (Mutual Recognition of Securities Offerings - Australia) Regulations 2006 ("**Mutual Recognition Regulations**") in New Zealand and the Corporations Amendment Regulations 2008 (No 2) in Australia.

As noted previously, Part 5 of the Securities Act permits "recognition regimes" to be implemented, which may themselves grant exemptions from the requirements of the Securities Act and Regulations. Under a recognition regime, issuers from a designated country can offer securities in New Zealand in accordance with the securities laws of that designated country.

The Mutual Recognition Regulations implement the treaty between New Zealand and Australia by creating a recognition regime for Australia under Part 5 of the Securities Act. Australian issuers will therefore be able to make offers in New Zealand in accordance with Australian law and pursuant to their Australian offer documents. No New Zealand prospectus or investment statement will be required, but certain procedural steps must be taken. This should result in a substantial reduction in costs for Australian issuers in extending offers to New Zealand.

The Mutual Recognition Regulations

The Mutual Recognition Regulations will apply to an offer of securities made in New Zealand by an "Australian offeror", being an offeror who:

(a) if a natural person, is resident in Australia; or

(b) if not a natural person, is incorporated or established under Australian law or registered as an overseas company under Australian law.

A "security" means any of the following:

(a) an equity or debt security;

(b) an interest in a "collective investment scheme" (including a managed investment scheme as defined in section 9 of the Corporations Act 2001 (Cth)); and

(c) any interest in, or any option to acquire, any of the securities in (a) or (b).

Entry requirements for issuers under the new regulations

A number of entry requirements will need to be met by an Australian issuer. These are set out below. However, an Australian issuer will not be able to utilise the Mutual Recognition Regulations if:

(a) the issuer, or an associated person of the issuer, has, in relation to any previous offering of securities in New Zealand in reliance on the Mutual Recognition Regulations, breached the ongoing requirements of those regulations for that offer (described below); and

(b) the Commission has given notice to that issuer that it must not make further offers to the New Zealand public in reliance on the Mutual Recognition Regulations.

The Mutual Recognition Regulations provide for the following entry requirements:

(a) The issuer must be entitled to offer securities to the public under Australian law. For example, this would mean that all offer documents required to be filed with ASIC must have been filed and any “waiting period” following such filing must have expired.

(b) The offer must be one in respect of which a product disclosure statement (PDS) or similar offer document is required under Australian law;

(c) The issuer must, before making the offer in New Zealand, give notice to the New Zealand Registrar of Companies. The notice must:

   (i) state that the issuer intends to make an offer in accordance with the Mutual Recognition Regulations;

   (ii) specify the name of the issuer and the securities to be offered;

   (iii) specify the period in which it is proposed to offer the securities in Australia and New Zealand;

   (iv) state the name and address of a New Zealand process agent;

   (v) state that the issuer submits to the jurisdiction of the courts of New Zealand;

   (vi) be signed by a person with authority to act on the issuer’s behalf;

   (vii) be accompanied by the following documents:

      (aa) the offer documents (as filed with the Australian regulator if filing is required);

      (bb) a copy of any exemption relevant to the offer granted by the Australian regulator that is specific to the offer or the issuer;

      (cc) particulars of any general exemptions relevant to the offer granted by the Australian regulator;

      (dd) the constitutional documents of the issuer or the securities offered.

The offer document is also required to include a warning statement as set out below:

> "This offer is made in both Australia and New Zealand and is regulated under the securities legislation of Australia. The securities legislation of New Zealand does not generally apply to the offer made in New Zealand. However, sections 35 (restrictions on door to door sales), 38B (prohibition of advertisements), and 58 (criminal liability for misstatement in advertisement or registered prospectus) of the Securities Act 1978 do apply to the offer made in New Zealand.
>
> Under the agreement between Australia and New Zealand in relation to mutual recognition of securities offerings, both the New Zealand Securities Commission and the Australian Securities and Investments Commission (ASIC) have enforcement responsibilities relating to this offer. In the first instance, you should make any complaint to the New Zealand Securities Commission who will pass on your complaint to ASIC if necessary. New Zealand investors should satisfy themselves as to the tax implications of investing in these securities and should be aware that investing in Australian securities may involve a currency exchange risk."

If the Commission is satisfied that a failure to meet any of the notice requirements of (c) is technical and minor only, it may declare in writing that such breach is non-material. The effect of that declaration is that the offeror is deemed to have complied with that requirement.

If an Australian issuer does not comply with any of the entry requirements referred to above, it will be unable to rely upon the Mutual Recognition Regulations. Any offer of securities by that issuer to the public in New Zealand would therefore need to fully comply with the substantive New Zealand securities laws.

Exemptions under the new regulations

Under the Mutual Recognition Regulations, the offer of securities in New Zealand would be exempt from all requirements of the Act and Regulations (including the requirement to prepare a New Zealand prospectus and investment statement), except for sections 35, 38B and 58 of the Securities Act, which provide as follows (in summary):

- **Section 35** prohibits persons going from house to house offering securities to members of the public in New Zealand.

- **Section 38B**, in effect, imposes an obligation on an issuer to ensure that any advertisement relating to an offer is not likely to deceive, mislead or confuse, and complies with the Securities Act and Regulations. If the Securities Commission is of the opinion that an advertisement does not meet those requirements it may make an order prohibiting the distribution of that advertisement.

- **Section 58** imposes criminal liability for untrue statements in an advertisement. Where an advertisement is distributed that contains an untrue statement, criminal liability is imposed on the issuer (if an individual), or (otherwise) every director of the issuer at the time the advertisement is distributed. Persons committing an offence in breach of section 58 are liable to imprisonment of up to five years, or a fine of up to $300,000, and if the offence is continuing, a further fine of up to $10,000 for every day or part day the offence continues.

As a result of the latter two provisions, there would need to be some element of local due diligence and preferably a legal sign-off in relation to securities law compliance of the offering documents and any relevant advertisements.

Ongoing requirements for issuers under the new regulations

Once the entry requirements of the Mutual Recognition Regulations have been met (in relation to any offer of securities), a number of ongoing obligations must continue to be met by the issuer of those securities. Those ongoing requirements are:

(a) The offer must be open for acceptance in Australia at all times when it is open for acceptance in New Zealand.

(b) The offer must remain an offer in respect of which a PDS or similar offer document is required under Australian legislation at all times when open for acceptance in New Zealand, and must comply with Australian legislation.

(c) The offer documents for the offer must be accompanied by a “warning statement”, in the form set out above. That “warning statement” could be contained in the offer document, or set out in a document that accompanies the offer document, such that when the offer document is distributed, the “warning statement” is also distributed.

(d) The issuer must:

  (i) provide an investor, upon request, with copies of the relevant constitutional documents of the issuer or the securities; and

  (ii) ensure that any person prohibited by New Zealand legislation from being concerned in the management of a company in New Zealand, is not concerned in the management of the issuer.

There are also event-based filing requirements if any of the following occur:

- Change made to an offer document or any other document required by the law of Australia in relation to the offer.
- A change in issuer’s address for service.
- A supplementary or replacement offer document is required by the law of Australia.
- A change made to a relevant constitutional document in respect of the issuer or the securities offered.
- An Australian regulator grants, amends, or revokes a general exemption relevant to the offer.
- An Australian regulator grants, amends, or revokes an exemption relevant to the offer that is specific to the offer or the issuer.
- An Australian regulator begins an enforcement action, or exercises a power it has under law, in relation to the offer or the issuer.

It is apparent from this list that the ongoing requirements are mild and certainly fall well short of being a continuous disclosure regime of any description (this would apply separately under the NZX Listing Rules if the securities were listed). One matter that is not clear is what if any exemptions will be available on a class basis under the Financial Reporting Act. This does not seem to be contemplated in that Act itself and is not covered by the Financial Reporting Act (Overseas Companies) Exemption Notice 2007 described previously. In the absence of an exemption, Australian issuers would face the prospect of needing to prepare and file annual financial statements under NZ GAAP (NZ-IFRS).

Consequences of breach of ongoing requirements

A breach of any of the ongoing requirements set out above will not invalidate the exemptions granted by the Mutual Recognition Regulations. Accordingly, the Australian issuer would still have the benefit of those exemptions.

However, under section 76 of the Act, if there is a contravention of the ongoing requirements of the Mutual Recognition Regulations, a criminal offence is committed by the following persons:

(a) the issuer; and

(b) every principal officer of the issuer at the time of the contravention; and

(c) every promoter of the security; and

(d) every person who authorised himself or herself to be named (and is named) in any advertisement relating to that security as a director of the issuer (or as having agreed to become a director).

A person who commits such a criminal offence is liable to a fine not exceeding $300,000, and if the offence is continuing, a further fine of up to $10,000 for every day or part day the offence continues.

LIABILITY AND RISK MANAGEMENT ISSUES

Liability issues have a particular significance in relation to international offerings because of the unfamiliarity the issuers, and their directors and executives, will have with New Zealand's securities laws. This is exacerbated by the peculiarities of the New Zealand regime, with its strict liability regime and potential criminal penalties and lack of a formal due diligence defence. It also has practical difficulties for any large multi-national enterprise, in which the directors on whom liability may be imposed will have delegated all aspects of compliance in connection with funding operations and who as a result will have very limited direct knowledge of the details of individual offerings around the world.

Criminal and civil liability under the Securities Act

Section 56(1) specifies who may be liable for a "pecuniary penalty order" under section 55C of the Securities Act, and for compensation under section 55G, for distribution of an advertisement or registered prospectus that includes an untrue statement. As previously mentioned, "untrue" in this context is defined by section 55 of the Act to include any statement that is "misleading in the form and context in which it is included", including by omission of a material particular. Those who may be liable include:

- the issuer itself;
- for advertisements, directors of the issuer at the time of distribution;
- for a prospectus, anyone who has signed, or authorised signature, of the prospectus as a director; and
- promoters and their directors.

Distribution of an advertisement or a registered prospectus that includes an untrue statement is also a "civil liability event" under section 55B of the Securities Act, giving rise to the following potential civil remedies:

- a pecuniary penalty order and declaration of civil liability (on application by the Commission only) under section 55C of the Securities Act; and
- compensation under section 55G of the Securities Act.

Pecuniary penalty orders

If the Securities Commission applies for a pecuniary penalty order under section 55C, the Court is required to decide whether a "civil liability event" has occurred, and whether the person against whom the order is sought is liable under sections 56 through 57A.

If the Court concludes that both those tests have been met, it must make a declaration of civil liability. It may additionally order a pecuniary penalty be paid to the Crown if the civil liability event:

(a) materially prejudices subscribers for the securities;

(b) is likely to materially damage the integrity or reputation of any of New Zealand's securities markets; or

(c) is otherwise serious.

The maximum amount of pecuniary penalty under the Securities Act is $500,000 for an individual, and $5,000,000 for a body corporate. The Court is required to take into account the following matters when setting pecuniary penalties:

(a) nature and extent of the civil liability event;

(b) likelihood, nature and extent of any resultant damage to the integrity or reputation of New Zealand's securities markets;

(c) nature and extent of resultant loss or damage suffered by subscribers;

(d) surrounding circumstances; and

(e) court findings under the Act on previous conduct.

This new regime, which is a hybrid of criminal and civil law, is part of an emerging trend to have regulatory regimes enforced by civil penalties and thus avoid the cost of prosecution resources and the process of criminal sanctions.[81]

[81] Simon Haines " Civil Penalties - Compliance at a Cost" *NZ Lawyer* (16 May 2008), pg 12).

Compensation orders

Section 55G(1) provides for compensation to be payable to securities subscribers who have suffered loss or damage by reason of an untrue statement in an advertisement (which includes an investment statement) or a registered prospectus (together "**offering documents**"). Subscribers must have subscribed for the securities "on the faith of" the offering document that included the untrue statement. Application for compensation may be made by the Securities Commission or by subscribers. A person bringing a compensation proceeding can rely on a declaration of civil liability as conclusive evidence of a civil liability event without further evidence.

Section 55G(1) contains two basic elements — reliance and causation. To be entitled to compensation an investor must have subscribed for securities on the faith of an offering document which included an untrue statement and sustained loss or damage by reason of the untrue statement.

Section 55G(1) does not require that faith be placed on the untrue statement or misstatement itself but merely on the relevant offering document. The concept of "faith" is not defined in the Act but seems to be equivalent to reliance.[82] The investor must show that he or she received or saw the offering document before subscribing (noting in this regard that each investor must receive the investment statement before subscribing and that, for this reason, the application form for retail securities is almost invariably attached to the investment statement). Liability is determined at the date the investor subscribes for the securities.

The plaintiff must show that the misstatement caused loss or damage. In most circumstances this would equate to any reduction in the market value of the securities in question plus associated costs of enforcement.

Due diligence defences and other protections

In relation to civil liability for misstatements, relevant persons have a "noisy withdrawal" defence where they have withdrawn consent to the distribution of the prospectus and given written notice of the reasons to the Securities Commission: section 56(2). Similarly, in relation to the distribution offences, it is a defence if the relevant offering document was distributed without the person's knowledge or consent, and on becoming aware of the distribution or registration the person gave notice forthwith to the trustee, the Registrar, and the Securities Commission: section 56(1).

In relation to the potential civil liability for both pecuniary penalty and compensation orders, directors also have a defence is they prove they "had reasonable grounds to believe and did believe, up to the time of the distribution of the advertisement or registered prospectus, that the statement was true" (section 56(3) of the Securities Act).

The reference to reasonable grounds essentially imports a due diligence defence, ie that the person took such steps as are reasonable in the circumstances to verify the relevant facts or engaged advisers to do the same on whom reliance would be reasonable. However, a person may not rely on this defence (that is, claim that he or she had reasonable grounds to believe the statement was true) if he or she knows the true position on an issue but the prospectus contains a mistake.[83]

Although audit letters will be provided in connection with the offering and issuer's counsel generally will be expected to sign off on the legal compliance of the offering documents,

[82] *Black's Law Dictionary: Definitions of the Terms and Phrases of American and English Jurisprudence, Ancient and Modern* (6th ed).
[83] *District Registrar of Companies v Heenan* (1997) 8 NZCLC 261,334.

there is no equivalent in New Zealand of a "10b-5" letter or comfort letter, that form the basis for formal due diligence defences in United States and other jurisdictions. Indeed, New Zealand does not have a market norm of requiring comfort letters for securities offerings at all.

Grants of relief where a director has acted honestly and reasonably

The Securities Act also makes provision for the Courts to grant relief to any person for negligence, default, breach of duty or breach of trust in connection with an offer or allotment of securities or distribution of offering documents: section 63. This will rely on the director or other person establishing that he or she had acted honestly and reasonably and ought fairly to be excused for the relevant negligence or default. The following are guidelines from case law as to what may constitute reasonable grounds:[84]

(a) a director is not expected to be able to verify the truth of all the statements in a prospectus from his or her own knowledge;

(b) an intending director is not expected to adopt a lawyer's or accountant's role by making specific inquiries into facts or figures;

(c) other directors' investigations and the fact that other directors had signed the prospectus are not enough for a director relying on s 56(3)(c) to prove reasonableness — a director cannot simply rely on statements made by a promoter or another director but should sek verification of relevant statements; and

(d) a director is entitled to rely on audit reports and reports from internal personnel who are reliable and competent.

Criminal liability

Section 58 creates criminal liability for misstatements in an advertisement (including an investment statement) or registered prospectus (again these will be referred to generically as offering documents).

Section 58(1) provides that where any advertisement is distributed that contains an untrue statement (within the wider meaning of that term set out in section 55) the issuer will be criminally liable (where the issuer is an individual) or if the issuer is a body, every director of the issuer at the time the advertisement is distributed will be liable. Where a registered prospectus is distributed that includes an untrue statement, every person who signed the prospectus, or on whose behalf the registered prospectus was signed, commits an offence. Despite the potential severity of the penalties, these are strict liability offences that do not require proof of any *mens rea*.[85] While the civil liability sections require an investor to subscribe on the "faith" or "reliance" of the advertisement or registered prospectus, section 58 merely requires that an untrue statement was "included". The prosecution is not required to demonstrate that any investor was actually misled by the untrue statement, suffered loss, or even read the particular statement.[86]

The criminal liability provisions incorporate a similar due diligence type defence (that the person had reasonable grounds to believe, and did, up to the time of the distribution of the offering document, believe that the statement was true). It also has the additional

[84] *Adams v Thrift* [1915] 2 Ch 21 (CA) (at p 24*), Bundle v Davies* [1932] NZLR 1097*, R v Reid* (1990) 5 NZCLC 66,483*, and Escott v Barchris Construction Corp* 283 F Supp 643 (1968) (US DC).
[85] *District Registrar of Companies v Heenan* (1997) 8 NZCLC 261,334; *R v Baxter* [1998] 3 NZLR 144; (1998) 15 CRNZ 580 (CA) (at p 157; p 592).
[86] *R v Rada Corp Ltd (No 2)* [1990] 3 NZLR 453 at 477.

defence of proving that the relevant untrue statement was immaterial (section 58(4) of the Securities Act).

REFORM PROCESS AND MATTERS REQUIRING URGENT ATTENTION

The state of New Zealand's savings and capital markets does not present a pretty picture. In an OECD survey of New Zealand conducted in 2007, New Zealand appeared at the extreme wrong end of virtually every measure of savings and indebtedness among developed nation counterparts. Notably New Zealand has:

- The smallest capital market per GDP in the OECD (the corporate bond market would have to grow by 800% to attain the OECD average).
- Net international liabilities amounting to 80% of GDP, exposing our economy to exchange and interest rate risks and, more generally, to the whims of international capital flows.
- The lowest level of pension fund assets and insurance investments (less than 20% of GDP compared to almost 120% of GDP for the U.S. and U.K and almost 100% for Australia).

A former head of New Zealand's Securities Commission, John Farrell, considers that the high level of borrowing by New Zealanders throws up the following regulatory challenges:[87]

> to maintain and enhance the standards of transparency in securities markets, both primary and secondary, both wholesale and retail, in respect of both market transactions and market participants;
>
> to maintain and enhance corporate governance in the banks and other financial institutions, and in the borrowers, particularly in the evaluation of risk;
>
> to ensure that the law contributes to the efficient intermediation of investors' funds, at the same time as it contributes to the development of markets of integrity, markets in which both issuers and investors, whether domestic or overseas, can have confidence;
>
> to encourage New Zealand citizens to save more.

Recent policy initiatives to address these matters have included the RFPP process, the introduction of the New Zealand Superannuation Fund and the Kiwisaver scheme to make public and private provision for retirement income, reforms in the taxation of investment (notably the new Portfolio Investment Entity, or PIE, regime), and funding of investor literacy, particularly through the Retirement Commission.

Current reform initiatives

In August 2006 the New Zealand government recently launched a comprehensive reform packaging in relation to laws relating to financial products and providers. The securities offerings discussion paper includes proposals to remove the investment statement/ prospectus split and having only one offer document albeit with two compulsory parts and to mandate the inclusion of educational materials.

Submissions have been received on the proposals, which in the case of securities offerings have yet to obtain a settled form. Although it is hoped that that they will tidy up

[87] John Farrell "Facing Challenges to Bond Market Development - Lessons from the New Zealand Experience" (2005) Asian Development Bank Institute.

a number of the deficiencies in the current regime, it is unlikely that any enactment will be made in before 2009 or even 2010 — the financial intermediaries aspect of the reform is currently being treated as a higher priority, along with some specific changes in relation to finance companies and their supervision.

Matters requiring urgent attention

Due to the importance of strengthening the domestic capital markets and the length of time it is likely to take to implement the full suite of changes under the RFPP, it is important to address on a more urgent basis some of the more pressing defects in the current offering regime. These include:

- **Inconsistency between the requirements for prospectuses and GAAP**: As mentioned earlier in this paper, the Second Schedule to the Securities Regulations impose specific requirements in relation to financial statements for debt securities that are both frozen and are inconsistent with GAAP (for example, they pre-date New Zealand's adoption of IFRS). These impose very material costs for no benefit whatsoever. There is also a very easy fix for this: where an issuer has or is to file financial statements under the Financial Reporting Act (including under an exception pursuant to section 35A or 35B thereof), those financial statements should be able to used without any additional requirement that those accounts contain "the information required to be contained in a registered prospectus by clauses 16 to 31" (see clause 15(2)(a) of the Second Schedule).

- **Duplicative and irrelevant accounting requirements**: With the enactment of the Financial Reporting Act in 1993, which issuers automatically will be bound by, the Securities Act ceased to be a place where there should be substantive additional audit and accounting record requirements. These requirements are problematic, particularly for overseas issuers, and do not make much sense in the context of modern business. They should be repealed.

- **'Widely offered' exception to withholding tax**: It was recognised by the OECD in its recent survey of New Zealand's financial markets that the Non-Resident Withholding Tax and Approved Issuer Levy regime provide a significant impediment to the development of the New Zealand capital markets.[88] These provisions are also completely out of step with the position in Australia, which has a widely held exception (section 128F) which facilitates capital markets activity. The AIL and NRWT regimes are particularly damaging (and ineffective from the perspective of revenue-gathering) because they do not apply to any of the significant overseas funding markets, including the Eurokiwi and Uridashi markets and the New Zealand banks' offshore funding activities.

- **Eligible persons exception**: The anomaly that wholesale offerings can only be made to institutional investors and others enjoying an exception under section 3(2)(a) of the Securities Act, or to "eligible persons" (wealthy and experienced investors) meeting the relevant tests in sections 5(2CB) to 5(2CF) of the Securities Act, but not to both at the same time, should be removed. This restriction has no policy basis and prevents extension of appropriate offerings into the very large wealth management / private banking sector, which holds much of New Zealand's financial assets, to the detriment both of those savers and of small productive enterprises who could benefit from an alternative source of funding to bank lending.

Ross Pennington and Ed Brown
Russell McVeagh

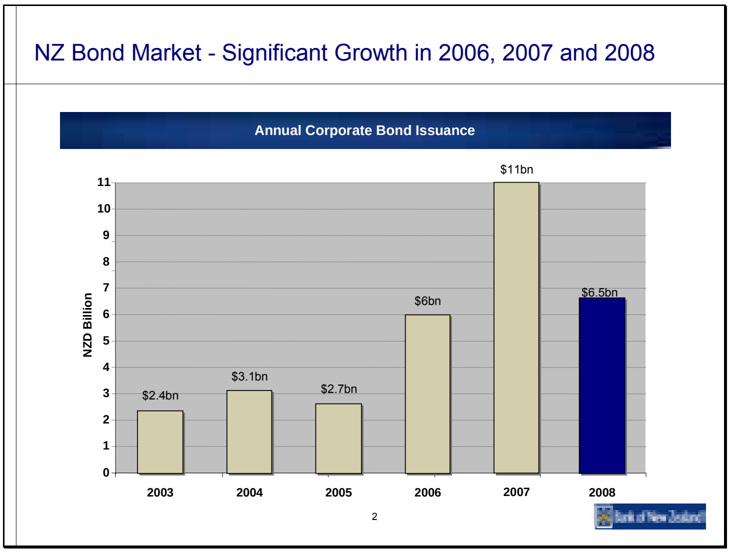
[88] "Deepening Financial Markets" (*OECD Economic Surveys*), Paris, April 2007, pg 79 at pg 87.

Patrick Mullins, Head Capital Markets Origination, Bank of New Zealand, Auckland

NZ Bond Market - Significant Growth in 2006, 2007 and 2008

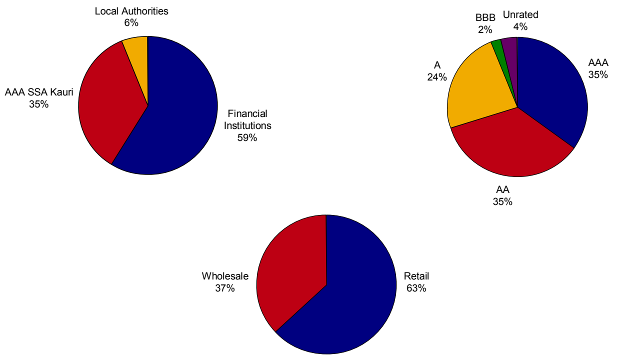
Slide 1

Slide 2



Slide 3

Issuance Dominated by Banks and Supras



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Slide 4

NZ$ 6.5 billion domestic issuance year-to-date in 2008

Issue Date	Issuer	S&P Issue Rating	Volume (NZ$ mio)	Tenor	Maturity	Credit Spread	Coupon	Retail Direct
Jun-08	Marac Finance Ltd	BBB-	125	5y	[15-Jun-13]	[swap + 275 bp]	10.5%	Y
Jun-08	**EDC**	**AAA**	**200**	**3y**	**24-Jun-11**	**swap less 22 bp**	**7.54%**	
Jun-08	Rentenbank	AAA	50	9y	15-Dec-17	swap less 12 bp	7.485%	Y
Jun-08	ANZ	AA	175	6y	09 Ju-14	swap + 117 bp	8.50%	Y
Jun-08	ANZ	AA	100	2y	09-Jun-10	swap + 68 bp	8.50%	Y
May-08	**Municipality Finance**	**AAA**	**100**	**3y**	**10-Jun-11**	**swap less 10 bp**	**7.73%**	
May-08	ANZ	AA	120	3y	27 May-11	bkbm + 90 bp	FRN	Y
May-08	**BNZ**	**AA**	**250**	**5y**	**27-May-13**	**swap + 110 bp**	**8.56%**	**Y**
May-08	**BNZ**	**AA**	**110**	**3y**	**20-May-11**	**bkbm + 90 bp**	**FRN**	**Y**
May-08	**BNZ**	**AA**	**58**	**1y**	**22-May-09**	**swap + 28 bp**	**Zero cpn**	**Y**
May-08	**BNZ**	**AA**	**118**	**7y**	**27-May-15**	**swap + 125 bp**	**8.68%**	**Y**
May-08	South Canterbury Finance	BBB-	[125]	3y	16-Jun-11	swap + 275 bp	[10.5%]	Y
May-08	**BNZ**	**AA**	**97**	**1y**	**05-May-09**	**swap + 28 bp**	**Zero cpn**	**Y**
May-08	ASB Bank	AA	325	3y	21-May-11	swap + 90 bp	8.42%	Y
May-08	ASB Bank	AA	143	3y	21-May-11	Bkbm + 90 bp	FRN	Y
May-08	Eurofima	AAA	275	5y	22-May-13	swap less 20 bp	7.125%	
May-08	**BNZ**	**AA**	**97**	**1y**	**22-Apr-09**	**swap +28 bp**	**Zero cpn**	**Y**
Apr-08	**Auckland City**	**AA**	**50**	**4.5y**	**15-May-12**	**private placement**		
Apr-08	**Auckland City**	**AA**	**25**	**7y**	**15-Nov-12**	**private placement**		

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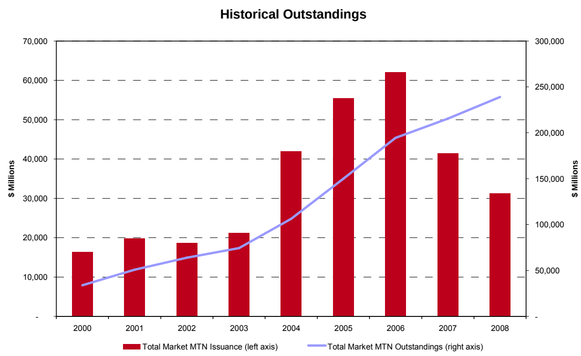
Slide 5

NZ$ 6.5 billion domestic issuance year-to-date in 2008

Issue Date	Issuer	S&P Issue Rating	Volume (NZ$ mio)	Tenor	Maturity	Credit Spread	Coupon	Retail Direct
Apr-08	Council of Europe (COE)	AAA	100	10y	30-Apr-18	swap less	7.50%	
Apr-08	BNG	AAA	125	1y	15-Jun-09	swap less	8.00%	
Apr 08	Westpac NZ	AA	90	3y	18-Apr-11	bkbm + 90 bp	FRN	Y
Apr 08	Westpac NZ	AA	200	3y	18-Apr-11	swap + 90 bp	8.87%	Y
Apr 08	Westpac NZ	AA	100	1y	09-Apr-09	bkbm + 28 bp	FRN	Y
Apr-08	Dunedin City Treasury	AA-	40	3y	15-Apr-11	swap + 75 bp	8.70%	
Apr-08	BNG	AAA	100	2y	27-Sep-10	swap less 13 bp	7.75%	
Mar-08	NIB	AAA	100	7y	15-Apr-15	swap less 22 bp	7.50%	
Mar-08	**EIB**	**AAA**	**100**	**10y**	**15-Dec-17**	**swap less 28 bp**	**7.50%**	
Mar-08	ANZ Upper Tier 2	A+	835	5y call	Perpetual	swap + 200 bp	9.66%	Y
Mar-08	**BNZ Tier 1**	**A+**	**450**	**5y call**	**Perpetual**	**swap + 220 bp**	**9.89%**	**Y**
Feb-08	**BNZ**	**AA**	**200**	**2y**	**1-Mar-10**	**bkbm + 60 bp**	**FRN**	**Y**
Feb-08	African Development Bank	AAA	200	5y	28-Feb-13	swap less 20 bp	7.75%	
Feb-08	Quayside (Bay of Plenty Regional Council)	NR	200	3y call	Perpetual	swap + 170 bp	10.00%	Y
Jan-08	**EDC**	**AAA**	**100**	**3y**	**30-Nov-10**	**swap less 25 bp**	**8.13%**	
Jan-08	Rentenbank	AAA	175	5y	15-Apr-13	swap less 14 bp	7.76%	
Jan-08	Council of Europe (COE)	AAA	375	3y	15-Nov-11	swap less 18 bp	7.75%	
Jan-08	**IADB**	**AAA**	**200**	**7y**	**15-Apr-15**	**swap less 26 bp**	**7.50%**	
		TOTAL	**6,185**					

Slide 6

A$ Market – A$ 40-60 billion per annum



6

Slide 7

What is a Kauri? - Tane Mahuta

Kauri are among the world's mightiest trees, growing to more than 50 metres tall, with trunk girths of up to 16 metres. They covered much of the top half of the North Island when the first people arrived around 1000 years ago.

The Waipoua forest is home to **Tane Mahuta**, king of the forest and the largest remaining kauri tree in the country. The 1500 year old Tane Mahuta is 51.5 metres tall, with a girth of 13.77 metres.

Slide 8

So……What is a Kauri Bond?

- Foreign borrower issues a bond to domestic (and international) NZ$ investors
- Like the Kangaroo (A$), Samurai (Yen), Yankee (US$), Bulldog (STG) and most recently the Maple Bond (CAD) markets
- Settled and cleared domestically through Austraclear New Zealand, with a domestic registrar (typically Computershare)
- Can also be settled and cleared internationally through Euroclear and ClearStream
- Similar to a EuroKiwi issue, but with Austraclear settlement
- Typically documented under a borrower's existing debt programme

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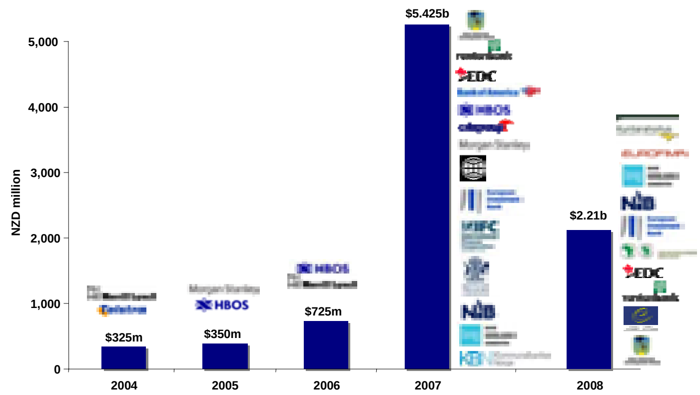
Slide 9

From small beginnings, the Kauri market has grown significantly…



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Bank of New Zealand

Slide 10

Driven by RBNZ Repo-eligibility changes

- From 20 August 2007, the RBNZ accepted a limited amount of Supranational, Foreign Sovereign, Agencies and Semi-Government issues as acceptable securities in the Overnight Reverse Repo Facility ("ORFF").
- Issues must:
  - have at least two AAA ratings
  - be domiciled in a set list of countries or be a Supranational
  - be "plain vanilla" with no optionality and no subordination
  - follow RBNZ pricing convention and be semi-annual
  - be denominated in NZ$
  - be lodged in Austraclear NZ
  - have a NZ registrar and paying agent e.g. Computershare NZ
- RBNZ initially set repo limits for individual issues e.g. World Bank (IBRD), EIB, IFC, COE, IADB, AfDB and NIB limits of NZ$2 billion, QTC of NZ$ 1.3 billion and EDC, BNG, KNB and Rentenbank of NZ$500 million
- **This has now changed to a haircut of 3% for < 3 years and 5% for >= 3 years, from 3 June.**

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Bank of New Zealand

Slide 11

AAA issuers to date

- World Bank – IBRD
- European Investment Bank – EIB
- International Finance Corporation – IFC
- Nordic Investment Bank - NIB
- Queensland Treasury Corporation - QTC
- Bank Nederlandse Gemeenten – BNG
- Kommunalbanken Norway - KBN
- Rentenbank
- Export Development Canada – EDC
- Inter American Development Bank – IADB
- Council of Europe – COE
- African Development Bank – AfDB
- Municipality Finance PLC
- Eurofima

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Slide 12

Highlights

- NZ$ 6 billion of AAA issuance in 6 months
- Largest issue size – NZ$ 400 million (EIB, NIB)
- Largest outstanding – NZ$ 800 million (EIB 2012 – 2 tranches)
- Maturities: 3 years to 10 years
- Accounted for 50% of all bond issuance in 2007

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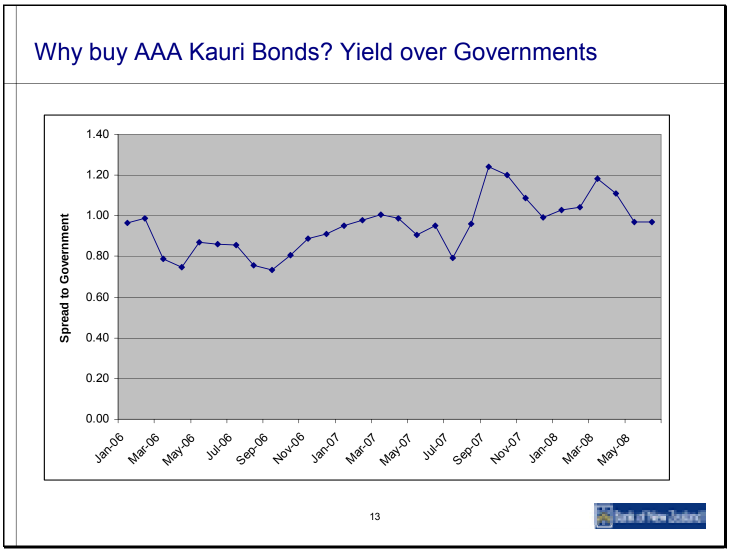
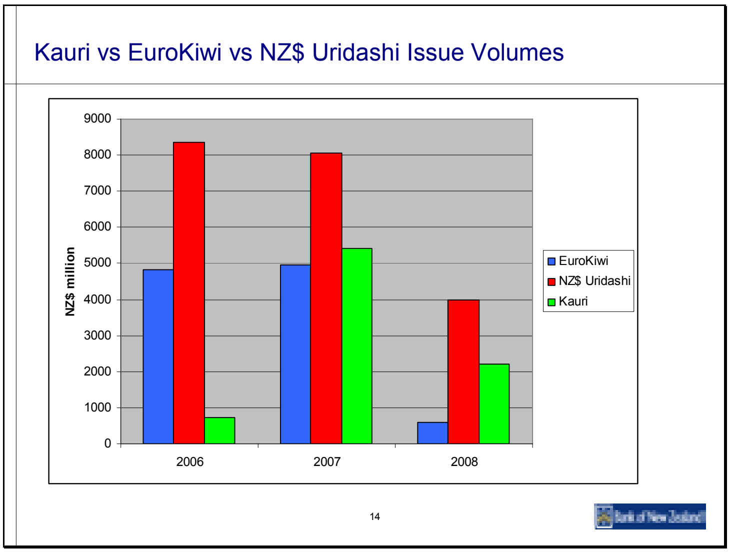
Slide 13



Slide 14



Slide 15

Opportunities Going Forward

- Combine Kauri and EuroKiwi markets as the A$ Kangaroo has?
- Develop retail market – World Bank the first retail Kauri issuer
- Replace NZGB market as core asset class
- NZX Kauri Bond Index
- Broader Mix of names
- Repo-eligibility criteria have been extended further
  - NZ registered banks
  - Local Authorities and SOEs
  - AAA corporates

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Slide 16

BNZ Kauri Forest

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Sale in New Zealand and Australia of International Capital Markets Instruments

Banking & Financial Services Law Conference
Queenstown, New Zealand
June 2008

John Elias
Partner, Minter Ellison, Sydney

1. Introduction

The impact of the credit crunch on the international capital markets over the past 12 months has been well documented, and its ramifications are likely to continue to be felt for some time.

However, there has been some good news from the legislative and regulatory perspective in the past 12 months in relation to the issuance of capital markets instruments into the Australian market:

- **repos**: the range of instruments accepted for repo purposes by the Reserve Bank of Australia (***RBA***) has been expanded to include certain Kangaroo bond issues;
- **mutual recognition regime**: a regime has been introduced for the mutual recognition of securities issued into other jurisdictions, with New Zealand being the first jurisdiction with which Australia has formalised mutual recognition arrangements, and there have been positive steps towards this being reflected for other jurisdictions; and
- **investment by general insurers**: the issues relating to the acceptability for investment of Kangaroo bonds by general insurers have been resolved.

On the downside, there has been confirmation of the continued exclusion of covered bond issuance by Australian ADIs – which although not directly impacting upon Kangaroo covered bond issuance, may have a residual effect.

Each of these issues is considered below.

2. Repos

2.1 Introduction

In late 2007, the RBA broadened the range of instruments with respect to which it is prepared to enter into repos.

Prior to September 2007, the securities accepted were Australian commonwealth government securities, securities issued by Australian state and territory borrowing authorities, securities issued by some supra-national and foreign government agencies, and bills and certificates of deposit issued by some Australian banks.

With effect from September 2007, this list was expanded to include Australian dollar bonds issued by ADIs - including ADIs incorporated outside of Australia - that satisfied certain criteria. (By way of completeness, we note that with effect from October 2007, this list was also expanded to included certain residential mortgage-backed securities and asset-backed commercial paper instruments.)

2.2 Criteria

Australian-dollar denominated debt securities may be accepted by the RBA for repo if they are issued domestically by an authorised deposit-taking institution which holds an ES account at the RBA, provided that:

(a) the issuer is rated A3 or higher by all major credit rating agencies that rate it – and in any event by at least two such agencies;

(b) the securities are not subordinated;

(c) the securities are not structured – such as index-linked, embedded derivatives or variable rate interest margins;

(d) the securities are lodged and settled in Austraclear, and not traded as Euro entitlements; and

(e) the securities are not issued by itself or a related entity.

The rationale for this expansion was of course to assist banks with their liquidity – but the RBA has indicated that the expansion is to be permanent, rather than merely a temporary measure to assist during the credit crunch.

3. Mutual recognition

3.1 Legislative background

In December 2007, a new chapter (Chapter 8) was included in the Corporations Act 2001 (Cth) which provides in generic terms for the mutual recognition of the securities offered under the issuance regime of other jurisdictions. This was introduced through the passing by the Australian Commonwealth government of the Corporations (NZ Closer Economic Relations) and Other Legislation Amendment Act 2007 (Cth).

Notwithstanding the specific reference to New Zealand in the title of the enacting legislation, Chapter 8 is couched in generic terms, so it may be readily adapted to permit the mutual recognition of other countries – by being "activated" through regulation.

Nonetheless, the first mutual recognition regime introduced was as between Australia and New Zealand.

3.2 Australia/New Zealand mutual recognition regime

(a) Introduction

The Australia - New Zealand mutual recognition regime was established pursuant to the *Corporations Amendment Regulations 2008 (No.2),* which reflected an agreement reached between the parties under treaty in 2006.[89]

The regulations – and their New Zealand equivalent – established a mutual recognition scheme which allows an issuer of securities to offer securities, or interests in collective/managed investment schemes, in <u>both</u> countries using <u>one</u> disclosure document prepared under the regulations in its home country ie. from the point of view of a New Zealand issuer seeking to offer securities into Australia, compliance with the applicable New Zealand legislation – and some procedural Australian law requirements (such as the requirement for a specific warning statement) – will be sufficient to permit the securities to be offered in Australia.

The benefits are of course considerable costs savings – and thereby encouragement of trans-Tasman capital flows.

(b) Applicable legislation and regulatory guidance

[89] *The Agreement between the Government of Australia and the Government of New Zealand in relation to the Mutual Recognition of Securities Offerings.*

The actual instrument required to implement the legislation was regulations totalling approximately a dozen pages, which essentially lock into the Chapter 8 provisions of the Corporations Act (as described above), and make certain conforming amendments in relation to managed investment schemes and other matters.

Regulatory Guide 190 *Offering securities in New Zealand and Australia under mutual recognition* – which was published by the Australian Securities and Investments Commission (***ASIC***) in June 2008 – provides guidance as to the manner in which ASIC will administer this regime. (This regulatory guide is an essential reference for any persons contemplating such an issuance.)

(c) Initial requirements

The requirements for a New Zealand offeror seeking to issue securities into Australia are essentially as follows:

(i) Who can be an offeror?

The offeror must be incorporated under the law of New Zealand, or be a natural person resident in New Zealand, or be a legal person established under the law in New Zealand.

In addition, the issuer – and each person concerned with the management of the issuer – must not be:

- disqualified from being concerned in the management of the issuer under New Zealand law;
- be an undischarged bankrupt or having been convicted of certain offences;
- banned from ASIC from providing financial servicers or disqualified by a court under the Corporations Act;
- previously banned by ASIC from making a recognised offer.

(ii) What securities can be offered?

Shares, debentures and interests in managed investment schemes, and legal or equitable rights or interests in these products, or options in these products (see section 1200A of the Corporations Act).

(iii) What lodgements are required?

The issuer is required to lodge with ASIC a written statement of the intention to make the offer, including:

- any offer document required by NZ securities law;
- the constituent document of the issuer/scheme;
- details of any exemptions from the NZ securities laws that apply to the offer; and
- address for service of process in Australia.

These documents must be lodged at least 14 days before the day on which the offer is first made in Australia, and no later than the time the New Zealand Registrar of Companies is notified.

(iv) Are there any specific content requirements for the offer document?

The offer document must contain specific warning statements, as set out in the regulations.[90]

(d) Ongoing requirements

There are ongoing requirements as well:

(i) The offer

For so long as the offer is open to Australian investors, the offer must:

- remain a recognised offer in New Zealand;
- comply with NZ securities law; and
- be open to acceptance by persons on New Zealand.

(ii) The offeror

There are certain ongoing notification requirements to ASIC – such as in relation to amendments to the offer documents required under New Zealand securities law or supplementary offering documents.

(e) Sanctions for breach

Breach of the offering conditions has the following implications:

(i) breach of law (section 1200Q Corporations Act);

(ii) ASIC may make a stop order under section 1200N of the Corporations Act; and

(iii) ASIC may ban the issuer from making an offer under the regime for a specified period.

3.3 Further cross border mutual recognition

A key development to be watched is the extent to which this is the forerunner for additional mutual recognition regimes for securities offerings.

ASIC has recently issued a joint consultation paper with the Australian Treasury, entitled "Cross border recognition - Facilitating access to overseas markets and financial services". This paper was issued on 16 June 2008, with comments sought by 25 July 2008, and the intention of next steps to be proposed in August 2008. One of the key themes it explores is the extension of mutual recognition.

It notes that recent trends in international financial flows and regulatory developments highlight the need to address these issues. The paper refers to recent US and European developments, but it also discusses mutual recognition proposals in general. It notes that mutual recognition involves a party ceding part of its regulatory authority to a foreign regulator – and therefore requires extensive investigation.

[90] *Corporations Amendment Regulations 2008 (No.2).*

The aim of mutual recognition is stated to be:

- effective regulatory compliance and enforcement;
- market integrity;
- investor protection;
- reduced regulatory requirements; and
- encouraging the growth of Australia's domestic finance industry.

The paper notes that mutual recognition is founded on:

(a) joint commitment of the relevant governments and regulators to recognising the regulatory arrangements from the other country;

(b) substantial regulatory equivalence between Australian regulation and the relevant foreign regulation; and

(c) enhanced co-operation between ASIC and the relevant overseas regulator[91].

3.4 Australia/Hong Kong

On 7 July 2008, ASIC and the Hong Kong Securities and Futures Commission (SFC) signed a "declaration of mutual recognition" to facilitate the sale of retail funds to investors in each other's market.

The regime only applies in relation to managed investment schemes/collective investment schemes, and not other investment products at this stage.

The intention is to encourage investment flows between the different jurisdictions, and thereby facilitate more choice for Australian retail investors.

ASIC is to shortly issue a class order providing relief from certain product disclosure requirements. At the time of writing, this class order was not available.

4. GPS 120: "Assets in Australia"

Section 28 of the *Insurance Act 1973* (Clth) provides:

> "*A general insurer commits an offence if:*
>
> *(a) it does not hold assets in Australia (excluding goodwill and any other amount excluded by the prudential standards for the purposes of this section) of a value that is equal to or greater than the total amount of its liabilities in Australia….".*

The legislative intention behind this provision is essentially to ensure that general insurers maintain assets in Australia of a value that equals or exceeds the total amount of the general insurer's liabilities in Australia. Accordingly, an important consideration for insurers has been precisely what constitutes an "asset in Australia".

Kangaroo bonds were initially excluded as "assets in Australia" under Prudential Standard GPS 120 issued by the Australian Prudential Regulatory Authority (APRA). After much industry consultation and discussion, a revised

[91] Subsequent to the date of this paper, ASIC issues Report 134, "*Enhancing capital flows into and out of Australia*", which further explored a number of these issues.

form of GPS 120 was issued in June 2008, with effect from 1 July 2008 (there being no transitional arrangements, as the new criteria are an expansion of the prior position) – as described below.

(a) Policy perspective

As a preliminary matter, it is worth noting that the response paper issued by APRA in respect of GPS 120 acknowledges Kangaroo bonds as a source of quality assets, but references the policyholder protection perspective: that is, in the event of an insurer being wound up, APRA needed to be satisfied that the Kangaroo bonds would be considered assets in Australia by a court of law.

(b) *Prima facie* exclusion

Paragraph 11 of Prudential Standard GPS 120 describes the parameters of certain assets that are excluded from constituting "assets in Australia".

The terms of paragraph 11 are such that on its face, Kangaroo bonds would not constitute "assets in Australia", and therefore may not be included within the capital base of a general insurer.

(c) Carve-out for Kangaroo bonds

However, paragraph 12 provides that these exclusions do not apply in relation to Kangaroo bonds – which therefore may be included as "assets in Australia" – provided that they satisfy certain criteria as follows:

> "*Paragraph 11 does not exclude an interest of a locally incorporated insurer in a kangaroo bond from being an asset in Australia if all the following conditions are complied with:*
>
> *(a) the underlying bond is legally owned by Austraclear Ltd or a nominee for Austraclear Ltd and is lodged in the Austraclear system; and*
>
> *(b) the register recording legal ownership of the underlying bond is kept in Australia; and*
>
> *(c) the bond is created by a deed poll which is sealed, or deemed by its governing law to be sealed, and the deed poll is governed by Australian law and kept in Australia; and*
>
> *(d) the debt under the bond is expressed to be payable in Australia except where payment in Australia is prohibited by law (provided that if, at any time, such payment in Australia is prohibited by law, the debt under the bond shall be excluded from being an asset in Australia for so long as that payment is prohibited)."*

Accordingly, Kangaroo bonds may now be treated as "assets in Australia" by general insurers provided that:

(i) they are owned by Austraclear's nominees and are registered on Austraclear;

(ii) a separate register is kept in Australia;

(iii) they are created by deed poll under seal (or deemed to be sealed) that is governed by Australian law and kept in Australia;

(iv) the debt is expressed to be payable solely in Australia; and

(v) if there is a custodian between Austraclear and the insurer, the relevant account and any right the insurer has against the custodian are in Australia.

(d) Practical implications

These amendments remove a prudential "block" on investment in Kangaroo bonds by Australian general insurers. While the precise impact on demand is difficult to quantify, this can only improve the market appetite for these securities.

5. Covered bonds

Finally, it is worth noting for completeness that there has been recent confirmation of APRA's position with respect to covered bonds issued by ADI.

Covered bonds have been a significant feature of the European bank funding landscape for a number of years. However, they have traditionally not been permitted in Australia as a result of APRA's view of section 13A of the Banking Act 1959, which provides:

> *"If an ADI becomes unable to meet its obligation or suspends payment, the assets of the ADI in Australia are to be available to meet that ADI's deposit liabilities in Australia in priority to all other liabilities of the ADI."*

These are essentially depositor protection provisions. In November 2007, by way of the amendments to the prudential standards necessary to implement Basle II regulatory capital requirements, APRA confirmed that it did not permit covered bonds to be issued by Australian ADIs. Australian Prudential Statement 120 states that:

> *"Covered bonds are not considered to be consistent with depositor preference provisions set out in the Banking Act and hence are prohibited."*

In late 2007 and early 2008, as a result of the well-documented issues within the securitisation industry, covered bonds had been the focus of renewed interest by ADI's, and there was widespread discussion as to whether there may be an appropriate structure that APRA would accept.

This has effectively been rejected by APRA, which issued a notice to ADIs in April 2008 which included a statement to the following effect:

> *"...the arguments advanced in support of such structures, many of which have been raised before, do not adequately address APRA's in principle objection to covered bonds…".*

Accordingly, it is unlikely there will be any issuance of covered bonds by Australian ADI's in the near future.

6. Conclusion

As may be seen, there have been some positive legislative and regulatory developments in Australia with respect to the sale of international capital markets instruments into Australia, notwithstanding the overall difficulties in the capital markets generally at that time.

Friday 25th July, 2008

Concurrent 2a
Copthorne Hotel

1.30pm – 3.00pm

Chair:
Graham Curd
Senior Counsel Legal Services
Westpac Banking Corporation
Sydney

Speakers:
Graham Gill
Fair Trading Manager
New Zealand Commerce Commission
Auckland

Karen Cox
Co-ordinator, Consumer Credit Legal Centre
Sydney

Narelle Smyth
Partner
Clayton Utz
Sydney

Prudent? Imprudent?? Predatory???
Lender liability
for riskier lending – The developing regulatory
responses to it. Can we avoid collateral damage?
Examining regulatory responses

Graham Gill, Fair Trading Manager, New Zealand Commerce Commission, Auckland

"Regulatory Responses to Unreasonable Consumer Lending Practices".

BANKING AND FINANCIAL SERVICES LAW ASSOCIATION
Graham Gill: Manager, Fair Trading Auckland
Commerce Commission
25 July 2008

"Regulatory Responses to Unreasonable Consumer Lending Practices".

The Regulatory Environment – Pre April 2005

1. Prior to the introduction of the Credit Contracts and Consumer Finance Act in 2003, consumer lending in New Zealand had been governed by either the Credit Contracts Act 1981 or the Hire Purchase Act 1971. Consumer lending that fell outside these Acts, for example home loans that exceeded the $250,000 threshold within the Credit Contracts Act, were largely unregulated except in relation to rules for registering security and establishing processes for enforcement of the loan transactions[92].

2. While consumers received some protections under these Acts and further protection under the Consumer Guarantees Act, which contains provisions requiring services to be fit for their purpose and undertaken with reasonable care and skill, for the average consumer trying to understand which laws applied to their situations and their corresponding statutory rights and accessing statutory consumer protections was difficult, to say the least.

The Introduction of the Credit Contracts and Consumer Finance Act

3. In 2003, the Credit Contracts and Consumer Finance Act ("the Act") repealed the Hire Purchase Act and Credit Contracts Act. The statutory protections relating to the realisation of loan securities and those under the Consumer Guarantees Act remained in force.

4. The Act removed the $250,000 threshold and moved instead to a "primary purpose" test[93], with transactions being considered in light of whether they were primarily for personal, domestic or household purposes. While providing consumers with improved statutory protections this also had the effect of largely deregulating business to business lending[94]. The purpose

[92] Personal Property Securities Act, Land Transfer Act and the Credit (Repossession) Act.
[93] Section 11 (1)(b)
[94] With the exception of retaining the ability for business borrowers to access the "oppression" and re-opening provisions of the Act[94].

provisions of the Act[95] quite clearly established the move to a more consumer focussed approach.

5. The Act also introduced a new range of consumer protection provisions including:

   - A uniform disclosure regime;
   - The right to claim statutory damages if the disclosure requirements are not met by creditors;
   - Rules specifying how interest can be debited;
   - Rules governing how full prepayment (early payment) charges for consumer transactions are to be calculated;
   - The statutory right to relief for consumers experiencing unforeseen hardship;
   - New rules requiring credit fees to be "reasonable";
   - The ability to obtain refunds and other remedies from the Courts where unreasonable credit fees are charged;
   - Additional protections in relation to buy-back transactions, in particular the requirement for independent legal advice.
   - An extension of the right to cancel loan transactions to all consumer credit contracts, with the exception of revolving credit contracts[96].

6. Also, for the first time in New Zealand, an enforcement agency, the Commerce Commission, was charged with promoting compliance with consumer credit law by investigating alleged breaches of the Act and being able to initiate prosecutions and civil proceedings for non-compliance with the Act. The Commission was also given the role of monitoring credit markets and making information available to consumers, creditors and others in order to promote compliance with the Act.

7. The Commission's powers under the Act[97] include:

   - Search and seizure powers;
   - The ability to compel the production of evidence, documents or information[98];
   - The power to prosecute for breaches of the Act;
   - The ability to take class actions on behalf of consumers[99];
   - The ability to apply for injunctions restraining conduct breaching subparts 2-8 of Part 2 of the Act and Part 3 of the Act[100], attempting to

[95] Section 3 "The purposes of this Act are – to protect the interests of consumers in connection with credit contracts, consumer leases, and buy-back transactions of land …".
[96] Previously this right had been limited to those contracts covered by s22(2) Credit Contracts Act 1981
[97] Some of which are imported from the Commerce Act 1986
[98] Section 98 Commerce Act 1986
[99] Sections 125(5), 90(4), 95(3)

breach the same provisions, aiding or abetting a breach of those provisions, or conspiring to breach those provisions under the Act[101];

- The ability to apply for banning orders under the Act[102];
- The right to appear, provide evidence and cross examine witnesses[103] in any proceedings brought under the Act, irrespective of whether the Commission was a party to the proceedings during any earlier stage of the proceedings.

8. The Commission's approach to enforcement of the Act recognises the important role of competition within our economy. Informed debtors, those able to make rational information-based decisions promote competition. Effective enforcement of regulation designed to replicate competitive forces also promotes competition. Competition in turn can provide "both carrots and sticks to encourage the best from everyone [trading within markets]"[104]. Competition within credit markets can also result directly in reduced costs to consumers, innovation and efficiency within markets.

9. Disclosure and the ability to switch are two key tools to ensure consumers are informed and have the ability to act on their choices. Disclosure ensures transparency of information before debtors are irrevocably committed to the credit arrangement. Even after consumers have committed to credit arrangements, the Act provides debtors with statutory rights to prepay or cancel contracts, specifically removing a disincentive to switching between credit providers and products. Debtors' ability to switch products and providers within credit markets functions, in the same way as within the telecommunications and energy sectors, as a powerful driver of competition.

10. Informed consumer choices reinforce messages sent by the Commission's enforcement actions; those creditors complying with the Act receive incentives – consumers select their products and services, and they can reap the benefits of the level-playing field enforcement action promotes. Those failing to comply with the Act will lose any incentives to breach the Act as a result of having to remedy any breaches and losing consumer confidence and willingness to purchase their products and services. If consumers make choices based on inaccurate or misleading information, they may end up buying the wrong credit or insurance product, and supporting the less efficient business.

---

[100] These provisions deal with disclosure, interest, unreasonable fees, fees or charges passed on by the creditor, payments, prepayments, unforeseen hardship and the provisions specifically in relation to consumer leases and buy-back transactions of land.
[101] Section 96(1)
[102] Section 108,109. These powers are not limited to the Commission however.
[103] The right to cross examination is limited to those proceedings that are not on appeal
[104] Commerce Commission Statement of Intent 2007-2010 "Chair's Foreword".

Unreasonable consumer lending practices

11. As the agency enforcing the Act, the Commission is in a unique position. It has the opportunity to focus on individual creditor's practices through its investigations and enforcement actions but in doing so has also built up a wider picture of general practices across the credit industry.

12. When considering "unreasonable consumer lending practices" the initial focus for the Commission is whether a practice complies with the provisions of the Act.

13. The Commission will also consider whether the creditor's conduct breaches the Fair Trading Act. It is important for creditors to be aware that the Commission can take action in relation to breaches of the Fair Trading in situations where debtors have been misled about any of their statutory rights. Those statutory rights are not limited to those under the Act but could include rights under the Property Law Act, Credit (Repossession) Act, Consumer Guarantees Act, Privacy Act, and the Second-hand Dealers and Pawnbrokers Act. Additionally in situations where creditors make misleading representations about the contractual rights of classes of debtors, (notwithstanding their individual rights to remedies), closer scrutiny by the Commission may be warranted.

14. The Commission sets its threshold for unreasonable lending practice as being any practice which fails to comply with the Act. Our role is clearly limited to enforcement, monitoring and educative activities designed to promote compliance with the Act.

15. While the Commission does not become involved in larger social equity issues within the markets it regulates, its enforcement criteria does consider the extent of public interest in an issue and also whether conduct affects vulnerable consumers. The Commission recognises that other agencies or consumer advocates may have different thresholds for assessing whether a practice is unreasonable and that some of those practices may not contemplated by the Act. While such practices may not necessarily constitute oppressive conduct under the Act, or in fact be illegal in any way, the conduct involved can exceed perceptions of reasonable and acceptable standards of commercial practice.

16. The Commission receives a number of complaints about allegedly "unreasonable", "unconscionable", "unfair", "oppressive" or unreasonable lending practices and it encourages consumer advocates to raise these issues with the Commission. Similar practices were discussed in the Ministry of Consumer Affairs 2007 report into Pacific consumers' experiences within the credit markets[105]. They include:

    - Including "hidden" costs within loans;

[105] Ministry of Consumer Affairs "*Pacific Consumers' Behaviour and Experience in Credit Markets, with Particular Reference to the 'Fringe Lender' Market*" (August 2007)

- Taking enforcement action that failed to comply with debtor's statutory rights;
- Advertising or business practices aimed at attracting particular ethnic or socio-economic groups of debtors;
- Aggressive marketing practices;
- Advertising targeting vulnerable creditors which promises "easy credit" and identifies lenders as having particularly low lending criteria (i.e. "bankrupts welcome", "lo doc" "no drivers licence required" approach seen within the some sectors of the market providing car loans);
- Offering high cost lending to enable debtors to use funds for specific cultural practices in circumstances where they might otherwise not be able to access loans for these purposes.

17. There have also been issues raised by consumers, consumer advocates and within the credit industry about "socially responsible lending" and a push towards creditors being more accountable for ensuring loans are affordable and tailored to individual circumstances.

18. The Commission has specifically focussed some of its efforts on informing consumer and industry groups and developing relationships with them as their referrals assist the Commission's monitoring of unreasonable lending practices, and those who use these practices, allowing the Commission to identify the worst behaviours within the industry.

19. Further, referrals about these practices from consumer groups in particular, enable the Commission to identify creditors and debtors that might not otherwise come to the Commission's attention.

20. In some cases, practices that consumers and consumer groups allege to be unreasonable or unconscionable may assist the Commission in identifying smaller creditors operating outside the mainstream credit industry; those effectively operating "back-yard businesses" or upon further enquiry, other practices which breach the Act and/or Fair Trading Act. These have recently included:

    - Mobile truck operators providing credit, and
    - Fringe lenders providing credit mainly to the Tongan community.

Enforcement Actions

Disclosure breaches

21. During the early stages of its enforcement of the Act, the Commission took an educative approach to its compliance activities. Our initial enforcement

actions focused heavily on encouraging voluntary compliance and giving feedback to credit providers where it identified issues indicating potential breaches of the Act.

22. The Commission also focused on ensuring creditors provided full disclosure. Initial disclosure, one of the pillars of the Act, addresses issues of asymmetric information between creditor and debtor, ensuring that debtors have sufficient information to compare competing credit arrangements before being irrevocably committed to them. A creditor's failure to meet disclosure requirements impacts directly on the debtor's ability to be informed, thus reducing their choices and reducing competition within credit markets. This impacts negatively on consumers and competitors and distorts market signals.

23. The Commission's first prosecution related to a disclosure breach by Senate Finance Limited. Senate Finance provided finance to debtors buying motor vehicles. Debtors conducted the transaction initially through car dealers, with the dealer faxing the relevant credit application to Senate Finance. If Senate accepted the transaction it subsequently faxed back the relevant disclosure information to the car dealer who then provided it to debtors. The fax process rendered some of the disclosure information so illegible that in one case a car dealer even suggested the debtor use a magnifying glass to read it. As the Act prohibits the enforcement of consumer credit contracts until disclosure is made, Senate also subsequently breached the Fair Trading Act when it made false representations that it had the right to enforce the contracts. The Court fined Senate Finance $59,000 and ordered statutory damages totalling $13,700 to be refunded to 17 debtors.

24. Dolbak Finance was also successfully prosecuted by the Commission for failing to make adequate disclosure when it failed to include information about the fees they were charging debtors in their disclosure statements. The omitted charges included a $5 fee for warning letters sent when payments were missed, $20 fees for repossession notices and $75 fees for preparing repossession authorities. Dolbak Finance was fined $100,000 and ordered to make refunds of $46,600 to over a hundred debtors.

Credit Related insurance, extended warranties, repayment waivers

25. During the course of the Commission's investigations it became clear that debtors were buying relatively expensive insurances but were not aware or did not realise they were purchasing these products until well after they'd entered the loan transaction and either did not understand how or when to access these services or could not access the benefits under these products, as they simply didn't apply to the debtor's circumstances. The Commission knows retailers and creditors can receive substantial commissions from the sale of these products. However, when selling these products retailers and creditors need to ensure products sold are suitable for debtors' needs and purposes[106].

[106] Failure to do so may have implications under the Consumer Guarantees Act, Fair Trading Act or Credit Contracts and Consumer Finance Act.

26. The Commission has recently issued compliance advice regarding an industry wide practice of selling credit related insurance products, repayment waivers and extended warranties to debtors as part of a “pre-packaged” loan. In some of these cases, as the computer software used defaults to a setting assuming the products are purchased, debtors must actively “opt out” of purchasing the products. In other cases, agents are selling these products on behalf of creditors (for example at car dealerships or other retail outlets) and may not be aware of the serious consequences for creditors (or potentially their own employers) of selling these products without undertaking an adequate assessment of their applicability to the debtor’s situation and needs. The Commission is concerned with the apparent lack of care taken by some agents when selling these products. The compliance advice informed industry of the Commission’s enforcement approach to these practices in an effort to ensure that debtor’s actively consent to the purchase of these products or that debtors receive the full statutory protections the Act provides in relation to these products, and that the products sold are suitable for individual debtors. The Commission’s enforcement approach is where a creditor fails to ensure that a debtor understands that they do not need to take out the product we will take the approach that the creditor has required the product within the meaning of the Act.

27. The consequences of “requiring the product” are that the creditor must take steps to ensure that it complies with section 69[107] and 70[108] of the Act, it discloses the charges in accordance with sections 17 and 32 of the Act and that the fees charged for these services comply with the provisions in section 41-45 of the Act.

28. Industry had previously been warned about the dangers of packaging products on a “one size fits all” basis when Club Finance had entered a $788,000 settlement with the Commission as a result of selling over 1500 of its unemployed debtors redundancy insurance. Club Finance required these debtors to purchase the insurance, despite a clause in the insurance contract preventing debtors who were unemployed at the time of purchasing the insurance from being covered by the insurance, even if they later became employed.

29. The Commission had also previously issued guidelines to the credit industry detailing its enforcement approach to commissions charged on credit related insurance products, and providing an indication of an appropriate level of commission, and has subsequently put insurers on notice that the Commission will consider taking injunctions against those who aid or abet breaches of sections 69, 70, 17, 32, or 41-45 of the Act.

[107] The requirement by a creditor to purchase the product must be reasonably necessary for the protection of its legitimate interests or is reasonably justifiable in light of the risks undertaken by the parties to the arrangement.
[108] Requirement to provide a copy of the terms of the product within 15 working days.

30. The recent compliance advice to industry has also reminded creditors of their obligations to rebate unused credit related insurance premiums when debtors pay their loans off early. If the insurance is financed under the loan contract, creditors need to consider whether the insurance contract is also terminated, and if so they must calculate any refund in accordance with the formula contained in the Act. The Commission recently settled with Geneva Finance Limited in relation to this issue. Geneva refunded approximately 3700 debtors over $510,000 as a result of failing to correctly rebate insurance premiums when debtors paid loans off early.

Enforcement action that failed to comply with debtor's statutory rights

31. Geneva Finance also has entered into with the Commission in 2007 in relation to a breach of section 13(i) of the Fair Trading Act. It was alleged that by making representations that Geneva Finance had the right to interest and fees on loans where securities had been repossessed and sold, when that was prohibited under section 35 of the Credit Repossession Act, Geneva Finance had breached the Fair Trading Act. Under that settlement, a total refund of $589,114 was provided to over 900 debtors, being the total overcharged fees and interest.

32. The Commission has taken a number of enforcement actions against creditors who breach debtors' statutory rights. These actions have been taken under section 13(i) of the Fair Trading Act. Section 13(i) states:

> *"No person shall, in trade, in connection with the supply or possible supply of…services…make a false or misleading representation concerning the existence, exclusion, or effect of any condition, warranty, guarantee, right, or remedy …"..*

33. The most common example of this type of breach is when creditors fail to meet the disclosure standards or disclose fully and subsequently attempt to enforce the consumer credit contracts. Section 99 prohibits the enforcement of consumer credit contracts where disclosure under section 17 or 22 has not been made and representations that the contract is enforceable will breach section 13(i) of the Fair Trading Act. Lelei Finance, Galistair Enterprises Limited, Dolbak Finance and Senate Finance Limited were all prosecuted in relation to disclosure breaches and breaches of section 13(i) when they later attempted to enforce consumer credit contracts that were subject to the section 99 prohibition on enforcement. A number of similar breaches have also been detected and addressed through settlements the Commission has undertaken with creditors.

34. Debt collection agencies also need to be aware that they may breach the Fair Trading Act if they attempt to enforce prohibited contracts where creditors have failed to meet the disclosure requirements of the Act. As a matter of best practice, the Commission encourages debt collectors to review their compliance programmes and consider what, if any, steps they undertake to

verify whether they can enforce consumer credit contracts without breaching the Fair Trading Act.

Full prepayment fees – switching costs?

35. While the majority of creditors the Commission has seen disclose their full prepayment formula as required under section 17 of the Act, it has become clear that creditor's are using a number of different methods to calculate their loss in situations of full prepayment.

36. While the Act allows creditors to either use the safe harbour formula or an alternative "reasonable" procedure the Commission took the position that any alternative procedure should be based on similar general principles to the safe harbour formula.

37. The Commission has recently prosecuted Avanti Finance in relation to its full prepayment formula. Avanti Finance was found not guilty however the matter is currently the subject of further proceedings.

38. Why is this issue important? The Act gives debtors a statutory right to full prepayment[109], enabling debtors to switch between different loans and creditors if that proves cheaper (or otherwise better suits their needs).This right removes disincentives to switching between credit providers and products. Debtors can build up or re-establish their credit histories within the lower tiers of the credit market, where credit is more accessible but often more costly, and then switch to cheaper loans from mainstream creditors once lenders have information to assess their risk profiles. Debtors' ability to switch products and providers within credit markets functions in the same way as within the telecommunications and energy sectors, as a powerful driver of competition. It also gives creditors the ability to recover their relevant administration costs and a reasonable estimate of their loss if this is authorised within the loan contract[110]. Generally the ability for consumers to switch promotes competition, innovation and drives costs down. Switching is important as it sends accurate, effective and timely signals to traders and competitors within markets.

39. Within the Act there is some tension between the debtor's and creditor's positions, the key issue being how to balance the ability to switch with creditors needs for certainty in situations of full prepayment. The guidance given by the Act is that an alternative procedure for estimating creditor's loss must be "appropriate[111]".

40. Allied Nationwide Finance Limited accepted it had breached the full prepayment provisions of the Act and agreed to refund over 1200 customers who were charged the equivalent of 31 days interest on the outstanding loan

[109] Section 50
[110] Section 51
[111] Section 54

balances at the time of prepayment. Customers received approximately $173,000 in refunds. Allied stopped charging this calculation of creditor's loss in August 2007 following the Commission's investigations being initiated.

41. What is clear is that creditors have a responsibility to mitigate their losses in the circumstances of full prepayment. The key issue with full prepayment continues to be that creditors need to be able to justify the procedure used to determine their loss and if necessary be prepared to explain it to both the Commission and Courts.

Targeting particular groups of debtors

42. The Commission has also taken enforcement action against a number of traders targeting vulnerable debtors, particularly those with English as a second language or in lower socio-economic areas. The Commission's enforcement criteria specifically considers whether more vulnerable consumers are targeted by non-compliant conduct, whether there is likely to be widespread public interest in the issue or if there are any aggravating features involved in the alleged conduct.

43. Recently the Commission successfully prosecuted Lelei Finance for failure to provide disclosure to over 600 debtors and subsequent breaches of the Fair Trading Act when it published pictures of "defaulting" debtors in a Tongan language newspaper Te Taimi o Tonga, despite the fact that the failure to disclose the terms of the credit contracts rendered the contracts unenforceable[112]. Lelei Finance specifically targeted Tongan debtors, advertising the newspaper and accepting traditional Tongan mats and tapa as security for loans. Lelei had previously been warned by the Commission in relation to its non-compliance with the disclosure provisions of the Act and elected not to change its documentation accordingly.

44. Lelei Finance had initially come to the Commission's attention as a result of feedback about it publishing defaulting debtor's photographs, a practice that at the time was considered unreasonable by the complainant, a consumer advocate.

45. The Commission recognises the challenges it faces in dealing with vulnerable consumers and has responded by developing relationships with key organisations these consumers are comfortable and familiar with using. The importance of these relationships was illustrated again during the course of this investigation. In an attempt to identify affected debtors, the Commission ran a quarter page advert in the same publication Lelei Finance used both to advertise and to "name and shame" defaulting debtors. The advert requested debtors to contact the Commission, it provided a free phone number, was run both in Tongan and in English and also stated that a

[112] Section 99. See the Commission's CCCF Act media releases for further information www.comcom.govt.nz

translation service would be available if required by callers. The Commission received one response to that advert, despite the fact that 616 debtors were eventually awarded total statutory damages of $12,520 as a result of the Commission investigation.

46. The Commission also became aware of other creditors targeting the Polynesian community. These creditors had also failed to comply with the disclosure provisions of the Act. In those cases, the creditors had provided some but not all of the information required to be disclosed in accordance with Schedule One of the Act. Nine creditors were subsequently warned and others provided with compliance advice letters and were later invited to attend a training seminar on the Act and the Commission's enforcement of it run jointly by the Commission and the Ministry of Pacific Island Affairs.

47. The Commission also prosecuted Galistair Enterprises Limited trading as xtraCash for failing to disclose key information; including the annual interest rate, the method used to calculate full prepayment, and how and when customers could cancel their loans; calculating interest on the total amount of the initial loans instead of on the decreasing unpaid balance and charging establishment fees ranging from $300 - $500 per loan. Galistair admitted that in setting these fees it included the cost of processing other customers' unsuccessful applications. The Auckland District Court found that successful applicants were charged a fee which, in effect, covered the cost of processing up to five unsuccessful applications. Judge Aitken said that this was "palpably an unfair and inappropriate business practice where the client base comprises some of the more vulnerable and desperate members of society." District Court Judge Aitken agreed with the Commission that Galistair Enterprises was "utterly reckless" when it provided top-up loans or additional advances to existing customers without entering into written agreements. Judge Aitken said that the potential for abuse was considerable, particularly as the company kept poor records. Galistair provided both pawn broking and personal loan services and had franchises throughout New Zealand.

48. In a similar case, the Commission also took enforcement action against four mobile truck operators, after receiving a number of complaints about these traders from consumer organisations. The complaints ranged from general concern about the industry and the ability of the debtors to make informed choices about whether to use the services to specific concerns based on comparisons of prices of products sold by the mobile shops and competing traders. Mobile shops provide a service where debtors can purchase household items, including groceries, clothing, and small appliances and pay for them using credit. In the cases the Commission considered, the creditors did not charge interest and most did not charge any sort of fees either. However the products they sold were more expensive than those you could purchase elsewhere. Mobile shops generally target lower socio-economic areas.

49. As a result of these complaints, the Commission undertook an industry wide investigation of mobile shops and four of the main mobile shop traders were

warned after they failed to disclose all of the information required by the Act. During the course of these investigations the Commission also considered whether there were elements of undisclosed interest included within the prices of the goods these creditors sold as the complaints alleged, however the Commission did not take action against the traders on this basis. The lack of disclosure did however have consequences under the Act for the mobile shop traders: section 99 prohibits the enforcement of contracts if debtors have not received adequate disclosure.

Credit Fees

50. The Commission's current enforcement focus for the 2007/08 and 2008/09 years is on taking action with respect to reasonableness of credit fees, for instance loan establishment, administration, and default fees. The Commission will be actively pursuing litigation with regard to credit fees considered to be unreasonable. The Commission has communicated this to the credit industry[113] on a number of occasions.

51. Ensuring fees are reasonable and disclosed will reduce an area of significant detriment for consumers as well as encouraging competition. Certainty on the acceptable components of various categories of fees will enable creditors to compete on the level of fees, or on interest rates, or on both. Inefficient creditors, who fail to comply with the Act and are currently over-recovering fees, will be exposed so that consumers are able to accurately compare creditors on the fees and interest rates charged.

52. The consumer detriment in unreasonable fees cases can be considerable, impacting adversely on the debtor's ability to repay the loan and their subsequent credit opportunities, as well as restricting their real ability to switch. While the Court is able to order refunds or reductions of unreasonable fees, the potential impacts of breaching the Act in this area can be significant. Although the competitive process presumes that those businesses responding to market signals will thrive and others will fail, the reality is failure can have significant personal impacts on employees, debtors, and investors alike.

53. Litigation is a priority for the Commission. The Commission intends to use civil and criminal proceedings to address alleged breaches of the Act, give creditors greater certainty about the obligations imposed under the Act and an indication of how various provisions of the Act will be interpreted by the Courts. It is only through the development of a body of case law that the issues relating to reasonableness of fees will be clarified.

54. The Commission will also be looking to provide greater guidance on its position with regard to credit fees in upcoming months. The area is a complex one and it has taken time to develop the necessary analytical framework. We are aware that there are creditors seeking this guidance.

[113] For further information see Communique issue 15: May 2008 www.comcom.govt.nz

55. The Commission has already communicated a number of positions on credit fees over the last 18 months to the industry however there are some creditors who have not accepted those views. This may not be unexpected given the revenue creditors generate through charging credit fees. Therefore the Commission has few options but to take litigation to ensure creditors comply with the Act in those cases. There is evidence that since the introduction of the Act some creditors:

- Have taken advantage of the lack of clarity regarding the unreasonable credit fee provisions to over-recover their costs, and have increased credit fees accordingly;
- Are setting fees at the same level of competitors, without regard to their own costs as required by the Act.

56. While the Commission recognises that justifying fees under the Act can be a complex process involving consideration of accounting, economic and commercial issues, the Commission still expects this process to be undertaken adequately if creditors elect to charge fees, rather than recovering their costs through interest rates. The Commission strongly encourages creditors to carefully consider how they would justify their fees before they are required to do so and to establish effective compliance systems for reviewing fees, in order to decrease their likelihood of breaching these provisions.

57. The Commission understands that discussions around potential amendments from an unconscionable to unreasonable fees test have also occurred in Australia. Given this, we are conscious that action taken in New Zealand may be followed closely by Australian observers as part of the wider public interest affecting CCCF Act enforcement.

Conclusion

58. The Commission has clearly signalled to industry that it will take strong enforcement action to ensure compliance with the CCCF Act and the Fair Trading Act. We have around 40 open investigations for a range of alleged breaches, but predominantly credit fee related investigations.

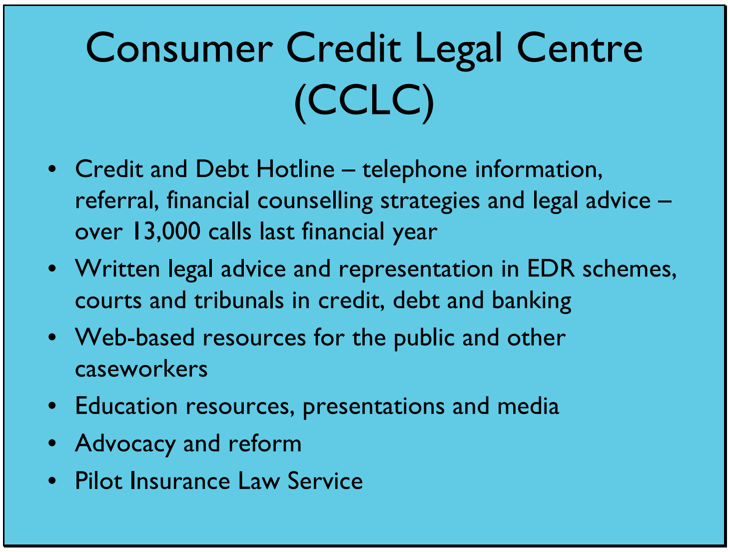
59. To date the Commission's enforcement action has recovered in excess of $3,000,000 of refunds or statutory damages for almost 25,000 debtors. Creditors who have failed to comply with the Act and been the subject of Commission enforcement action have also been fined over $240,000.

60. The consequences for creditors of failing to comply with the Act can be severe, while the Commission recognises the challenges faced by the credit industry; the Commission is committed to enforcing the Act to ensure the dual objectives of consumer protection and competition within the Act are upheld.

Karen Cox, Co-ordinator, Consumer Credit Legal Centre, Sydney

Slide 1

Slide 2



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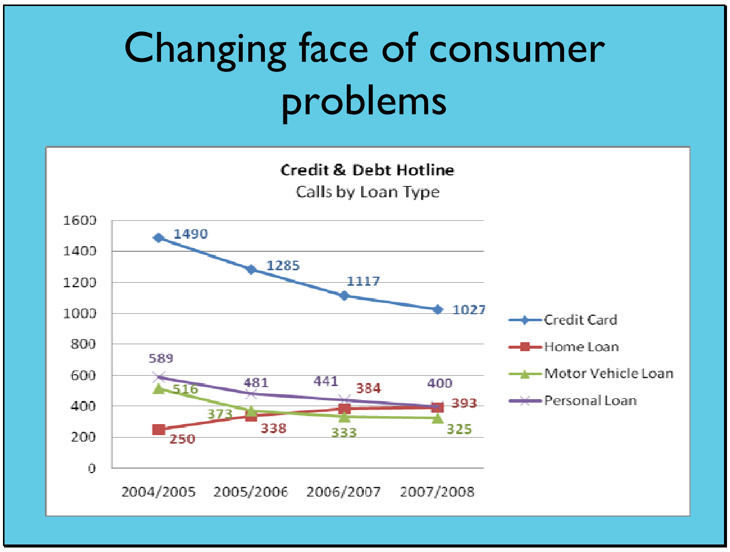

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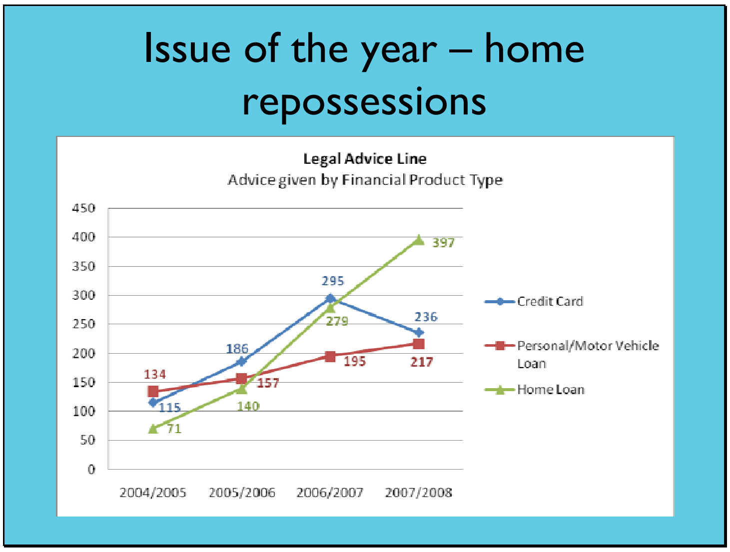

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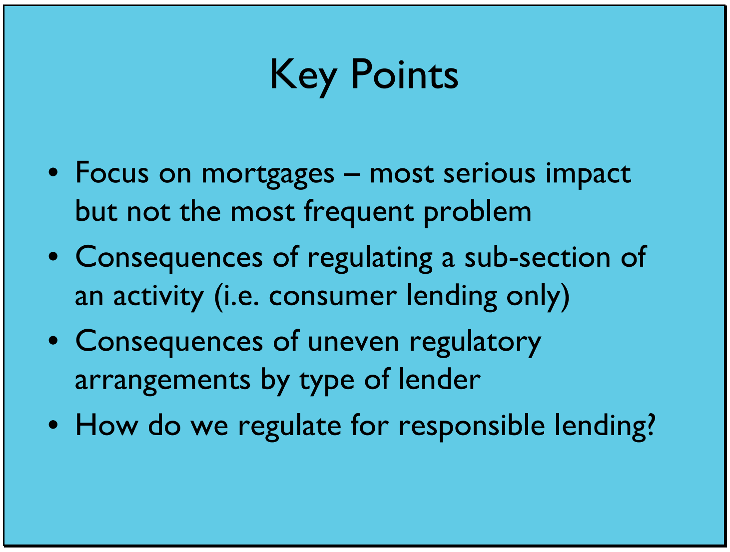

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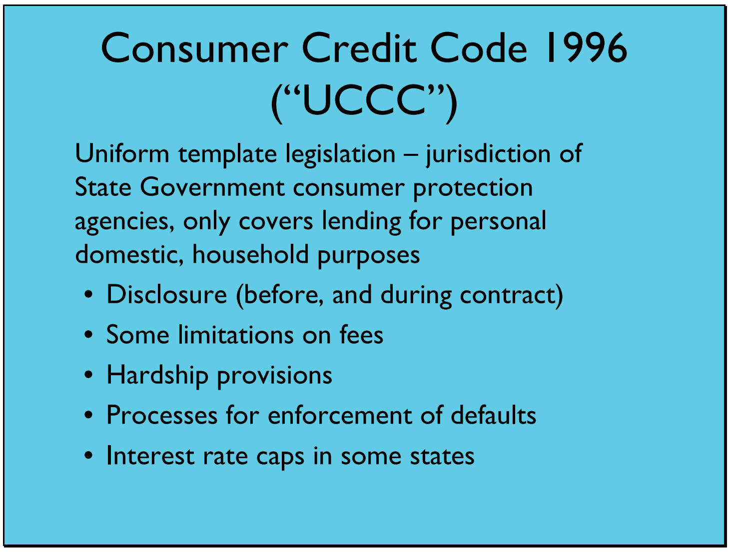


Slide 7

ASIC Act 2001

- Credit not included in Financial Services Reform generally
- ASIC given limited role in relation to misleading and deceptive conduct, unconscionable conduct, suitability for purpose and debtor harassment
- ASIC Act covers small business and individual investment, UCCC does not.

Slide 8

History of avoidance: regulators playing constant catch-up

- Short-term lending (payday lending)
- Interest expressed as fees to avoid interest rate caps
- Split entities charging brokerage, cheque cashing fees, and other means of avoiding minimum credit charge (to be caught by UCCC) or caps
- False business or investment purposes declarations to facilitate predatory and exploitative asset-based lending
- Price of goods are inflated and associated loans are characterised as "interest-free"
- Promissory Notes and Bills of Exchange

Slide 9

Failed to keep pace with market developments

Not kept pace with product development…
"Mortgages go down over time" - no longer true:

- Reverse mortgages
- Shared appreciation mortgages
- Interest-only loans
- Line of credit loans

More complex interaction with property values

Slide 10

Failed to keep pace with market developments

Growth of complications in the supply chain:

- One or more brokers/aggregators
- Mortgage managers
- Mortgage originators

Slide 11

Uneven regulation across sectors

Home lending - ADIs cf non-bank lenders. Latter have:

- No licensing obligations (no AFSL)
- No requirements to belong to EDR
- No oversight by APRA
- Complex supply chains which are more difficult to hold to account through current law of agency and fact that UCCC largely covers products not players

Slide 12

CCLC statistics for 2007/08

Of 238 calls analysed about home loans:

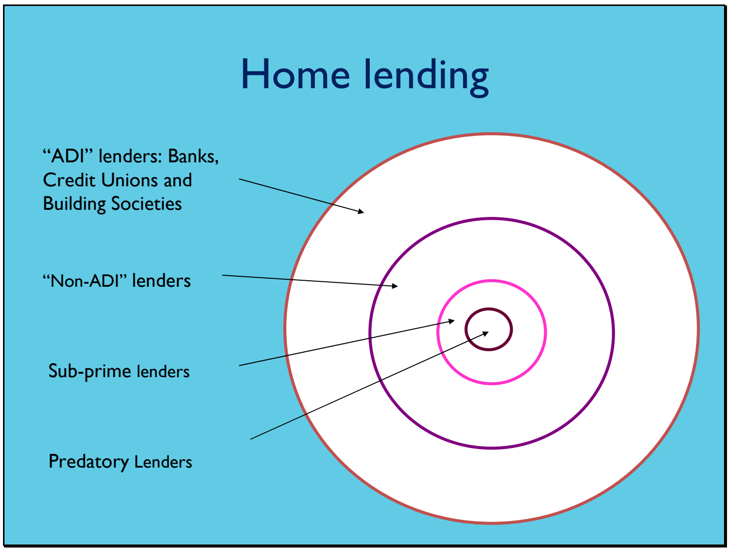
59% non-bank lenders against a peak market share of about 20%

- 22 % major banks

16% other banks

3% mutuals

Slide 13



Slide 14

Problems for consumers in non-bank sector

- Predatory lending
- Asset based lending
- Risk based pricing
- Risky debt consolidation/repetitive refinancing
- High exit costs
- Lack of access to dispute resolution
- Lack of understanding of roles of players in the supply chain

Slide 15

Predatory Lending

- Lender relies solely on asset which borrower has no desire to sell, indifference to income, poor credit history, including arrears on current mortgage
- Borrowers are vulnerable due to desperation, a lack of financial sophistication, or both
- High set up costs (usually financed into the loan) and significant penalty interest, default fees and enforcement costs
- The use of one or more brokers, solicitors or other intermediaries

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Predatory Lending

- Avoidance of the UCCC (most commonly using a business purpose declaration)
- Referred to solicitor for "independent" advice when solicitor appears associated with the broker or the lender
- Short terms such as 1-5 years, or even bridging finance with the interest rate stated on per month basis
- Interest-only and sometimes periods of "prepaid" interest in which additional amounts are borrowed to cover the interest payments, greatly adding to the cost of the loan.
- Rollovers, where the loan is rolled over at the end of the term, and another set of brokerage and fees are added to the amount borrowed.
- Swift enforcement action, particularly if there insufficient equity for a rollover.

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Predatory Lending

- Couple with four children and another on the way. Unemployed and in receipt of social security payments. Already in default on their existing sub-prime home loan. Need money to convert garage into another bedroom and to register car.
- Sold loan with double the repayments on their existing loan. Undisclosed set-up costs of close to $30,000 (Brokerage and lenders solicitors fees alone $20,000).
- Were told they would get a six month "repayment holiday" to get back on their feet (really prepaid interest) which did not eventuate.
- Defaulted immediately.

Slide 18

Predatory Lending

- A had home unit in Sydney and a first mortgage with a bank. She was up-to-date on her bank loan. She was from a non-English background and sought a loan to pay strata fees.
- She was given a loan secured by an equitable second mortgage.
- Fees were over $1500 on a $3000 loan and the interest rate was 5% per month.
- When fell into default and proceedings were issued in the Supreme Court. The lenders first demand was for $20,000 to settle the proceedings.

Slide 19

Fringe lending proposals

Uncertain future due to announcement in early July 2008 that Federal Government will take over the regulation of all types of credit

Key provisions:

•Amendment to business/investment purposes declaration provision

•Greater regulation of fees

•Prohibition on "blackmail" securities

Slide 20

Business/Investment Purpose Declaration ("BPD") Provisions

- S11 (1) Code presumed to apply unless contrary established
- S11(2) a valid BPD will defeat the presumption
- S11(3) "however, such a declaration is ineffective....if the credit provider (or any other relevant person who obtained the declaration from the debtor) knew, or had reason to believe, ...that the credit was in fact to be applied" for personal purposes.

Slide 21

UCCC avoidance explained…?

- *Employee* 1:The Applicants [the borrowers] would have been unable to obtain a personal loan as they were **unable to provide proof of income**. The only appropriate means to obtain finance would be a mortgage (emphasis added).

- *Employee 2:* It would have been impossible for the Applicants to obtain a personal loan, if they [the broker] **cannot do a loan conforming with the provisions of the Code then it may be appropriate to obtain a different type of loan**. A limited credit history must have been provided by the Applicants as the Respondent [the broker] only arranges private mortgages in such circumstances (emphasis added).

Slide 22

Proposed Amendment to BPD provisions

- S 11(1) presumption remains unchanged
- New sub-section 11(2) The contrary can be established for the purposes of subsection (1) only by establishing that-
- (a) the credit provider under the contract made inquiries about the purpose of the credit provided, or intended to be provided, under the contract; and
- (b) as a result of the inquiries, the credit provider was given information by or on behalf of the debtor that the purpose of the loan was wholly or predominately for either of both of the following-

  (i) an identified business purpose

  (ii) an identified investment purpose

Slide 23

Alternative BPD proposal

•The UCCC will apply, despite a BPD, if it is proved that the funds are actually used wholly or predominantly for consumer purposes (actual use test)

• However, if the credit provider has made appropriate/reasonable inquiries when making its decision to approve the application for credit, the UCCC applies, without civil or criminal penalties for non-compliance with contractual formation requirements;

•If the credit provider has not made sufficient inquiries, the civil and criminal penalties apply.

•Reasonable enquiries' test open-ended and referable to the nature of the transaction and circumstances of the customer (reasonable enquiries test)

Slide 24

Current provisions in relation to fees

UCCC (s72) currently gives the court or tribunal the power to review unconscionable fees and charges but these are limited to:

•A change in the annual percentage rate

•An establishment fee or charge

•A fee or charge payable upon early termination of a credit contract

•A fee or charge for a prepayment of an amount under the contract

Enforcement costs also able to be challenged as "in excess of those reasonably incurred" (s99)

Slide 25

Proposals in relation to fees

- Provisions extended to cover all fees however named and *unconscionable* replaced with *unreasonable*
- Limits on the fees already covered by s 72 not greatly altered
- Appears to limit all fees to underlying costs, or in the case of default fees, the credit provider's estimated reasonable loss flowing from the default
- Court may have regard to standards of commercial practice generally in deciding on reasonableness
- Government Consumer Agency given standing to apply under this division on behalf of a debtor, groups of debtors or the public interest.

Slide 26

Proposals in relation to fees

Interest charges (APR) disclosed must include all charges "that are in the nature of interest charges (whether or not it is expressed to be interest charges)"

Eg Credit contract for $20,000 over four years. Interest rate expressed as 17% but there is a $16,000 establishment fee.

Slide 27

Fee issues for consumers

Fees and charges can

- Detract from ability to genuinely compare cost of contracts - anti-competitive
- Defeat interest-rate caps when they apply
- Severely exacerbate hardship and lead to further default – default/penalty fees
- Detract from motivation to properly assess ability to repay (eg predatory home lending/payday lending)
- Trap consumers in uncompetitive loans

Slide 28

Effective fee regulation

- Must be comprehensive – all fees
- Must be limited to reasonable estimate of underlying losses for default charges/penalty fees
- Must consider anti-competitive effects (generally and exit fees in particular)
- Must include capacity for regulator to take action

Slide 29

Broker Regulations

•Currently patchy regulation in some states. Licensing only in WA

•Other states have no regulation or limited and tied to UCCC

•Brokers market share has increased rapidly to about 37% of new loans in 2007

•Finance Broking Bill 2007 out for comment in late 2007 after 4 year gestation period

Slide 30

Finance Broking Bill

- Covers all finance/mortgage brokers, other intermediaries (such as mortgage managers and originators) and credit advisers (for example, debt reduction scheme consultants)
- Compulsory licensing, minimum training standards, fit and proper person test, and compulsory membership of EDR
- Exemptions from some parts of the bills for small business broking and "white label" originators but all must be licensed and in EDR

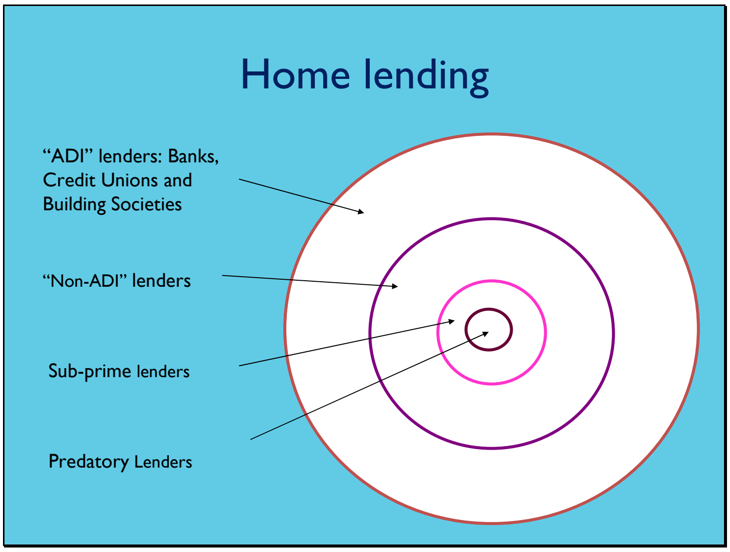
Slide 31

Controversial Provisions

- Obligation to assess capacity to pay
- Lender liability
- Stay of proceedings

Consumer groups are also lobbying for a limit on the amount of brokerage, if any, that can be financed under a loan/mortgage

Slide 32



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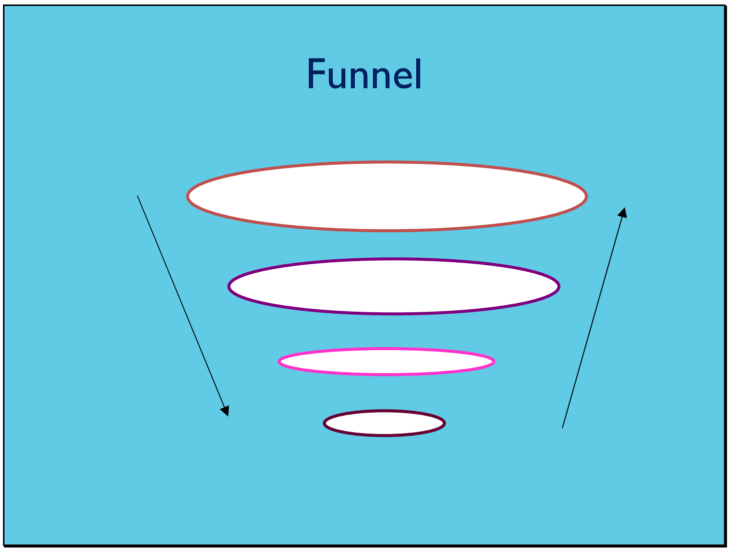


Slide 34

Deterioration in mainstream lending standards

- High loan to valuation ratios (up to 100% or more)
- Increased use of "low doc" and "no doc" loans (including for PAYG earners and social security recipients)
- Increased use of brokers/intermediaries, some of whom participate in a number of activities of concern, from "up-selling" consumers into loans larger than they want or need to encouraging or perpetrating fraud
- Decline in the quality of property valuations

Slide 35

Deterioration in mainstream lending standards

- Acceptance of a wider range of income types from more insecure sources
- Creative but arguably dangerous product design (older people sold lines of credit secured over their home with no capacity to repay the loan once it is fully drawn except to sell their home, for example)
- Deterioration in quality control and verification processes within lenders.

Slide 36

Low-doc and *no-doc*

Moody's Investor Service report June 2008 re loans 2004-2007

•defaults most prevalent for contracts with high loan to value ratios (more than 90 per cent), "low doc" and "no-doc" loans.

•95 per cent or more LVR had risen from negligible to 4.7% in 2006 and 14.2 % in 2007

•Low-docs peaked in 2006 and 2007, representing almost 17% of loans issued in the latter year

Fitch ratings report June 2008

•sharp rise in low-doc and no-doc loans in WA due to economic boom, 28.8% of mortgages written in 2007

•NSW the worst performing states and WA the best, but mortgage performance in WA is deteriorating at fastest rate of all the states despite the mining boom

Slide 37

Responsible Lending

Responsible lending needs to be key in Federal regime, but what does this mean?

•UCCC section 70 – facilitates no-doc lending, has not driven change in credit card lending

•Code of Banking Practice – too non-specific, danger of lowest common denominator approach

•ACT provision- very prescriptive about process rather than outcome

Slide 38

The future?

CCLC submits:

- Comprehensive coverage – players and products
- Licensing with appropriate conduct provisions and EDR
- Much of UCCC enacted at the Commonwealth level but with greater capacity to develop with product innovation in the market
- Specific outcome based credit assessment provision – perhaps "knew, or could have ascertained by reasonable enquiry, that the debtor could not pay without substantial hardship; and/or could not pay without selling primary residence" – with appropriate penalties for breach and remedies for borrowers
- Extension of the role of APRA

Slide 39

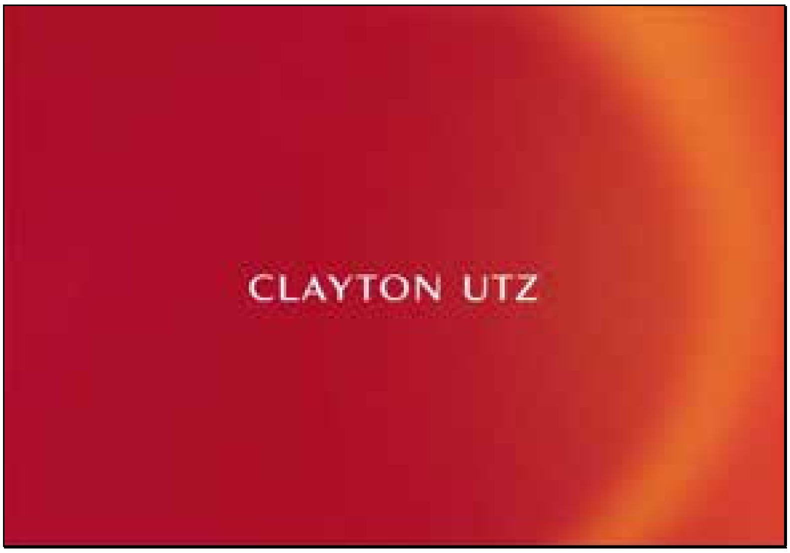
Challenges

- Appropriate remedies for consumers
- Credit advice – mathematics v actual human behaviour
- Appropriate treatment of revolving credit
- Aging population
- Marketing
- Interest rate caps

Narelle Smythe, Partner, Clayton Utz, Sydney

Lender Liability for Riskier Lending – Developing Regulatory Responses

Slide 1



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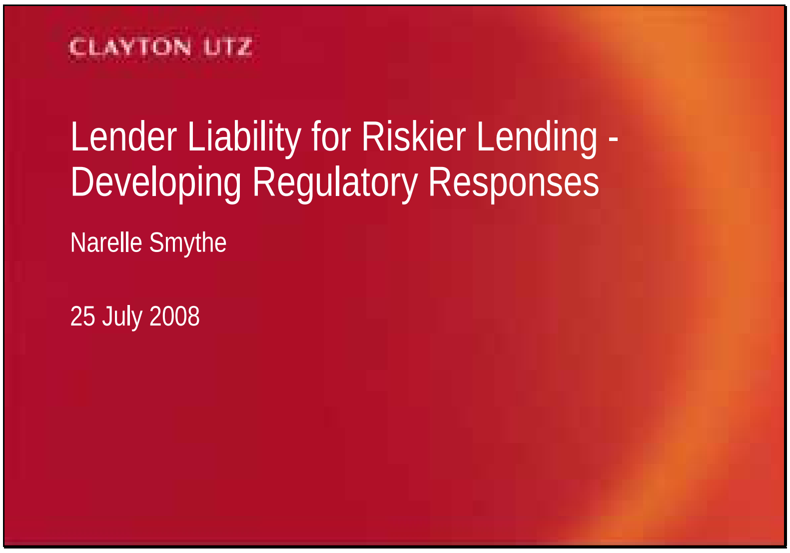

Slide 3

Current Environment

- s70 UCCC - Court may reopen unjust transactions
- s28A Act Fair Trading Act - must carry out a satisfactory assessment process before entering into or increasing the limit under, a credit card contract
- cl 25.1 Code Banking Practice - exercise care and skill of a diligent and prudent banker in selecting and apply credit assessment methods

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Slide 4

Current Initiatives and Proposals

- Ministerial Council on Consumer Affairs
  - credit card over-commitment and responsible lending
  - external dispute resolution
- Draft National Finance Brokers Legislation
  - Finance brokers must take steps to assess consumers capacity to repay

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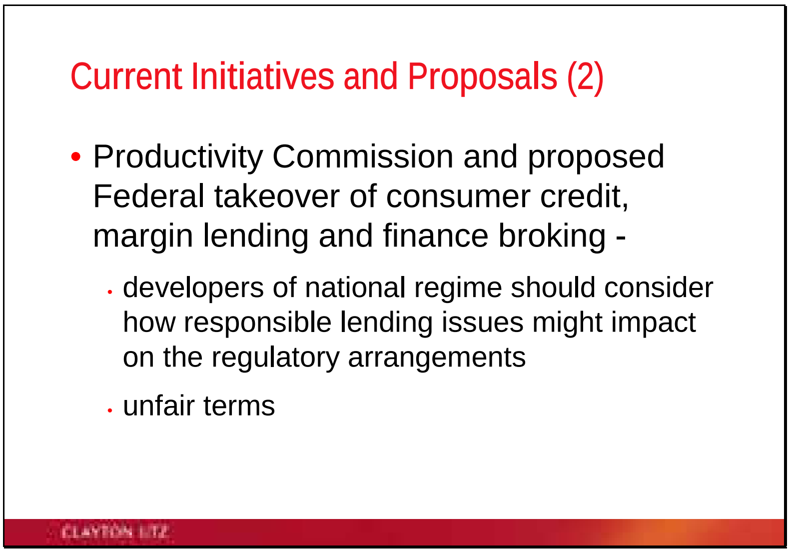
Slide 5



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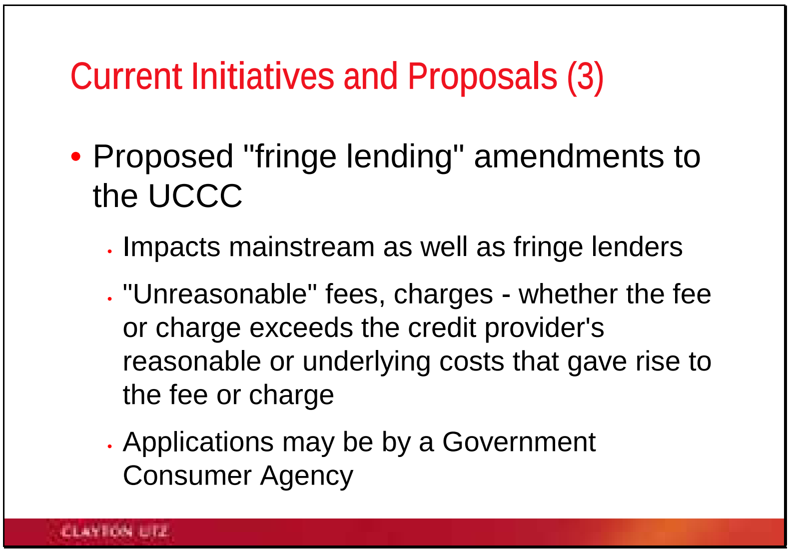

Slide 7

Current Initiatives and Proposals (4)

- Removal of presumptions relating to Business Purpose Declarations - active steps must be taken to ascertain the purpose of the loan.
- Annual percentage rate must include charges 'in the nature of interest charges".

- Review of Code of Banking Practice - Interim recommendation that a general principle of responsible lending be included

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Slide 8

Other matters

- International Trends

CLAYTON UTZ

Slide 9

Friday 25th July, 2008

Concurrent 2b
Millennium Hotel

1.30pm – 3.00pm

Chair:
Richard Fawcett
Partner
Blake Dawson
Sydney

Speakers:
Rick Drury
Director, Credit Restructuring
National Australia Bank
Melbourne

Prof. John Stumbles
University of Technology
Sydney
‘

Workouts – What lurks beneath:
The Impact of Credit Derivatives,
Credit Default Swaps & Debt Trading’

Rick Drury, Director, Credit Restructuring, National Australia Bank, Melbourne

The Hidden Aspects of Workouts (joint paper with Prof. John Stumbles)

Slide 1

Credit Derivatives

The Hidden Aspects of Workouts
John Stumbles
Rick Drury

9516714

Slide 2

Credit Derivatives – What are they? Why?

Financial instruments designed to allow the independent trading/hedging of credit risk

Types:
- Credit Default Swaps (“CDSs”)
- Synthetic collateralised debt obligations
- Credit linked notes

Why:
- Active Portfolio Management
- Management of individual exposures
- Market making and trading

Slide 3

Credit Derivatives Market

Global Credit Derivates Market	**US Dollar**
1997	180 billion
1999	586 billion
2001	1,189 billion
2003	3,558 billion
2004	8,400 billion
2005	17,100 billion
2006	26,000 billion

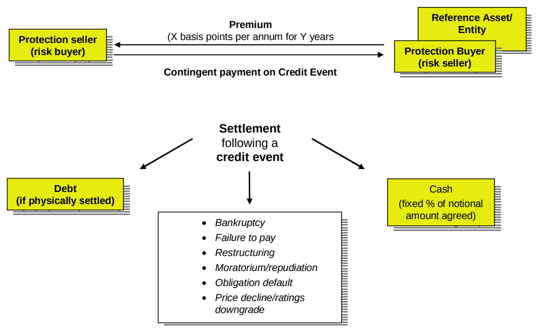
Slide 4

Main Buyers and Sellers

	% of Trade
Banks	50% (falling as a %)
Hedge/PE Funds	17% (on the rise)
Securities Firms	15%
Insurers/Re-insurers	8%
Other (corporates, super funds)	10%

Slide 5

Single Name Credit Default Swaps



Slide 6

Documentation

- ISDA Master Agreement
- Schedule to ISDA Master Agreement
- Confirmation
- Credit Support Documents

Note: ISDA Credit Derivatives Definitions - incorporated by reference

Slide 7

Confirmation

Confirmation particularises:

- Notional amount
- Reference Entity
- Scope of protection (obligations covered)
- Tenor
- Premium
- Settlement Method

Slide 8

Settlement of CDS's

1. **Physical**
   - Protection seller pays the protection buyer the debt in cash
   - Protection buyer delivers the protection seller the debt obligation
2. **Cash**
   - Protection seller pays the difference between debt and "market value" of the debt; OR

     Protection seller pays an agreed percentage of the debt
   - Protection buyer remains holder of the debt

Slide 9

ISDA Protocols

Designed to facilitate settlement if shortage of physical debt obligations

Slide 10

Deliverable Obligations

- Full Restructuring
- Modified Restructuring
- Modified, Modified Restructuring
- Rationale: control use of ‘cheapest to deliver’ option by stipulating maturity date of deliverable obligation

Slide 11

ISDA Credit Events

- Failure to Pay
- Bankruptcy
- Restructuring

Slide 12

Failure to Pay

- Inconsistency with payment clause in underlying documentation
- Potential for inconsistent 'grace periods'
- Payment default may arise earlier in time in, for example, the APLMA Multicurrency Term and Revolving Facilities Facility Agreement
- Payment default may arise later in time in ISDA master agreement
- Financiers' reluctance to trigger payment default in loan agreement if wish to avoid indication of insolvency and/or resignation of borrower's directors

Slide 13

Bankruptcy

- ISDA Master Agreement –triggered on filing of court process unless dismissed in 30 days
- APLMA – Potential for different grace period
- Differing potential thresholds if a security is enforced
- APLMA – covers negotiations with financiers with aim of rescheduling debt

Slide 14

Rescheduling Credit Event

- Scope of Reference obligations
- Characteristics of reference obligations (eg: unsubordinated, listed, particular currency)
- Threshold amount (default choice of US$10 million)
- Multiple holder obligation- need obligation held by at least 4 unrelated holders under documentation variable only with consent of 66 2/3% of holders

Slide 15

Problems with Restructuring credit event

- Timing – ambiguity when restructuring agreement actually reached
- Debt Extension
- Debt Exchange
- Prepayment
- Reference Entity

Slide 16

Assessment

- Practical utility of each credit event
- Is there a a difference between utility of each credit event?
- Extent of impact of CDSs on workouts

Slide 17

Major Credit Events since 1999

Credit Events called under Credit Derivatives:

AT&T Canada	Enron	Indonesia Sov. Debt
Air Canada	Global Crossing	Russia Sov Debt
British Energy	K-Mart	**Railtrack**
Collins & Aikman	**Marconi**	United Airlines
Delphi	**Parmalat**	**Worldcom**
Delta Airlines	Swissair	Xerox

Slide 18

Risk for workouts

- Disclosure Issues
- Disparate Economic Interests and Motivations
- Syndicate Stability and Competence

Slide 19

Credit Derivatives in Restructurings

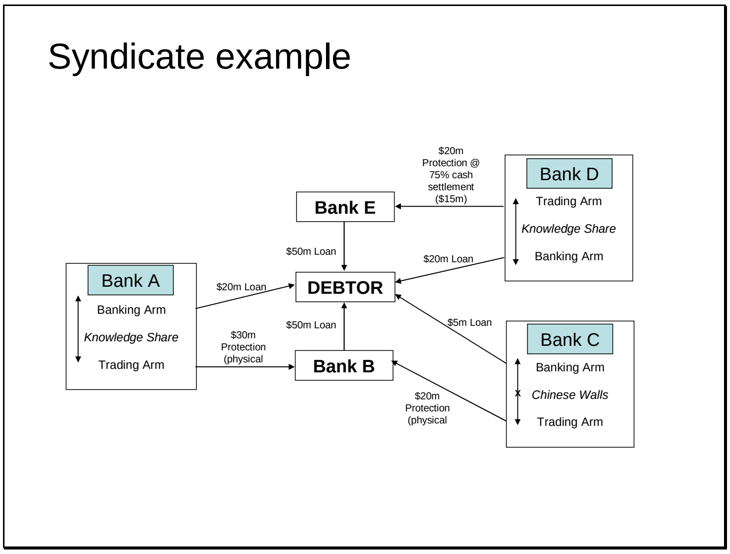
- Key Question: is the borrower a ‘reference entity’ in the CDS market?
- Has each member of the syndicate disclosed whether they are covered by a CDS?
- What are the terms of the CDS including tenor?
- What are the significant differences (if any) between the terms of each CDS?
- Is it possible to identify any convergence of interests?
- What are the approval mechanisms in the syndicate? Problems if need 100% approval

Slide 20

Syndicate Example

Facts:
- 100% approval needed for standstill
- Standstill likely to involve a restructure in which each financier accepts a debt/equity swap for 20% of its debt
- Trade on with no standstill highly risky
- Receivership return calculated at 60 cents in the dollar.
- Banks B and E are on the steering committee. Banks A, C and D are not.
- Two financiers out of the ten have purchased credit protection in varying degrees. Three of the ten financiers have provided credit protection

Slide 21



Slide 22

Syndicate Example

Bank	Face Value Debt	After Credit Protection	Probable Mind Set of Bank
A	$20m (standstill is a credit event)	$50m	Won't want a credit event to occur. Probably want **trade on.**
B	$50m	Nil	Will be trying to engineer a credit event. **Receivership** would be preferred option.
C	$5m (standstill is not a credit event)	$25m	Playing "ransom card" to get paid out as only a small player. Is threatening to vote "no to standstill but unaware of $20m protection by trading arm.
D	$20m (standstill is not a credit event)	$20m (plus $15m cost)	Definitely wants **standstill** but not the biggest voice at the table.
E	$50m	$50m (with $15m cash coverage)	**Undecided:** - Standstill – 8-% + equity - Receivership – 90% + 10% write off - Trade on – may be 100%

Slide 23

Developing Trends

- Growth of market
- Increase in Australian reference entities?
- Credit Derivatives – type and complexity mushrooming
- Cash settlements will increase
- Are Financial Institutions' back offices keeping up?
- Basel II – Capital Adequacy and Credit Derivatives
- Non-disclosure / inequality of information flows

Slide 24

Credit Derivatives

The Hidden Aspects of Workouts
John Stumbles
Rick Drury

Prof. John Stumbles, University of Technology, Sydney
Some Hidden Aspects of Workouts

Some Hidden Aspects of Workouts

John Stumbles
University of Technology, Sydney

Introduction

In a corporate collapse, a creditor of a distressed company has an economic interest in identifying the preferred way in which its return is maximised. Typically, this may involve the acceptance by a financier of waivers of defaults, extensions of time, and on occasions, and the release of part of the outstanding indebtedness or a conversion of the debt into equity. This mechanism breaks down if a holder of a debt lacks that economic interest in maximising the recovery of its outstanding indebtedness.

The severance of exposure from ownership of a debt may arise in a number of ways. A financier may have sold down its debt to a third party even though that financier may remain the lender of record; or a financier may have entered into a participation arrangement with a third party such that in the event of default, that financier looks to its participant for recovery rather than to the distressed entity. More recently, it is equally likely that a financier may have entered into a credit default swap (CDS) with a third party.

Up until the latest credit crisis, the role of financiers had been evolving with many focusing on the origination and syndication of corporate loans rather than holding them to maturity. The ability to originate and syndicate depended on an ongoing relationship between the financier and its borrower. If a bank sold a loan which it has originated, this might damage that relationship. If, however, the financier purchased a CDS, it may reduce its exposure to its borrower and at the same time, retain the loan on its books thereby maintaining the relationship with that borrower.

A CDS arrangement may encompass all or a part of that financier's exposure to a borrower. In effect, the buying of protection under a CDS operates as a form of credit insurance, even though as a matter of law, it is quite distinct from insurance[1]. In the first two types of protection mentioned above, the lender of record is usually required to act on the instructions of the economic owner of the debt or of the entity which ultimately bears the risk of loss. In the case of a CDS, the seller of protection usually has little input into the way in which a buyer of protection deals with the borrower. At the same time, the lender of record that is fully covered by a CDS may have little incentive to participate in a workout.

In its survey of the risks associated with private equity, the Financial Services Authority in the United Kingdom noted that the diversity in debt ownership, whilst spreading exposure, resulted in 'increased complexity in managing a corporate restructuring, or default workout, involving a large number and variety of investors.'[2] There have also been suggestions that

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1 *Aeon Fin Prods, Inc, v. Société Generale,* 476 F. 3d 90 96 (2d Cir. 2007) (noting that credit default swaps differ significantly from insurance contracts as "they 'do not and are not meant to indemnify the buyer of protection against loss'" but
"'[r]ather allow parties to 'hedge' risk by buying and selling risks at different prices and with varying degrees of correlation'") (citations omitted).

2 *Private equity: a Discussion of Risk and Regulatory Engagement'*. (Feedback Statement 07/03), Financial Services Authority, (June 2007) at 22 (FSA Survey).

the INSOL Approach'[3] for negotiating a workout is no longer suitable where there is such a diversity of investors.

This paper analyses the typical single named CDS and then considers whether the holding of credit protection by financiers poses additional risks for effecting a workout.

Description of a Credit Derivative

A "derivative" is a contract between two parties where the value of the contract is determined by reference to an external circumstance. Thus derivatives have been used to hedge (or speculate on) risks in connection with interest rates, currency exchange rates and the price of commodities. Since the mid 1990s, the external circumstances that are the subject of derivatives have expanded to cover hedging of and trading in credit risk. CDSs have accounted for much of the development in the use of derivatives by market players.[4]

A CDS should be distinguished from a portfolio credit default swap, a collateralised debt obligation and a credit linked note even though such instruments may have an economic function similar to a CDS. A description of these other forms of instrument is set out in the Appendix.

The majority of CDSs are effected by dealers in the over-the-counter market. The contracts are usually recorded in standard form documentation published by the International Swaps and Derivatives Association, Inc. ('ISDA').

The standard documentation consists of:

- an ISDA 'Master Agreement' (the 'master agreement'), which particularises matters such as events of default, representations and warranties, covenants, liquidated damages, and choice of law;
- a 'Schedule' to the master agreement, which modifies the master agreement to reflect the specific requirements of the parties;
- a 'Confirmation' (the 'confirmation') which stipulates the economic terms of each individual transaction, and incorporates by reference not only the master agreement but also any definitions referable to the subject matter of the derivative;
- In the case of a CDS, the '2003 ISDA Credit Derivatives Definitions' (the 'credit definitions'), which are of particular importance; and
- 'Credit Support Documents' where the contracting parties have differing credit quality and security is required.

A typical single name CDS may be represented diagrammatically as follows: [5]

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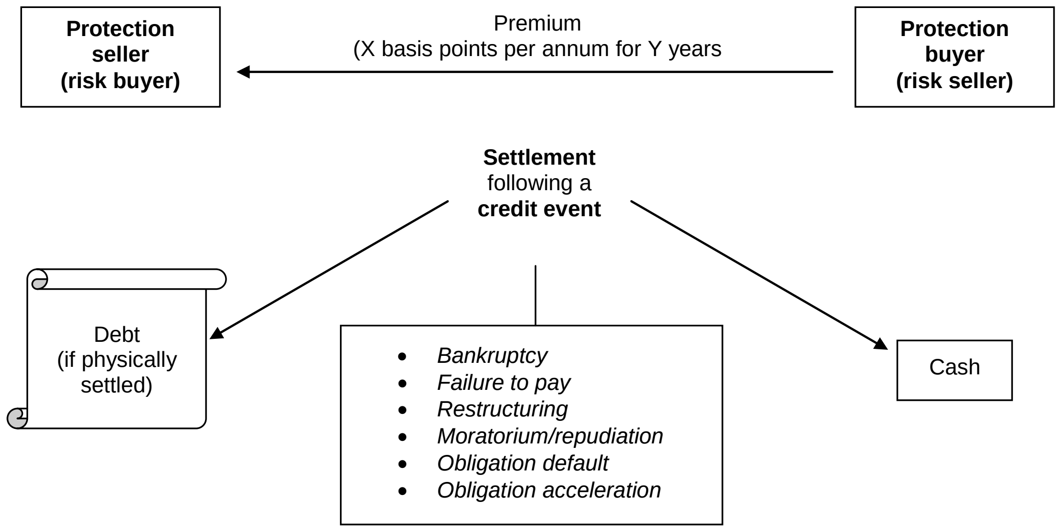
[3] See *Statement of Principles for A Global Approach to Multi-Creditor Workouts,* (INSOL International, October 2000). The principles represent best practice for multi-creditor workouts and are broadly consistent with the so called 'London Rules.'

[4] David Yeres, *An Overview of the Uses of and Issues Surrounding Credit Derivatives, in Nuts & Bolts of Financial Products 2007,* at 529,531 (PLI Corp. Law & Practice, Course Handbook Series No B-10870, 2007) ('The International Swaps and Derivatives Association, Inc…estimates that the notional value of credit default swaps grew alone by 52% during the first half of 2006 to reach a notional value of over US$ 26 trillion. This is up from US$ 2.60 trillion in 2003').

[5] Taken from *Credit Derivatives in Restructurings a Guidance Booklet* (INSOL INTERNATIONAL, September 2006) (INSOL Guide). This booklet is an excellent introduction to the issues which arise in this area.



As illustrated in the above diagram, one party (the ‘protection buyer’) will pay another (the ‘protection seller’) for assuming the risk on a specified principal amount (the ‘notional amount’) of debt (the ‘reference obligation’)[6]. of a specified entity (the ‘reference entity’)[7]. during a specified period (the ‘tenor’).

The protection buyer pays the protection seller a premium, made up of a series of fixed payments made (typically, quarterly in arrears) and computed at a fixed rate per annum on the notional amount. In return, the protection seller agrees to pay all or, more usually, a certain portion of the notional amount upon the happening of one or other of the events particularised in the diagram (a ‘credit event’). If a credit event does not occur during the term of the CDS, the protection buyer will not receive any payment at all from the protection seller.

In specifying the economic terms, the confirmation will include of the following:

- the notional amount;
- the reference entity;
- the reference obligation;
- the tenor;
- the premium; and
- the settlement method, which may either, be physical settlement or cash settlement.

After the occurrence of one of six credit events[8] described in the above diagram, either the protection buyer or the protection seller must deliver a ‘Credit Event Notice’ (the ‘credit event notice’) to the other, which describes the credit event and of its formal request to settle

6 The obligations are typically confined to obligations to bondholders but may also include obligations under a guarantee.

7 Single named CDSs may include provisions identifying a successor entity if the reference entity is subject to merger such that the cover continues in respect of the successor entity.

8 It is common practice to select only three events: bankruptcy, failure to pay and restructuring; See paragraph 5.2 of the INSOL Guide infra note 5.

the CDS[9]. The mechanics of settlement depend on whether the confirmation for the CDS stipulates physical settlement or cash settlement.

In the physically settled CDS, the protection seller must pay to the protection buyer the notional amount in cash, in exchange for the buyer physically delivering a debt obligation to the protection seller (measured by principal amount or the fair market value of the reference obligation as at the date of the CDS).[10] The CDS will usually also require the contemporaneous delivery of a notice of publicly available information. This notice is required to cite information referable to the occurrence of the identified credit event as published in a recognised source[11].

In cash settled CDS, the protection seller pays the protection buyer the difference between (i) the original principal amount of the reference obligation (or its fair market value on the date of the CDS) and (ii) the market value[12] of the reference obligation after the credit event occurs. Alternatively, the parties may stipulate the price by reference to a formula which estimates the actual amount recoverable by the protection buyer in connection with the reference obligation.

Historically, a physically settled CDS was more common than a cash settled CDS[13]. The advantage of a physically settled CDS is that it does not necessitate the calculation of the value of the reference obligation after a credit event occurs - a time when the market for reference obligations may be distorted. However, the notional amount of CDSs for many reference obligations far exceeds the aggregate amount of reference obligations on issue. As a consequence, the market for reference obligations may be distorted after a credit event, as protection buyers of physically settled CDSs struggle to obtain sufficient amounts of the reference obligations to satisfy their delivery obligation.

In the collapse of the US reference entity Delphi, only $2 billion in reference obligations were on issue in the market and were available for delivery. Yet Delphi was referenced by $28 billion in notional amount.[14] Following the commencement of Delphi's bankruptcy, protection buyers scrambled to find the then relatively rare Delphi reference obligations. At

9 *Practical Guide to 2003 Definitions* 99-100.

10 The confirmation usually stipulates the specific obligations of the reference entity which would satisfy the delivery obligation. Commonly, the delivery condition is satisfied by the delivery of any senior unsecured and unsubordinated loans in an agreed currency. In *Nomura International plc. v. Credit Suisse First Boston International*, [2003] 2 All ER (Com) 56, there was a dispute as to whether the delivery of convertible bonds satisfied the delivery obligation. The parties had stipulated a 'Non Contingent' delivery obligation. It was held that the delivery of conditional bonds convertible at the holder's option did not render the bonds contingent for the purposes of the credit definitions.

11 The confirmation would usually specify the source. It may also include information from a trustee, paying agent, fiscal agent or clearing agent. In *Deutsche Bank AG v. ANZ Banking Group Ltd*. 2000 WL 1151384 (QBD Comm. Ct) the provision of a news article confirming a late payment was held to have satisfied this requirement.

12 Quotes are obtained from dealers during a specified period following the occurrence of a credit event. However, other methods are evolving. See INSOL Guide infra note 5 at paragraph 5.7.

13 As at 2003/2004, it was estimated that approximately 86% of CDS were settled physically. See BBA *Credit Derivatives Report 2003/2004.* This percentage has probably diminished since 2004. For CDS referencing structured finance facilities, it is standard practice to select cash settlement because of the small issue size makes physical settlement difficult. See Moorad Choudhry, *Credit Derivatives and Structured Financial Products: Transforming the Debt Capital Markets*, Euromoney, Nov. 2004 at 2.

14 Compare the Marconi restructuring discussed below, where it was estimated that the market in Marconi swaps exceeded the $4 billion the company owed its creditors.

the same time, the price of Delphi notes increased to a price of 70% of par when the price had been 63% of par before the commencement of the bankruptcy proceedings[15].

By way of response to the difficulty in obtaining debt obligations to satisfy the physical settlement requirement, ISDA has promulgated a series of protocols[16] permitting the cash settlement of CDS which, as originally agreed, contemplated physical settlement. Parties may follow the ISDA procedure in adopting the protocol for an identified reference obligation and thereby mutually agree to amend their original contract. The take up rate of the protocols has been high[17].

If the parties select the restructuring credit event, they must also stipulate whether their deliverable obligation involves 'Full Restructuring', 'Modified Restructuring' or 'Modified Modified Restructuring'.

Under the first alternative, which applies in default of the selection of any other alternative, there is no restriction imposed on the maturity or transferability of obligations in order for them to be deliverable[18].

If notice is given of the occurrence of a restructuring credit event and if the parties have selected 'Modified Restructuring,'[19] then the deliverable obligation must have a final maturity date no later than the earliest of:

- 30 months after the scheduled termination date of the CDS;
- 30 months after the effective date of the restructuring; and
- the latest final maturity date of any restructured loan or bond,

and in the case of a loan be transferable to an 'Eligible Transferee'[20] without consent. If the deliverable obligation is a bond, then the bond must be transferable without restriction[21].

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15 Quoted from Jay M. Goffman, Mark A. McDermott and Andrew Thau '*Distressed Investing: Selected Topics'* (an unpublished paper presented as seminar conducted by the American Bankruptcy Association in October 2007 at Georgetown University Law Center)('Goffman') at note 11.

16 For example ISDA has published the following protocols in relation to index products: the *2005 CDS Index Protocol* (relating to Collins & Aikman Products Co., a US supplier of automotive parts and the *2005 Delta & Northwest CDS Protocol* (relating to Delta Airlines, Inc. and Northwest Airlines, Inc.). Further examples are available at www.isda.org.

17 Goffman infra note 15 at 18.

18 Long dated bonds may trade at a price considerably lower than short dated paper reflecting the market's opinion of the long term prospects of the reference entity. In the 2000 restructuring of Conseco in 2000 (involving a debt extension), this occurred allowing the protection buyer to deliver not loans (trading at 92% of par) but long term Conseco bonds trading at 66%-90% of par thereby delivering a windfall gain to the protection buyer. See further Goffman infra note 15 at 13.
The other alternatives discussed in the text were intended provide mechanisms for avoiding such an outcome. The first alternative is largely reflected in Section 2.32 of the credit definitions and gained the market title 'Modified Restructuring' and largely reflected US practice at the time rather than European practice. To bring US and European practice further into accord and because European bonds had a shorter term and contained more restrictive transfer restrictions than was the case with US bonds, the 'Modified Restructuring' option was further changed. The further alternative gained the market title 'Modified Modified Restructuring' and is reflected in Section 2.33 of the credit definitions. See further Chris Allen and Matthew Dening, *A Question of Definition*, The Treasurer, (November 2003) 19.

19 For more detail see credit definitions Section 2.32. In Australia and New Zealand, it is the usual practice to adopt the 'Modified Restructuring 'alternative.

20 credit definitions Section 2.32(f).

21 credit definitions Section 2.20(b) (v) and Section 2.32(b).

If notice is given of the occurrence of a restructuring credit event and if the parties have selected ‘Modified Modified Restructuring’[22], then the deliverable obligation must have a stated maturity no later than the later of:

- the termination of the CDS; and
- 60 months after the effective date of the restructuring (where there is a bond or loan) or 30 months after the effective date of the restructuring (in the case of all other deliverable obligations),

and be transferable to the protection seller without any requirement for consent (except for any consent of the obligor under the relevant loan documentation where such consent is not to be unreasonably withheld or delayed)[23]. This type of consent requirement is commonly seen in European loan documentation such as that used by the Loan Market Association.

In addition to modifying the requirements concerning term and consent, the class of persons to whom the obligation may be transferred is more specific and easier to satisfy.[24]

In the case of either ‘Modified Restructuring’ or ‘Modified, Modified Restructuring,’ the obligations to be delivered must be ‘Multiple Holder Obligations’. That is, it is necessary that the obligations are held by no less that 4 unrelated entities and for at holders of at least 662/3% to consent to any changes in the loan documentation.[25]

The ISDA credit events[26]

In a CDS entered into outside the US, failure to pay, bankruptcy and restructuring constitute the usual risks which are covered. In the US, often the restructuring event may not be included.

(a) Failure to Pay

In the ‘Multicurrency Term and Revolving Facilities Facility Agreement’ published by the Asia Pacific Loan Market Association (‘APLMA Agreement’), a failure to pay occurs if the borrower fails to pay any amount due under that document on the due date unless the borrower is given the option whereby the payment date may be extended because of administrative error or in some instances a disruption event[27].

By contrast, the ISDA Failure to Pay event[28], which is not identical, only arises if the borrower omits to effect payment on its due date (after taking into account any ‘Grace Period’ (a ‘grace period’)[29]) provided the amount is not less than a threshold amount (or $1 million if no amount is stipulated), and provided further the default relates to a specific obligation (commonly but not always ‘Borrowed Money’[30]). Thus the quantum of the default sum in the APLMA Agreement may be less than the amount required for the ISDA failure to pay credit event while the grace period

22 credit definitions Sections 2.33.
23 In other words, the loan obligation does not have to be a ‘Fully Transferable Obligation’ (see credit definitions Section 2.33(b)) but need only be a ‘Conditionally Transferable Obligation’ (see credit definitions Section 2.33(b)).
24 See credit definitions of ‘Eligible Transferee’ and ‘Modified Eligible Transferee’ in credit definitions Section 2.32(f) and Section 2.33(f) respectively.
25 Ibid. Section 4.9.
26 Ibid. Section 4.7.
27 See for example APLMA Agreement clause 23.1.
28 credit definitions Section 4.5.
29 Ibid. Section 1.12(a).
30 Ibid. Section 2.19.

in the latter document may be longer than that in the APLMA Agreement. For these reasons, the ISDA failure to pay credit event may not occur at all or may only occur at a point in time later than the occurrence of the non-payment event of default in the APLMA Agreement.

If a financier wishes to effect a workout, it is normally in its interests not to trigger a payment default. Because a payment default is one of the indicia of insolvency and because the directors of a borrower will have a justified concern about becoming personally liable for insolvent trading, a well advised financier without any credit protection would not want to trigger a payment default if it wished to avoid the resignation of those directors or the borrower going into voluntary administration. For these reasons, the failure to pay credit event may be of limited utility to a purchaser of a CDS, at least in the early stages of a workout[31].

(b) Bankruptcy

Likewise, the ISDA bankruptcy credit[32] event is not coterminous with the events in the APLMA Agreement dealing with insolvency and insolvency proceedings. In relation to the appointment of a liquidator, for example, the applicable clauses in the ISDA credit definitions and in the APLMA Agreement are engaged on the actual filing of court process unless the process is dismissed within an applicable grace period. In the ISDA bankruptcy credit event, the grace period is thirty days whilst in the APLMA Agreement could be for a shorter period.

The applicable provisions also cover the enforcement of a security by a secured creditor. In the ISDA credit definitions, the enforcement must extend to 'all or substantially all '[33]of the assets of the reference entity whilst in the APLMA Agreement, the enforcement needs to extend to assets having an aggregate monetary value.

The insolvency event of default is also engaged in the APLMA Agreement if the borrower or a member of the group of which it forms a part 'commences negotiations with one or more of its creditors with a view to rescheduling any of its indebtedness'[34]. There does not appear to be a similar provision in the ISDA credit definitions with the consequence that the insolvency event in the APLMA Agreement, in so far as it relates to a potential restructuring, may be engaged at an earlier point in time than would be the case with the former document.

There are thus differences as to the timing of the operation of the applicable clauses in each instrument. For present purposes, the fact that negotiation for a restructuring is an event of default in the APLMA Agreement but not in the ISDA credit definitions may mean that a 'restructuring' event of default in the former document is triggered at a much earlier point in time than would be the case in the ISDA credit definitions where the issue is addressed as part of the ISDA restructuring credit event.

The inability to issue a credit event notice under the ISDA credit definitions in these circumstances runs the risk for the holder of the CDS that its coverage may expire due to the effluxion of time notwithstanding that in substance an event is occurring which was intended to be protected by the CDS. This circumstance may advantage

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31 In Marconi, the failure to pay credit event only occurred near the end of the restructuring.
32 See credit definitions Section 4.2.
33 Ibid.
34 APLMA Agreement clause 23.6.

the protection seller and is a salutary reminder to ensure consistency between CDS and the underlying agreement.

For those uncovered or partially covered financiers seeking to develop a workout, the absence of such consistency could be used in the right circumstances as a lever to obtain co-operation from a recalcitrant financier holding a CDS.

(c) Restructuring

The ISDA restructuring credit event is particularly relevant in the context of an out-of-court work out and is addressed separately from the bankruptcy credit event. Other than as mentioned above, there is no equivalent clause in the APLMA Agreement.

In practice, the ISDA provision has proved to be very difficult to apply; so much so, that in order to achieve certainty, some counterparties may exclude altogether this circumstance from the list of credit events incorporated in the CDS.

The desire for certainty obtained by excluding that event is counterbalanced by the fact that the inclusion of the ISDA restructuring credit event permits banks to have full regulatory capital relief under Basle II. If a CDS does not contain the restructuring credit event, then only 60% of the amount of protection purchased will be recognised[35].

Application of ISDA restructuring credit event definition

Section 4.7 of the credit definitions nominates the following circumstances as credit events in relation to an identified obligation provided that the relevant credit event was not contemplated expressly under the terms of the underlying facility documentation when it was originally executed or at the date the parties enter into the CDS (the 'trade date')[36]:

(i). reduction in interest rate or in the amount of interest payable;

(ii). reduction in the amount of principal payable at maturity or its other due date;

(iii). postponement or deferral of the repayment date for principal or interest;

(iv). change in the ranking of the priority of a payment obligation which results in the subordination of that obligation; and

(v). change in the currency of payment except where the replacement currency is approved[37]under the documentation.

The above events, which are regular features of a workout, must result from an agreement between the reference entity and a certain number (as to which see further below) of holders of the reference obligation so as to bind all holders of that reference obligation.

The following conditions precedent must also be satisfied:

(A) the reference obligation must be of a certain type as particularised in the confirmation.

In particular, the reference obligation may encompass any payment obligation whatsoever, including certain obligations under a guarantee. It may also be limited

35 Australian Prudential Standard 112 at 43 published by the Australian Prudential Regulation Authority.
36 credit definitions Section 1.5.
37 Ibid. Section 4.7(a) (iv).

to a particular payment obligation in respect of borrowed money only, or any other nominated form of obligation. Furthermore the obligation may need to satisfy certain other characteristics identified in the confirmation which, for example, may stipulate that the obligation be unsubordinated, listed or in a particular currency[38];

(B) *the obligation must be for an amount of not less than US$10 million or its equivalent in another acceptable currency[39]; and*

(C) *the obligation must be a 'Multiple Holder Obligation'. As mentioned above, this means that the obligation must be held by at least 4 unrelated holders where the documentation requires at least 66 2/3% to consent to the restructuring[40].*

The current version of the credit definitions is a modification of the 1999 credit definitions. These modifications arose as an attempt to address the problems in construing the definitions, but have not succeeded in removing all of them.

Continuing Problems with ISDA restructuring credit event definition

The following problems still remain with the restructuring credit event definition.

(a) ***Timing of Occurrence***

An initial issue is the precise identification of the point in time at which a credit event occurs. Section 4.7(a) of the credit definitions requires that the restructuring circumstance arises either from an agreement between the reference entity and the requisite number of holders of the reference obligation, or that the restructuring is announced by the reference entity, so as to bind all holders of the reference obligation. The latter event would occur more often in the restructuring of sovereign debt.

A typical workout commences with some form of notification by the reference entity of a potential inability to meet a payment obligation or of a potential event which could trigger a future acceleration of a debt obligation. The financiers would then meet with representatives of the reference entity, and either waive the breach or potential breach, or seek to negotiate changes to the documentation. The changes may include changes in the reference entity's current business plans and senior personnel and may also involve significant asset sales.

Pending finalisation of the restructuring, the financiers may enter into a standstill agreement with the reference entity and the corporate group of which it may form part. The standstill agreement may contain temporary waivers of breaches of any terms of the documentation or extensions of time for the satisfaction of any payment obligation under the documentation.

For the purposes of section 4.7 of the credit definitions, when is the 'agreement' reached between the reference entity and the requisite number of holders of the reference obligation? Does it encompass the series of arrangements (some of which may be informal or which may not bind all holders of the reference obligation[41]) which may precede the execution of a formal restructuring agreement?

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38 Ibid. Section 2.14 (definitions of 'Obligations') and Section 2.19.
39 Ibid. Section 4.7(a) and Section 4.8(a) and definition of 'Default Requirement'.
40 Ibid. Section 4.9.
41 This assumes the 'Multiple Holder Obligation' option is applicable. See Section 4.9 of the credit definitions.

These circumstances arose for consideration in the workout of Marconi Corporation,[42] during the period commencing in September 2001 to April 2003, at which time the restructuring was effected by means of a creditors' scheme of arrangement under the English equivalent of Part 5.1 of the Australian Corporations Act.

One of the issues in the Marconi workout was whether a press release announcing a proposal for a non binding debt swap, involving the surrender of debt in return for a replacement of debt with cash, bonds and equity, constituted a restructuring credit event[43]. Under the current definitions, a press announcement of itself would appear to be insufficient to trigger the restructuring credit event, since any restructuring must bind all holders of the reference obligation. The initial restructuring proposal in Marconi only bound holders who voluntarily decided to take advantage of the debt swap.

In the end, the initial voluntary proposal was abandoned and the restructuring was effected by the scheme of arrangement which contained a clear trigger for the restructuring credit event. Even then, there was an issue whether the restructuring credit event was triggered upon publication of the scheme document advising of the details of the creditors' scheme or (as seems more likely as a matter of law) upon the making of the final court order approving the scheme.

While supporting the restructuring in principle, the holders of CDSs still wished to retain and access the benefit of those contracts. Further, over the many months of negotiations, it was still unclear whether a credit event had occurred. As matters turned out, there was very little time between the date at which a credit event had actually occurred and the voting on the restructuring proposals, for delivery of bank debt to the CDS providers.

(b) Debt Extension

A debt extension would constitute a debt deferral within Section 4.7(a) (iii) of the credit definitions. Again, issues arise concerning the scope of this provision.

On occasions, some but not all lenders will agree to a deferral. The non-consenting creditors often temporise and fail to commit themselves either way.

Whilst this may raise problems for the directors of the distressed entity, it also creates problems for the purchaser of the credit protection. For the purposes of the definition is one able to argue that this category of indecisive lender has agreed by its conduct to the deferral or that it is estopped from later asserting the right in a manner inconsistent with those holders who have agreed? Would those circumstances amount to a deferral agreed to by all holders? These issues may be of vital importance to a buyer of credit protection especially if the deferral extends the repayment date beyond the tenor of the CDS and the period of uncertainty extends right up to the expiration of the tenor of the CDS.

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[42] See further 'Marconi reveals shortcomings of credit swap documents' (October 2002). 21 *IFLR* 3; Nicholas Frome & Claude Brown, 'Lessons from the Marconi Restructuring', (September 2003) 22 *IFLR 19;* Martin Hughes, 'Derivatives must deal with Restructuring Quandary', (December 2003) 22 *IFLR* 17.

[43] In part, the argument that a restructuring credit event had occurred also relied on the following subparagraph (i) in the 1999 version of the credit definitions:'…[the taking of any] action in furtherance of , or indicating its consent to, approval of, or acquiescence in, any of the foregoing acts.' This subparagraph has been deleted from the 2003 credit definitions

(c) Debt Exchange

Whilst the issue of debt replacement and whether this amounts to a restructuring credit event was not fully resolved in Marconi, in *Eternity Global Master Fund Limited v Morgan Guaranty Trust Company of New York* this matter did receive judicial consideration in the context of the 2001 Argentine debt crisis[44].

In that case, Eternity entered into a CDS with a Morgan entity referencing Argentine debt. Subsequently, Argentina offered the holders of the debt an exchange facility whereby holders could voluntarily offer their bonds in return for secured loans having an increased term, but with a lower interest rate. Argentina was free to accept or reject the offers[45]. The surrendered bonds were to be held by a trustee of a trust the sole beneficiary of which was Argentina. The Argentine Government had also announced that the 'restructured loans held domestically'[46] would have highest priority for payment.

Eternity argued that the restructuring credit event had been triggered because the announcement effectively subordinated the original bonds to the restructured loans. It further argued that, during the holding of the surrendered bonds in the trust, the bonds would not be enforced because 'Argentina's role as both beneficiary and obligor on the trust assets suspended…any enforceable legal obligation created by those debt instruments'[47] . Morgan argued that in substance, the terms of the surrendered bonds had not changed and that there was no subordination.

Ultimately the court decided that in part these were matters of fact and remitted the case back to the trial judge for further consideration.

Despite the failure to resolve the matter, the voluntary debt exchange proposals in each of Marconi and Argentina may provide some scope for future action in a workout if it is desired to avoid the triggering of the credit event.[48]

More recently, the 2008 voluntary debt exchanges in respect of the English mortgage lender RecCap and the Canadian timber manufacturer, Tembac also raised questions as to whether the restructuring credit event in CDSs were triggered for referenced obligations of each of those companies. In each of those cases, the bondholders were offered the option of surrendering voluntarily the bonds which they held. Commercially, the bondholders argued that they had no choice but to surrender their original bonds and accept the exchange since they would be effectively subordinated if they failed to do so. On this basis they argued that, in substance, the exchange was not voluntary. The argument failed because the exchange was not effected under any binding agreement[49].

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44 *Eternity Global Master Fund Limited Morgan Guaranty Trust Company of New York and JP Morgan Chase Bank* (2004) 375 F.3d 168.('Eternity Global').

45 One issue no longer relevant and arising out of the 1999 credit definitions was whether there was an 'Obligation Exchange' (…'the mandatory transfer …of any securities in exchange for such Obligations'. This concept of 'Obligation Exchange' was deleted in the 2003 credit definitions.

46 *Eternity* infra note 44 at 185.

47 Ibid, at 184.

48 However, as occurred in Marconi, the price of support for a partially covered financier may well be to trigger the credit event which in Marconi clearly happened on the final court order approving of the scheme of arrangement.

49 See The Financial Times (May 21, 2008) on www.debtwire.com.

All three examples referred to above serve to reinforce the need for an anterior agreement which satisfies the definition of 'Multiple Holder Obligation' before the restructuring credit event is engaged.

(d) Prepayment

A workout may involve a prepayment of a liability by a reference entity in circumstances where the reference entity is not necessarily insolvent. A protection purchaser under a CDS may object to such an outcome on the basis that the prepayment of the relevant reference obligation prior to its due date would render worthless the CDS for which the protection purchaser had paid a significant premium. The prepayment may be associated with major asset sales or changes in business operations requiring the consent of lenders. As a condition to consenting to the prepayment, and even though the prepayment may not trigger the restructuring credit event, a lender with CDS protection in connection with its exposure may require the value of the CDS to be maintained.

Such an issue arose when in 2006 Avis prepaid all of its outstanding bonds thereby wiping out its CDS reference obligation. After extensive negotiations with investors in Avis' referenced CDSs, a separate senior note issue in 2007 by Avis' subsidiary, Avis Budget Car Rental, was guaranteed by Avis for a fee of US$14 million paid to Avis by institutional investors. The previously orphaned CDSs leapt in value[50].

(e) Reference entity

When drafting the terms of the CDS, it is necessary to be precise about the identity of the reference entity. Confusion may arise in the structuring of a workout if there are misunderstandings concerning the identity of the reference entity.

The decision in *Aon Financial Products v Societe Generale*[51] illustrates how these problems can arise. That case concerned two different CDSs. In the first CDS (the Bear Stearns CDS), Aon sold credit protection to Bear Stearns in respect of a reference entity wholly owned by the Republic of the Philippines, being the Government Service Insurance System (GSIS), in respect of certain obligations of GSIS under a surety bond executed in favour of Bear Stearns as security for a loan facility provided by the latter company.

In turn, Aon entered into a second CDS with Societe Generale as protection seller and naming the Republic of the Philippines as the reference entity (the Societe Generale CDS).

A dispute arose as to whether the refusal of GSIS to pay under the bond constituted a credit event under the Bear Stearns CDS (this was resolved affirmatively in separate litigation). A separate dispute, the subject of the reported decision, then arose as to whether this circumstance also constituted a credit event under the Societe Generale CDS. Despite the specific wording of the second CDS, it was held that the default of GSIS under the Bear Stearns CDS constituted a credit event under the Societe Generale CDS since GSIS' liability under the surety bond was guaranteed by the Republic of the Philippines such that GSIS' default was in substance equivalent to a default by the Philippines. The decision at first instance

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50 See the Treasurer (March 2007) at 17. The reconstruction of the Gus Plc group was also structured to avoid rendering its CDS Reference obligations worthless. See The Treasurer (January/February 2007) at 34.

51 2005 WL 427535 (S.D.N.Y.).

has since been reversed on appeal[52]. Nevertheless, the case illustrates the importance of not overlooking the need for careful drafting in the description of the reference entity.

The restructuring credit event has been labelled the 'soft' credit event because, although its occurrence may signify deterioration in the credit ranking of a reference entity, it is not necessarily followed by a failure to pay or bankruptcy[53]. However, the 'softness' of the clause is increased if it is never triggered in the first place.

Do the restructuring credit events pose a risk to Workouts?

Workouts occur where each of the debtor and its financiers opt for an informal out of court procedure to resolve issues faced by an entity experiencing financial difficulties. The assessment of the practical impact of a CDS on a workout is not capable of a straightforward answer. It is difficult to obtain detailed knowledge on such matters, as workouts are conducted largely in private, and holders of credit protection are usually unwilling to share with fellow syndicate members, let alone outsiders, information concerning the tactics which they will use to maximise their recovery from the distressed entity. Furthermore, the impact may be manifested in a subtle or indirect fashion.

Writing in 2006, the authors of the *INSOL* Guid*e*[54]assessed the position in the then more benign economic times as follows:

> "…[I]t appears that credit market participants have seen no evidence to date that the presence of CDS protection has caused an otherwise viable restructuring to fail, though there have been instances where problems have been encountered."[55]

Nevertheless, there is sufficient evidence that the existence of CDS protection among a syndicate can make the workout more difficult, not least because the triggering of a CDS, which calls for physical settlement, results in changes in the financiers involved in the workout thereby destabilising the whole process.

It should also be emphasised that these issues are not new and may arise apart from the holding of a CDS. A financier who has the benefit of traditional credit insurance, or who has entered into a participation arrangement with a third party, may approach the matter in a similar way, albeit with possibly more direction from the participant than is the case typically with a holder of a CDS. Then again, financiers lending at differing levels within a corporate group or in differing amounts may assert a special claim to priority, or adopt a blocking position, so as to maximise their recovery or be taken out completely.

Yet, where the distressed entity is a reference entity or a member of a group which includes a reference entity, the existence of a CDS with respect to the reference entity does give rise to a special set of problems for each of the distressed entity, covered and uncovered members of the syndicate, as well as for syndicate members who are exposed to the distressed entity in an additional capacity such as being a seller of credit protection.

At the general level, the behaviour of financiers may be analysed by reference to:

- disclosure issues;

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52 *Aeon Financial Products Inc.v Societe Generale* infra note 1.

53 N McPherson, H Remeza and D Kung, *Demystifying Restructuring Credit Events* (Credit-Suisse First Boston, 2003) at 2.

54 Infra note 5.

55 Ibid. 22 at 8.11.

- the existence of disparate economic interests and motivations among financiers; and
- syndicate stability and competence.

Disclosure Issues

A facility agreement usually contains a clause requiring the borrower to disclose to the financier information relating to its financial condition[56], but it is not the practice to impose a reciprocal clause on a financier[57] requiring that financier to disclose to the borrower whether it holds CDS protection, or has otherwise reduced its economic exposure to the borrower, such as by means of a participation arrangement. Some respondents to the FSA Survey identified the difficulty in identifying the true investors for the purposes of participating in the restructuring as a 'key risk'[58].

In crafting a workout proposal acceptable to all parties, an understanding of the stakeholders who bear the ultimate economic exposure is fundamental. A seemingly irrational response from a syndicate member (such as the desire to trigger an event of default under the facility agreement) may be understandable if it is known that the financier is fully covered by a CDS. In the latter case, those propounding the workout may be more effective if they recognise the issue and are able to deal directly with the protection seller under the CDS.

It may well be that the price of obtaining the consent of all syndicate members is the structuring of the workout in such a way that (as happened in the Marconi workout), it triggers the right for the protection buyer to issue a credit event notice under the CDS. In that situation, it would be beneficial to identify the protection seller who will inherit the financier's exposure if the CDS contemplates physical settlement.

Disclosure is also an issue when a financier has a direct exposure through its lending desk and an indirect exposure through its trading desk. It may have the latter capacity as a protection seller to another financier of the distressed entity. Because of insider trading rules, neither division of the financier may be aware of the other's exposure to the same entity, and it is not inconceivable that each division may take a different attitude to the terms of any proposed workout. It is also conceivable that the attitude of one division may change once it learns of that financier's aggregate exposure to the distressed entity or to the group of which it may form a part.

It has been suggested that current market practice does not support disclosure in this situation and that the practice is unlikely to change because of financiers' reluctance to disclose the existence of credit protection to their borrower and because of confidentiality requirements imposed either at general law or by contract. The confidentiality issue may also include reluctance by financiers to disclose the techniques which they may use to manage their various credit exposures.

In this writer's experience, the relationship between a borrower and its financier assumes a secondary position when the borrower is in financial difficulties. By that stage, different teams with the financial institution usually take over the management of the matter and the desire to maximise recovery predominates over any desire to have a fruitful ongoing commercial relationship with the borrower.

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56 See for example clause 20 in the APLMA Agreement.

57 The Association of Corporate Treasurers suggests that with respect to single name credit derivatives, such a clause should be inserted into loan documentation and be operative following the notification of an event of default. See *Syndicated loan facilities: non-bank lenders and the influence of credit derivatives: current issues and opportunities for Borrowers (Part 2)*, published by that UK association in July 2007.

58 FSA Survey infra note 2 at 22.

If and to the extent confidentiality is an issue, it is suggested that it may be managed either by a form of limited disclosure (such as the disclosure of the fact of the existence of credit protection if not of the actual terms of the protection if not the precise terms of the CDS), or by obtaining the requisite consent of the protection seller. Whilst it is acknowledged that financiers do not currently disclose the existence of credit protection in the analogous situations where they may have credit insurance or the benefit of a participation arrangement, in this writer's opinion there is also a strong case which can be made for disclosure in those cases as well in order that there is a clear and early identification of all relevant stakeholders and their respective motivations.

Disparate Economic Interests and Motivations among Financiers

General Comments

The disparate economic interests of financiers may generate differing responses and motivations amongst financiers. A partially covered financier is more likely to support a workout and allocate resources (in terms of management time and serving on steering committees) to promote a result which will maximise its recovery.

In contrast, a fully covered financier may perceive that there is no benefit in supporting a workout, and the associated management time which that task entails[59], and may adopt a stand which will facilitate the ability to serve a credit event notice under the CDS at a time most convenient to itself. Such a financier may act in such a way so as to trigger an event of default under the facility agreement or temporise, on the basis that the ability to deliver a credit event notice under the CDS at the latest point in time possible will maximise its recovery. This tactic may render decision-making within the syndicate impossible and paralyse the processes and steps associated with the workout.

Furthermore, one model of behaviour suggests that a fully covered financier will have little or no economic incentive to participate in a workout unless that financier has superior information as to the prospects of the reference entity or unless the financier is able to use the ‘cheapest to deliver’ option to satisfy its delivery obligation. Such a model assumes that the fully covered and satisfied financier will only remain involved, even if it has received full payment from the seller of the credit protection, where it perceives the prospect of a satisfactory return from the reference entity and where it has retained its original debt because of its ability to satisfy its delivery obligation by finding, for example, long dated debt selling at a deep discount[60] or cash settlement.

Mr Jeremy Green[61] has also perceptively analysed this issue from the perspective of the extent or duration of the CDS cover and the method of settlement and has reached a conclusion.

If a financier is able to obtain payment under the CDS and at the same time still retain is underlying debt obligation (either because the financier is able to use the cheapest to deliver obligation or because the CDS calls for cash settlement), a financier has a prospect of obtaining a windfall if it is able to maximise the value of the underlying debt obligation. In

59 For a US perspective, see Stephen J. Lubben ‘*Credit Derivatives & the Future of Chapter 11*’ (2008) 81 Am. Banker. L. J. 405.(‘Lubben’)

60 Note that this model ‘assumes that the cost of the debt used to settle the CDS and the ultimate recovery on the creditor’s claim will be identical, at least on average’. Quoted from Goffman infra note 15 at note 89.It is also noted that the ‘assumption may overestimate the efficiency of markets in distressed debt and derivatives’. See further Lubben infra note 58 at 425.

61 Jeremy Green, *The Impact of Credit Derivatives on Corporate Debt Restructuring* (unpublished paper 2007 which was awarded first prize in the BFSLA Essay Competition of that year). (‘Green’)

these circumstances, Mr Green concludes that a financier would be likely to support any workout because of the prospect of the windfall gain.

With respect to the extent or duration of the CDS, he concludes (correctly in this writer's opinion) that the holder of a CDS would be unlikely to agree to any restructuring proposal if it involved a debt extension beyond the term of the CDS with the consequence that the financier would then be uncovered especially where the cost of extended protection may have increased due to the distressed circumstances of the debtor.

As to the method of settlement: if physical settlement is contemplated and there is no restriction on the transferability of the underlying debt, he concludes that the financier can be expected to exit at the earliest available opportunity and that prior to exiting the facility, the financier will be concerned to ensure that the terms of the underlying debt are not changed in such a way as to render it incapable of satisfying a delivery obligation under the CDS.

The existence of CDSs may also mean that a large cohort of protection sellers end up holding the debt. When such sellers provided credit protection, it is likely that they were motivated in so doing solely by the fee income generated by the sales rather than by any real consideration of the underlying debt. In the US, it has been noted that there is a real question as to whether protection sellers have either the motivation or the skills to participate in a workout[62].

Similar sentiments have been expressed in the FSA survey which, in summarising the results of the survey, noted that newer participants such as hedge funds and distressed debt funds 'were less motivated to manage long term relationships with issuers [and] …may be motivated to push for a short-term strategy which would maximise their returns but act against the long term sustainability of the underlying firm.'[63]

A steering committee of creditors is often formed to facilitate a workout. That committee acts as a conduit for conveying information to the other creditors concerning the structuring and prospects of a satisfactory workout. In performing this role, a member of a steering committee may owe fiduciary duties to the other creditors who often rely on the committee's superior knowledge and recommendations. If a member of the steering committee were covered by a CDS, there is a potential for a conflict of duty and interest to arise. It may be in the interests of the majority of creditors for the steering committee to support a long term workout in circumstances where the duration of the workout may extend beyond the tenor of the CDS held by a member of the steering committee. As consequence the member may have an incentive not to support the workout. The prospect of such a conflict arising could well mean that able and experienced workout specialists may refuse to become members of steering committees. Indeed, there may be real difficulties in forming such a committee at all[64].

In Marconi, it has already been noted that holders of CDSs did make the workout more difficult. On the other hand, it has also been argued[65] that in supporting a workout plan, a holder of a CDS may take a cavalier or unrealistic approach in the knowledge that it would be protected in any event, if the failure results in subsequent insolvency proceedings in respect of which the creditor is fully protected.

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62 Lubben infra note 37 at 426.
63 FSA Survey infra note 2 at 22.
64 Goffman infra note 38 at 16.
65 Ibid.

It has also been suggested that the holding of a CDS could increase the number of cases in which a creditor might commence proceedings to wind up a reference entity. In the absence of an undertaking not to institute winding up proceedings[66], a creditor has full control as to whether or not it will wind up a reference entity and as to the timing of commencement of those proceedings. As a related matter, it has also been suggested that a group of creditors might purchase credit protection on a reference entity and use a small claim to commence such proceedings. In this way, it has been suggested that some creditors may seek to profit by commencing winding up proceedings.[67]

Documentary Considerations

Apart from general statements concerning risk and possible creditor behaviour, it is difficult to provide a precise analysis as to whether the holding of a CDS increases the risks of a workout failing. As mentioned earlier, these issues are not new where a lender has obtained other forms of credit protection such as credit insurance. It is also worth recalling that not all CDSs are identical and that caution should be exercised when making generalisations.

The difficulties associated with the construction and operation of the restructuring credit event has been discussed above. It is here that an appreciation of the precise wording of the credit events assumes a particular importance. Because the triggering of that event, amongst other matters, requires an actual agreement between the borrower and its financiers and because often it is necessary to obtain the consent of 66 2/3% of financiers if not all financiers to obtain such agreement, in practice there would appear to be real practical difficulties for a financier seeking to rely on the restructuring credit event.

The failure to pay and bankruptcy events thus assume a greater importance in this situation. A modification of a failure to pay clause often requires the unanimous consent of financiers if the failure is to be waived. It is not inconceivable that a financier holding credit protection will withhold its consent noting that even if some banks agree on a bilateral basis not to take action, the failure to pay may trigger the bankruptcy event (such as the appointment of a voluntary administrator by the directors of the borrower) because of, as mentioned above, the fear of the directors of the borrower that they may incur personal liability for insolvent trading unless the failure to pay is avoided by changing the contractual date for payment. In this fashion, the failure to pay credit event assumes the greater importance because it would usually precede the bankruptcy credit event

It has been suggested by Mr Green[68] that institutional banks (as distinct from hedge funds or debt traders) have an interest in the ongoing existence of the borrower and that their institutional relationship with the borrower would reduce the likelihood of their acting in such a fashion.

In current times of large financial institutions experiencing shortages of capital and the expense of having to provide capital for distressed borrowers, there is no real certainty that institutional banks will act on the basis of historical relationships or the desire for the ongoing maintenance of such a relationship. Furthermore, early in the workout the institution may have sold its debt to a debt trader with CDS protection. Such traders are

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[66] In Australia, it is not clear whether such covenants are enforceable in any event. See *Community Development Pty Ltd v Engwirda Construction Co* (1969) 120 CLR 455 at 460. See also *A Best Floor Sanding Pty Ltd v Skyer Australia Pty Ltd* (1969) VSC 170. Cf. *TBGL Enterprises Ltd v Bellcap* (1996) 14 ACLC 205 and *Colt Telecom Group Plc* [2002] EWHC 2815.

[67] Goffman infra note at 15. There have been suggestions that the US Bankruptcy Code be amended so as to require creditors commencing winding up proceedings to disclose any credit derivative positions so that the court is made aware of any all the circumstances surrounding the commencement of insolvency proceedings prematurely or in bad faith.

[68] Green infra note 60.

often motivated only by the desire to exit the defaulting facility at a price higher than their original entry price.

More controversially, it has also been suggested by Mr S Frith (by analogy to principles derived from insurance law) that a protection buyer is subject to a duty of good faith to act in such a way so as to avoid the deliberate occurrence of a credit event thereby enabling a call to be made under its CDS[69]. In support of this view, Mr Frith relies on Section 9.1(b)(iii) of the credit definitions and, in particular, the requirement that for so long as a party has an obligation under a CDS that each party '…may act with respect to such business in the same manner as each of them would if such Credit Derivative Transaction did not exist'. Mr Frith construes these words as enabling a party to conduct its business activities only the basis that the CDS did not exist. The writer respectfully agrees with Mr Green[70] that this construction involves a reading into a permissive clause an implication inconsistent with the natural and ordinary meaning of the provision. Moreover, such a reading ignores the distinction between an insurance contract and the rights conferred under a CDS[71].

Syndicate Stability and Competence

There has been significant growth in distressed debt trading over the last decade. It has been suggested that the existence of CDSs may increase the amount of debt trading in relation to the debt of distressed borrowers. It is unclear whether the increase in rate is a result of the holding of CDSs referencing the traded debt and which require physical settlement or if this has occurred independently of any CDS holding. In any event, changes in the composition of a syndicate do destabilise a syndicate and may well render the effective resolution of the workout more difficult especially if active members of the workout team change policy and decide to cut their losses and run.

Although it is difficult to obtain actual information on this issue, it may be concluded intuitively that CDSs may have contributed to the increase in the rate of debt trading. This conclusion must be qualified if and to the extent that the consent of the borrower is required in relation to any transfer of the underlying debt. This depends on the stage as at which the transfer may be made. For example, in the APLMA Agreement, the borrower's consent is not required for a transfer after the occurrence of an event of default[72]. Thus whilst it may be true to conclude that the need for borrower consent may impose some form of control over debt transfers, the control may fall away as the workout proceeds either because the provision ceases to be applicable or because the provision is removed as a condition to the granting of any waivers which are required during the workout.

Debt traders (which would include hedge funds) tend to be passive investors in distressed borrowers and many lack the desire or skill to become involved actively in the administration of the workout. In large measure, the reluctance is attributable to the need for debt traders to retain the ability to on-sell their debt if they see an opportunity to do so. If the debt trader or hedge fund took an active role in any workout, this may give the trader to non public information which they may not want because this may limit their ability to freely trade the debt in the future without a proper disclosure which they be prevented from making because of either obligations of confidentiality or concerns about a potential liability for insider trading.

69 See S Frith, *Derivatives Law and Practice* (Sweet and Maxwell) at paragraph 16-02 by analogy from the insurance decisions in *British and Foreign Marine Insurance v Gaunt* [1921] 2 AC 41 and *Beresford v Royal Insurance Co Ltd* [1938] 586.
70 Green infra note 60.
71 See *Aeon Products* infra note 1.
72 APLMA Agreement clause 24.2.

Even if a debt trader wished to become involved in the workout, it has also been argued that the typical debt trader or hedge fund lacks the skills and resources to make an effective contribution to any workout. Despite these reservations, there have been some suggestions that some hedge funds may have an interest in becoming involved actively in a workout if they purchased debt as part of a strategy to own the distressed debtor.

At this stage, there is insufficient evidence to reach a conclusion on the last point but experience does suggest passivity rather than active involvement in workouts by both debt traders and hedge funds. As a consequence, there are general concerns that cases may arise where no institution wishes to get involved in a workout at all with the consequence that the only option that becomes viable is formal insolvency proceedings and the risk of reduced return which that option may generate.

Conclusion

The holding by a creditor of credit protection via a CDS referencing a distressed borrower together with the disparate economic interests of financiers and syndicate instability which those circumstances may generate, combine to add an additional complexity to a workout especially when there is lack of clarity as to who bears the economic risk of the insolvency.

To date, there have not been sufficient recent examples to establish whether or not holdings of CDSs referencing the distressed borrower are fatal to a successful workout, but the limited experience which exists does indicate that this has not been the case even though a successful work out may have been more difficult to achieve. Because of the very existence of the credit events and the commercial drive by some financiers to trigger the credit events, there is nevertheless some justification for concluding that the days of a pure workout based solely on mutual contractual undertakings between the stakeholders may have passed, and that in the future, the work out in conjunction with a formal insolvency proceeding such as voluntary administration may be more likely.

A workout involves the identification of the stakeholders who bear the economic risk in connection with the fate of the distressed borrower and the production of an outcome which accommodates those interests. In this writer's opinion, improved disclosure obligations will go a part of the way in resolving at least some of these issues. At the very least, this will enable the identification of the interests of the creditors and recognition of the need for the workout to accommodate those interests if the workout is to have any chance of success. The actual terms of a CDS, including its tenor, form part of the process of identification. In this connection, it is suggested tentatively that, because of the manner in which it is drafted, the reconstruction credit event is of less practical significance than the failure to pay and bankruptcy credit events.

Instability and a lack of cohesion within a syndicate may result from debt trading, whether or not attributable to the holding of a CDS. The resulting problem of potential instability within a syndicate, coupled with the lack of desire or skill by new holders of the underlying debt to participate in or effect a workout, do pose significant questions as to whether a workout, based solely on contract, has a viable future.

Appendix

Selected types of Credit Derivatives and other credit-linked products[73]

Portfolio credit default swap.[74] CDSs may be written on a portfolio of reference entities. The calling of a credit event with respect to any entity in the portfolio will require one or more protection payments to be made by the protection buyer to the protection seller (though in some portfolio CDSs, the aggregate amount of such payments as would otherwise be required must reach an agreed threshold before payment is actually made). During the term of the CDS, the aggregate notional amount of the CDS is reduced from time to time by the notional amount that relates to each reference entity that experiences a credit event.

Collateralised debt obligation (CDO). Collateralised debt obligations are secured credit-linked securities, usually issued by a special purpose vehicle that is sponsored by a financial institution. Among other things, CDO transactions are used by financial institutions often to comply with internal risk controls or regulatory capital requirements.

In a simple CDO transaction, the financial institution initially enters into a contract with the vehicle, under which the financial institution transfers to the vehicle exposures to a portfolio of debt obligations. The transfer may be accomplished:

(a) by a direct sale of such obligations from the financial institution to the vehicle for cash (in which case the transfer of credit risk and the resulting CDO transaction are referred to as a *cash* transfer and a *cash* CDO transaction, respectively); or

(b) by entering into a portfolio CDS under which the financial institution buys protection from the vehicle in respect of the credit risk of such obligations (in which case the transfer of credit risk and the resulting CDO transaction are referred to as a *synthetic* transfer and a *synthetic* CDO transaction respectively).

The vehicle then issues CDO debt securities to third parties, such securities being secured by (and recourse under which being limited to) the available collateral, i.e. payments to be received by the vehicle under the obligations in the portfolio (in the case of a cash transaction) or under the portfolio CDS (in the case of a synthetic transaction).

The proceeds of the sale of securities are applied by the vehicle to pay the purchase price of the portfolio (in a cash transaction), or to cover protection payments to be made under the portfolio CDS (in a synthetic transaction).

A payment default under an obligation in the portfolio or the calling of a credit event in respect of an obligation covered by the portfolio CDS (as the case may be) would result in a corresponding reduction in payments to the holders of the CDO securities, subject to any protection provided by over-collateralisation of the securities.[75]

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[73] Taken from the INSOL Guide infra note 5.

[74] The terminology used in respect of portfolio CDSs is analogous to that used in respect of single-name CDSs (for a description of which, see sections 4 and 5 above).

[75] In most CDO transactions, the principal amount of obligations in the collateral portfolio is larger than the principal amount of CDO securities secured by it. In addition, the vehicle may issue to the sponsoring financial institution subordinated debt securities or preferred shares to absorb initial loss amounts (if any) incurred under the portfolio before additional loss amounts are passed onto the purchasers of more "senior" CDO securities.

Credit-linked note. A credit-linked note is a debt instrument, the issuer's payment under which is contractually linked (and the purchaser's recourse under which is limited) to the credit and performance of another debt obligation or a portfolio of other debt obligations. Among other things, a credit-linked note allows its issuer to transfer the credit exposure associated with such an obligation or obligations to the purchaser of the note. The economic relationship between the issuer and purchaser of a credit-linked note is thus similar to that between the protection buyer and protection seller, respectively, under a portfolio CDS.

In a simple credit-linked note structure, an entity with credit exposure to a portfolio of debt obligations issues credit-linked notes in an aggregate principal amount up to the aggregate principal amount of the obligations in the portfolio,[76] and with a term to maturity that is no longer the longest term to maturity of any obligation in the portfolio. The terms of the notes also provide, among other things, that recourse by the holders of the notes is limited to the amounts paid from time to time by the obligors under the portfolio. Interest on the notes is paid from a combination of investment returns on proceeds of the sale of such notes and interest payments made under the obligations in the portfolio.

A payment default under an obligation in the portfolio would result in a corresponding reduction in the payments made to the holders of the credit-linked notes.[77]

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[76] To provide a measure of protection to note purchasers, the principal amounts of credit-linked notes in most transactions are smaller than the principal amounts of obligations in the related portfolios.

[77] Such a reduction would be subject to the protection provided to the noteholders by the excess (if any) of the aggregate principal amount of obligations in the portfolio over the principal amount of the related credit-linked notes.

Friday 25th July, 2008

Concurrent 3a
Millennium Hotel

3.30pm – 5.00pm

Chair:
Glen Smith
Special Counsel
Corrs Chambers Westgarth
Brisbane

Speakers:
Matthew Allchurch
Partner
Allens Arthur Robinson
Sydney

Alistair Jeffrey
Founder & Executive Chairman
Bluestone Group
Sydney
(paper not available)

Lyn Cobley
Group Treasurer
Commonwealth Bank of Australia
Sydney

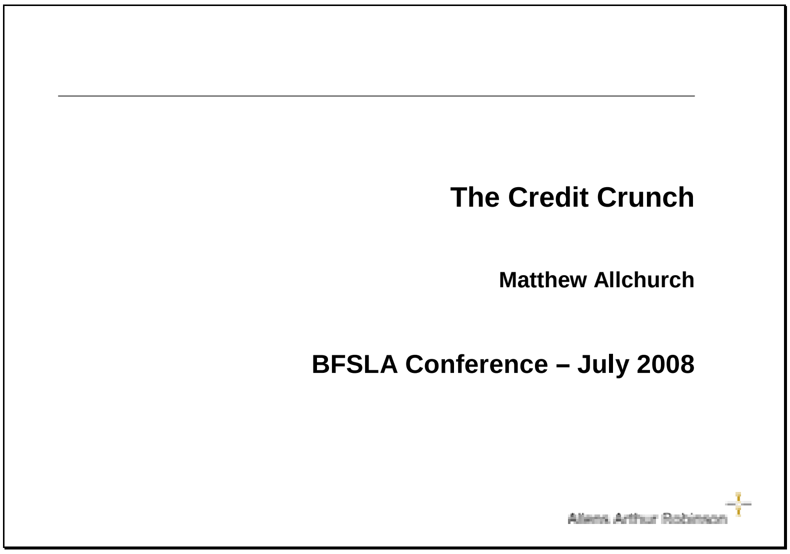
The credit crunch, securitisation and structured finance: lessons learned and the future

Matthew Allchurch, Partner, Allens Arthur Robinson, Sydney

The Credit Crunch

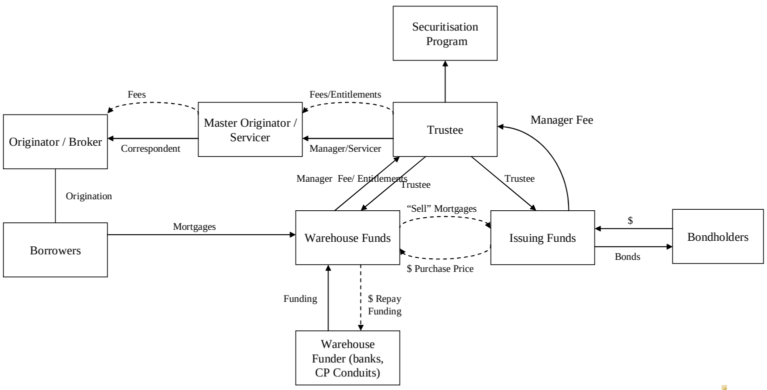
Slide 1

Slide 2



Slide 3

Standard RMBS Structure



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Slide 4

RMBS Term Issue – Economics – Pre Crunch

Income		
Mortgage Interest Rate		7.60%
Expenses		
Trustee Fees	0.03	
Security Trustee Fees	0.02	
Trust Manager Fees	0.02	
Servicing Fees	0.25	
Transaction Costs	0.05	
GST	0.01	
Mortgage Insurance	0.01	
Total Expenses	0.39	
Funding Costs		
BBSW	6.62	
Margin (AAA RMBS)	0.20	
Total Costs		7.21
Excess Spread / NIM		0.38

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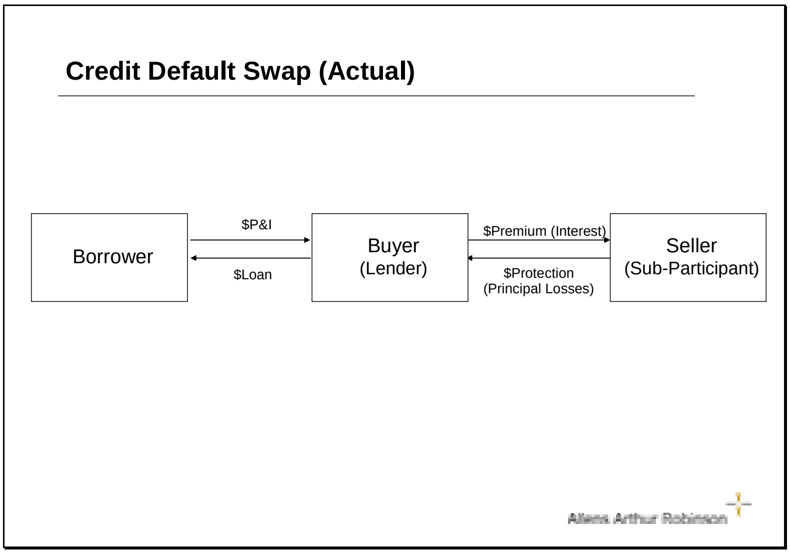
Slide 5



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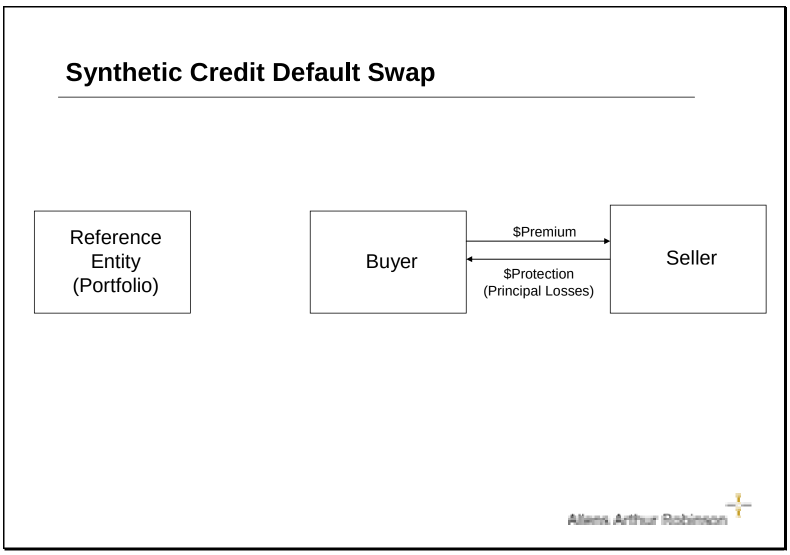

Slide 7

Credit Default Swap – Crystallisation of Losses

Credit Event -	**Insolvency**
	Failure to Pay
	Restructuring
Notice -	**Notice of Publicly Available Information**
Mark to Market -	**eg 55 days later**
Seller Pays -	**Loss Amount**
	(Recovery % x Notional Principal)

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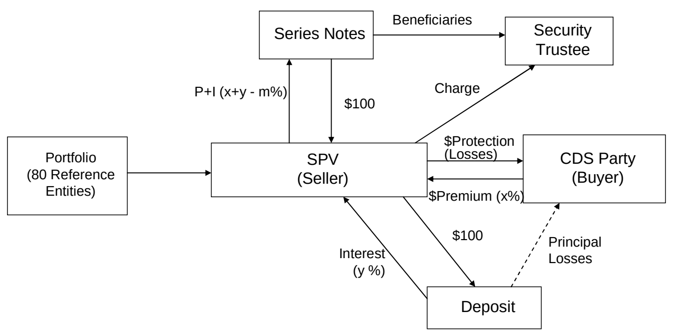
Slide 8

Synthetic Retail CDO



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Slide 9

Synthetic Retail CDO - Example

Commercial Features

- **High Yield**
- **High Leverage**
- **High Risk**
- **Effect of Leverage**

  80 Companies

  $20 mm notional principal each Company

  Portfolio (notional) = $1.6 bn

  Protection Amount (First Loss) = $50 mm

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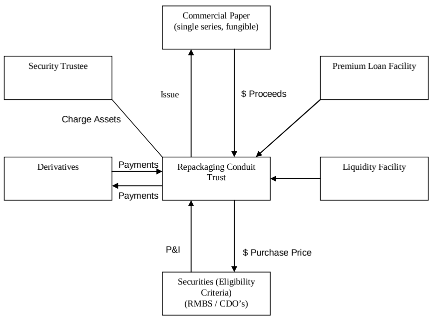
Slide 10

Repackaging Conduit



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Slide 12

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Lyn Cobley, Group Treasurer, Commonwealth Bank of Australia

The Sub Prime Crisis

Slide 1

Slide 2

Contents

- **Causes of the credit crisis**
  - **- US sub-prime sector**
  - **- Growth of leveraged and off balance sheet investors**
- **Impact on cost of funds**

Group Treasury

Slide 3

Causes of the credit crisis

Two International Developments

- Deterioration in the US sub-prime mortgage sector, and resulting impact on those who took the risk by providing the funding.
- Growth in leveraged and off-balance sheet investors, often sponsored by the banks.

Group Treasury

Slide 4

US sub-prime mortgage sector

- Grew out of excesses of a strong US housing market between 2002-2006 where there was aggressive lending in products with relaxed credit standards.
    - High loan-to-value ratios
    - Low or no doc loans
    - Adjustable rates which started at 7% and rose to 10-11%
    - Inappropriate eligibility standards – so called "NINJA" loans - no income, no job or assets.
    - Lack of understanding by many borrowers that if house prices fell, they may not be able to refinance when rates adjusted.

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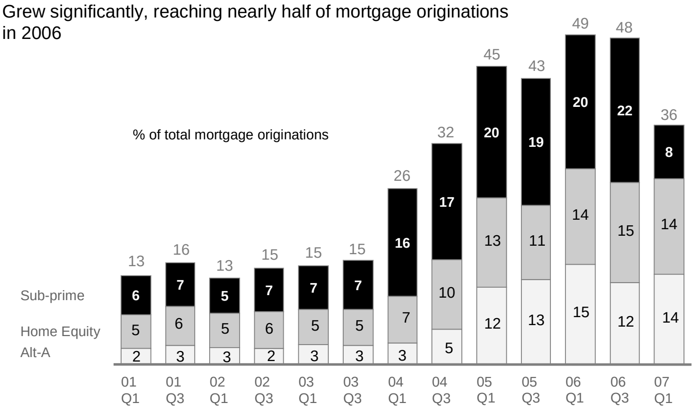
Slide 5

US sub-prime mortgage sector

Grew significantly, reaching nearly half of mortgage originations in 2006



Source: Mortgage Bankers Association, Census Bureau, Goldman Sachs Research Estimates

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Slide 6

Growth in leveraged and off-balance sheet investors

- In the US, substantial disconnect between originator and funder, or ultimate risk-taker
- Exponential growth in:
  - Hedge funds that increased returns by taking higher risks through increased leverage
  - "Special Investment Vehicles" or SIV's that increased returns by investing in long term assets but funding in the short-term markets

Group Treasury

Slide 7

The intersection

- Sub-prime mortgages mostly funded by being packaged up into structured tradeable securities and sold to investors.
- These structured securities had lots of fancy titles like ‘collateralised debt obligations - “CDO”, “CDO2”. They were highly rated on the basis of cashflow performance over a benign period, ie; a small market that so far experienced low defaults.
- When the storm hit, it was very difficult to tell just where the failing sub-prime mortgages were, so investors simply stopped buying altogether.

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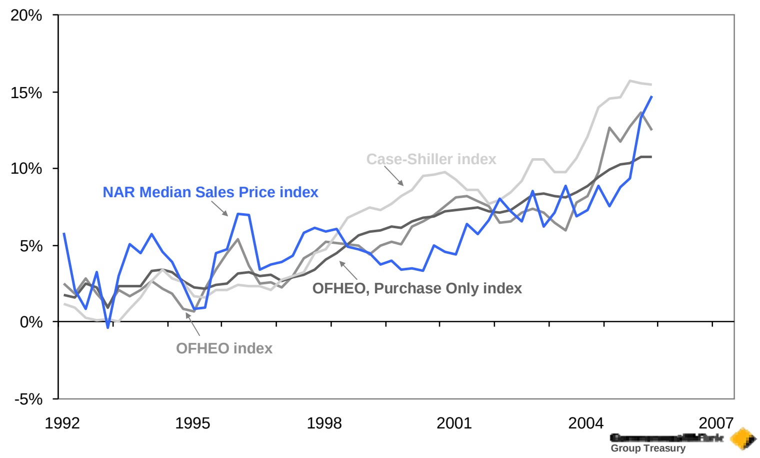
Slide 8

Investors were betting on rising housing prices, not low default rates, in sub-prime mortgage loans…



Group Treasury

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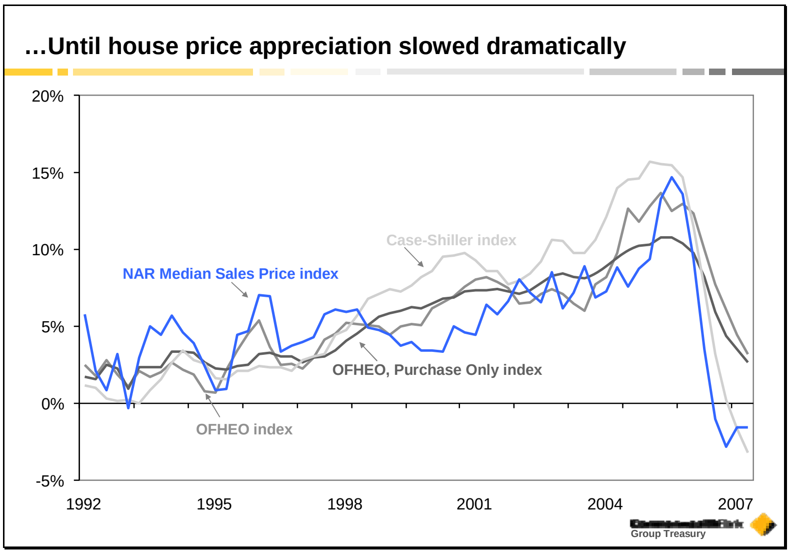

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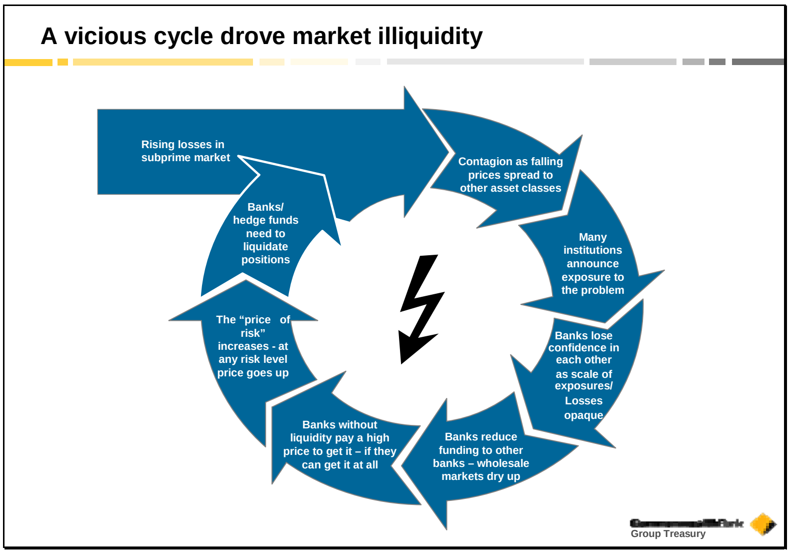

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The Northern Rock story

- Suffered a major liquidity crisis resulting from its reliance on a particular type of wholesale funding…… which dried up.
- Share price fell from 1200 to ~100. Bank of England provided more than 25bn pounds of funding.
- Resulting in every banker's nightmare: a run on the bank.


Source: Company website; literature search

CommonwealthBank Group Treasury

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There are many losers and winners

The winners

- Well-capitalised, prudently funded, highly-rated institutions that will weather the crisis and be able to make intelligent strategic investments at attractive prices
- Nimble proprietary investors that can buy assets at 'firesale' prices
- Emerging markets, which appear to have been insulated from the turmoil - so far

CommonwealthBank Group Treasury

Slide 13

There are many losers and winners

The Losers

- Owners of credit assets purchased at improbably narrow spreads. The subprime mortgage market is filled with examples, some of which are well-known
- Residential real estate owners in badly-affected markets, including Florida, Nevada, Arizona and California
- Institutions with imprudent levels of leverage and overly reliant on the availability of the securitisation markets
- Investment banks with a heavy dependence on the mortgage markets
- Rating agencies (particularly their structured credit groups)
- Mortgage guarantors and credit guarantors
- Some regulators that may have been slow to act

Group Treasury

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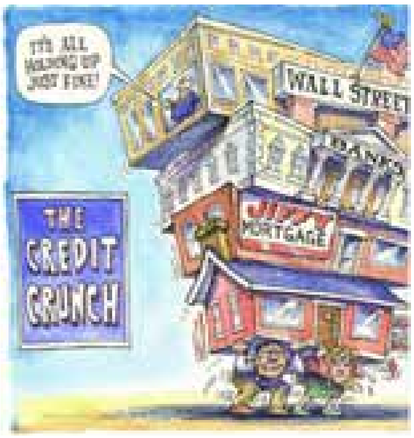

Group Treasury

Friday 25th July, 2008

Concurrent 3b
Copthorne Hotel

3.30pm – 5.00pm

Chair:
Angela Flannery
Partner
Clayton Utz
Sydney

Speakers:
Karen Price
Director
New Zealand Carbon Exchange
Auckland

Ashley Stafford
Partner
Baker and McKenzie
Sydney

Graeme Dennis
Partner
Clayton Utz
Sydney

Carbon trading and carbon credits

Karen Price, Director, New Zealand Carbon Exchange, Auckland

NZ ETS Brings A New Era Of Trading

NZ ETS brings a new era of trading

Introduction and Background to the New Zealand Emissions Trading Scheme

1. In December 2008 the New Zealand Government introduced legislation to implement a greenhouse gas emissions trading scheme (*NZ ETS*) to assist in meeting its Kyoto Protocol obligation to reduce emissions to 1990 levels during the period 2008 to 2012 (the first commitment period for Kyoto).

2. The proposed NZ ETS provisions are encapsulated in the Climate Change (Emissions Trading and Renewable Preference) Bill (*the Bill*), which has been shepherded rapidly through the Parliamentary processes. Following a public consultation period earlier this year, the Bill has now been reported back to the House by the Finance and Expenditure Select Committee, with several changes being recommended as outlined below. The passing of the Bill at the time of writing was a 'hot' political issue and whether it is passed before the general election later this year remains to be seen.

3. The Bill proposes substantial amendments to the Climate Change Response Act 2002 and the Electricity Act 1992. The broad objectives of the Bill are supported by provisions of the Government's New Zealand Energy Strategy to 2050. Specifically, Part 2 of the Bill gives preference to renewable electricity generation and provides that new fossil fuel generation is only an available option if security

of supply is threatened (and supplemental or standby generation is required in addition to the renewables).

4. The Government has stated that New Zealand's clean, green image is part of its international brand, which underpins important sectors of the economy. In fact the Prime Minister has stated she wants "*New Zealand to be in the vanguard of making it happen – for our own sakes, and for the sake of our planet*."[78] A failure to act sustainably and responsibly could reduce New Zealand's international credibility and influence internationally.

5. While major international sources of greenhouse gases do not have binding greenhouse gas targets under Kyoto (i.e. China, India (and the USA being a non-Kyoto party)), Europe has an established trading scheme, and recent Australian announcements confirm that our trans-Tasman neighbours will also be pursuing a sectoral-wide emissions trading scheme in coming years.

6. In terms achieving our international treaty target, the latest Treasury estimate (May 2008) for New Zealand's binding emissions obligations under the Kyoto Protocol is $NZ480 million (based on a carbon value of $NZ22.13 per tonne of CO_2 equivalent). Our increasing deficit position with respect to target emissions levels under Kyoto is of course a key driver for the NZ ETS.

7. Beyond Kyoto's first commitment period (ending December 2012), it is clear that Europe at least is in strong pursuit of further international binding treaty commitments – so establishing a pathway towards emissions reductions seems central to New Zealand's long term economic survival, and its trading relationships with Australia and the EU. It is also a global reality that business will be forced to operate in an increasingly carbon-constrained world moving forward.

8. Ultimately the New Zealand Government considers that an ETS will be more flexible, and allow lowest cost abatement for greenhouse gas emissions across the economy.

[78] http://www.climatechange.govt.nz/sustainable-nz/sustainable-nz.shtml

New Zealand's Unique Emissions Profile

9. New Zealand has a unique emissions profile compared with most other developed nations, as over 50% of its emissions come from the agricultural sector. Undoubtedly that sector that faces the greatest challenges in reducing net emissions, and there are presently very limited technological solutions. In addition to agriculture, New Zealand's maturing plantation forests will contribute significantly to New Zealand's overall future emissions profile when those sinks are 'removed' upon harvest in years to come. Indeed it is these two sectors that have given rise to a high proportion of New Zealand's greenhouse gas emissions increase since 1990.

10. In terms of the electricity sector, New Zealand's electricity profile is currently highly focused (indeed dependent) on renewable energy as is clear from this winter's expected power shortages. In fact, New Zealand's renewable energy sources comprise approximately 69% of the country's electricity generating potential. Accordingly, the potential gains in this sector are somewhat limited compared with other countries that are heavily reliant on fossil fuel generated electricity and may accordingly have greater potential to adapt and diversify.

Basics of the New Zealand Emissions Trading Scheme

Obligations

11. The NZ ETS will require those participants with emissions obligations to surrender one emissions unit for each tonne of carbon dioxide equivalent of greenhouse gas emitted (or associated with products or services). Self monitoring is required under the scheme, with audits also being undertaken by officials (not unlike the tax system requirements for income returns in New Zealand). In recognising the inherent difficulties in monitoring and reporting requirements proposed by the NZ ETS, the Select Committee recommends both voluntary and mandatory reporting requirements be imposed on some sectors in years prior to actual binding emissions unit obligations coming into effect.

Absolute emission approach preferred

12. The Select Committee has also confirmed that the NZ ETS be based on an 'absolute'/'net' emissions approach, as opposed to an intensity-based approach (which would relate more to emissions efficiency). The recommendation is not particularly surprising given that earlier Government announcements (prior to release of the Bill) indicated an 'absolute' based scheme was undoubtedly preferred. From an administrator's perspective, an absolute emissions approach is significantly easier to implement, and can provide a greater degree of certainty as to achievement of the absolute emissions allowance permitted under Kyoto, and the likelihood of industry sectors assisting in meeting New Zealand's obligations.

13. An intensity-based scheme was sought by a large number of industrial submitters on the Bill, who had concerns about grandfathering of plants, and the inability of the scheme to recognise achievements of early action by some businesses.

Coverage

14. The NZ ETS proposes to phase in compliance obligations over the next six years, with all major sectors of the economy being captured by January 2013. Agriculture will enter last, given the difficulties outlined above with respect to the present limitations on abatement options. In comparison, the Government recognises that deforestation of existing plantation forests could have dire effects on New Zealand's emissions profile, given the critical sequestration potential such forests represent, and the NZ ETS will accordingly apply to post-1989 forests retrospectively from January 2008. The Bill also now proposes to introduce the liquid fossil fuels sector two years later than initially proposed. In light of the current economic climate and rising international fuel cost, entry of that sector in January 2009, could prove too burdensome. Entry dates in accordance with the Select Committee recommendations for the various sectors are as follows:

• Forestry	*January 2008*
• Stationary energy (coal, gas, geothermal) and Industrial process emissions	*January 2010 (with earlier mandatory reporting)*
• Liquid fossil fuels (mainly transport)	*January 2011 (with earlier mandatory reporting)*
• Agriculture; Waste; and All other emissions	*January 2013 (with earlier mandatory reporting)*

Participants

15. Most New Zealand companies will not become participants under the NZ ETS. However, they will feel its impact through increases in energy costs, transportation and distribution, and raw inputs. Those increases are unlikely to amount to merely the cost of emissions unit purchases by the suppliers with NZ ETS compliance obligations. The costs that will be actually passed through will include the costs associated with verification, administration, compliance and trading requirements including managing trading risks.

Registry Information

16. New Zealand has its own Emissions Unit Register (*EUR*), which records types of units, where they are held and links them to individual Kyoto accounts to allow all transactions (domestic and international) between participants to be recorded. New Zealand's EUR is already operational and compliant with Kyoto. The first international transfers of Kyoto units were traded early in 2008.

17. In our view, the Select Committee's recommendations in terms of public access to information in individual Registry accounts is important. It is now anticipated that access to information on unit holdings in the Emissions Unit Register will only be available in aggregate form, one year after the end of the relevant NZ ETS compliance period.

18. Industry participants initially were concerned about the public availability of a participant's unit holding information, given it may reveal trading positions to competitors, and potential buyers or sellers in the market for any given compliance period. The nature of trading, and price setting under emissions purchase contracts means that availability and knowledge of a participant's trading/compliance position with respect to its emissions obligations, could potentially influence relative power (volume and pricing terms) in parties' contractual negotiations.

Impact of Bill on the Personal Property Securities Act 1999

19. The Bill seeks to amend the Personal Property Securities Act (*PPSA*) in order to allow securities investments over emissions units to be registered in the personal property securities register.

20. A new subsection 18(1A) is to be inserted into the PPSA by the Bill to provide specific methods through which possession of emissions units gain be gained. As a point of distinction, unlike other forms of investment securities covered by the PPSA, emissions units by their nature cannot be gained through physical possession of a security certificate or by using records maintained by the issuer. However, specific to emissions units, it is possible to gain possession through the use of the EUR established by the Climate Change Response Act 2002.

Acceptable Unit Types

21. The primary unit of trade in the NZ ETS will be the New Zealand Unit (*NZU*), which is 1 tonne of CO_2 equivalent. At least initially, the bulk of the NZUs traded in the NZ ETS are likely to be sourced from New Zealand forestry or free allocation. Certain other Kyoto compliant units may also be traded, some with restrictions.

Certified Emissions Reductions

22. The Bill specifically excludes certain Kyoto Protocol units (such as Certified Emission Reduction units (*CERs*) from nuclear projects) - such prohibition being

based on this country's nuclear-free stance, and resulting political reluctance to condone support for nuclear project units in the international arena.

Assigned Amount Units

23. A further unit type, Assigned Amount Units (*AAUs*) are units allocated to Kyoto ratifying countries, based on their binding country allocation (or 'cap') under that international treaty. AAUs are sometimes referred to as 'hot air', as many originate from the Eastern Soviet Bloc countries that have excess AAUs - following post-1990 economic collapse and subsequent industrial downturn of those countries, rather than actual and deliberate environmental efforts to reduce emissions. Accordingly, concern has been expressed by environmental policy advocates about such units entering the NZ ETS, given their questionable origins. In particular, 'non-GIS' AAUs (*non-Green Investment Scheme* project units*)* are perceived to have reputational risks in their use for meeting compliance obligations under the NZ ETS. This is despite their legitimacy under the Kyoto Protocol for use by ratified parties to meet their individual country targets during the first commitment period of Kyoto (2008-2012).

24. Some consider acceptance of AAUs into the NZ ETS will curtail New Zealand's ability and prospects to link to other countries' schemes in the future – particularly given that the EU ETS does not allow use of AAUs for meeting participants' compliance obligations.

25. While there are presently no entry restrictions on the volume of AAUs that can enter the NZ ETS, these units may be somewhat restricted as the Select Committee Report on the Bill, recommends prohibitions being placed on foreign country AAUs from the Kyoto first commitment period, being used for compliance with unit obligations beyond 2012. Such restriction on use of imported AAUs beyond the first commitment period is intended to overcome perceived future linking difficulties with other international schemes - in the event that AAUs prove to be a hurdle in future international negotiations.

26. Notably, similar provisions do not extend to the other Kyoto units – New Zealand based AAUs, CERs, Emission Reduction Units (*ERUs*), and Removal Units (*RMUs*). However, the Minister retains the ability to regulate future changes to unit entry.

Forestry

27. As noted above, the Bill proposes that the forestry sector (exotic forestry) enters the NZ ETS with retrospective effect from 1 January 2008.

28. Essentially, deforestation liabilities have been devolved to pre-1990 forestry owners, who must account for losses in sequestration of carbon dioxide if their forest is felled. Pre-1990 forestry therefore compulsorily enters the NZ ETS early, in an attempt to discourage further deforestation. Deforestation has increased significantly in New Zealand over past years with much forestry land being cleared for dairy farms supported by high dairy commodity prices. To this end, deforestation is seen as one of the lower cost abatement options in the domestic economy during the first commitment period for Kyoto.

29. Pre-1990 forestry owners will be offered some free allocation of NZUs for deforestation. This is presently set at 55 million tonnes.[79] While there were early indications that this will be allocated on a pro-rata basis of forestry hectarage, the actual allocation regime will be determined at a later date by way of delegated legislation processes. This has caused concern within the sector and lobbying is already occurring with some owners seeking to gain allocations based on the ultimate end use of the land - where other viable higher value land uses exist. However, the Government and Select Committee still appear to support pro-rata allocation.

30. The Select Committee recommended that greater assistance be provided to two groups within this sector. This is because the Select Committee believed the initial levels of allocation were insufficient to assist those facing the greatest costs

[79] New section 69, clause 43.

under the NZ ETS, as well as not encouraging the introduction of alternative land uses.

31. The first group to receive greater assistance is owners of pre-1990 forests purchased before late 2002 from 39 NZUs per hectare to an estimated 60 NZUs per hectare. A new formula to calculate the exact amount of allocation for this group is recommended by the Select Committee.

32. The second group is any Treaty of Waitangi claimants who receive Crown Forest Land (*CFL*) under a settlement at any time after 21 December 2007. This allocation will increase from zero to 18 NZUs per hectare.

33. In general, any settled Treaty of Waitangi claim involving the transfer of CFL before the NZ ETS came into force would receive the same level of allocation as purchasers of land at the same time. However, some exceptions have been acknowledged as potentially warranting different allocation.

34. Post-1989 forestry owners can also opt-in to the NZ ETS to gain free NZUs. However, any future deforestation liabilities associated with a participant's forest will also accrue. That means when harvesting occurs, carbon credits must be held if the land is not to be replanted.

35. Early entry to the NZ ETS has also been driven by optimism that forestry units (NZUs) accrued from post-1989 plantings, will be sold by forestry owners and provide early liquidity to the New Zealand domestic trading market. Many existing foresters seem reluctant to take on the trading risks associated with the requirement to hold credits at harvest time, to the extent that they would rather retain a proportion of free NZUs accrued now, to protect themselves against potential future liabilities.

Liquid Fossil Fuels

36. As recommended by the Select Committee, the liquid fossil fuels sector will now enter the NZ ETS from January 2011, with voluntary reporting from 2009 and mandatory emissions reporting from 2010. As noted above, the five main oil

companies will be the point of obligation under the NZ ETS. Essentially, this will result in a cost pass-through to end users of petrol and diesel, with price rises obviously significant for large transport users. In addition, the concern of a number of consumers is that the ultimate cost pass-through is likely to reflect not only the cost of emissions units purchased, but the administrative costs of establishing commercial trading teams and the price risks inherent in contracts for delivery.

37. In this way, some argue that emissions from the fossil fuels sector would have been better dealt with by way of a carbon tax. Unlike an ETS, a tax could provide greater transparency (and a separate line item), for the increased costs attributable to GHG emissions, rather than the perception at least of an arbitrary value merely being added by fuel companies at the pump.

38. Significantly, the EU ETS does not address emissions associated with the transport sector (only industrial processes) and New Zealand oil companies will be required to purchase vastly greater quantities of emissions units compared with their counterparts in the EU. Given the necessary emissions volumes, New Zealand oil companies will need to establish and implement their trading strategies as soon as possible.

Stationary Energy

39. The stationary energy sector captures fossil fuel electricity generators and enters the NZ ETS in 2010. For coal and gas generators, costs attributable to emissions unit purchases can be passed through as increased electricity costs, so no transitory assistance will be provided by the Government in the form of free NZU allocations.

40. Similar to the operation of the fossil fuels sector outlined above, costs associated with administration and trading risk may also be factored into that electricity price increase, which many consumers argue is a major pitfall and non-transparent aspect of the NZ ETS.

41. In addition, because of the way the NZ electricity market is structured, thermal generation will ultimately set the marginal cost of electricity in the open market. Renewable generators that are not exposed to the cost of carbon will essentially receive a windfall profit for emissions-free generation. Similar to what was experienced in the EU ETS, hydro and wind generators will on that basis realise increased profits for existing infrastructure output, and for which no additional upgrading or effort has had to be expended. This type of pricing ability may actually erode the open and transparent market regime upon which the New Zealand electricity system is presently based. In any case, given the renewable generation already exists, the windfall is gained with no net environmental benefit to New Zealand.

Industry

42. Industrial process operators may be either compulsory or voluntary participants, depending on their specific activities, and in particular, the volumes of primary fuels used.

43. For example, large scale emitters that consume huge volumes of coal, gas or jet fuel may choose to opt in to the NZ ETS,[80] purchase such raw materials without any carbon charge being applied, and then trade their way out of emissions associated with the fuels' consumption by surrendering the appropriate volume of emissions units. An entity does not have to purchase all of the threshold level of coal or gas from one participant to opt-in. A company would likely opt to do this in order to minimise its own exposure to emissions charges pass-through from a supplier, and particularly in cases where the company already has an established trading strategy.

44. Under the Bill, it is intended that special free allocation be provided by the Government to assist those industrial firms that meet the statutory test of being "trade-exposed" due to the NZ ETS. Briefly, a company may be trade-exposed if

[80] Parts 3 and 4, Schedule 4, clause 43 of the Bill.

it is likely to face increased costs due to the implementation of the NZ ETS, face direct foreign competition that is not subject to a price on carbon, and is unable to pass on those costs to consumers.

45. Initially, an emissions threshold of 50,000 tonnes of carbon dioxide equivalent emissions per annum had to be met before a firm could receive any free allocation. However, the Select Committee has now recommended the threshold be removed or significantly lowered.

46. The initial level of assistance to eligible trade-exposed industrial firms has been set in the Bill at 90% of 2005 emissions from direct use of coal, natural gas or geothermal steam; direct consumption of electricity; and non-energy industrial processes. Allocation is now to reflect direct emissions and units sufficient to offset cost increases associated with electricity use in the stationary energy and industrial sectors. The purpose of such free allocation is to provide some protection to trade-exposed companies from predatory pricing by international competitors that are not burdened by an equivalent, or any, price on carbon. In effect, without such support, many companies may be forced to shut down operations or move offshore where production is cheaper (relative to New Zealand) and competition effects are not as strong.

47. Many New Zealand based companies operating at their profit margins argued that the free allocation to industry did not go far enough to assist the sector. They argued increased costs and loss of competitiveness could lead to 'long term regrets' if the NZ ETS resulted in reduced output or closures of firms. Further concerns would arise if large or concentrated job losses resulted, or New Zealand's reputation as a good place to do business relative to its neighbours and trading was damaged.

48. Significantly, the Select Committee recommended that the linear phase-out of free allocation (initially to commence in 2013), be delayed five years - commencing in 2019 through to 2030.

49. Industry expressed concern that the linear phase-out assumes businesses can continually improve their emissions inventory – which is not always the case, particularly for those with existing high emissions efficiency. It also assumes that companies can compete with the increasingly full price of carbon – something that may not be commercially achievable.

50. As noted above, there is concern regarding the possibility of 'carbon leakage'. Leakage could result if New Zealand businesses are displaced to countries where industrial and environmental standards are less stringent, and production therefore significantly cheaper. Such an outcome would mean there are in fact no global environmental benefits – which would be directly contradictory to the primary drivers of the Government's current climate change policy decisions and the Bill.

51. The basis for allocation (on a 'net' rather than 'efficiency' basis) has been attacked by some – claiming that grandparenting is distortionary, penalises responsible early movers that have proactively lowered their emissions, rewards firms that have refused or failed to reduce emissions, and perversely fails in the primary objective of the Bill to reduce emissions at 'least cost'. Accordingly, some stakeholders suggest the best approach for addressing competitiveness and leakage concerns would be to adopt an intensity-based approach for key sectors, including agriculture. Under this approach, participants would only be responsible for meeting their emissions over and above a 'best practice' benchmark level of emissions per unit of output.

52. As noted above, such an intensity-based approach has been dismissed by the Government and the Select Committee, which considers that in addition to being administratively difficult, intensity approaches provide an incentive inconsistent with New Zealand's Kyoto Protocol obligations – which are expressed in absolute terms.

Agriculture

53. The NZ ETS is also unique in that there is no international experience in including agriculture in an emissions trading scheme. However, exempting such a large sector from the NZ ETS would undoubtedly limit the effectiveness of the scheme because, as noted earlier, the majority of New Zealand’s GHG emissions profile is attributable to this sector. In this way, New Zealand’s profile is more akin to that of a developing than a developed nation. To exclude agriculture would certainly place a disproportionate burden on the transport and industrial sectors to account for New Zealand’s significant Kyoto Protocol deficit position.

54. As agriculture is not such a significant emissions contributor in other developed countries, which are focused on reducing industrial process emissions, there is presently limited new technology and investment in this area. In the short term, major emission reductions are not expected from the agricultural sector as current opportunities for abatement are limited, particularly with respect to methane which represents about two-thirds of agriculture’s emissions. However, some early opportunities exist around nitrogen inhibitors. For this reason agriculture’s entry into the NZ ETS is delayed to 2013. The sector will have a two year lead-in period, with voluntary reporting for one year commencing 2011, followed by one year of mandatory emissions reporting in 2012.

55. The significance of agricultural emissions in New Zealand means that technological gains must be developed in New Zealand, and the Government has aspirations for leading the world in this regard.

56. The Government has signalled its preference for a processor/company level point of obligation, rather than at the farm gate. Administratively, and from a monitoring and compliance perspective, this is the more appropriate obligation point. However, the price signals reaching farmers will be weak or distorted and may ultimately less abatement. The Bill provides a deadline of 30 June 2010 for deciding, by Order-in-Council, whether the obligation point be set at the processor level or farm level.

57. The initial level of assistance to agricultural firms under the Bill is 90% of 2005 emissions of methane and nitrous oxide from eligible activities. This is in addition to the high level of funding that will be provided for agricultural research and development projects.

Other Climate Change Initiatives

Permanent Forest Sink Initiative (PFSI)

58. The Permanent Forest Sink Initiative (*PFSI*) was quietly promulgated in early December 2007. It allows landowners to realise the economic value of removing carbon dioxide from the atmosphere and sequestering it in new forests established after 31 December 1989 (and directly human-induced through planting and active management). Landowners can gain tradable Kyoto Protocol compliant emission units from the Government equivalent to their forests' sequestration potential. Those units may then be sold on the international and domestic trading markets.

59. Agreements between landowners and the Crown will be registered as covenants against the land titles, binding all future landowners and significant penalties will accrue if deforestation occurs.

60. Limited harvesting of the forests is allowed on a continuous canopy basis, but clear-fell plantation forests are excluded. Landowners are responsible for all costs and risks associated with the initiative, and must replace any units should the stored carbon be depleted through accidental or weather events, for example fire or wind throw.

Evaluation of the Proposed NZ ETS

Emissions Reducing Incentives

61. Overall the NZ ETS provides few incentives for developing emissions reducing technology or for those who are already emissions conscious. Certainly, companies that have already invested in reducing emissions consider they have been treated unfairly, particularly if they will receive a smaller free allocation than

companies that have not. The consequences of not incentivising carbon abatement projects early are serious. At present the Government seeks to rely on the embedded cost of carbon to get new projects started. However, it is likely that further incentives similar to the Projects to Reduce Emissions (*PRE*) tenders will be required to target new developments in the tough areas, such as agricultural emissions.

Risks of Early Implementation

62. Despite the Government's belief that early introduction of an ETS would bring benefits for New Zealand, others believe that any achieved reduction will be eclipsed by increased emissions in countries without any regulations over carbon emissions. This issue is most stark in the industrial sector. While most countries do not yet have emissions trading schemes, trade-exposed industries in New Zealand may eventually have to shift their operations to countries with no such controls and thus significantly cheaper production costs. Carbon leakage is a very real threat for trade-exposed companies already a long way from export markets. It is also a problem for the global environment because generally those New Zealand companies will have been operating to very high environmental standards in New Zealand, whereas their competitors not facing a carbon cost often also have significantly lower environmental standards to meet.

Interaction with the Voluntary Carbon Markets

63. Currently the Bill fails to provide any specific guidance as to how the purchase and use of Voluntary Emissions Reductions (*VERs*) is intended to interact with the regulated NZ ETS. Given that an active voluntary market already exists in New Zealand, and indeed several Government Departments have been charged with securing carbon neutrality, including via voluntary credits, this is an area needing clarification. At present there are no mechanisms for the EUR to deal with project proponents wishing to obtain voluntary credits rather than NZUs.

64. At the time of writing this paper officials had begun working on policies for the voluntary market. More impetus for this came in early July with the announcement that the Voluntary Carbon Standard (one of the most widely recognised voluntary standards) had awarded four registries worldwide, one of these to New Zealand.

65. The Bill undoubtedly poses huge challenges for New Zealand. While its intent is generally supported, a number of specific aspects of the Bill do need clarification and careful consideration if equitable and achievable outcomes are to result. In many respects the Bill is ambitious, and has received criticism for the short implementation timeframes - when compared with the EU scheme for example. Its far-reaching sectoral coverage, while novel internationally, is necessary due to New Zealand's forestry and agricultural sectors having key roles to play, and its unique methane emissions profile.

66. Liquidity issues in the early stages of the NZ ETS will make trading challenging for those with compliance obligations. International unit fungibility and future international linking will be key to ensuring the NZ ETS is sustainable in the longer term and beyond Kyoto's first commitment period.

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An Overview of the proposed Australian Carbon Pollution Reduction Scheme

On 16 July the Australian government released its Carbon Pollution Reduction Scheme Green Paper. The greenhouse gas emissions trading scheme proposed in that paper will represent a considerable opportunity for the Australian banking and financial services sector, which could previously only watch carbon trading developments in Europe or participate in the various local voluntarily or State-based incentives. Despite press coverage to the effect that Australia's proposed emissions trading scheme is "half baked", emissions trading in Australia has been the subject of a protracted and complex policy debate. The Green Paper now presented adopts many of the hallmarks of the emissions trading scheme designs developed in earlier policy proposals, while some of the proposed mechanics represent a complete departure from the previous policy direction (including proposals that were not raised by the Government-commissioned Garnaut Review). This paper briefly reviews the history of policy development and turns to consider some key elements of the Green Paper proposal.

Development of an Australian emissions trading scheme

Although popular interest in the consequences of an Australian emissions trading scheme has only found its way into local Australian media in the last few months, the policy development of emissions trading in Australia has a much longer history. New South Wales had one of the first mandatory greenhouse gas emissions trading schemes in the world. That emissions trading scheme, the New South Wales and Australian Capital Territory Greenhouse Gas Abatement Scheme[81] ("**GGAS**"), commenced on 1 January 2003 in New South Wales and is still operating. The scheme was politically palatable at the time because the liability was imposed primarily on electricity retailers, the greatest market share of which in New South Wales is held by State-owned corporations. The scheme does not operate like a "cap and trade" scheme, of the type now proposed in the Commonwealth Government's *Carbon Pollution Reduction Scheme Green Paper*[82] ("**Green Paper**"), but rather each of the liable electricity retailers (and certain other liable parties) are deemed to have caused a volume of emissions based on the electricity that they buy[83] and are allocated a benchmark or targeted level of emissions based on the electricity that they sell as a proportion of the total demand for electricity in the State[84].

[81] *Electricity Supply Act 1993* (NSW) ("**ES Act**") part 8A
[82] Department of Climate Change, *Carbon Pollution Reduction Scheme Green Paper*, July 2008, Commonwealth of Australia ("**Green Paper**")
[83] *Greenhouse Gas Benchmark Rule (Compliance) No. 1 of 2003* ("**Compliance Rule**"), equation 2
[84] Compliance Rule, equation 3

Effectively, based on the relative contributions of these liable parties to emissions from the electricity sector in New South Wales and a targeted cap on emissions in that sector[85], the liable parties are required to offset part of their deemed emissions to achieve their individual benchmarks and so the required cap across the sector. The required offsets are recognised in the form of "New South Wales Greenhouse Abatement Certificates" (known as "**NGACs**") which are tradable[86] and can be created by accredited persons[87] from certain eligible activities that are considered to contribute to reducing emissions[88]. Large electricity consumers are entitled to elect to take on this deemed greenhouse gas emissions liability[89], with a view to managing the required offset of emissions more effectively than their electricity retailer might have otherwise. Such large users are also entitled to be recognised for another form of offset from certain accepted reductions in process-related greenhouse gas emissions not connected with the consumption of electricity[90] (by creating non-tradable Large User Abatement Certificates or "**LUACs**").

New South Wales implemented this scheme at a time when Australia's Federal Government had refused to ratify the Kyoto Protocol and was refusing to implement a consistent national emissions trading scheme. The scheme was soon adopted by the Australian Capital Territory[91]. Other States chose not to implement the scheme, which was possibly the political reality of some States having privatised the retail electricity sector and other States considering that the impact on industry, in terms of the costs passed through the electricity market, could be too great. GGAS was also administratively complex because the benchmark and offset system required complex rules and processes to determine whether a particular project to reduce emissions could be recognised as an offset.

In the absence of Federal Government action, the Australian State and Territory Governments established a National Emissions Trading Taskforce ("**NETT**") in January 2004. Its terms of reference were to develop a scheme design for an inter-jurisdictional national emissions trading scheme that could be driven at the State and Territory level[92]. The NETT produced a discussion paper in August 2006 which proposed a "cap and trade" emissions trading scheme[93]. Under cap and trade schemes, the Government auctions or gives away tradable permits or allowances (each corresponding to 1 tonne of carbon dioxide equivalent emissions) up to the volume of the

[85] ES Act ss 97B and 97BC
[86] ES Act part 8A division 6
[87] ES Act part 8A divisions 4 and 5
[88] ES Act ss 97DA(2)-(6)
[89] ES Act s 97BB(1)(d)
[90] ES Act s 97DA(3)(c) and *Greenhouse Gas Benchmark Rule (Large User) No. 1 of 2003*
[91] *Electricity (Greenhouse Gas Emissions) Act 2004* (ACT)
[92] First Ministers of State and Territory Governments, *Terms Of Reference for the Inter-Jurisdictional Working Group On Emissions Trading*, January 2004
[93] National Emissions Trading Taskforce, *Possible Design for a National Greenhouse Gas Emissions Trading Scheme*, August 2006 ("**NETT Discussion Paper**")

intended cap on emissions. Entities that are covered by the scheme are liable to periodically surrender or bring to account a number of permits or allowances corresponding to the volume of greenhouse gases emitted during the relevant compliance period. Liable entities, if in shortfall of the required number of permits, are typically required to pay a penalty or fee and may also be required to make good any shortfall in following compliance periods (although the NETT proposed only a civil penalty in these circumstances). The broad design features of the scheme proposed by the NETT were similar to the scheme now proposed in the Federal Government's Green Paper. However, the scope of the scheme proposed would have only applied to electricity generators initially (with a capacity over 30 MWe) and would have extended to certain other stationary energy sources of greenhouse gas emissions over 25 ktCO_2-e per annum (including deemed emissions from natural gas sales and fugitive emissions from gas pipelines) after the first 5 years of the scheme[94].

In the face of public pressure, the former Prime Minister separately established the Prime Ministerial Task Group on Emissions Trading ("**Task Group**") in December 2006 with a similar objective to the NETT. Key to its terms of reference was a requirement that the scheme proposed should not affect Australia's international competitiveness and should have regard to Australia's competitive advantage from "large reserves of fossil fuels and uranium"[95]. The Task Group was comprised of a number of representatives from Australian business and industry, as well as Government representatives. To the surprise of Australian industry, and possibly to the surprise of the Prime Minister himself, the Task Group when it reported on 31 May 2007 recommended that Australia implement a "cap and trade" emissions trading scheme by 2011[96]. Significantly, the scope of the scheme proposed by the Task Group was broader than any emissions trading scheme proposed before in Australia. The scheme design encompassed liability for direct emitters meeting a 25 ktCO_2-e per annum threshold not only in the stationary energy sector, but also proposed to impose upstream liability on fuel distributors for the downstream emissions associated with distributed energy consumption such as in relation to transport, industrial processes and off-grid diesel applications. The Task Group adopted, without acknowledgement, many of the proposals previously put forward by the NETT[97], but in some cases expanded on the tests or mechanisms that could be used to implement the scheme[98].

[94] NETT Discussion Paper, pp 20 -23
[95] Prime Minister of Australia, *Task Group on Emissions Trading terms of reference*, 10 December 2006
[96] Prime Ministerial Task Group on Emissions Trading, *Report of the Task Group on Emissions Trading*, Commonwealth of Australia, 2007 ("**Task Group Report**")
[97] For example, "caps and gates" from the NETT Discussion Paper pp 40-43 were similar to the "caps" and "gateways" which appeared in the Task Group Report pp 103-106
[98] For example, possible tests for the quantum of compensation for energy intensive or trade exposed industries, considered in NETT Discussion Paper pp 124-145 and reconsidered with worked simple examples of potential methodologies in Task Group report pp 113-117

In April 2007, before the 24 November 2007 Federal election and before the former Prime Minister's Task Group reported to the Prime Minister, the former Federal Opposition (the Australian Labor Party) commissioned a well-known Australian economist, Professor Ross Garnaut of the Australian National University, to conduct an independent review of the impacts of climate change on the Australian economy. This was expected to be similar to the report that had been prepared by Professor Stern in the United Kingdom. When the Task Group's report exceeded all expectations and the former Australian Opposition was subsequently elected to Government, the Australian Labor Party was still committed to having such a report prepared independently from Government (it had criticised the former Government for not undertaking such a review[99] and had committed to a report that would "embody the independent judgments of its author"[100]). The Garnaut Climate Change Review proceeded even though it was clear that Australia would implement an emissions trading scheme regardless of its outcome.

The Garnaut Review

Insofar as a scheme design for emissions trading, the *Garnaut Climate Change Review Draft Report*[101] ("**Draft Report**") did not advance the policy context much further than the schemes proposed by the NETT or former Prime Minister's Task Group. By the time it was released on 4 July 2008, political debate over the science of climate change and the need for emissions trading had been silenced by the Task Group and by the polling of climate issues prior to the last election[102]. Much of the Draft Report was dedicated to the science, impacts of climate change on Australia and the potential economic consequences, all of which was eclipsed by political will by the time the Draft Report was issued.

One chapter of the Draft report was reserved for emissions trading. While Professor Garnaut's review adopted a "cap and trade" model and repeated some of the potential design features considered by the NETT and Task Group, some of the approaches advocated differed in a number of key respects that may, ultimately, not advance the policy debate concerning what form an Australian emissions trading scheme should take. For example, the Draft Report proposed a system of "trajectories" under which a series of potential paths for Australia's overall

[99] Australian Labor Party, *Media release: Garnaut Climate Change Review*, 30 April 2007
[100] Garnaut Climate Change Review, *Terms of Reference*, 30 April 2007 (http://www.garnautreview.org.au/CA25734E0016A131/WebObj/GarnautClimateChangeReviewTermsofReference2007/$File/Garnaut%20Climate%20Change%20Review%20Terms%20of%20Reference%202007.pdf)
[101] Garnaut Climate Change Review, *Draft Report*, Commonwealth of Australia, June 2008 ("**Draft Report**")
[102] See, for example, Hon. A Downer MP (Minister for Foreign Affairs), *Media release: Lowy Poll Confirms Confident, Optimistic Australia*, 31 August 2007: "*Australians regard climate change as the most important external threat facing Australia*"

emissions cap from year to year would be identified at commencement of the scheme[103]. Australia could switch between these trajectories on five years' notice and the trajectories would in theory give industry some idea of the proposed caps going forward. The previous two scheme designs proposed by the NETT and Task Group had, on the other hand, proposed a system of caps and "gates", under which firm emissions caps would be set for 10 years into the future and that would be followed by two ranges of caps (the "gates" - each of which might be five years, for example), the latter of which would be wider than the first[104]. As each year passes after commencement of the emissions trading scheme, another cap would be set for the 10th year into the future and, after each set of five years, the ranges would also be extended for a further five years each. The consequence was to be, in theory, that industry would have some certainty as to the level of greenhouse gas emissions limitations on the whole of the Australian economy for up to 20 years into the future. Under the Garnaut proposal, by comparison, it would be possible for the Government to significantly change the trajectory of allowable emissions on five years' notice. While this gives the Government more flexibility, it does not give industry the certainty it requires to make investment choices more than 5 years into the future. In this sense, the NETT and Task Group proposals provided a better balance between investment certainty and flexibility.

Although the Draft Report favoured an immediate move to a system where the price of carbon is set by the market, in response to submissions from industry the Draft Report raised the possibility of a transition period from 2010 to 2012 during which time it might be possible to set some controls on the cost of complying with the scheme[105]. Garnaut rejected placing a cap or limit on the cost of compliance of the type that had been proposed by the Task Group, which had proposed a fee for each tonne of carbon by which a liable entity is in shortfall of permits (set effectively low enough to cap the cost of carbon). Instead Garnaut suggested that liable entities might be able to acquit European Union Allowances against their liabilities or (as the less preferred option) that the Government might consider fixing the price of permits to the end of 2012. The former proposal would effectively cap the cost of compliance at the carbon price in the European Union Emissions Trading Scheme anyway and would mean that Australia's emissions would increase above its cap by the number of emissions permits taken out of the European Union system. To be consistent with Australia's obligations under the Kyoto Protocol, there would need to be a concurrent transfer of "Assigned Amount Units" from Europe to Australia in accordance with Kyoto Protocol rules or a cap placed on the number of units that can be transferred, so as to avoid Australia's total emissions exceeding Kyoto Protocol limits. If the latter approach were adopted, and fixed permit pricing imposed, it is unclear how the

[103] Draft Report pp 365-366
[104] Supra n 97
[105] Draft Report pp 390-392

Government would choose to distribute permits that might otherwise be auctioned if a number of liable entities are prepared to pay the fixed price for the same permits. If the Government held a ballot to distribute fixed price permits, the choice of entities that would be entitled to permits would be made purely on the basis of luck and this would hardly seem to be an appropriate means of allocating a scarce resource in an economy. If discretion were given to a regulator to choose who gets to buy the permits at the fixed price out of a number of willing buyers, the considerations that the regulator might be required to apply would become a political question and open to debate – that is, who is most worthy to be entitled to pollute? Given these difficulties, it is not clear whether any direct form of price control would be effective in a market mechanism and instead, if there is to be a transition period so that companies can adjust, a simpler solution (and one that avoids untested market intervention) would appear to be setting a more modest cap in the first two years.

The Garnaut Review's Draft Report criticised the Clean Development Mechanism ("**CDM**") to the Kyoto Protocol, under which offsets called Certified Emissions Reductions ("**CERs**") can be generated from projects in developing countries (as they do not have a binding target for emissions reductions under the Kyoto Protocol) that reduce emissions below a demonstrated business as usual baseline[106]. The Draft Report indicates that the mechanism is "flawed" due to the difficulty in establishing whether a project reduces emissions in addition to the business-as-usual case (known as the test of "additionality"), high transaction costs, the fact that the use of offsets merely allow a concomitant increase in emissions in developed countries and because it provides a financial disincentive for developing countries to take on commitments while ever a revenue stream is received under the CDM[107]. For this reason, the review suggested that the import into Australia's emission trading scheme of CERs from the CDM should be limited as to source and quantity, and should only be possible from relatively lower-income economies without emissions reduction targets[108]. By this Garnaut was suggesting that Australia should not import offsets under the CDM from economies like India and China. The current political reality, however, is that – in the absence of support for binding targets from wealthier developing countries – establishing clean development projects in India and China may well be better than not at all. While it is true that the CDM is not free of difficulties and the emissions reductions achieved under the CDM might be negligible compared with the rate at which emissions are growing in increasingly wealthy developing economies like India and China, the CDM has been successful in promoting technology transfer (a benefit that Garnaut has acknowledged) and spreading awareness of climate change in developing countries. Likewise, even the commentators on which Garnaut relies to support the difficulty of proving

[106] *Kyoto Protocol to the United Nations Framework Convention on Climate Change* ("**Kyoto Protocol**"), Article 12
[107] Draft Report p 279
[108] Id p 378

"additionality" under the CDM do not condemn the mechanism altogether and although they advocate a more limited role for it suggest that "*[t]he [CDM] system can work better, if not perfectly, provided it pursues substantial reforms*"[109].

In effect the Garnaut review was a useful review and summary of some of the science and potential design proposals for an Australian emissions trading scheme, but given the substantial policy history that had gone before the Garnaut review it has not changed the course of the policy debate concerning the shape that emissions trading should take in Australia. Indeed, its release was overshadowed by the release of the Government's Green Paper on 16 July 2008, which for the first time set out in detail the new Australian Government's thoughts on emissions trading.

The Australian Green Paper

The new Government confirmed its proposal to implement a "cap and trade" emissions trading scheme in its Green Paper, to be known as the *Carbon Pollution Reductions Scheme* ("**CPRS**"). The cap and trade model advocated in the Green Paper is similar to the type that is already well-known internationally and outlined above[110]. The Kyoto Protocol itself is a type of cap and trade emissions trading scheme under which countries are the liable entities, by contrast with the domestic emitters that might be liable under a domestic scheme. The Government confirmed that its CPRS will set a series of limits on the total tonnes of carbon dioxide equivalent emissions that entities covered by the scheme are entitled to emit, each such limit being applied over a 12 month period[111]. Entities covered by the scheme will be required to obtain and annually surrender "carbon pollution permits" (an allowance or permit by any other name) for every tonne of carbon dioxide equivalent greenhouse gas emissions for which they are responsible or deemed to be responsible. The Government will issue a number of permits corresponding to the total "cap" that it wishes to achieve, each of which is tradeable. In this sense, the price of carbon (in the absence of fixed-price permits proposed by Professor Garnaut[112]) is established by the worth that liable entities place on each permit, given the finite supply of permits and the total demand for them across all entities covered by the CPRS.

This can be contrasted with a carbon tax, where the price of each tonne of carbon is set by the Government. In theory, under a cap and trade model, the price of carbon will closely reflect the

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[109] M. Wara and D. Victor, *A Realistic Policy on International Carbon Offsets*, PESD Working Paper #74, April 2008 p 19
[110] See pp 2 and 3 above
[111] Green Paper p 74
[112] Supra n 26

minimum cost that is necessary to achieve the cap, whereas a tax set by the Government could be higher (or, if set too generously, lower) than what is necessary to achieve a greenhouse gas emissions reduction target. If a tax is set too high, entities covered by the scheme pay too much to achieve its environmental objectives, which costs are passed onto the broader economy. If the tax is set too low the tax will be insufficient to achieve the environmental objectives of the scheme. On the other hand, if the CPRS rules are complex when they are released (leading to higher transaction costs), if the market established is not sufficiently liquid or if there are barriers to exchange of pricing information, the price of carbon under emissions trading could be higher than it needs to be and efficiency gains from having the market set the price could be lost.

- "Cap" trajectories

The Green Paper does not express a view on the likely trajectory of caps on greenhouse gas emissions that will be set by the Government, referring only to the Government's previously stated commitment to reduce Australia's greenhouse gas emissions by 60% below 2000 levels by 2050[113]. At this stage, the Government proposes to publish a decision on the caps in its White Paper, that is to be released in December 2008 with draft legislation on the CPRS. While the Green Paper adopts the language of "trajectories" used by Professor Garnaut, the paper effectively adopts the system of "caps and gates" proposed by the NETT and the Task Group but with a shorter horizon of firm caps. It is proposed that caps will be set for 5 years into the future[114] and a medium-term range (or "gateway") would be established (possibly until 2020) with upper and lower bounds[115]. Each year the caps would be extended by another year so that firm caps are always known for the next 5 years at any point in time and every 5 years the gateways would similarly be extended for a further 5 years. While this approach provides some investment certainty, it is in effect similar to setting a longer trajectory and allowing changes between trajectories on 5 years notice. Any investment decisions cannot be made with any certainty that carbon constraints beyond 5 years into the future will be tighter or weaker than the present path of the caps, only that the cap will lie between the established medium-term range.

- Coverage and commencement

While the Government estimates there will be approximately 1000 liable entities and that more than 99% of all "firms" in Australia will not need to be directly involved in the regulation of emissions or the obligation to acquire permits[116], the reality of the CPRS is that these key liable entities are employers and buyers or sellers of goods or services so that the costs of complying with the scheme will be passed up or down the supply chain, onto the broader economy and, ultimately, to consumers. The emissions trading scheme will change the way that the economy

[113] Green Paper p 65
[114] Id pp 173-174
[115] Id pp 180-185
[116] Id p 13

operates and create a price signal throughout the economy in connection with the cost of carbon – even where greenhouse gas emissions underlie goods or services that do not obviously or directly cause emissions. Liable entities that are able to either adapt to the cost of carbon, or can produce sufficient revenue from each tonne of carbon so that they can meet the additional cost of the CPRS, will survive. Activities undertaken by other liable entities may no longer be viable and those liable entities will be forced to change or will face becoming unviable themselves.

The Australian Government proposes to implement a scheme with broad coverage from its likely commencement in 2010[117] - no narrower in scope than the proposal of the former Government - which would include direct emissions from facilities emitting over 25 $ktCO_2$-e per annum[118] from (broadly) stationary energy, transport, fugitive emissions, industrial processes and waste sectors[119]. CPRS will encompass all of the greenhouse gases covered by the Kyoto Protocol[120]. This is an early start given that the greenhouse gas emissions and energy reporting regime which will underpin CPRS, the *National Greenhouse and Energy Reporting Act 2007* (Cth) ("**NGER Act**"), only commenced on 1 July 2008 and industry is still grappling with how it will implement this new legislation. CPRS will, if the Government meets its proposed timetable, commence less than 12 months after the first set of data is obtained under the NGER Act. Like the former Prime Minister's Task Group, the Green Paper proposes to place an obligation to surrender permits on upstream fuel suppliers for greenhouse gas emissions that are to be caused by the combustion of fuels that they supply[121]. In addition, bulk importers of synthetic greenhouse gases and large importers of equipment containing synthetic gases would be responsible for surrendering permits corresponding to those imports[122]. Agriculture would not be included in the scheme initially (before at least 2015) until a practical means of estimating and reporting emissions can be developed with the industry[123]. Owners of forests can elect whether or not to participate[124] - a decision that will likely be made based on whether the forest can be recognised as a net carbon sink (see "Offsets and sinks" below).

To ease the political blow of including petrol in the scheme from its commencement, given the inevitable price increases when the cost of carbon is no longer an externality, the Government is proposing to offset the increased cost of fuel as a result implementing the CPRS with a cut to fuel taxes on a "cent for cent basis"[125]. The Government proposes to reassess the offset every three years and sends a strong signal in the Green Paper that the measure is only transitional

[117] Id p 88
[118] Id p 98
[119] Id pp 99-138
[120] Id p 96
[121] Id pp 99-102
[122] Id pp 104-105
[123] Id pp 123-126
[124] Id pp 127-134
[125] Id p 278

while businesses and consumers have an opportunity to make decisions informed by the long-term intention of the scheme[126]. This measure will of course initially be inefficient given the cost of administering the fuel tax cuts and the fact that, if the CPRS and tax measures operate as intended, there will be no net carbon price signal applied to petrol. That is, applying the CPRS to transport will present a net cost to Government with no net environmental benefit in the first three years. However, politically this may have been the only way to apply the mechanics of the scheme to fuel consumption, so as to prepare fuel consumers and the transport industry for the processes that must be followed in a carbon constrained future. Where industries would not benefit from a cut to fuel excise (for example, in the agricultural and fishing industries) the Government proposes to provide a rebate equivalent to the excise cuts[127].

- Offsets and sinks

Given the broad coverage of the scheme proposed, the Government has left few opportunities for carbon offsets to play a role in the CPRS. "Carbon offsets" most often represent a tradable credit awarded where greenhouse gas emissions can be reduced below a business-as-usual level of emissions. In some other emissions trading schemes around the world, offsets can be used like permits to enable a liable entity to emit an additional 1 tCO_2-e of greenhouse gas emissions for each offset that is surrendered to the regulator. Offsets, however, are only possible if the activity that reduces greenhouse gas emissions is carried out in a sector that is not otherwise covered by the obligation to surrender permits under the emissions trading scheme. If greenhouse gas emissions are reduced by 1 tCO_2-e in a sector that is covered by an emissions trading scheme the entity that would have otherwise been liable to surrender a permit for that emission avoids the need to do so. This frees up the permit for use by that person (or another entity) and so, if the reduction in emissions were also to generate an offset, the spare permit and new offset can be used to effectively allow 2 tCO_2-e to be emitted where only 1 tCO_2-e has been reduced: a net increase in emissions of 1 tCO_2-e.

For this reason, only activities that are not covered by the CPRS, effectively agriculture, would be entitled to generate offsets until those activities are included in the scheme. As the Government takes the view that "*[o]ffset schemes are administratively complex and require considerable judgement to determine [business as usual] baselines*" and because effectively only agriculture would be eligible to create offsets (which could be included in the scheme as soon as 2015 anyway) the Government is not proposing in the Green Paper to establish any offset system for the CPRS at all[128]. The Government will review this for any emissions sources that cannot be included in the scheme post-Kyoto Protocol. This will mean Australia will forgo

[126] Id p 17
[127] Id p 101
[128] Id pp 137-138

opportunities up to 2015 for farm businesses to create offsets under the CPRS and so generate a revenue stream from reduced emissions in animal management practices and the like. Agricultural projects have been a popular source of emissions reductions in Mexico and South America under the CDM (albeit that Australia, as an Annex B country, is not eligible to participate in that mechanism).

Offsets are not, however, the only way that liable entities can legitimately generate additional tonnes of emissions over and above the permits originally issued under the scheme cap. Growing forests capture carbon from the atmosphere and, unlike offset projects, they do so without being the source of the emissions that are sought to be reduced. In this sense, forests are "sinks" that can capture additional carbon but that do not free up a permit for each tonne of carbon that is captured. For this reason, even if forestry and agriculture are ultimately all covered by the scheme, there is no increase in emissions (unlike offset projects) if the carbon captured in forestry projects is recognised with credits that can be used to offset other emissions covered by the CPRS. Consequently, the Government is proposing to enable owners of the rights to carbon captured in forests ("**Forest Landowners**") to elect to have their forest participate in the scheme[129]. Although detailed design is to be determined, it is expected that for each net tonne of carbon dioxide equivalent emissions captured in eligible forests, Forest Landowners that opt-in would be issued with a permit by the Government that could be traded in the CPRS[130]. Likewise, for each net tonne of carbon dioxide equivalent emissions in those forests that is lost, the Forest Landowner would be required to surrender a permit.

If forest plantations can be established at a lower cost than permits can be purchased at auction or from third parties, this will contribute to reducing the overall cost of complying with the CPRS across the economy and for those entities that choose to obtain permits from plantations. Entities that are liable to participate in the scheme can establish forestry plantations to obtain further permits, or can buy permits from others that have establish forestry plantations either directly or from the secondary market. These permits would effectively enable them to emit more greenhouse gases than would have been possible with the permits that the Government issues (by auction or otherwise) under the scheme cap alone.

It is proposed that the rules for this part of the scheme would operate in parallel (and so be no less onerous than) Australia's obligations under the Kyoto Protocol to account for forestry activities[131]. For this reason, forestry activities that reforest land which had been deforested by 31 December 1989 will be eligible to generate permits[132]. Projects that merely avoid

[129] Id pp 129-132
[130] Id p 127
[131] Id pp 17, 133 and 461
[132] In accordance with the definitions of *afforestation* and *reforestation* under the Kyoto Protocol

deforestation[133] or that reforest land that was cleared after that date will not be eligible. There are other land-use changes for which Australia could elect to account under Article 3.4 to the Kyoto Protocol, including certain forest, grazing or cropland management activities and revegetation (not meeting the afforestation or reforestation definitions), but Australia has elected not to do so for the first commitment period of the Kyoto Protocol (2008-2012)[134]. As Australia has not elected to account for other land use changes it is likely it will not be possible to generate permits from stored or avoided emissions as a result of these activities, as this would add permits into the CPRS market that would not coincide with emissions reductions for which Australia could be recognised under its international obligations.

- The nature of permits and how they will be distributed

The Government proposes to distribute the majority of permits by way of auction, but to move to 100% auctioning over time[135]. Up to 30% of permits are to be allocated for distribution free of charge at the commencement of each compliance year to trade exposed, energy intensive industries, to provide transitional support to avoid the risk of those entities moving processes offshore and so merely shifting emissions (and investment) elsewhere[136]. The permits are proposed to be tradable personal property which could only be extinguished with compensation[137]. This would appear to rely not only on any legislation that might be introduced for the CPRS but also on Australia's Constitutional protections for acquisition of "property" on just terms[138] and the array of rights that have been recognised to be "property" within the meaning of those provisions[139]. However, this might be no real impediment to the Federal Government choosing to repeal any compensation legislation and extinguish permits if it were determined to do so, given that there is no Constitutional protection in Australia for property that is merely extinguished in the course of a Government performing regulatory functions and not actually "acquired":

> *The statutory modification or extinguishment of a permit or an interest in a permit is not an acquisition of property by the Commonwealth, for the Commonwealth was under no liability reciprocal to the permit or interest and acquires no benefit by the modification or extinguishment.*[140]

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[133] Green Paper pp 134-135
[134] Department of Climate Change, *The Australian Government's Initial Report under the Kyoto Protocol*, Australian Government, 2008 p 4
[135] Green Paper p 256
[136] Id pp 292-297
[137] Id p 150
[138] *Australian Constitution Act 1901* s 51(xxxi)
[139] *Telstra Corporation Ltd v Commonwealth* (2008) 243 ALR 1 at 13-16
[140] *Commonwealth of Australia v WMC Resources Ltd* (1998) 152 ALR 1 at 12

While it is conceivable that the Commonwealth might be obtaining a material benefit by extinguishing CPRS permits if in so doing it afforded the Commonwealth more Assigned Amount Units ("**AAUs**" - effectively permits under the Kyoto Protocol) than it would have had if the CPRS permits were used by its owner to generate more emissions, it is questionable whether this would be a relevant acquisition requiring compensation on just terms. When a right to mine on Commonwealth land was sterilised by the Commonwealth it was held to be a compensable acquisition of property because the miner lost the right to mine and the Commonwealth lost a reciprocal liability to have its minerals removed[141]. However, if the Commonwealth were to extinguish a CPRS permit to emit, avoiding the need for (or freeing up) another permit to emit (AAU) under its Kyoto Protocol obligations, it is questionable whether the right extinguished and the benefit acquired (or liability avoided) are sufficiently reciprocal – even though the right extinguished need not be the same as the right gained or liability avoided by the Commonwealth[142] – given that the CPRS permit is itself an instrument implemented by the Commonwealth for purposes that include meeting Australia's international law obligations under the Kyoto Protocol.

The Green Paper also proposes that permits under the CPRS would be a "financial product"[143]. This is in some ways akin to making wheat or gold a "financial product" in the sense that permits under the CPRS represent the underlying tradable commodity. If permits (as distinct from other products that are generated from them) were literally added to section 764A of the *Corporations Act 2001* as a financial product alongside derivatives and securities, services provided in connection with carbon trading could (without further amendment to the law) be regulated in a way that could reduce the liquidity of what should effectively be a simple commodities market in which liable entities can freely participate without high transaction costs. It will remain to be seen what approach the Government takes and the consequences this has for licensing and financial services regulation in the context of carbon trading in Australia.

Under the Government's preferred position, CPRS permits could be unlimitedly banked[144], meaning they may be surrendered by liable entities in any year after they are issued and would not expire. The Government is proposing a limited borrowing scheme that would allow liable entities to "borrow" a certain percentage of permits from the following year to meet liabilities in the current year[145]. Although this affords more flexibility to comply with present year obligations, the scheme cap will effectively be tighter (and the carbon price potentially higher)

[141] *Newcrest Mining (WA) Ltd v Commonwealth* (1997) 147 ALR 42 at 48 (per Brennan J, albeit dissenting on other grounds) and 129 (per Gummow J)
[142] *Georgiadis v Australian And Overseas Telecommunications Corporation* (1994) 119 ALR 629 at 633
[143] Green Paper p 151
[144] Id p 153-155
[145] Id p 157-158

in the following year. This is similar to the mechanism already in operation under GGAS to carry a certain percentage of any shortfall in offsets over to the following year[146].

For trade exposed, energy intensive industries, the assessment of eligibility to receive free permits is proposed to be made on the basis of "activities" and not on a whole-of-firm or industry level, so that activities with an emissions intensity over 2,000 tCO_2-e/ $ million revenue would receive permits corresponding to around 90 percent of industry average emissions per unit of output, while activities with emissions intensities between around 1,500 and 2,000 tCO_2-e/ $ million would initially receive permits corresponding to around 60 percent of industry average emissions per unit of output[147]. While taking industry average emissions will mean that firms will not be rewarded with free permits for emissions that are in excess of industry average, by restricting the eligibility assessment to firms that exceed a certain emissions intensity per unit of revenue the Government will take no account of firms that could be highly trade exposed and work to small margins. For some such firms, a small increase in their costs per unit of revenue could make the return insufficient for some processes to be undertaken in Australia. The intensity threshold appears aimed at limiting the number of trade exposed industries that receive free permits based on an assumption that if the increase in cost is low per unit of revenue then most such trade exposed industries will not be seriously affected. It remains to be seen whether this is the case for low margin firms.

The Government will separately establish the Electricity Sector Adjustment Scheme ("**ESAS**") to provide limited direct assistance to existing coal-fired electricity generators[148], which could include free permits[149]. Assistance to adjust to the scheme will also be provided to households, predominantly through increases to Commonwealth benefits and allowances, and through the tax system[150]. The detail of these measures is to be the subject of consultation.

- Penalties, price controls and international linkages

The Government does not propose a definitive penalty for non-compliance, rather "flexible measures" are advocated to seek to achieve compliance voluntarily[151]. The Green Paper indicates that a penalty could be imposed for surrendering fewer permits than required[152], but no potential measure of the penalty is suggested.

[146] ES Act s 97BE
[147] Green Paper pp 320-321 and 330
[148] Id pp 371-391
[149] Id pp 385-386
[150] Id p 278
[151] Id p 215
[152] Id p 216

At this stage the Green Paper is proposing to place a cap on the price that businesses would be required to pay for permits (sufficiently high that it would unlikely be used) between compliance years 2010/2011 to 2014/2015[153]. The Government suggests this could be achieved through an administrative penalty or by providing an unlimited further supply of permits at a fixed price (in addition to permits issued in accordance with the cap). If the price cap is not high enough to make its use prohibitively expensive and is established to allow businesses to "buy out" the obligation to surrender permits by paying the capped price, the environmental integrity of the scheme will be compromised because total emissions allowable across all covered sectors would be greater than the cap set under the scheme. If the emissions caps are ultimately set at such a point so that there is, at least in the transitional period, only a limited difference between actual and targeted emissions and if a proportion of entities were to choose an administrative buy-out while others hoard permits, the price of permits may crash when those banked permits (effectively in excess of the intended cap) are later brought to the market. Either scenario can be avoided with a sufficiently high administrative penalty or a requirement to make good any permits in shortfall in the following year.

Gone from the Green Paper is the suggestion in Garnaut's Draft Report to issue all permits at a capped price or to allow European Union Allowances to be acquitted as a form of price cap[154] – even from the summary of the Draft Report in the Green Paper[155]. The Government does, however, propose to establish some links between the CPRS and global emissions trading. In particular, the Green Paper proposes that:

- liable entities would be able to use some Kyoto Protocol units for compliance with the CPRS (subject to possible limits or restrictions which have yet to be proposed), being Emission Reduction Units created under the Joint Implementation Mechanism, Removal Units, and CERs created under the CDM (with the exception of CDM forestry offsets)[156];
- liable entities could not use Assigned Amount Units under the Kyoto Protocol[157] or any international non-Kyoto units to comply with the CPRS[158]. This will include European Union Allowances and New Zealand Units;
- a permit under the CPRS would not be attached to one of Australia's Assigned Amount Units under the Kyoto Protocol – these units would be registered separately, and traded separately, from Kyoto Protocol units[159]. This is not the approach the European Union has implemented;

[153] Id p 165
[154] Supra n 26
[155] Id p 465
[156] Id pp 236-238
[157] Id pp 234-236
[158] Id pp 242-243
[159] Id p 229

- CPRS permits could not be converted to Kyoto Protocol units for trade internationally[160]; and
- projects under the Joint Implementation Mechanism to the Kyoto Protocol cannot at this stage be undertaken in Australia: not in covered sectors (even in the case of forestry sinks where the additional permits generated might be exported under the Kyoto Protocol as Emission Reduction Units) and not in uncovered sectors unless offsets can be generated (which they cannot at this stage)[161].

In effect, the global linking proposed at this stage is unilateral and conservative. A measured approach to progressively linking the CPRS to the global carbon market may well prove to be sensible. However, the benefits that come from a larger and more liquid linked market – and a commodity that the banking and financial services industry will doubtless wish to see become easily tradable across jurisdictional boarders – mean that more global linking and convergence between the carbon that is traded in different markets, in one form or another, is inevitable.

The road to the White Paper

As for any other markets involving the sale and purchase of essential commodities for businesses, the banking and financial services sector will play a central role in the carbon market including by backing acquisitions of permits, financing emissions reduction projects and developing funds or products that raise capital, offer exposure to carbon trading or manage risks. Many Australian companies in this sector have already gained experience in international carbon trading or in financing projects under the domestic precursors to the CPRS.

Of the 1000 or so Australian businesses operating in the broader economy that are expected to have direct liabilities under the CPRS, the leaders will come to grips with what Australia's proposed emissions trading scheme could mean for them by the time submissions on the Green Paper close on 10 September 2008. Many other companies that are not directly liable under the scheme may nonetheless have considerable real liabilities as a consequence of carbon costs being passed to them through their supply chains or even upwards from their customers. Even some entities within groups in the banking and financial services sector will be subject to a direct liability under the scheme.

The final detail of the scheme will not be known until the proposed White Paper is released in December. However, the long experience of carbon policy development in Australia and the

[160] Id pp 244-246
[161] Id pp 246-247

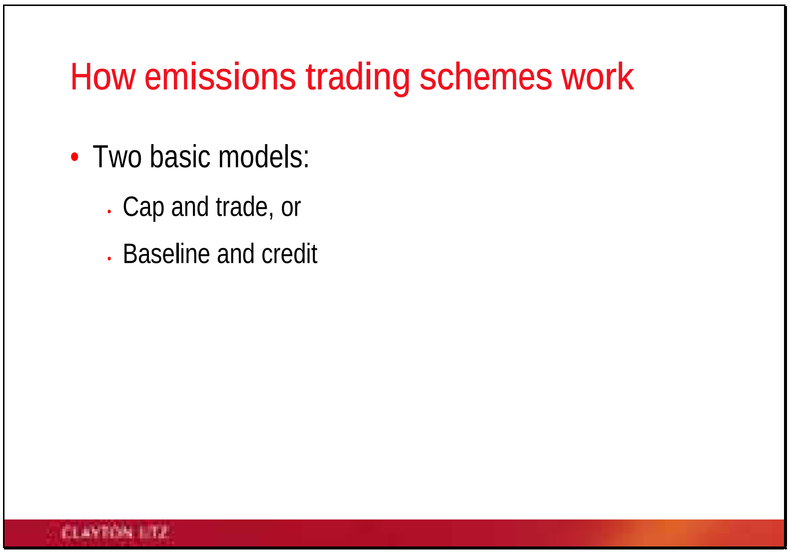
proposed mid-2010 start for CPRS means the demand for carbon financial services and products in Australia started long ago.

Graham Dennis, Clayton Utz, Sydney
Carbon Trading

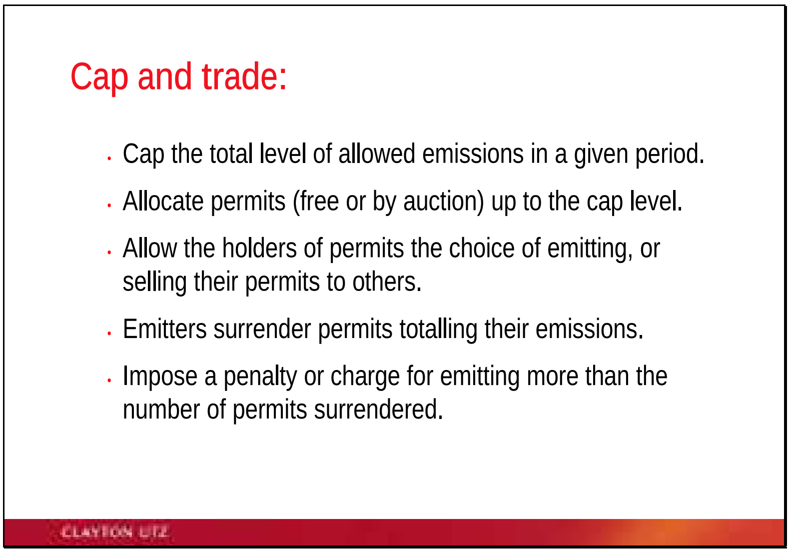
Slide 1

Slide 2

Slide 3



Slide 4



Slide 5

Baseline and credit

- Establish a baseline (typically historical or "business as usual") emissions.
- Award a credit for behaviour that is better than the baseline.
- Impose an obligation on emitters (or other liable entities) to surrender a certain number of credits (typically percentage of emissions) for their emissions.
- Impose a penalty or charge for any shortfall in surrender of credits.

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Slide 6

Offsets

- Often an additional component of a cap and trade scheme.
- Applies to sectors of emissions (or countries) where emissions are not capped.
- Award a credit for positive behaviour that reduces emissions in that uncapped sector (typically on a baseline and credit basis).
- Allow the credit to be surrendered under the cap scheme, as a substitute for a permit.
- Increases emissions in the capped sector, but nets out because of the reduction in the uncapped sector.
- Inclusion of offsets allows a greater range of activities / sectors to participate, and assists with finding lowest cost abatement.

CLAYTON UTZ

Slide 7

The Kyoto Protocol

- Essentially an international cap and trade scheme.
- Applies to countries. Binds countries.
- Developed countries are capped, others are uncapped.
- Developed countries are allocated permits ("Assigned Amount Units" or "AAUs") totalling their permitted emissions in the compliance period (2008-2012).
- Countries can use up these AAUs, by emissions in their country, or can trade them to other countries.

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Kyoto Protocol – compliance + penalty

- Capped countries can decide themselves what measures to take domestically to get their emissions down to the level of their AAUs – e.g. domestic schemes, taxes, regulation, education, buy more AAUs…
- A country whose emissions for the compliance period exceeds its assigned amount (including the results of trading):
  - has 1.3 times the shortfall deducted from the next compliance period;
  - must develop a compliance action plan;
  - can be suspended from trading.

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Slide 9

Kyoto Protocol offsets

- In addition to the AAU permits, the Kyoto Protocol has 3 offset credits available:
- CERs: Certified Emission Reductions, which can be earned from “Clean Development Mechanisms” in uncapped countries.
- RMUs: Removal Units, which can be earned by countries from reductions in emissions in capped countries relating to land use, land use change, and forestry.
- ERUs: Emission Reduction Units, which can be earned by “Joint Implementation” (JI) programs that reduce emissions in capped countries. ERUs are converted from, and hence reduce, the host country’s AAUs or RMUs. When transferred to another capped country they increase the recipient country’s assigned amount of permitted emissions.

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Slide 10

Voluntary offsets

- Voluntary offsets: credits created under schemes that are outside the Kyoto Protocol or compulsory domestic schemes.
- “VERs”: Verified Emission Reductions. Usually accredited and audited to demonstrate emission levels, or emission reductions, that would be better than “business as usual”. Need to be created in a sector that is not already under emission control regime.
- A number of standards and schemes, including:
  - “Gold Standard”
  - “GHG Protocol”
  - “Greenhouse Friendly”
- Traded for “public relations” purposes – bought by organisations that wish to demonstrate their “greenness” or “carbon neutrality”.

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Slide 11

Legal nature of these units

- AAUs, CERs, ERUs: international contractual promises made under the Kyoto Protocol, which is part of an international convention (UNFCCC).
- Domestic scheme units: Typically either:
  - Transferable statutory licence or permit (if consequence is prohibition or penalty);
  - Transferable tax credit (if consequence is tax or charge);
- VERs: Typically transferable chose in action, representing promise by abator that certain action has occurred, or not occurred.

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Slide 12

Use of offsets

- Countries can buy these Kyoto offset units from other countries, or the projects that generate them.
- Traders can buy the Kyoto offset units and sell them to capped countries.
- Some capped countries allow emitters or traders in their country to surrender the Kyoto offset units against liabilities owed to the country under domestic schemes (e.g. EU scheme).
- Purchase of the offset units, or obtaining them by surrender under domestic schemes, allows the country to increase its emissions in addition to the AAUs held.
- Query future of offset mechanisms post-2012.

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Slide 13

Is there a role for banks?

- Arbitrage opportunities, particularly between international schemes and domestic schemes.
- Also arbitrage due to insufficient price discovery and demand-supply information.
- Liquidity providers, brokers between sellers and buyers, who are often in different jurisdictions and sectors, and who can't see each other to trade.
- Investment opportunity (?!!), if you think price of carbon will rise as targets tighten and reductions become more expensive.
- Offering risk management products – carbon price hedges.

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Trading methods

- Exchange trading of EU allowances and Kyoto offsets, particularly on European exchanges.
- Bilateral OTC trading.
- Brokered OTC trading.
- Some cash-settled derivatives against future prices.
- Kyoto units and EU allowances delivered via registries.
- VERs delivered by private transfer.

CLAYTON UTZ

Slide 15

Documentation

- Exchange-traded: typical exchange delivery terms.
- OTC – most common is the ISDA “European Part 6”, which is designed for the EU scheme and operates as an addition (Part 6) to the ISDA Master Agreement Schedule.
- ISDA also used for OTC Kyoto units and non-EU domestic allowances by subtle amendment to the “European Part 6”.

CLAYTON UTZ

Saturday 26th July, 2008

Plenary Session
Millennium Hotel

9.00am – 10.15am

Chair:
Diccon Loxton
Partner
Allens Arthur Robinson
Sydney

Speakers:
Prof. Philip Wood
Visiting Professor in International Financial Law,
Oxford University, UK
(Special Global Counsel, Allen & Overy LLP; Yorke Distinguished Visiting Fellow, University of Cambridge; Visiting Professor, Queen Mary College, University of London)

International Developments In The Law Of Security - International Approaches To Security Interests

Prof. Philip Wood – Visiting Professor in International Financial Law, Oxford University, UK
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University of Cambridge; Visiting Professor, Queen Mary College, University of London)

International Developments In The Law Of Security - International Approaches To Security Interests

INTERNATIONAL DEVELOPMENTS IN THE LAW OF SECURITY

INTERNATIONAL APPROACHES TO SECURITY INTERESTS

By Philip R Wood*

Special Global Counsel, Allen & Overy LLP
Visiting Professor in International Financial Law, University of Oxford
Yorke Distinguished Visiting Fellow, University of Cambridge
Visiting Professor, Queen Mary College, University of London
Visiting Professor, London School of Economics & Political Science

Introduction

The three most important risk mitigants in financial transactions are:

(1) insolvency set-off and netting;

(2) the trust, such as settlement systems, custodianship, and the like; and

(3) security interests.

In my view, the arguments in favour of strengthening all of these risk mitigants are open and shut. But the world disagrees. In the case of insolvency set-off and netting, the world is a kaleidoscope of different colours. The case for and against trusts is an argument which has been going on for more than 1000 years and shows no real signs of resolution. In the case of security interests, there is still no consensus on what the future should be. Even the Uncitral Legislative Guide on Secured Transaction in its latest draft enthusiastically proposes the expansion of security interests at their inception but then proposes to impose stays and freezes on enforcement which is the very time that the security is needed. Hence it gives with one hand but takes with the other. This ambiguity and uncertainty is reflected worldwide.

Differences in security interests

There is an enormous disparity in the world in the approach to security interests. In one group of jurisdictions, the traditional English-based jurisdictions, it is possible for a company to create a charge over all its present and future property, including post-commencement property, to secure all present and future debt, to register it only once at the company's register without any necessity to register in title registers, such as a title register for land, and then the security interest is valid against all other creditors, other than certain limited wages and taxes which typically have priority over the floating collateral (mainly inventory and commercial receivables.) If the debtor defaults, then, if the security agreement so provides, the creditor can by letter appoint an accountant or other professional as a receiver (a type of possessory manager) over the collateral without any order of court and the receiver can run the company's operations over the heads of the directors for the benefit of the secured creditor. The receiver is not bound to sell.

This 19th century liberal creation is said to be justified on the grounds that it is for the benefit of the both creditors and debtors. It benefits debtors in that the cost of credit is reduced and that banks tend to stay with a company in difficulties for longer than would otherwise be the case because they are safer. If the situation is hopeless, the seamless change of management means that it is not necessary to turn off the power station. It is possible to continue the business as a going concern without the delays caused by court proceedings or public auction. The business can be sold as a whole, instead of in pieces. Unless the situation is hopeless, it is in the interests of the parties to keep the business going, so the effect is that suppliers have a de facto priority to the extent the business is continuing. Many suppliers also have retention of title clauses which enable them to strip out, ahead of the secured creditor, goods which they have supplied to the company.

From the point of view of creditors, the view taken in these jurisdictions is that the security interest mainly protects banks who (unlike suppliers) are medium-term creditors and represent depositors so that the protection of banks is ultimately the protection of depositors, i.e. the citizen.

There have been a number of inroads on the extreme liberality of the above, including in England, but not Hong Kong.

In any event, in no other jurisdiction, with perhaps a very small number of exceptions, is the above possible. In the United States, for example, while it is possible to have universal security over movables, security interests over land (governed by state law) and Federal property (such as certain intellectual property, US vessels and US aircraft) require further steps and a single filing is not available. In addition receivership is not possible but is displaced by Chapter 11 debtor-in-possession where the management stays in charge and cannot be displaced by a secured creditor's representative. Mortgages over land are debtor-protective in some states.

The concept of the universal super-generic charge has found favour with a number of jurisdictions which reformed their law of security interests after emerging from communism, such as Estonia, Hungary, Latvia and Poland.

At the other extreme are some traditional Napoleonic jurisdictions, particularly for example in South America. In these jurisdictions it is not possible to create security over all present and future assets. Nor is it possible to create security for all present and future debts. In the most traditional jurisdictions enforcement is typically by judicial public auction which causes considerable delays and gives rise to costs. Certain preferential creditors, notably employees and taxes, often rank ahead of security interests on insolvency.

Most Roman-Germanic jurisdictions are between the Anglo-American common-law and the Napoleonic, but this is very much a generalisation and there is a widespread variation of approaches in this group.

Pros and cons of security interests

The policies in favour of security interests include protection of creditors on insolvency, especially creditors such as banks who represent the citizens as depositors, that security encourages capital and the availability of credit, that security reduces the cost of credit, that security encourages the private rescue since the lender is safer and that, from the ethical point of view, security is a fair exchange for the credit: effectively it is a hold on the asset pending payment.

The objections to security interests are that unsecured creditors get less on insolvency so this is a violation of bankruptcy equality, that security confers too much power and that the secured creditor can disrupt a rescue.

Deep policies are involved either way, but choices have to be made. The international tendency seems to be to encourage security and it is probably true to say that security has much greater international recognition than the other two major risk mitigants – insolvency set-off and the trust. But the support is often half-hearted and is frequently countered by corporate reorganisation statutes which, as mentioned, restrict security when it really matters, i.e. on insolvency enforcement.

Classification of main issues

The main legal issues in relation to security interests are the following:

- **Scope** The scope of security interests and in particular whether a universal charge is available. The jurisdictions which restrict scope usually do so by two rather subtle methods. The first is by requiring that the creditor publicises the security interest by possession or control (or its equivalent) of the collateral. This is impracticable in the case of goods, inventory and bulk receivables. Therefore in countries such as Switzerland and Austria, which require a possessory pledge of goods, effectively there is no means whereby the creditor can have a charge over these assets and so the goods are left available to unsecured creditors. In countries, especially in the Napoleonic group and half of the Roman-Germanic group, which require that notice of an assignment of a receivable is given to the debtor (a rather futile publicity mechanism), the infeasibility of this in the case of bulk receivables renders charges over receivables impracticable unless there is some exception or a general enterprise charge is available (as there sometimes is). Note that Belgium abolished this requirement in 1994 and the Netherlands in 2004 and that France introduced a universal business charge in 2006, thereby moving ahead of the numerous Napoleonic countries which have limited business charges, eg. Luxembourg, Spain, Italy and Greece.

The second limitation is the doctrine of specificity which requires that the collateral is specified so as to confer identity. If it is necessary to specify the collateral, the effect is that future collateral cannot be included and has to be added by lists where this is feasible. A subsequent addition of collateral may be set aside as preferential if provided in the suspect period. The doctrine of specificity was dropped in English-based jurisdictions in the 19th century and super-generic descriptions of the collateral are permitted eg. "all my present and future assets". The doctrine of specificity has almost gone in such countries as Germany and the Netherlands but in Germany it is, for example, still necessary to state "all our goods in our warehouse in Frankfurt".

- **Publicity** The publicity needed to validate security interests and whether this can be achieved simply and cheaply. The most efficient method of publicity is by registration or filing in a central debtor indexed register, such as a company's register. The most inefficient is possession or its equivalent by the creditor in respect of each asset, e.g. possession of goods, notice to the debtor in respect of receivables and registration of the creditor in an asset title register for land, securities, ships, aircraft or intellectual property.

The insistence on publicity, except for universal charges, is questionable. If one compares the publicity required for the validity on insolvency (as opposed to priority against other adverse claimants) of the three main transactions of sale, trust and security interests around the world in the main groups of jurisdictions and for land, goods and debts, one perceives astonishing results. New Zealand is the only country in the world which does not require any form of publicity (by possession or the equivalent) or filing in the case of sale, trust or security interest for land, goods or debts but virtually all other countries do for one or other of these assets. The Napoleonic countries are particularly insistent on publicity for the validity of the transfer on insolvency. The common law countries do not require any form of publicity for the sale of land, goods or debts or for trusts of land, goods or debts but are fanatical about publicity in relation to security interests. The Roman-Germanic jurisdictions require publicity by possession for the sale of land and half of them for the sale of debts and for security interests over land and debts, but not for security interests over goods in the case of some countries. They do not permit the trust of any asset, subject to patchy exceptions, because of the absence of publicity and hence the encouragement of the so-called false wealth doctrine.

We cannot all be right on this issue. The whole false wealth proposition (many possessions but no assets) seems irrelevant in the modern world except in the case of universal charges. Most important assets are invisible. Creditors rely on financial statements, as opposed to inspection. The penalty for non-compliance with these requirements is disproportionate because it makes transactions void.

The question of whether publicity is desirable for regulating priorities is a different issue. Most jurisdictions regulate priorities against other property claimants by the first to get the most public possession for value without notice, but there are inroads on this in the case of the article 9 countries, such as the United States, Canada and New Zealand. The English-based company charge registration system is not explicitly a priority system but it can have priority effects.

- **The scope of the secured debt** In some countries secured debt is limited to existing debt.

- **The priority of security interests over preferential unsecured creditors.** These are mainly taxes, employees, insolvency expenses, rehabilitation new money and personal injury and environmental claims. There is considerable international diversity on this issue.

- **Restrictions on enforcement,** in particular the need for a judicial public auction and the imposition of reorganisation freezes.

The main issues in relation to enforcement outside insolvency are whether a private sale is possible as opposed to the inefficiency and delays of judicial public auction, and whether receivership is available. In relation to enforcement on insolvency the main categories of intrusion on security interests in the case of rescue proceedings (and sometimes liquidation proceedings as well) include freezes on enforcement until a reorganisation plan is approved, a right of the administrator to sell, use or lease the collateral, including an exclusive right to realise it, the right of the administrator to substitute collateral, the stopping of unsecured interest, the exclusion from collateral of property acquired by the debtor post-commencement, including post-commencement revenues (revenues which may be crucial to servicing the secured debt), the subordination of the collateral to post-commencement claims (employees, leases, contracts, new money to finance the rescue), the deduction of the administrator's expenses in preserving or disposing of the collateral repair (payroll, etc. - a large item in some cases, especially in Germany) and the subjection of secured creditors to a majority vote on the plan which can reduce their debt or stretch its maturity. Sometimes secured creditors are entitled to adequate protection.

The approach to enforcement – whether in or out of insolvency proceedings – should be looked at as a whole. Restrictions on enforcement take away what was originally granted at the time it is most needed and therefore question the strength of the policy in favour of security interests; The end is as important as the beginning.

- **Transaction costs** In some countries security is regarded as wicked as cigarettes and alcohol and therefore deserving of high taxes. There are numerous countries, especially in Latin America, where the costs are so high that security is unrealistic.

- The vulnerability of the security interest to be set aside as a **preference**.

- The presence of corporate doctrines limiting **financial assistance** to buy a company's own shares or those of its holding company and restricting group guarantees.

- The **priority** of secured creditors over buyers and chargees of the collateral and other claimants.

- The availability of **trustees** of security interests – usually essential for debt novations.

Most of the above contests are concerned with the collision of interests between secured and unsecured creditors. For example, if a universal charge is not available, then there are more assets available for the unsecured creditors. If security interests are subordinated to preferential creditors, then those classes of creditors are protected. If the security cannot cover future loans, then the secured debt may be less. If security interests cannot be enforced on a rescue proceeding, the effect is that critical unsecured creditors, such as suppliers and employees, tend to be paid ahead of the secured creditor so that the priorities are upside down.

Virtually all of the issues relating to security interests can be seen as expressing the views of a jurisdiction one way or another about the relative weight given to protect unsecured creditors.

Classification of main sectors of secured finance

The classification of the main sectors of secured finance is useful in showing the role of security interests in advanced economies. The pattern of secured creditors is different according to the type of economy, e.g. whether advanced or developing. One of the main reasons for the classification is to see whether or not debtor-protective policies in relation to security interests are or are not appropriate.

A brief taxonomy is as follows:

- **Large listed corporate groups** Publicly listed groups of companies usually borrow unsecured under a loan agreement which contains a negative pledge, i.e. a restriction on the creation of security by members of the group and often restricting title finance as well. Senior bond issues by large listed corporates are almost invariably unsecured and generally contain very limited negative pledges - typically restricting security only for marketable debt issues, but not security for bank debt and not title finance. The reason that these corporate groups do not borrowed secured is that they need to diversify their sources of finance and because they have sufficient credit strength to borrow unsecured.

  Hence normally the commanding heights of the economy are outside the net of security.

  These corporate groups do, however, borrow secured in two situations. The first is where they are in financial difficulties when existing creditors may demand security as a condition of survival and as a condition to the grant of fresh emergency credit. The second situation is where the group is taken over in which case the assets of the target group may be used to secure the finance for the takeover, where permitted (often it is not).

  Sovereign states also do not usually borrow secured.

- **Single purpose companies**. These are companies set up to own and operate a project or a single ship, aircraft or property or to make a bid for another company or to act as a securitisation vehicle. These single purpose companies are, contrary to the practice in the 19th and first half of the 20th centuries, now the main vehicles for enterprise finance. The single purpose company is set up for a variety of reasons, including the desire to insulate the shareholders from the risk of the project and conversely to insulate the lenders from the risk of the insolvency of the shareholders (which could crystallise a need to enforce charges over a perfectly good project and to get involved in the insolvency laws of the several shareholders).

In these cases the security is generally universal, where possible. Since the special purpose company typically does not have general creditors, other than those who are wholly involved in negotiating the transaction (which is usually for their benefit), there are normally no special issues about protecting general unsecured creditors. The company is in any event to some degree ring-fenced from other creditors by clauses restricting the business of the company. They often have a negligible number of employees and no pensioners. They do not incur outside debt accept for the single purpose.

The amounts involved in this sector are extremely large.

There does not seem to be any role for publicity by filing or possession or the like in relation to this situation. There appears to be no need for debtor-protective policies. These companies do not need the legislator to tell them what is good for them or how they should run a work out on a rescue: hence the various interferences by rescue statutes also appear inapplicable.

- **Small and medium-sized companies.** These typically do not have the credit strength to borrow unsecured and in addition they have less need to diversify their sources of finance. They tend to have one house bank which takes the maximum security over the assets. They do not have access to the bond markets and in any event corporate law typically prevents them from issuing securities to the public. The finance tends to be domestic. Often the credit is a line, cancellable on demand but in practice outstanding for many years.

  The purpose of security is to increase the availability of capital to this sector and to reduce its costs.

  The sector is extremely large in many economies and attracts considerable political interest, often expressed in debtor-protective policies.

Whether publicity is needed for this sector is questionable. Unsecured creditors can assume that the house bank will have a universal charge. The need for a restrictions on enforcement depends on one's view as to whether responsible banks habitually pounce on companies in the sector and whether there is any point in restraining the banks when they do.

- **Trade finance**. The export and import of goods is typically financed by letters of credit issued by or on behalf of the buyer's bank which takes a pledge over the documents of title to the goods plus the insurances and sometimes other items. The security is short-term, often lasting no more than a few weeks at most. The amounts involved are tiny compared to other sectors. The amounts and assets are so minor that there seems hardly a case for protecting unsecured creditors or for the other paraphernalia of enforcement restrictions. Publicity is irrelevant for such small items and in any event the secured creditor has possession.

- **Wholesale financial markets**. The main categories here are security for the obligations of banks and payment systems, the obligations of participants in securities settlement systems, the obligations of participants dealing with central counterparties established for netting purposes, and collateral for over-the-counter derivatives transactions. The collateral is usually highly liquid, mainly cash and government securities. The finance is often quite short-term – sometimes overnight only. The amounts are extremely large, particularly in financial centres.

  Financial security interests are considered fundamental as a protection against systemic risks so that many advanced states disapply laws which interfere with the security agreement, such as freezes under insolvency rescue statutes, publicity requirements and the priority of preferential creditors, as well as a requirement for judicial public auction enforcement. There are EU directives on these matters.

- **Home loans**. The home loan is secured on the property, plus the insurances. The transactions are mainly domestic and the borrowers are individuals. Home-owners are commonly protected by consumer credit statutes, by official guidelines and by the responsibility of mainstream mortgage institutions.

- **Consumer goods finance**. Some of this is provided by title finance, such as hire purchase for cars and consumer durables. The credit is often quite short-term, e.g. up to three years. The finance tends to be domestic. Consumer credit statutes often provide protection.

- **Title finance**. This section comprises financial leasing, retention of title to goods sold, sale and repurchase, sale and leaseback, securities lending and other. Some of this is short-term but not in the case of big ticket title finance, such as the financial leasing of aircraft. Title finance typically applies to a single asset or a set of assets and is almost never universal.

If one examines the above sectors, it would seem that debtor-protective policies and the desire for publicity appear mainly driven by security granted by small and medium-sized companies, i.e. the ideas underline consumer protection. It seems doubtful that these ideas should influence the whole area of this important risk mitigant. Debtor-protective policies are considered irrelevant in the case of the single purpose company (a huge sector) and wholesale financial markets. Their applicability in other areas is also considered doubtful, or at least worthy of reconsideration.

UCC Article 9 and the Uncitral Legislative Guide on Secured Transactions

Article 9 of the American Uniform Commercial Code is probably the most thorough and comprehensive codification of security interests over moveable property and of their priorities in the world and represents a splendid effort spanning around sixty years until its consummation by almost universal acceptance in the United States, finally around the year 2000.

The basic ideas have been adopted in most Canadian common law provinces and in New Zealand. Australia is considering adopting the principles. The adoption of article 9 was discussed in Britain a few years ago but was rejected.

The Uncitral Legislative Guide on Secured Transactions is in effect a direct descendant of article 9 and of chapter 11 of the US Bankruptcy Code 1978 which is the main US rescue proceeding.

Article 9 and the Guide would be an advance for many jurisdictions in the traditional Napoleonic group and some members of the Roman-Germanic group. It is less liberal and supportive of security interests than the regime in the English common law group and it is considered that the adoption of the article 9 regime would be a set-back in this group in most cases.

Chapter 11 is a reorganisation provision reflecting the pro-debtor mood of the 1970s and the Uncitral Guide reflects that approach in terms of the various stays on security and contracts. As already discussed, the applicability of insolvency stays, having regard to the uses of secured finance in advanced economies, is considered questionable.

Article 9, as the precursor to the Uncitral Guide, has special features which can be best understood by its history.

When work was started on article 9 in the late 1940s onwards, most states of the US had extremely poor regimes for security interests. They had nothing anywhere approaching the simple English universal charge which could cover all present and future assets generically and secure all present and future debts generically. Instead there were a variety of chattel mortgage statutes, accounts receivable acts and various other provisions which in their requirements for specificity, control and possession, their limitations and their problems with enforcement were not all together different from the current regimes in many Napoleonic states with poor security interests. The problems were compounded by very adverse case law, in particular the notorious case of *Benedict v Ratner* (1925) decided by the US Supreme Court where an assignment of receivables not notified to the debtor was set aside as fraudulent. The effect of this decision and the general regime was to torpedo US secured lending based on manufacturing assets such as inventory and receivables. The creditor had to have a degree of control and dominion, which of course was not possible.

As a result of this situation, financiers had to resort to all kinds of title finance transactions instead, e.g. leases, conditional sales, and retention of title, field warehousing, factors liens, factoring of receivables, trust receipts and all the rest

Hence when the draftsmen of article 9 came to prepare article 9 they were faced with the almost universal use of title finance transactions to escape the misfortunes of the law relating to security interests. It was natural that they should resolve to bring all of these devices, which they saw as evasive, within the scope of security interests. The decision was therefore taken that all title finance would be re-characterised and treated as a security interest, including sales and leases of goods, including outright sales of receivables.

This had a number of significant consequences which determined the peculiarities of article 9, nearly all of them resulting from the decision to extend the regime to sales and leases.

As the concept of security interest had to cover sales, leases and the like which were not traditional core mortgages, charges or pledges, the drafting had to be much more complicated, especially when it was dealing with retention of title.

Title finance normally involves distinct assets, such as a piece of equipment or a particular class of assets such as commercial receivables, rather than the assets of the company super-generically and universally, so that article 9 deals with assets separately and creates at least 30 to 40 different classes of assets. It seemed to the legislator that each asset deserved special treatment, which in fact is doubtful.

As each asset was treated separately and because the legislator was not focusing on universal charges, there was a preoccupation with what happened to the proceeds of an asset once it was sold and how the security would flip over into the proceeds. This brought further complications in the drafting.

There is in article 9 an intense interest with dealing with all of the priority questions which could possibly arise. These priority problems are much more likely to arise in the case of security or title finance in respect of discrete assets, such as pieces of equipment, especially if individuals are involved, as opposed to universal charges created by corporations. The classic case is the motor car on lease or hire purchase. This is part of the reason explaining why the article 9 filing system is an explicit priority system, whereas the English-based registration system for company charges is not intended to be a priority system, although it does have some residual priority effects. There are much more likely to be priority contests where financiers take security over separate assets – one over goods, another over receivables and the like so that one would then have to deal with such issues as priority of the proceeds and priority over the bank accounts into which the proceeds are paid.

If this reconstruction is at all plausible, it would provide an explanation of why article 9 often seems so complicated and why the draftsmen adopted the solutions which they did. Article 9 was a creature of its time. The Uncitral Guide is a demonstration of the indelibility of a history which leads to the reproduction of quite conservative model, at a time when there was another model – the English-based universal charge - which in many respects is simpler, cheaper and more liberal, if we leave aside the bad bits of it (e.g. the subordination of the floating charge to preferential creditors, the arguments about what is fixed and floating, and the unavailability of the charge for individuals – the latter is somewhat minor).

One may therefore briefly summarise the more controversial features of article 9 and the Uncitral Guide.

- **Title finance.** The inclusion of title finance, such as sales and leases, means that they are caught by the provisions as to publicity, enforcement, compulsory repayment to the debtor of a shortfall after enforcement and the various stays and other interferences on insolvency. These seem questionable. The issue is not whether the transactions are like security – which often they are – but rather whether the overall regime should be restrictive or liberal and whether the regime should only apply to core charges or to sales and leases as well.

- **Publicity**. Both article 9 and the Guide are quite conservative on the need for publicity to validate the security interest on the insolvency of the debtor. For example, they both require either registration or creditor control in the case of bank accounts, investments and some title registered property. We should be aiming to reduce these methods of publicity, based, as they are, on the outdated false wealth principle.

- **Excluded assets.** There are various exclusions in both article 9 and the Guide, some of which stem from the US constitutional divide between federal and state rights. Consider land, aircraft, intellectual property, ships and the like. It is considered that all assets should be subject to the same principles, subject to whatever modifications are required in relation to the particular asset. In other words the security regime should be unitary, instead of being fissured and fragmented. This is a considerable advantage of the English-based system.

- **Enforcement.** The various good-faith tests and a bureaucracy of compulsory notices on enforcement may give rise to a damages liability for a pure technicality. They assume that secured creditors habitually lie in wait to pounce suddenly without any advance warning, which in my experience is not generally true of regulated banks.

  The various restrictions on enforcement imposed by chapter 11 of the US Bankruptcy code of 1978 and also proposed by the Uncitral Guide appear to be inappropriate. If one examines the particular areas of the use of security interests, the anti-dismantlement policy in the case of a rescue proceeding freezes seems to be of doubtful validity.

- **Assignment restrictions** Both article 9 and the Uncitral Guide contemplate that restrictions on the assignment of commercial receivables are ineffective. Whatever view one may have about this, it is essential that assignments should not prejudice set-off and netting since, if set-off and netting are not effective against assignees, there would be a fatal gap in the set-off and netting protection.

- **Conflict of laws** There are mandatory rules about which law applies to the validity, priority and enforcement of security interest. This is a very large field, but my view is that there should be a move to contract freedom, where appropriate, as opposed to the law of the location of the collateral or the law of the place of the debtor or the law of the place where insolvency proceedings are opened.

The rules in article 9 and the Uncitral Guide on retention of title creditors seem reasonable, if complicated.

For various technical reasons, the proposition that filing deals once and for all for the whole issue of priorities is doubtful. In fact article 9 filing has quite a low impact on priorities.

Conclusion

Security interests are the victim of battles of the past. The security interest regimes in the various jurisdictions all have defects, It ought now to be possible to combine the best international experience so far and to discard the worst.

* The ideas contained in this paper are based on Philip Wood *Comparative Law of Security Interest and Title Finance* (Sweet & Maxwell 2007). This is one of a series of nine books in the author's Law & Practice of International Finance Series, 2007-2008.

Saturday 26th July, 2008

Concurrent 4a
Millennium Hotel

10.50am – 12.20pm

Chair:
Paul Rogerson
Head of legal
St George Bank
Sydney

Speakers:
Prof. Bob Baxt
Partner, Competition Law Group
Freehills
Melbourne

John O'Sullivan
Chair, Australian Investment Banking Division
Credit Suisse
Sydney

Commentator
Paul Rogerson

Conflicts of Interest in Financial Services Firms

Prof. Bob Baxt, Partner, Competition Law Group, Freehills, Melbourne

Conflicts of Interest in Financial Services Firms

Conflicts of Interest in Financial Services Firms

Bob Baxt AO, Partner Freehills and Professorial Associate of the University of Melbourne♦

Saturday 26th July 2008, Queenstown New Zealand

1 Introduction

It is a great pleasure for me to present a paper at this conference on the occasion of the 25th anniversary of the Association. When I helped form the Banking Law Association (as it then was) whilst a Professor at Monash University Law School, little did I anticipate just how important this area of the law (which of course now embraces financial services more generally) would become.

My major interest in this area has always been associated with issues of governance and the duties of fiduciaries, ie directors and others, in organisations such as companies, and trusts and partnerships. In that context the banking institutions and their relevant operations captured my interest. I have never lost that interest and still follow with eagerness some of the matters that are being discussed at this conference.

New challenges arise for the industry and for those advising the industry every day. However most of them in my view pale into some insignificance when compared to the crucial question of conflicts which pervade not just the operations of financial institutions but of many organisations and those advising them.♣

The decision in *ASIC v Citigroup Ltd*[162] (*Citigroup*) whilst it quietened the nerves of many in the financial services sector (and those advising them), because of the positive rulings of Jacobson J on the facts of the case, as well as on some issues of the law, nevertheless poses some interesting further problems in the context of conflict issues. The particular facts of the case meant that some of the more critical questions arising in the context of potential conflicts of interest were distinguished. What is needed, going forward, is for greater focus on some of the underlying questions of conflict which have been raised in a number of different ways in recent times. Professor Jack Coffee, in his

♦ I am very grateful to Thea Chesterfield, paralegal assistant and graduate employee elect of Freehills, and Gillian McKenzie, paralegal, for their assistance in the preparation of this paper.

♣ Since this paper was presented on 26 July 2008, momentous events have occurred in financial markets throughout the world. Insofar as the scenarios that were discussed at the Conference, and they were alluded to in my oral presentation as well, is that Australia has taken a tougher line on short selling with the enactment of the *Corporations Amendment (Short Selling) Act 2008*; a temporary ban continues on short selling (being reviewed from time to time by the Australian Securities and Investments Commission).

In addition, the Corporations and Markets Advisory Committee (**CAMAC**) has been given a reference on the topic of *Market Integrity*. Under this reference, CAMAC will be reviewing some of the issues that are touched upon in this paper.

[162] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* **(2007) 160 FCR 35.**

pioneering work *Gatekeepers: The Professions and Corporate Governance*[163] poses some of these questions in the context of accounting firms (reviewing the extraordinary events surrounding the collapse of Arthur Andersen and Co) rather than focusing on the industry the subject of the *Citigroup* case.

In this paper what I hope to do is to discuss some of these broader conflict issues before turning to a more detailed examination of the *Citigroup* case. To me, the critical questions that we have to face in Australia is whether our economy, and the small markets which operate in a number of the relevant areas, warrant a more or less robust approach in dealing with questions of conflicts. Pioneers we might be in the area of climate change; I am not sure whether the professional services market would be happy for our courts to be too pioneering in the context of conflict of interest solutions illustrated by some of the matters that I will discuss in this paper.

2 Some other conflict scenarios

With your indulgence, I will deal with some other matters initially (in the broad context of conflicts) before turning to examining the spotlight that has been provided to this area of the law by the decision of the *Citigroup* case.

The question of conflict of interest arose most starkly for me when I was Chairman of the Trade Practices Commission (the Commission **– now the Australian Competition and Consumer Commission) from 1988 to 1991.**

Very early in my term as Chairman I learnt that the former immediate past Chairman of the Commission, the late Bob McComas, wanted to appear before the Commission to argue for a clearance by the Commission of a merger on behalf of his new client (the Arnott's Biscuit Company) a company which just six months earlier he and the Commission were vigorously 'assessing' in the context of a different matter. I raised with the Attorney General of the day Lionel Bowen the question of how a former Commissioner (or Chairman) of a regulator could within weeks of retiring from that position appear as a protagonist before that very same Commission.

In the US and Canada there is a compulsory period of quarantine (12 months to 2 years) for such public officials. Similar rules of course apply to judges of the Federal Court and other courts appearing before those courts once they retire from the judiciary and return to practise. The Attorney General advised me that the Australian market was too small to introduce such a rule. Yet the dangers of a former regulator lobbying an organisation of which he/she was either in charge or a member very soon after stepping down from their position are not insignificant. The issues that I raise here still raise problems, perhaps even more so.

3 Apparent conflict in the regulation of the stock markets

Whilst the Australian Securities Exchange (ASX**) is the sole 'player' in the non-governmental regulation of our securities markets (there are new companies ie AXE-ECN and Liquidnet Australia seeking recognition), it also is the administrator which governs the activities of many persons who operate in the securities markets. It is the overseer of the relevant securities market in which ASX Limited has its shares listed and traded. This particular scenario, which some have described as a potential problem, is not discussed by Eric Mayne as a problem. He is the ASX's Chief Supervision Officer and he suggests that the relevant parts of the ASX's operations are 'separately managed' from the rest of the ASX. In a paper delivered on 23 May 2008 he states that the supervising arm**

[163] Oxford University Press, 2006.

of the ASX "has a purpose to make supervisory decisions in accordance with the legal and rule framework, the policies and principals on which they are based, and the ASX's licence obligations under the Corporations Act".[164] He added in the relevant paper that in the long term its supervisory responsibilities are broadly aligned with its commercial interests, in the sense that its sustainability as a business depends on its ability to operate markets of the highest integrity.[165]

However, this view is not shared by many in the community and there has been a number of issues raised by executives of companies such as QBE Insurance, and by Adele Ferguson in the Australian newspaper of 17 September 2007.[166] A number of general conflicts of interest can arise for the ASX.

This was particularly relevant this time when short selling/market margin and lending difficulties have been prevalent. These difficulties have lead to an emergency regulation in the US being introduced on 16 July 2008.

Some would suggest that the ASX occupies three different roles – it is a company whose shares are listed on its own market; it is the regulator of the relevant market; and it also operates "in partnership" with the Australian Securities and Investments Commission (ASIC**) in dealing with critical issues (eg short selling) thus occupying a very influential regulatory role over our financial services markets.**

The essence of the conflict argument is that the position of the ASX as a company listed on its own exchange - from which it derives a large amount of income from higher trading volumes - renders it less likely to act firmly against hedge-funds and other investors who might be prepared to drive down share prices – an issue that was critical earlier this year and remains a matter of great concern in the US where the new regulations have just been introduced. Critics suggest that the ASX is no longer best placed to protect shareholder interests. This issue continues to place pressure on the Federal Government at a time when new entrants referred to earlier are seeking licences to undertake a similar role in the market to the ASX.

In defence of the ASX Eric Mayne noted in the paper referred to earlier that all of the functions that the ASX performs, in particular its market supervisory functions, are reviewed annually by ASIC.[167]

4 Conflicts of interest in corporate law

This is an area of great interest to me. Some very difficult questions arise in particular in the ability of the relevant person to 'contract out' of fiduciary obligations. The traditional approach in corporate law has been much stricter than that which operates in other areas of the law where the contractual relationship plays a more significant role. I will deal with this topic at the end of my paper.[168]

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[164] See Eric Mayne, 'No Conflicts in ASX's Market Role', *The Age* (Melbourne), 23 May 2008, Business 10.

[165] This point is made in the introduction to the ASX's 'Commercial & Supervisory Conflict of Interest Policy for All ASX Group Employees' (1 March 2007) available at: http://www.asx.com.au/supervision/conflicts/. But note the appointment announced on 21 July 2008 of Alan Cameron, former Chair of ASIC, as the new Chairman of ASX Markets Supervisor (see comment in the Australian Financial Review on 22 July 2008 at page 7).

[166] Adele Ferguson, 'Query on ASX's Supervisory Power', *The Australian* (Australia), 17 September 2007, Finance 36.

[167] Mayne, above n 164.

[168] A good example of conflict arising in the corporate law scenario and one which can arise fairly regularly is that described in *Permanent Building Society (in liq) v Wheeler* (1994) 11 WAR 187.

5. Conflict scenarios arising out of decisions concerning law firms

In *Citigroup* (which is the key decision for discussion), Jacobson J makes heavy reference to leading decisions dealing with conflict of interest issues in law firms and in particular *Prince Jefri Bolkiah v KPMG (*Prince Jefri Bolkiah*).*[169] I will deal with issues arising out of conflict scenarios in law firms as a backdrop to the decision in the *Citigroup* case.

In *Prince Jefri Bolkiah*, the House of Lords considered how and when a 'Chinese wall' might be used to lessen the danger of a conflict of interest in the context of a large accounting firm, particularly those that offer a full range of legal services through their legal arms. The case confirmed that an accounting firm, by analogy to a firm of solicitors, may be restrained from acting in a matter which involves a former client. The House of Lords decision reflects a fairly strict approach towards the protection of former clients' confidential information, and importantly, a rejection of the idea that the interests of client confidentiality should be balanced against the commercial interests of the firm when deciding whether an injunction should be granted to safeguard confidentiality.

5.1 *Prince Jefri Bolkiah* – factual scenario

At the risk of boring you, it is appropriate to discuss the facts of the case in a little detail before turning to a discussion of the legal issues. An injunction was sought by the plaintiffs to restrain the accounting firm KPMG from continuing an investigation into the affairs of Prince Jefri, the youngest brother of the Sultan of Brunei. Prince Jefri had been the Chairman of the Brunei Investigation Agency (BIA**) until his removal in 1998. For a period of 18 months between 1996 and 1998, Prince Jefri had instructed KPMG to investigate his financial affairs in anticipation of private litigation (a matter which KPMG codenamed 'Project Lucy'). The litigation settled in March 1998, and up until that point KPMG's forensic accounting department had provided extensive litigation support services, performing a number of tasks usually undertaken by solicitors. During the course of the retainer KPMG had obtained extensive confidential information about Prince Jefri's assets and financial affairs.**

Prince Jefri was subsequently removed as chairman of BIA, after which BIA sought to engage KPMG to investigate the alleged use by Prince Jefri of BIA's assets for his own use (which was codenamed 'Project Gemma'). KPMG took the view that no conflict of interest arose, as the firm had ceased to act for Prince Jefri more than two months prior, and no longer had a client relationship with him. Nevertheless, the firm decided to erect a Chinese wall in an effort to prevent the misuse of confidential information that was obtained when acting under Prince Jefri's instructions. The Chinese wall had two components:

(1). staff were selected for Project Gemma so as to exclude those in possession of confidential information obtained in the course of Project Lucy; and

(2). steps were taken to ensure that those working on Project Gemma did not become exposed to such confidential information in the future. Among other measures, the work on Project Gemma was carried out in a separate project room with restricted access, in a building separate to that which houses the forensic accounting department.

KPMG did not inform Prince Jefri of the new assignment, nor did it seek his consent to it acting for BIA.

5.2 The decision in *Prince Jefri Bolkiah*

I will not discuss the decisions of the lower courts but I should note that there are some very interesting issues raised by the Court of Appeal in this matter

[169] [1999] 2 AC 222.

which are picked up by the House of Lords in its decision. In essence the approach of the majority in the Court of Appeal was to consider three issues:

(1). whether there was confidential information which, if disclosed, was likely to adversely affect Prince Jefri's interests;

(2). Whether there was a 'real or appreciable risk' that the confidential information would be disclosed; and

(3). whether the nature and importance of the former fiduciary relationship meant that the confidential information should be protected by an order of the kind sought.

I note that the House of Lords, in its decision, agreed that these were the relevant issues for consideration. The majority of the Court of Appeal balanced the different interests involved in this particular matter and reflected on the positive obligation of the accounting firm by reference to whether it had taken reasonable efforts to protect the relevant confidential information. Prince Jefri's original successful application for injunction was overturned by the majority and an appeal was lodged with the House of Lords.

Lord Millett, who delivered the leading judgment in the House of Lords, was careful to draw a distinction between the duties owed by solicitors to existing clients (and by analogy, duties owed by accountants providing litigation support services), and those duties that survive the termination of the retainer. Lord Millett commented that:

> **"Where the court's intervention is sought by a former client… the court's jurisdiction cannot be based on any conflict of interest, real or perceived, for there is none. …The only duty to the former client which survives the termination of the client relationship is a continuing duty to preserve the confidentiality of information imparted during its subsistence."[170]**

In essence the plaintiff had to establish whether there was information held by the accountants/lawyers that was confidential to the plaintiff and in a situation where no consent had been given to its disclosure; if the information was new then whether disclosure of it might act adversely to the plaintiff. The question of whether confidential information exists is always a question of fact. Lord Millett rejected the exercise undertaken by the Court of Appeal in balancing the different interests of the parties in these circumstances. He added:

> "Where in addition the information in question is not only confidential but also privileged, the case for a strict approach is unanswerable. Anything less fails to give effect to the policy in which legal professional privilege is based. It is of overriding importance for the proper administration of justice that a client should be able to have complete confidence that what he tells his lawyer will remain secret. This is a matter of perception as well as substance."[171]

The presumption adopted by Lord Millett was that the court would intervene unless it could be satisfied there was no risk of disclosure. The risk however must be a real one not a fanciful one.

He then examined whether the Chinese walls that had been created by the accounting firm were adequate. In Lord Millett's view there was no rule of law that arrangements such as Chinese walls are insufficient to eliminate the risk of disclosure, but the starting point must be that unless special measures are taken, information moves within the firm. In the case at hand, the Chinese wall had been established 'ad hoc' and was erected within a single department, and this reduced its effectiveness. On Lord Millet's view, for the wall to be effective, it "needs to be established as part of the organisational structure of the firm, not created ad hoc and dependent on the acceptance of evidence sworn for the purpose by members of staff engaged on the relevant work."[172]

[170] Ibid 235.
[171] Ibid 236.
[172] Ibid 239.

He further ruled that KPMG had failed to discharge the heavy burden of showing that there was no risk that confidential information obtained through Project Lucy could inadvertently or unwittingly be leaked to those staff working on Project Gemma. Mere physical segregation would not suffice – especially in the context of preparation for litigation, which typically involves the sharing of information and expertise between partners and managers, as new and unusual issues are generated. As a result the appeal was allowed and the injunction was granted on the terms originally proposed at first instance.

5.3 Australian decisions

I could spend a significant amount of time differentiating between the approaches taken in New South Wales, Victoria and Queensland in dealing with these matters. In my view the New South Wales approach would appear to coincide broadly with that of the House of Lords (see in particular *Blythe v Northwood*).[173] In that case Mason P stated that the relevant principles in the *Prince Jefri Bolkiah* case "reflect a proper understanding of the extent to which Equity acts on the conscience of a fiduciary".[174] His views are not necessarily the views adopted in all Australian jurisdictions.

In Victoria there are two interesting cases which are worthy of some consideration – *Spincode Pty Ltd v Look Software Pty Ltd*[175] (***Spincode***) and the later decision of *Village Roadshow Limited v Blake Dawson Waldron* (***Village Roadshow***).[176]

(a). The *Spincode* case

In *Spincode* the Victorian Court of Appeal unanimously agreed with the primary judge's decision to grant an injunction. The test enunciated by Justices Brooking and Ormiston was quite 'severe'. In particular Justice Brooking was critical of the notion that the duty of loyalty discussed by the House of Lords in *Prince Jefri Bolkiah* had 'perished' once the retainer which was applicable to the legal firm had been spent. He was critical of this rather 'slick' differentiation and made the following comments:

> "Once the contract of retainer comes to an end the solicitor does, it is true, cease to have active duties to perform for the former client. But why should we not say that "loyalty" imposes an abiding negative obligation not to act against the former client in the same matter? The wider view, and the one which commends itself to me as fair and just, is that the equitable obligation of "loyalty" is not observed by a solicitor who acts against a former client in the same matter."[177]

This view was not supported by either Ormiston or Chernov JJA although Ormiston J expressed some sympathy for Brooking JA's view. Goldberg J in the Federal Court did not share that view and preferred the approach taken by the House of Lords in *Prince Jefri Bolkiah* in deciding *Photocure ASA* v *Queen's University at Kingston*.[178]

(b). The *Village Roadshow* case

This decision is arguably one of the most interesting Australian decisions on this particular topic. The relevant facts were briefly these. Certain interlocutory proceedings were brought by a company called Boswell Fimgesellschaft MBH (**Boswell**) against the law firm Blake Dawson Waldron (**BDW**) on the basis that there was a conflict of interest in the fact that BDW owed a duty to a former client namely the Permanent Trustee Company Ltd (**Permanent Trustee**). The proceedings followed a plan by Village Roadshow Limited (**Village**) to buy back all of its A Class Preference shares by an arrangement under Part 5.1 of the *Corporations Act 2001* (**the Act**). For the purpose of the buy-back, Village entered into a trust deed with Permanent Trustee in compliance with Part 2L of the Act. BDW acted for Permanent Trustee, and in that capacity, the firm was involved in a review of the initial buy-back scheme booklet.

[173] (2005) 63 NSWLR 531.
[174] Ibid 542.
[175] (2001) 4 VR 501.
[176] (2004) Aust Torts Reports 81-726.
[177] (2001) 4 VR 501, 522.
[178] (2002) 56 IPR 86.

At some point after the scheme booklet had been made publicly available, BDW commenced acting for Boswell, a shareholder of Village and a 'determined opponent' of the buy-back scheme.[179] Boswell had engaged BDW apparently with a view to opposing the preference share buy-back, and contended that the scheme booklet contained misleading and deceptive information. When Village sought to have the scheme approved in the Victorian Supreme Court, Boswell obtained an order dismissing that application, with BDW acting for them in the matter. That order was the subject of an appeal which was pending at the time the present judgment was handed down.

Meanwhile, Village announced that it would pursue a second arrangement in order to achieve the original objective of the share buy-back. The scheme booklet was modified and a supplemented trust deed was prepared and executed with Permanent Trustee (this time with minimal involvement of BDW). Shortly thereafter the scheme booklet was made publicly available.

Minter Ellison (who acted for Village in the scheme) expressed its concern to BDW that BDW was acting for both Permanent Trustee and Boswell in the matter, and that this gave rise to a conflict of interest. An application was then made to the Supreme Court of Victoria to restrain BDW from continuing to act in relation to the second buy-back scheme.

Byrne J restated what he believed to be the relevant principle in these words:

> "Solicitors acting in the nature of a fiduciary, when faced with an allegation of conflict, should show the client's consent to the course that they would follow. And as officers of the court, they should do so with a candour which I regret was not here present."[180]

In his view there were two major issues that he had to consider:

(1). the risk of leakage of confidential information; and

(2). the question of whether a duty of loyalty was pre-eminent in these circumstances.

(c). Risk of leakage

On the facts, Byrne J felt that there was no real danger that confidential information obtained by BDW when acting for Permanent Trustee might be used to the disadvantage of Village, and to the advantage of Boswell. Leading up to this conclusion, he outlined the following applicable legal principles:

- The court will act where

  > "a reasonable person informed of the facts might reasonably anticipate a danger of misuse of confidential information of a former client and that there is a real and sensible possibility that the interest of the practitioner in advancing the case in the litigation might conflict with the practitioner's duty to keep the information confidential, and to refrain from using that information to the detriment to a former client." (citing *Sent & John Fairfax Publishing Pty Ltd* [2002] VSC 429 at [33] per Nettle J);[181]

- In applying the principle above, the client need not point to a specific item of confidential information (as in doing so they may defeat the purpose of the duty of confidentiality by exposing that information to the court and to the other party).[182]

- The confidential information may comprise "no more than the knowledge of the client's thinking, its attitudes and of the personalities involved."[183] Byrne J said that, given the relationship between solicitor and client, the ambit of

[179] *Village Roadshow Ltd v Blake Dawson* Waldron (2004) Aust Torts Reports 81-726, [20].
[180] Ibid [31].
[181] Ibid [33].
[182] Ibid [36].
[183] Ibid.

> professional confidence and the professional privilege in which it is manifested, "the court should… not be slow to accept the existence of such confidential information."[184]

(d). The duty of loyalty and public policy

Village's second submission was based on the practitioner's duty of loyalty to its clients, both former and present, and the need to protect the wider public confidence in the special relationship between solicitor and client. Byrne J restated the principle outlined by Brooking JA in *Spincode*:

> "The principle does not depend upon any risk of leakage of confidential communication, it depends upon an equitable duty reposed in a practitioner, even after the client's retainer has concluded, not to act for another person in the same matter or in a closely related matter against the interests of the former client."[185]

This obligation was likened to that of a fiduciary, such that a solicitor may be permitted to act where they establish that the former client has given their informed consent.[186]

For some reason, both parties accepted Brooking JA's reasoning in *Spincode* as a correct statement of the law, and confusingly, Byrne J applied elements of both *Prince Jefri Bolkiah* and *Spincode* without attempting to reconcile the conflict between the theoretical approaches employed in each.

Village argued successfully that in acting for Boswell with the aim of countering the first and second buy-back arrangements, BDW breached its duty of loyalty to Permanent Trustee, which had retained BDW to act for it in preparation of the first arrangement. Byrne J noted the applicant's comment that "for a firm of solicitors to take money from a client for erecting a legal edifice, it should not then take a fee from some other to dismantle it."[187]

Byrne J also noted the public policy consideration: the question of how this breach might influence public confidence in the administration of justice. On this issue he considered first the factual question of whether the matter for which Permanent Trustee had initially retained BDW was the same matter, or a matter related to, the Boswell retainer. This required an examination of the substance of the relationship. Here, Byrne J found that the work of BDW in preparing the trust deed was 'sufficiently related' to its work in opposing the buy-back arrangement to attract the aforementioned principle.

The focus then turned to the reaction that this would draw from the hypothetical 'well-informed reasonable bystander'. On this limb Byrne J concluded that an apprehension that the solicitor might act on a related transaction for a person with an adverse interest would be likely to erode public confidence in the administration of justice.

It was not enough for BDW to promise not to act for any other party than Permanent Trustee on matters arising out of a trust deed. It would be unclear to the hypothetical reasonable bystander who would enforce such a promise, especially if an issue concerning the trust deed was exposed in litigation over the second arrangement, which was likely to ensue in the coming months.

(e). Particular problems for the Australian legal market

It was the view of Byrne J that the Australian legal market raised some rather unusual difficulties for large law firms acting in matters of this kind. He made these rather interesting comments about the prevalence of conflict scenarios where there were potentially major cases of dispute resolution.

> "It is a notorious fact that a good deal of commercial litigation in this state is conducted by a handful of very large firms. How is a client to obtain the services of one of them if the conflict rule is applied too strictly? To my mind, this is the price which the clients of such firms and the firms themselves must

184 Ibid.
185 Ibid [40].
186 Ibid.
187 Ibid [41].

pay. The firms have found it commercially convenient to become large. This is but one disadvantage of this trend. It is certainly no reason for the courts to weaken the traditionally high standard of a practitioner's loyalty to the client which have characterised the practice of law in this State."[188]

Byrne J concluded that in accepting the retainer from Boswell, BDW was in breach of its duty of loyalty to Permanent Trustee. Byrne J noted that the relief sought was discretionary, and that in the present case he had reason to doubt the bona fides of Village's application (which, he suggested, was probably brought as a tactical ploy to disadvantage Boswell). Nonetheless, the restraining order was made, as the focus was on the concern of upholding public confidence in the client/solicitor relationship.

In Queensland there are two interesting single judge decisions in *Flanagan v Pioneer Permanent Building Society Ltd*[189] and *Pott v Jones Mitchell*.[190] Both Justices Dutney and McMurdo adopted the minor reasoning in *Prince Jefri Bolkiah* rather than the harder line taken in Victoria.

(f). Summarising the Australian approaches to conflicts of interest in legal firms

A useful summary of the position in Australia was set out by Justice Brereton in *Kallinicos v Hunt*.[191] I reflect on an extract from his judgment, which I have set out below without citations, in which he refers to a significant number of other cases in which these issues are discussed. These are in addition to the cases that I have discussed earlier in this paper.

- "During the subsistence of a retainer, where the court's intervention to restrain a solicitor from acting for another is sought by an existing client of the solicitor, the foundation of the court's jurisdiction is the fiduciary obligation of a solicitor, and the inescapable conflict of duty which is inherent in the situation of acting for clients with competing interests (*Prince Jefri Bolkiah*).
- Once the retainer is at an end, however, the court's jurisdiction is not based on any conflict of duty or interest, but on the protection of the confidences of the former client (unless there is no real risk of disclosure) (*Prince Jefri Bolkiah*).
- After termination of the retainer, there is no continuing (equitable or contractual) duty of loyalty to provide a basis for the court's intervention, such duty having come to an end with the retainer (*Prince Jefri Bolkiah*; *Belan v Casey*; *PhotoCure ASA*; *British American Tobacco Australia Services Ltd*; *Asia Pacific Telecommunications Ltd*; contra *Spincode Pty Ltd*; *McVeigh*; *Sent*).
- However, the court always has inherent jurisdiction to restrain solicitors from acting in a particular case, as an incident of its inherent jurisdiction over its officers and to control its process in aid of the administration of justice (*Everingham v Ontario*; *Black v Taylor*; *Grimwade v Meagher*; *Newman v Phillips Fox*; *Mitchell v Pattern Holdings*; *Spincode Pty Ltd*; *Holborow*; *Williamson v Nilant*; *Bowen v Stott*; *Law Society v Holt*). *Prince Jefri Bolkiah* does not address this jurisdiction at all. *Belan v Casey* and *British American Tobacco Australia Services Ltd* are not to be read as supposing that *Prince Jefri Bolkiah* excludes it. *Asia Pacific Telecommunications Ltd* appears to acknowledge its continued existence.
- The test to be applied in this inherent jurisdiction is whether a fair-minded, reasonably informed member of the public would conclude that the proper administration of justice requires that a legal practitioner should be prevented from acting, in the interests of the protection of the integrity of the judicial process and the due administration of justice, including the appearance of

[188] Ibid [49].
[189] [2002] QSC 346.
[190] [2004] QSC 048.
[191] (2005) 64 NSWLR 561, 582-3

justice (*Everingham v Ontario*; *Black v Taylor*; *Grimwade v Meagher*; *Holborow*; *Bowen v Stott*; *Asia Pacific Telecommunications Ltd*).

- The jurisdiction is to be regarded as exceptional and is to be exercised with caution (*Black v Taylor*; *Grimwade v Meagher*; *Bowen v Stott*).
- Due weight should be given to the public interest in a litigant not being deprived of the lawyer of his or her choice without due cause (*Black v Taylor*; *Grimwade v Meagher*; *Williamson v Nilant*; *Bowen v Stott*).
- The timing of the application may be relevant, in that the cost, inconvenience or impracticality of requiring lawyers to cease to act may provide a reason for refusing to grant relief (*Black v Taylor*; *Bowen v Stott*)."

5.4 Some observations about overseas jurisdictions – the USA, Canada and New Zealand

(a). The United States

The approach taken in the United States differs from that of the House of Lords in *Prince Jefri Bolkiah* in that the courts usually rely on presumptions.

Where a transferring lawyer actually possesses, or is *presumed to possess* confidential information relating to a client of his or her former firm, the lawyer will be disqualified from acting against the interests of the former client. The traditional approach has been that, so long as the prior retainer involved a substantial relationship between the lawyer and client, there is an irrebuttable presumption that the lawyer possesses confidential information. Moreover, their disqualification from acting for a new client against the former client does not depend on actual disclosure of confidential information.

To determine whether the entire firm to which the lawyer has transferred should be disqualified, the court presumes that transferring lawyers share confidences with other lawyers in the firm. This presumption is now rebuttable where the law firm can conclusively show that other lawyers did not receive confidential information from the transferring lawyer. It is unclear what is required for the firm to establish this, though Chinese walls are one method of preventing disqualification of firms.

(b). Canada

In Canada, there is an important judgment of the Canadian Supreme Court (*MacDonald Estate v Martin* (MacDonald**)).[192] That case concerned a junior lawyer who possessed confidential information about a plaintiff involved in litigation. The lawyer subsequently transferred to the firm representing the defendant in that litigation, and the plaintiff sought an order disqualifying that firm from acting for the defendant.**

Sopinka J delivered the judgment for the majority in the court, which recognised a number of competing policy considerations that had to be balanced in determining the outcome of the case. He commented:

> **"There is first of all the concern to maintain the high standards of the legal profession and the integrity of our system of justice. Furthermore, there is the countervailing value that a litigant should not be deprived of his or her choice of counsel without good cause. Finally, there is the desirability of permitting reasonable mobility in the legal profession."[193]**

The test adopted by His Honour in determining whether a firm could continue to act was whether a reasonably informed member of the public would be satisfied that confidential information would not be used. This involves a two stage inquiry:

(1). the court must determine whether the lawyer received confidential information from the former client that is relevant to the current matter, and then

(2). whether the lawyer will misuse the confidential information he or she possesses.

[192] (1991) 77 DLR (4th) 249.
[193] Ibid 254.

> **A rebuttable presumption arises with respect to the first step that confidential information will have been communicated by the former client in the course of the retainer. The onus of rebutting this presumption is a heavy one. It is virtually automatic that the transferring lawyer will be disqualified, because the potential for misuse of confidential information is great.**
>
> **The law is less clear on whether and in what circumstances the firm as a whole will be disqualified. Acknowledging the commercial realities of the modern Canadian legal services market (which would be quite similar to the position in Australia), Sopinka J considered that a rule assuming that the knowledge of one lawyer is the knowledge of every lawyer in the firm was "unrealistic in the era of the mega-firm".[194] However, there is a second rebuttable presumption that lawyers working together within a firm share confidences. A firm will therefore be disqualified unless it can show that 'all reasonable measures' were taken to ensure against the possibility of disclosure. Sopinka J considered that Chinese walls might be an example of such 'reasonable measures'.**
>
> **The minority judges in *MacDonald* argued for a stricter duty on the basis of the need to ensure the appearance of justice.[195] The essence of this approach was expressed by Cory J (Wilson and L'Heureux-Dube JJ agreeing) in this comment:**
>
>> **"Our judicial system… cannot function properly if doubt or suspicion exists in the mind of the public that the confidential information disclosed by a client to a layer might be revealed."[196]**
>
> **Cory J rejected the argument that a Chinese wall could reassure public confidence in client confidentiality:**
>
>> **"No matter how carefully the Chinese Wall might be constructed, it could be breached without anyone but the lawyers involved knowing of that breach …The public would, quite properly, remain skeptical of the efficacy of the most sophisticated protective scheme."[197]**

Cory J gave a strong and uncompromising response to policy arguments about the need to maintain a reasonable degree of mobility within the legal profession:

> **"… no matter how strong may be the current rage for mergers or how desirous the mega-firms may be to acquire additional lawyers, neither the large firms nor the lawyers who wish to join them or amalgamate with them should dictate the course of legal ethics."[198]**

The minority judgment in *MacDonald* parallels the reasoning of Byrne J in *Village Roadshow.* The argument that the commercial needs of large firms should not dictate the course of legal ethics echoes Byrne J's strict attitude toward firms that have 'found it commercially convenient to become large'. Similarly, while Cory J viewed Chinese walls as being of limited relevance to the issue, Byrne J emphasised that "what is here in issue is the concern of the court to uphold the public confidence in a solicitor/client relationship where the client does not affirmatively approved the conduct of its solicitor".[199]

(c). New Zealand

It is appropriate discuss the case of *Equiticorp Holdings Ltd v Hawkins*[200] (*Equiticorp*). This case was concerned with similar issues to those raised in earlier decisions – the same firm of solicitors acting for a range of litigants in opposition to each other was alleged to be acting in breach of its duties to its clients. This arose because three partners within the particular law firm wished to change firms and the client of that firm wished to prevent the transferring partners from acting. Henry J, who decided the case in

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194 Ibid 268.

195 A useful discussion of both the majority and minority approaches, as contrasted with approaches adopted in the United States and New Zealand, can be found in David Coull, 'Typhoid Marys: The ethical dilemma of lawyers who switch firms' (1998) 28 *Victoria University of Wellington Law Review* 41, 51-56.

196 *MacDonald Estate v Martin* (1991) 77 DLR (4th) 249, 272.

197 Ibid 273-4.

198 Ibid 274.

199 *Village Roadshow Ltd V Blake Dawson Waldron* (2004) Aust Torts Reports 81-726, [53].

200 [1993] 2 NZLR 737.

favour of the client, was influenced by the decision of the Canadian Supreme court in *MacDonald*. He noted:

> **"I have reservations as to the desirability of introducing Court-prescribed presumptions whether they be rebuttable or irrebuttable, to stated situations. I prefer an approach which is directed to applying facts to general principle so as to ensure the aim of the protection is fairly met in the particular circumstances."[201]**

Henry J held that the transferring lawyer could not act against his former client's interests in the continuing litigation.

The more difficult issue was whether the firm to which he transferred should be disqualified from acting for their existing client. Here, the new firm had not put in place sufficient safeguards to prevent the inadvertent disclosure of confidential information. Although the risk of disclosure was small, it nonetheless outweighed the competing considerations of the client's interest in retaining the firm of their choice, and the lawyer's interest in having mobility between firms. Whilst acknowledging that the latter factor was of particular concern, Henry J stated that it must "yield to the greater public interest in maintaining the integrity of the principle of protection".[202]

The approach taken in *Equiticorp* seems more flexible than the House of Lords' approach. It requires the court to weigh the competing policy considerations in light of the circumstances of the case. A further difference is that, while Henry J considered whether there was a 'reasonable possibility' that confidential information had been disclosed, Lord Millett said that the court should intervene unless it is satisfied that there is *no* risk of disclosure. The risk must be real, and not merely fanciful or theoretical, but it need not be substantial.

6 Conflicts of interests in the Financial Services industry

6.1 ASIC's investigation of AMP

There are many opportunity for conflicts of interest to arise in the provision of financial services. The *Citigroup* case provides one example. A further example which I will now briefly discuss is provided by ASIC's investigation in 2006 of financial advice provided by AMP Financial Planning Pty Ltd (AMP**).**

The investigation centred around advice provided to clients by AMP's financial planners recommending that they switch to a new superannuation fund. In the vast majority of cases customers were advised to switch to an AMP product. Of particular importance in this case was that in certain cases (for example where a client's existing superannuation fund was and industry fund or was not one on AMP's Approved Products and Services List) the advice was provided without also providing an assessment of the client's existing product.

At the conclusion of its investigation ASIC formed the view that AMP's financial planners may have contravened s 945A as well as several other sections of the Act. Section 945A requires that financial planners give personal advice only where they have a reasonable basis for that advice. In ASIC's view this obligation requires that a financial planner make adequate inquiries into, and give due consideration to, the client's existing product.

ASIC concluded that the advice given to clients recommending that they switch products may have been deficient in that:

- **they did not set out the consequences to the client of changing products (ie by setting out the difference in the value of ongoing costs between the existing product and the new product), and**

[201] Ibid 740.
[202] Ibid 741.

- **they did not adequately set out the fees and commissions payable to the trustee, the investment fund manager, and the financial planner resulting from the switch to an AMP product.**

In the present context it should be noted that ASIC also concluded that AMP may have contravened section 912A(1)(aa) by failing to have in place adequate arrangements for managing conflicts of interest. In ASIC's view "because of the presence of a number of potential conflicts of interest and the tendency for switches towards the AMP Flexible Lifetime – Super product…. AMPFP's must have robust arrangements for managing conflicts of interest and its supervision of its representatives to ensure that advice given by AMPFP Planners is appropriate".[203]

In resolution of ASIC's concerns ASIC accepted an enforceable undertaking from AMP to revise its procedures (and provide training on the new procedures) to ensure that clients are not given advice to switch products unless and until the financial planner can advise on both relevant products and the advice is vetted for compliance with the Act. AMP also committed to offering a review of advice previously given to affected clients, providing redress where that advice is found to be inadequate, and undertaking a compliance review on both its disclosure obligations and its arrangements for managing conflicts.

This case and the *Citigroup* case discussed below highlight many of the issues that I have discussed in the previous part of the paper. In the *Citigroup* case, what has most concerned members of the financial services industry, and those advising the industry, was that this was a test case being run by the regulator at a time when it was felt that the market itself, and those advising the 'players', were trying to work out strategies to deal with the particular issues thrown up by the operation of section 912A of the Act and attempts both by ASIC and by the ASX to deal with the managing of conflicts. ASIC had dealt with this matter in its Regulatory Guide 181. In the course of his judgment Jacobson J had to assess how Citigroup and its advisors managed to deal with the operation of these guidelines.

An additional question, the question of insider trading and the operation of Chinese walls (in the context of both section 912A and the insider trading provisions of the legislation) make the case a particularly interesting one. I will not be discussing the insider trading issues in any detail other than to deal briefly with the discussion of Chinese walls by Jacobson J.

6.2 The *Citigroup* case - the facts♠

The facts of the case were briefly these. Citigroup Global Markets Australia Pty Ltd (**Citigroup**) was the Australian branch of the global financial services organisation Citigroup Inc. The Australian company was divided into a 'private side' (areas of the company where employees were exposed to confidential, market sensitive information - such as the investment banking division) and a 'public side' (areas not exposed to such sensitive information, such as the Equity Division, where employees were expected to perform their role solely on the basis of publicly available information). Citigroup constructed a Chinese wall to deal with the conflict of interest and insider

[203] Enforceable Undertaking under section 93AA of the *Australian Securities & Investments Commission Act 2001* provided by AMP Financial Planning Pty Limited to the Australian Securities and Investment Commission on 27 July 2006, [2.6]

♠ Since this paper was delivered, the *Citigroup* case has been the subject of a number of interesting comments and published articles. Two of the more interesting and perhaps significant articles are:

Jennifer Butler, 'Are we there yet? The journey of the insider trading provisions' (October 2008) 26(7) *Company and Securities Law Journal* 260 – 469; and

Vince Battaglia, 'Dealing with conflicts: The equitable and statutory obligations of financial services licensees' (November 2008) 26(8) *Company and Securities Law Journal* 483 – 500.

The decision has been referred to in the interesting case *Motor Trades Association of Australia Superannuation Fund v Rickus (No 3)* [2008] FCA 1986. Flick J, in discussing the *Citigroup* case and the question of fiduciary duties in the context of the fact scenario outlined in that case, made a number of references to it (see paras 70 – 72).

trading issues and restrict flow of information from private to public. ASIC's case concerned, among other things, the adequacy of Citigroup's Chinese wall arrangements in fulfilling these objectives.

At the relevant time, Citigroup was providing corporate advisory and investment banking services to Toll Holdings Limited (Toll**) in relation to its planned takeover of Patrick Corporation Ltd (**Patrick Corp**). On the last day of trading before the takeover was to be announced, one of Citigroup's proprietary traders (who was employed in the public side of the business) purchased over $1 million worth of shares in Patrick Corp on-market. ASIC did not allege that the particular trader had inside information regulated by the Act at that particular point in time. Rather ASIC took issue with the fact that, after Citigroup's employees became aware of this transaction, there was some informal communication about the share purchase between specific employees and the particular trader, after which the trader sold, (on the market) over $200,000 worth of the shares he had bought earlier that day. Although ASIC agreed with the fact that Citigroup had established what was generally known as Chinese walls to 'regulate' communications between those who worked in the private and public sides of its business, it was ASIC's view that, even though the particular trader had been instructed to stop buying further shares in Patrick Corp once private side employees learnt of the original purchase, that nevertheless, some of the relevant shares were sold after the instruction to stop trading had been issued. In ASIC's view the steps taken by Citigroup in relation to the flow of information demonstrated the inadequacy of the Chinese walls it had in place and the sales breached the insider trading provisions of the Act.**

The more critical and fundamental point was, in ASIC's view, that as Citigroup was providing strategic advice to Toll in relation to its proposed takeover of Patrick Corp, it occupied a relationship which was, in all critical respects a fiduciary relationship. In that position, it was further argued by ASIC, that Citigroup was placed in a position where it had to ensure that it could not allow a conflict to arise, either in actual fact or potentially, which might compromise its duty of loyalty to Toll, and its other major concern, which was to generate as much profit as it could from the proprietary trading in the shares of Patrick Corp.

Justice Jacobson summarised ASIC's position as follows:

> **"… if trading by an institution such as Citigroup in the shares of its client's target company is to be undertaken, the institution needs to obtain the informed consent of the client. It is not sufficient, according to ASIC, for consent to be given indirectly. What is said to be required is the client's express permission for trading".[204]**

6.3 Does the contractual relationship override the fiduciary relationship in such a situation

In certain areas of the law it is not possible for contractual or other relationships to override a fiduciary relationship between the parties. I say this with some confidence by referring to the area of corporate law, because the Act overrides the fundamental principle in company law that directors (the fiduciary in this context) owe a duty only to the company (and in very special cases the shareholders). I infer this from the statutory set of duties contained in sections 180-184 of the Act that persons other than the shareholders (or the company) may seek enforcement of these duties through the operation of section 1324 of the Act. I will return to this issue briefly later.

In contrast to the position in corporate law, however, it is not clear that any fiduciary relationship that exists between a company such as Citigroup and its client Toll is based on any statutory regime. There has been a great deal written on the subject matter of when a fiduciary relationship exists and what elements the courts take into account to determine whether a fiduciary relationship can be created from a set of facts. The traditional areas are well understood –

[204] *ASIC v Citigroup* (2007) 160 FCR 35, 44.

company director and company, partners, joint venturers etc. That courts have considered that relationships of a fiduciary nature can arise between stockbrokers and clients[205] is perhaps the classic illustration. Andrew Tuch in his leading article *Investment Banks as Fiduciaries; Implications for Conflicts of Interest*[206], referred to at some length by Jacobson J in the *Citigroup* case, discusses the implications of the fiduciary relationship in investment banks and similar bodies. A different basis for assessing the nature of a fiduciary or similar relationship and the obligations imposed on persons who are in the position of, say, a financial advisor, is considered in a very entertaining and effective way by Professor Jack Coffee in his pioneering work *Gatekeepers: The Professions in Corporate Governance*.[207]

In the *Citigroup* case, Jacobson J felt that the contractual relationship was such that the fiduciary relationship was nullified or qualified. He relied heavily on two important statements in the High Court of Australia. In particular, he gave support to the judgments of Mason J in *Hospital Products Ltd v United States Surgical Corporation*[208] (Hospital Products**) and Gummow J in *Breen v Williams*[209] (**Breen**). In his view these two important judgments enabled him to hold that in the type of situation that he was asked to consider in this case, it was possible for the parties to exclude or modify the fiduciary relationship that otherwise existed between them.**

The first comment relied on by Jacobson J was that of Mason J in *Hospital Products* where that judge noted:

> **"That contractual and fiduciary relationships may co-exist between the same parties has never been doubted. Indeed, the existence of a basic contractual relationship has in many situations provided a foundation for the erection of a fiduciary relationship. In these situations it is the contractual foundation which is all important because it is the contract that regulates the basic rights and liabilities of the parties. The fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contract so that it is consistent with, and conforms to, them. The fiduciary relationship cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction."[210]**

The views of Mason J were supported in principle by Gummow J in *Breen* where he noted:

> **"The mere presence of a contract does not exclude the co-existence of concurrent fiduciary duties and the contract may, in particular circumstances, provide the occasion for their existence. That is not to deny that a contractual term may be so precise in its regulation of what a party may do that there is no scope for the creation of a fiduciary duty."[211]**

In the view of Jacobson J "[i]t follows from these statements of principle that it is open to the parties to contract to exclude or modify the operation of fiduciary duties."[212]

Whilst Jacobson J agreed that this particular exclusion would not cover the whole field, the limitations of its operation were fairly specific:

> **"It may well be that a fiduciary cannot exclude liability for fraud or deliberate dereliction of duty but beyond that there appears to be no restriction in the law to prevent a fiduciary from contracting out of, or**

[205] *Daly v the Sydney Stock Exchange Limited* (1986) 160 CLR 371.
[206] (2005) 29 Melbourne University Law Review 478.
[207] Oxford University Press 2006.
[208] (1984) 156 CLR 41.
[209] (1996) 186 CLR 71.
[210] *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 97.
[211] *Breen v Williams* (1996) 186 CLR 71, 132-3.
[212] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* **(2007) 160 FCR 35,** [278].

> **modifying, his or her fiduciary duties, particularly where no prior fiduciary duty relationship existed and the contract defines the rights and duties of the parties…"[213]**

The comments made by Jacobson J in relation to the nature of the fiduciary relationship are important. ASIC had not argued that the specific relationship that had been struck between Citigroup and Toll fell within any of the established categories of fiduciary duties known to the law. Of course the courts have made it clear that new fiduciary relationships can arise in particular circumstances.

In *Citigroup* ASIC argued that the fiduciary relationship arose from the letter appointing Citigroup. Drawing on a range of English and Australian authorities,[214] Jacobson J stated that:

> **"…where a fiduciary relationship is said to be founded upon contract, the ordinary rules of construction of contracts apply. Thus, whether a party is subject to fiduciary obligations, and the scope of any fiduciary duties, is to be determined by construing the contract as a whole in light of the surrounding circumstances known to the parties and the purpose and object of the transaction."[215]**

ASIC had vigorously argued that for a proper exclusion clause to operate Citigroup should have drawn to the attention of Toll the specifics of the exclusion, and that the relationship was being qualified. ASIC had emphasised this 'obligation' by referring to some of the cases dealing with the duty owed by solicitors in the line of cases flowing from the *Prince Jefri Bolkiah* case which I have discussed above.

Justice Jacobson referred to the obligation on the part of solicitors who wished to enter into time charging cost agreements with their client to make full disclosure to the client of all the implications of such an agreement. This duty can still apply where a cost agreement is made *before* the solicitor is instructed. It follows, then, that the fiduciary relationship in that circumstance can exist before the solicitor is actually retained, and can apply in the course of the making of the agreement between solicitor and client.

However, Jacobson J rejected the arguments put forward by ASIC and noted:

> **" …the authorities dealing with solicitors cost agreements have, as their foundation, the Court's inherent jurisdiction over solicitors and the fiduciary nature of the solicitor and client relationship as an established fiduciary category. … ASIC's case was that the fiduciary relationship between Citigroup and Toll arose from the mandate letter. …It follows that there is no place in these proceedings for the application of the principle that a person who is already subject to fiduciary obligations must obtain the client's fully informed consent to the exclusion or modification of these obligations."[216]**

Justice Jacobson then spent further time dealing with the relevant question not only by examining the facts, but also assessing some interesting decisions from Australia and also some comments from a US case (ie *Securities and Exchange Commission v Chenery Corp*).[217] In essence he felt it was essential for a fiduciary relationship to be spelt out in detail for the facts to support the

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[213] Ibid [280].
[214] I have not referred to many other cases, writings and reports in relation to this area. Other important decisions include the Full Federal Court decision of *Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390; and the decision of Austin J in *Aequitas Ltd v Sparad No 100 Ltd (formerly Australian European Finance Corp Ltd)* (2001) 19 ACLC 1006.
Tuch has also written a follow up article "Obligations of Financial Advisors in Change of Control Transactions: Fiduciary and Other Questions" (2006) 24 Company and Securities Law Journals 488 which is referred to by Jacobson J in the decision.
[215] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* **(2007) 160 FCR 35,** [281].
[216] Ibid [303] - [307].
[217] (1942) 318 US 80.

nature of the fiduciary relationship. The proposition that a fiduciary relationship of some particularity had to be established by those facts is emphasised by the decision of Mahoney JA in *Law Society of New South Wales v Foreman (No 2)*.[218]

ASIC apparently felt that the rather unusual case, *Australian Breeders Cooperative Society Limited v Jones*[219] **(**Australian Breeders**) assisted it in distinguishing the more traditional views. In summarising his conclusions on the arguments put forward by ASIC that a special type of a fiduciary relationship existed in this matter, Jacobson J noted that this would be to in effect say that "a person who is not a fiduciary may nevertheless owe an obligation which flows from a fiduciary relationship. That could hardly be correct".**[220] **In reaching that view Jacobsen J argued that the decision in the *Australian Breeders* case was rather an unusual one – it involved a person who was acting in a professional capacity in the establishment of a thoroughbred horse breeding venture and who sought to limit the extent of that duty in providing advice. In the view of Jacobson J this was not a case which involved a contractual acknowledgement that there was in fact no fiduciary relationship. In that case the court found that the consent provided by the advisee was not effective.**

In Jacobson J's view of the facts, Toll was fully aware of the possibility that there would be proprietary trading by Citigroup and that this in fact amounted to informed consent.

6.4 The Act – section 912A(1)(aa)

The decision then goes on to discuss the five alleged breaches of the Act. It is interesting to note that in Jacobson J's view, ASIC had not established any of these alleged breaches.

This discussion required the court to consider the operation of the relevant provisions of section 912A(1)(aa) (s 912A**) of the Act.**

In effect this section provides that a financial services licensee (as defined by the relevant legislation) must:

> **"have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representative."**

This statutory provision will only apply where a financial service is being provided. In Jacobson J's view, Citigroup was not providing a financial service under the terms of this statutory provision. Despite this finding Jacobson J went on to consider the obligations imposed by s 912A – the need to have in place adequate arrangements for the management of conflicts of interest. In this context he again considered the *Prince Jefri Bolkiah* case and the organisational structures considered by the House of Lords in that case. Citigroup described measures it had taken in this regard, including the physical separation between departments, education programmes for staff, procedures for dealing with 'crossing the wall', monitoring by compliance officers and disciplinary sanctions.

Upon consideration of the evidence Jacobson J believed that the measures taken by Citigroup would have been effective for the purposes of the statute. Nevertheless, and this is important, Jacobson J warned that:

> **"…it is not always realistic to place reliance on arrangements comprising Chinese walls… Adequate arrangements require more than a raft of written policies and procedures. They require a thorough**

[218] (1994) 34 NSWLR 408.
[219] (1997) 150 ALR 488.
[220] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* **(2007) 160 FCR 35, [**346].

understanding of the procedures by all employees and a willingness and ability to apply them to a host of possible conflicts."[221]

6.5 Insider trading and Chinese walls

A number of technical issues were raised in relation to section 1043A of the Act dealing with insider trading. ASIC raised a number of interesting technical issues which I will not be discussing here – the only question I wish to discuss in this regard are the views of Jacobson J in relation to the Chinese wall defence in the insider trading legislation.

The Act provides a 'Chinese wall defence' which will eliminate the possibility of a breach. For this defence to operate, the relevant Chinese wall has to meet 2 requirements:

- the Chinese wall must have been 'reasonably expected' to prevent the communication of insider information to the person who traded in the shares, and (s 1043F(b))
- the wall must have *in fact* prevented such communication (s 1043F(c)).

In applying this provision, Jacobson J found that Citigroup's Chinese wall arrangements were adequate to invoke the defence under s 1043F. Referring to the informal 'cigarette on the pavement' conversation between Citigroup's 'public side' and 'private side' employees, Jacobson J commented that:

> "…what the unscripted actions of [the relevant staff members of Citigroup] show is the practical impossibility of ensuring that every conceivable risk is covered by written procedures and followed by employees. However, the arrangements required to satisfy s 1043F(b) of the Corporations Act do not require a standard of absolute perfection. The test stated in the section is an objective one."[222]

Underlying ASIC's attack on the adequacy of Citigroup's Chinese wall procedures was the argument that in order for the wall to be effective, Citigroup must have obtained Toll's informed consent to Citigroup's proprietary trading. But Jacobson J rejected this idea as "contrary to the express recognition of the Chinese walls defence in s 1043F of the Act".[223]

We have considered earlier the effectiveness of the 'Chinese wall' aspects of s 912A of the Act.

6.6 The interaction of the Chinese wall requirements for financial services licensees and fiduciary duties

It is significant to note that s 912A of the Act is framed so as to require the relevant company to create arrangements which we have described throughout this paper (as they are generally known) as Chinese walls. This obligation obviously sits side by side with the fiduciary duty which may arise in appropriate circumstances to avoid a conflict of interest.

The kinds of arrangements that a licensee could implement to meet the requirements of s 912A of the Act may also be sufficient to invoke the defence to a claim of insider trading based on s 1043F of the Act discussed above. However, it may be the case that such arrangements do not shield a financial services licensee from a claim based on the fiduciary duty to *avoid* a conflict of interest.

ASIC considered what it means to 'manage' a conflict in its Regulatory Guide #181 - *Licensing: Managing conflicts of interest.* At RG 181.20 it outlines three mechanisms that licensees would generally use to manage conflicts of interest. Licensees could control conflicts, avoid conflicts and disclose conflicts. Whilst many conflicts will be manageable through internal controls and disclosure, some situations will require the

[221] Ibid [453] – [454].
[222] Ibid [591] – [592].
[223] Ibid [598].

licensee to avoid the conflict or refrain from providing the affected financial service.[224] Such will be the case where the financial services licensee owes, in addition, a fiduciary duty to avoid a conflict of interest.

The Regulatory Guide notes:

> "Many licensees are also bound by common law obligations that affect their management of conflicts of interest. For example, many licensees have fiduciary obligations to their clients to whom they provide advice or for whom the act in a trustee capacity. These obligations operate in addition to the statutory requirements and should be taken into account when formulating conflicts management arrangements."[225]

Not all investment banks acting in an advisory capacity will owe fiduciary duties. Reflecting on this in *Citigroup,* Jacobson J concluded that the question of whether a fiduciary relationship exists, and the scope of any duty, will depend upon the factual circumstances and an examination of the contractual terms between the parties. As I have discussed earlier, investment banks have developed contractual techniques to modify or displace fiduciary obligations. Citigroup had, on the other hand, sought to exclude the fiduciary relationship by the terms of the mandate letter. As we have also discussed earlier, Jacobson J held that the contract effectively achieved the exclusion in this manner.

6.7 Conclusions from the Citigroup case

Because ASIC failed to establish a fiduciary duty on the part of Citigroup, the outcome of the case turned on the question of whether or not Citigroup had fulfilled its statutory duty to 'manage' potential conflicts of interest. Jacobson J's judgment reflects a general acceptance of the efficacy of Chinese walls in meeting such statutory requirements, though in evaluating Citigroup's Chinese wall he drew on general law principles established in cases involving fiduciary relationships.

In s 1043F of the Act, the Chinese wall defence to an insider trading claim requires that the body corporate implement arrangements that could be 'reasonably expected' to prevent the proscribed communication. This differs from Lord Millett's comment in *Prince Jefri Bolkiah* that the court should intervene unless it is satisfied that there is *no risk* of disclosure. Nevertheless, when discussing Citigroup's Chinese wall arrangements in the context of the s 912A duty, Jacobson J infers that Lord Millett's comments in *Prince Jefri Bolkiah* were generally useful in determining which kinds of arrangements would constitute an effective Chinese wall. It is clear that, while the statutory provisions appear to incorporate elements of the equitable law of fiduciaries, there remains some conceptual and theoretical unease about the interaction of the statutory requirements with traditional approaches to the no-conflicts rule.

In any event, I believe two points at least can be drawn from *Citigroup*:

- The law does not prevent an investment bank from contracting out of, or modifying, any fiduciary obligations. This is because, where parties to an agreement do not fall within an established category of fiduciary relationship, there can be no need for one of those parties to draw the other's attention to the clause and gain their informed consent to it for it to be effective.
- When considering the adequacy of a Chinese wall in the statutory context of 'conflict management', equity and statutory law operate independently, even though the concept of conflict management derives from equity and may be understood by reference to equitable doctrines.

[224] Australian Securities and Investments Commission, Regulatory Guide 181, 'Licensing: Managing Conflicts of Interest', 30 August 2004, 181.27.
[225] Ibid 181.19.

6 Company law issues

Earlier on, I commented on the fact that in the area of company law, the ability to exclude a fiduciary relationship, or what is in effect an attempt to forgive a breach of duty, may fail because of the co-existence of statutory duties. I do not know to what extent one can extrapolate from all of this principles that may be transferred to other areas in the law (including that which impacts on the investment advisors). With increasing pressure in our community for conflicts of interests to be adequately managed, I reflect very briefly on some of the corporate law issues.

One of the most heavily litigated areas involving conflict of duties arise from the actions of company directors. They are subject to well known statutory and common law duties. One of the most interesting cases to illustrate the problems that can arise in this context (outside of the obvious scenarios where directors are trying to 'feather their own nest' at the expense of the company) is where a director believes that he or she cannot participate in a transaction because of a conflict, and this creates a problem for the company which no longer has the benefit of that director's expertise and knowledge in relation to that transaction.

In *Permanent Building Society (in liq) v Wheeler*,[226] the relevant facts arose when a company that invested in certain property at a significantly inflated price was faced with a potential challenge to that decision. It was alleged that the transaction involved a breach of fiduciary duties on the part of a number of directors.

The Chief Executive of Permanent Building Society – Hamilton – held an office of directorship in the companies on both sides of the relevant transaction, and abstained from voting due to the potential conflict of interest. Justice Ipp regarded Hamilton as being in breach of his duty of care to the company which entered the transaction to its detriment. The fact that Hamilton knew he had a conflict and abstained from voting was not sufficient to discharge his duty of care. Justice Ipp commented that the nature of the transaction required something further that mere abstention from voting:

> **"It was manifest that the transaction was capable of causing PBS serious harm... It may be that, because of the conflict, he should not have spoken or voted in favour of the resolution. But as chief executive and managing director there was a responsibility on him to ensure that the other directors appreciated the potential harm inherent in the transaction, and to point out steps that could be taken to reduce the possibility of that harm. Hamilton could not avoid that duty by, metaphorically speaking, burying his head in the sand while his co-directors discussed whether PBS should enter into such a potentially detrimental transaction."[227]**

In this case, the dual directorship gave rise to a situation where it would be virtually impossible to adequately discharge the director's duties to both companies at once. Similar problems have arisen in other high profile company law cases involving company directors. Perhaps the most notable problems face nominee directors. The Corporations and Markets Advisory Committee Report on *Corporate Groups* (2000) still has much to offer us in this regard.[228]

There are associated questions of whether a company can forgive a director faced with a conflict of interest situation. The impact of section 1324 of the Act and the rights of creditors remains a question yet to be tested.

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[226] (1994) 11 WAR 187.

[227] Ibid 241.

[228] Much has been written in relation to this area, and there are many other interesting comments from the courts that illustrate the impossible position that directors find themselves in when they are faced with a direct conflict. I will not deal with them here. I have discussed this at some length in an article *The Duty of Care of Directors: Does it Depend on the Swing of the Pendulum* published in Ramsay Ed *Corporate Governance and the Duties of Company Directors* (1997) Melbourne University Press.

Section 1324 of the Act takes away from the shareholders of the company the ability to forgive breaches of duty which arise under the provisions of the Act. The right of individuals whose interests are affected to seek an enforcement of the statutory duties under s 1324 have been discussed by me in various articles. It was recently referred to with some approval in a joint paper delivered at a Law Council of Australia Federal Workshop by John Sheahan SC and Leon Zwier.[229]

The fact that shareholders cannot forgive a statutory breach was emphasised by Santow J in *Miller v Miller & Miller.*[230] Whilst the matter was not referred to directly by the High Court of Australia in *Angas Law Services Pty Ltd (in liq) v Carabelas*,[231] it was inferred from the decision that shareholders could not override statutory rights that were vested in the interested parties by virtue of s 1324 of the Act. This is clearly a different situation to that which exists in relation to the provisions of s 912A of the Act where, in fact, there are parameters laid down for companies to create 'Chinese walls' and other arrangements to modify, or perhaps minimise, the nature of fiduciary relationships.

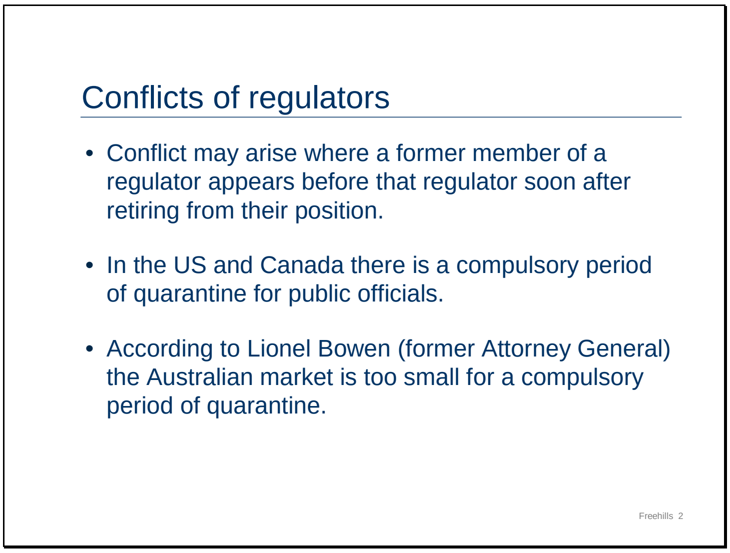
7 Conclusions

It is a trite observation to suggest that the *Citigroup* decision has drawn a definitive line in the sand. In relation to the problems of conflict, we as advisors and commentators face many future challenges in this area of the law. I look forward to evaluating and commenting on them in the years ahead.

[229] 'Directors' Duties and Creditors' (25 – 27 March 2006, Sydney).
[230] (1995) 16 ACSR 73.
[231] (2005) 226 CLR 507.

Slide 1

Slide 2



Slide 3

Australian Stock Exchange

ASX has 3 roles:

1. non-government regulator of the securities market;
2. administrator of the securities exchange; and
3. company listed on the securities exchange.

Potential for conflict:

- ASX obtains increased revenue from higher trading volumes
- Its listing on its own exchange may mean it is less likely to act against investors who seek to drive down prices

ASX claims:

- commercial interests and supervisory responsibilities are aligned
- ASX's operations are nonetheless separately managed

Freehills 3

Slide 4

Conflicts of Legal Practitioners

- Prince Jefri Bolkiah v KPMG

  per Lord Millett:

  - the court will prevent a firm from acting unless there is *no risk* of disclosure

- Spincode Pty Ltd v Look Software Pty Ltd
- Village Roadshow Limited v Blake Dawson Waldron

  per Justice Byrne:

  - the court will act where a reasonable person informed of the facts might *reasonably anticipate* a danger of misuse of confidential information AND there is a *real and sensible possibility* of a conflict of interest

Freehills 4

Slide 5

Conflicts of Legal Practitioners

"It is a notorious fact that a good deal of commercial litigation in this state is conducted by a handful of very large firms. How is a client to obtain the services of one of them if the conflict rule is applied too strictly? To my mind, this is the price which the client of such firms and the firms themselves must pay. The firms have found it commercially convenient to become large. This is but one disadvantage of this trend. It is certainly no reason for the courts to weaken the traditionally high standards of a practitioner's loyalty to the client which have characterised the practice of law in this State."

per Byrne J

Village Roadshow Limited v Blake Dawson Waldron

(2004) Aust Torts Reports 81-726, [50]

Freehills 5

Slide 6

Citigroup Global Markets Australia Pty Ltd

'private' side: exposure to confidential, market sensitive information
'public' side: roles performed on basis of publicly available information

1. Employee in 'public side' purchased shares in Patrick Corporation just prior to announcement of Toll Holdings takeover of the company.
2. After an 'informal cigarette on the pavement' conversation between that employee and employees from the 'private side' some of the shares were sold.

ASIC argued that:

- the share sales breached the insider trading provisions of the Corporations Act
- Citigroup had a fiduciary relationship with Toll due to its advisory role in the takeover
- the Chinese walls erected by Citigroup were inadequate to prevent the flow of information between the 'private' and 'public' sides of its business

Freehills 6

Slide 7

Citigroup – fiduciary & contractual duties

"It may well be that a fiduciary cannot exclude liability for fraud or deliberate dereliction of duty but beyond that there appears to be no restriction in the law to prevent a fiduciary from contracting out of, or modifying, his or her fiduciary duties, particularly where no prior fiduciary relationship existed and the contract defines the rights and duties of the parties.."

per Jacobson J
ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)
(2007) 160 FCR 35, [278]

Freehills 7

Slide 8

Citigroup – Chinese walls

s 1043F: 'Chinese wall defence' to insider trading where:

1. the Chinese wall was *reasonably expected* to communication of insider information; and
2. the Chinese wall has *in fact* prevented such communication.

According to Jacobson J, the test is an objective one:

- the section *does not require* absolute perfection; and
- it *does not require* every conceivable risk to be covered.

Satisfaction of requirements under s 912A(1)(aa) to have 'adequate arrangements for the management of conflicts of interest' may be sufficient to invoke s 1043F defence.

Freehills 8

Slide 9

Directors' duties

Permanent Building Society v Wheeler

The Chief Executive (**Hamilton**) held office of directorship in companies on both sides of a transaction. He abstained from voting due to his conflict of interest.

Justice Ipp found that:

- simply abstaining from voting on the transaction was not sufficient
- as the Chief Executive and Managing Director, Hamilton had a duty to:
  - ensure the other directors appreciated the potential harm inherent in the transaction, and
  - to point out steps that could be taken to minimise the possibility of harm

Freehills 9

Slide 10

Conclusion

Questions of conflicts continue to be crucial for many organisations and those that advise them.

There are many questions yet to be answered in this area. The cases discussed today provide some guidance as to how fiduciary duties and potential conflicts can be managed in today's business environment.

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John O'Sullivan, Chair, Australian Investment Banking Division, Credit Suisse, Sydney

Conflicts of Interest in financial Services Firms – a commentary

CONFLICTS OF INTEREST IN FINANCIAL SERVICES FIRMS

A COMMENTARY

BY

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* The views expressed in this paper are the author's alone and do not necessarily reflect the views of his employer.

I am indebted to your President Diccon Loxton for pointing out to me that, having defected from the law to investment banking, I could borrow from Judy Collins, and call my talk “Both Sides Now”. And it is true that I have looked at conflicts from both sides now, from up and down, and still somehow its conflicts illusions I recall. I really don’t know conflicts at all.

Only some of you are old enough to appreciate that ñ but Iím sure all of you will appreciate that I didn’t sing it.

Though I have been asked to address conflicts in financial services firms I would like to paint a slightly larger canvas. Emboldened by Bob Baxt’s reminiscences about my former partner Bob McComas and by the somewhat sniffy comments by Justice Byrne in the Village Roadshow case which Bob also quoted, I am going to start with a quick look at conflicts in the legal profession. I will use that as a basis for some broad generalisations about the policy underlying conflicts and then talk about financial services firms.

The Pope has just been in Sydney and that is a good enough reason for me to ask the lawyers here to examine their conscience. In particular to ask which of you is without sin and is thus happy to cast the first stone.

As Bob has pointed out lawyers face terrible conflicts, though in my experience they get much less publicity than those faced by investment banks. The Citigroup case is much better headline material than whether a law firm can act against a former or current client.

But any partner in a law firm who has ever been asked by a major client to give a legal opinion which stretches the truth ñ or bends it completely out of shape ñ knows what I mean. Your financial interest in preserving a profitable client relationship runs smack bang up against your duty to the court. Barristers are no different ñ we have all come across barristers whose opinions can be purchased.

And commercial conflicts between clients abound. How often are partners in law firms called on to decide whether to act for client A or client B in situations where A and Bís commercial interests (though not necessarily legal interests) collide? Law firms of any size have conflicts committees to decide these questions. If we are honest with ourselves we would admit that it is very tempting to make the choice based on which client is most valuable, not on which client has the best call on our loyalty.

In defence of the legal profession I believe ñ though I have no evidence for it one way or the other ñ that the percentage of lawyers who prefer their interest to their duty is small. Nor do I wish to be unduly sanctimonious about this. In the confessional spirit I will admit to one or two occasions in 25 years of practising law in a major law firm when I may have polished up an ordinary argument more than was strictly appropriate, when I sugar coated a bitter pill, when I did a little soft shoe shuffle around the unvarnished truth, in order to keep a client happy. And I am sure I found rationalisations that enabled me to feel good about choosing the remunerative client over the deserving one.

What is my point, you ask? Simply this. Conflicts are part of life. If you don't have major conflicts regularly you either are not smart enough to identify them or you're not playing first grade.

And whilst I accept there are some conflicts that are so egregious they must be prohibited, they are few. Most can and should be managed, using tools such as disclosure and consent, and maintenance of information barriers.

You see we as a society must understand the price of ideological purity. Byrne, J told only half the story when, in the passage Bob quoted, he said "It is a notorious fact that a good deal of commercial litigation in Victoria is conducted by a handful of very large firms … this is the price which the clients of such firms and the firms themselves must pay". In harking back to the golden days of cottage industry law firms and Lord Lindley on Partnership, Byrne J (with the greatest of respect) falls for what some sociologists call "noble savage myth". The myth that the old days were purer, simpler and happier than today.

The truth is that society as we know it today needs large full service law firms with whirring computers and hundreds of lawyers ready to be swung onto the due diligence for the BHP/Rio takeover. The size and complexity of law firms simply reflects, and is a response to, the complexity of modern commercial life. To return to the sweet simplicity of yore, as Justice Byrne would clearly like to do, would impose a significant cost not only on law firms and their clients, but on society. Less efficient law firms will mean less justice not more. A legal profession of one man firms would be slow, could not afford the efficiency of modern technology and would cost jobs. A Luddite legal system would bring commerce, and the jobs and wealth it creates, to a halt. The same is true of financial services firms to which I shall come in a moment.

Before I do, let me illustrate my point a little further by travelling to the field of private equity. This time last year, at a different conference in what seemed a happier, simpler pre-credit crunch time, I listened to a paper by Neil Young QC on "Conflicts of Interest in the Context of Private Equity Transactions". In a sobering analysis of the difficult conflict issues faced by public to private bids, especially those sponsored by private equity firms, Neil highlighted in particular those conflicts faced by incumbent management who are promised participation in the bid vehicle. Citing Furs Ltd v. Tomkies (1936) 54 CLR 583, he concluded that unless shareholders in general meeting give fully informed approval to such an arrangement the executives must account to shareholders for any profits they receive as a result.

Neil Young pointed out a "director or senior executive who makes a profit of this kind cannot avoid liability by contending that, in overall terms, the transaction was fair and beneficial to the target company". He acknowledges that in this respect, English and Australian law differs markedly from United States law.

I certainly would not argue the legal toss with Neil Young. I probably would not have done that even when I was a real lawyer. But I would say that if Australian law does make public to private transactions impossible because of rules such as this, that is the wrong answer from a public policy point of view. While it may make those who (like former German vice-chancellor Franz Muntfering) think private equity firms are "locusts", feel better, using fundamentalist views about conflicts to punish the marauding private equity hordes, may actually hurt Australia and Australians.

I know that some will say that it is outrageous that senior management of a listed company can take it private and make it more profitable in their hands than it was in public hands. Any extra profit that they could find in private ownership should be able to be made in public ownership too. If management have smart ways to make money they should exploit those techniques for the benefit of public shareholders.

This fundamentally mistakes the difference between public and private companies. The risk-reward tradeoffs, the appetite for debt and the ability to take decisive, perhaps unpopular action differs so vastly between public and private companies that the two kinds of company are essentially different forms of business vehicle.

And our society badly needs the discipline of private equity owned firms.

A survey done by PWC in 2006 shows that acquisition by private equity firms significantly enhances investor companies' levels of innovation and growth in employment. So it is fine to prefer the Australian approach to conflicts in private equity transactions to the US approach if you want your children to have worse job prospects and fewer new products.

Ditto with financial services firms. Ideological purity will have its costs.

Now don't get me wrong. I am not by any means advocating an open slather, back to the frontier, free-for-all on conflicts. I merely seek balance and some recognition that an unduly puritanical view on conflicts will have significant economic and social costs.

In my mind, the high water mark of conflicts fundamentalism was ASIC's case against Citigroup, to which Bob has referred. ASIC clearly disapproved of an investment bank engaging in proprietary trading of shares while simultaneously providing M&A advice. At the heart of its case was a belief that the nature of the relationship between an M&A adviser and its client was fiduciary and incapable of being contracted away except by extraordinarily clear language.

While directed at the conflicts between advisory and proprietary trading, let there be no mistake that ASIC's challenge was to the very business model of full service investment banks. Essential to the model is that investment banks house a number of different but related businesses, some of which are agency businesses and some of which are proprietary businesses. And while my comments, and ASIC's charges, were directed at investment banks, personal experience tells me that commercial banks are similar.

The complexity of today's financial services firms is such that conflicts between the interests of clients on the one hand and the interests of the firm on the other hand, or between the interests of different clients, are inevitable. Just as conflicts in law firms are inevitable.

As a reformed lawyer, I do not intend to agonise about when a fiduciary relationship exists and what impact that may have on conflicts. Bob and Paul's papers cover that territory admirably. My point is that irrespective of the legal characterisation, commercial conflicts are inevitable.

You could avoid these conflicts by unbundling financial services firms. You could make them operate as monolines ie. single business line, standalone operations. You could impose this form of purity by enacting a "mother of all Glass-Steagall statutes", thus forcing M&A firms to operate separately from research, sales and trading, asset management and proprietary trading. This would be possible ñ but not desirable. While I admire the boutique, single line businesses like Caliburn and Platinum Asset Management (to name but two excellent firms), and hope they continue to prosper, we need full service firms too. Full service firms add enormously to the strength and resilience of today's financial markets. Full service firms have global reach. They have the capital necessary to pay for the risk management, research and analytics and compliance necessary in today's world (not that the risk management is always foolproof). They can use their own capital in proprietary trading to ensure the markets operate with the ruthless efficiency that makes such a contribution to our standard of living. They can put their capital at the service of clients to help transactions happen.

So while I certainly do not argue all financial services firms should be full service, I do argue that we would be much worse off if full service firms were not permitted or were unduly restricted.

For full service firms to be permitted we must acknowledge and accept two propositions:

1. That conflicts are inevitable
2. That most conflicts can be managed and do not need to be prohibited.

The ASIC approach that many conflicts can only be cured by the most extraordinarily detailed confessions and consent is, in my view, not merely unworkable but undesirable. By setting a standard of consent so absurdly high it could, in practice, never be jumped, ASIC would send our financial services industries back if not to the Dark Ages, at least to Victorian times. Justice Jacobson not only got the right legal conclusion, if I may respectfully say so, but also the right policy result.

Now I must repeat that I do not scoff at conflicts and I do not advocate a laissez-faire approach. In my firm and other similar firms we have barriers between investment banking and research that cause frequent angst and loss of business. Investment bankers now dread being told they won't be hired by a client because their firm's research analyst has a "sell" on the client's stock. But they are used to it and accept it. That was a form of regulation made necessary by the excesses of the dot com boom. It was necessary and appropriate, and I certainly do not complain about it.

And I should add that in well run investment banks the solutions to these problems are not merely structural but cultural. Thus when I joined Credit Suisse I discovered structural separation between investment banking and research (as an example) that regulators would find reassuring, indeed perhaps surprising. Indeed not only are there the usual physical barriers and electronic firewalls but as a general rule investment bankers are not allowed to talk to an analyst on a business matter except through the head of research or with a compliance chaperone. But perhaps of even more comfort to me, as a former lawyer, is that a culture has been built under which compliance matters. That is reinforced through education, by example and through performance evaluation.

Nor is the benchmark set merely one of bare compliance with legal requirements. At Credit Suisse, and I'm sure other well run firms, the desire to avoid inappropriate reputational risk drives a high standard of behaviour. I do not say it is perfect. Perfection is usually only available to lawyers ñ and in hindsight. But a true appreciation of how top tier investment banks are run would help regulators understand that the best solutions are as much cultural as structural.

So to conclude, driving full service firms to compulsory unbundling or other similar drastic positions is neither necessary nor appropriate. Generally conflicts can and should be managed. Regulation, like alcohol, is best in taken moderation.

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Conflicts of Interest in financial Services Firms – a commentary

CONFLICTS OF INTEREST IN FINANCIAL SERVICES FIRMS

A COMMENTARY

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* **The views expressed in this paper are the author's alone and do not necessarily reflect the views of his employer**

INTRODUCTION

As we have heard from Bob, the instances of conflicts of interest are not restricted to financial services firms. It can arise in many circumstances, as many of you in private practice know only too well. Much of what arises in private legal practice formed the basis of argument by counsel for ASIC in *ASIC v Citigroup*. Bob has dealt with that case at some length in his paper and I will not cover that again.

When considering conflicts of interest in financial services firms, we often think of the classic situations that can arise in investment banks with insider trading issues and the tensions that exist between the “public side” and the “private side”. However, there are tensions within retail financial services organisations as well in managing conflicts of interest and with the enactment of Chapter 7 of the **Corporations Act 2001** (**Corporations Act**) the issue of conflicts management for retail financial service providers has exacerbated.

This paper will highlight the issue in the context of looking at the position of financial planners in Australia and in particular focus on whether a financial planner is a fiduciary. To the extent that New Zealand may contemplate following Australia in enacting legislation along the lines of Chapter 7, it could do well to look at the difficulties this legislation has caused for financial services organisations and the determine how much consumers have benefited with the increased level of disclosure and compliance generally.

REGULATORY LANDSCAPE IN AUSTRALIA

In Australia there is a mixture of general law and statutory legislation supplemented by regulatory guidance that regulates conflicts of interest in the financial services sector. The regulation of conflicts of interest is taken very seriously in Australia and the *Citigroup* litigation demonstrated the preparedness of ASIC to pursue perceived conflicts management failures through the courts and in the earlier enforceable undertaking obtained from AMP Ltd, failure to manage conflicts featured prominently in ASIC’s findings.

However, the mixture of general law and legislative regulation makes it difficult for licensees to determine whether they have adequately discharged their obligation to manage conflicts properly. If a licensee has managed their conflicts properly in accordance with the legislation does this mean they have discharged their general law duty and vice versa. This issue has also been commented upon by the Chairman of ASIC, Tony D’Aloisio, in a speech to the Financial Planning Association last year. [1]

GENERAL LAW OBLIGATIONS

The need to manage conflicts of interest at general law is predicated on a licensee owing a fiduciary obligation to its client[2]. If a licensee is a fiduciary then it is clear

[1] Tony D’Aloisio, “*Regulating Financial Advice – Current Opportunities and Challenges*” Address to FPA Conference, 28 November 2007, at p.17
[2] C Band, *Conflicts of Interest in Financial Services and Markets* [2006] J.I.B.L.R. 677

from Lord Herschell's speech in *Bray v Ford* [1896] A.C. 44 at 51-52 as to a fiduciary's obligation:

> 'It is an inflexible rule of the Court of Equity that a person in a fiduciary position…. is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict…. [There] is danger in such circumstances, of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those he was bound to protect.'

The obligation of a fiduciary is to avoid conflicts of interest unless there is informed consent. Licensees could on occasions be characterised as acting as a fiduciary. This could arise in accepted fiduciary relationships such as principal and agent as might exist in certain circumstances between a stockbroker and his client. It could also arise in a trustee/beneficiary scenario as would exist with a responsible entity of a managed investment scheme, a trustee of a superannuation fund or with a custodian of securities.

Outside of the accepted relationships of fiduciary, it is still possible for a relationship to be fiduciary in character. In *Hospital Products Limited v United States Surgical Corporation* (1984) 156 CLR 41, Mason J held (at 96-97) that a critical factor in determining whether a person was a fiduciary was if the person:

> 'undertakes or agrees to act for on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interests of the other person in a legal or practical sense. The relationship between the parties is therefore one that gives the fiduciary a special opportunity to exercise the power or discretion to the detriment of that other person who is accordingly vulnerable to abuse by the fiduciary of his position.'

The approach taken by Mason J identified a number of factors to be taken onto account by a court as indicative of the existence of a fiduciary relationship[3]. Another approach taken is to use analogous reasoning from the decided cases and existing categories of fiduciary relationship to determine if in a given fact pattern a fiduciary relationship can be found to exist. This approach has been taken by one author[4] to argue that investment banks are in a fiduciary relationship with their clients when acting in a financial advisory role. In reaching this conclusion reliance is placed on analogous situations to be drawn from cases concerning stockbrokers and their clients, bankers and customers and corporate advisers and their clients. It is possible that such an argument could be raised in the context of a financial planner and his/her client.

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[3] R P Meagher, J D Heydon and M J Leeming, *Meagher, Gummow and Lehane's Equity Doctrines and Remedies* (4th edition), Butterworths, 2002, p 157ff .

[4] A Tuch, *Investment banks as fiduciaries: implications for conflicts of interest* (2005) 29 MULR 15 (**Tuch 2005**) and A Tuch, *Obligations of financial advisers in change-of-control transactions: Fiduciary and other questions* (2006) 24 C&SLJ 488 (**Tuch 2006**)

Characterising the relationship between a licensee and its client as a fiduciary one is often readily made[5] when arguably it should not be so. The relationship between a licensee and its client normally arises in a commercial context where it might be reasonable for clients to expect and understand that licensees 'are seeking to promote the sale of financial products or financial services and to expect honesty rather than a lack of self-interest in that context'[6]. The courts have been reluctant to impose a fiduciary relationship where the parties are in a commercial relationship and dealing on an arms' length basis[7]. It is argued by advisers to the financial services industry that outside the accepted categories of a fiduciary relationship, financial services licensees are, generally speaking, not fiduciaries. Rather the relationship is one based on contract alone and that duties arise as part of the contractual relationship as well as under statute[8]. It is submitted that this analysis may not be correct. It is possible that fiduciary duties can co-exist with contractual duties[9]. The reasons for not wanting to characterise a licensee's relationship with its client as fiduciary are many. A fiduciary assumes many onerous duties such as the need to avoid conflicts of interest, a duty not to profit from its position as fiduciary at the expense of its customer/beneficiary, a duty of undivided loyalty and a duty of confidentiality. Failure to observe its duties may expose the fiduciary to 'equity's gain-stripping remedies'[10] such as an account of profits or a constructive trust.

The courts have nevertheless held that a fiduciary relationship can arise in the context of a licensee and its client in circumstances other than the usual categories of fiduciary. The leading Australian authority is *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371 (**Daly**). In that case, an investor sought advice from a stockbroking firm about potential investments. The broker advised the investor to deposit funds with the firm until such time as the stock market conditions improved to make investments. What the broker failed to disclose was the parlous state of the financial affairs of the broking firm that subsequently went into liquidation. The investor sought compensation from the stock exchange's fidelity fund on the basis of a breach of fiduciary duty by the stockbroking firm. The claim was unsuccessful as the money was not received in the manner required by the legislation to satisfy a claim under the fidelity fund. However, the High Court did give consideration as to

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[5] See: Financial Planning Association, *FPA proposes Principles for managing conflicts of interest*, Media Release 28 April 2005, quoting the then chief executive of the FPA as saying: 'This restatement of every financial planner's fiduciary duty is the touchstone for all dealings with clients'; Lori A. Richards, *Fiduciary Duty: Return to First Principles*, Speech to the Eighth Annual Investment Adviser Compliance Summit, 27 February 2006, found at www.sec.gov/news/speech/spch022706lar.htm where she says on page 1 'all advisory firms, whatever their size, type or history in the business, owe their advisory clients a fiduciary duty.'

[6] R Baxt, A.J Black & P.F Hanrahan, *Securities and Financial Services Law* (6th edition) Lexis Nexis Butterworths, 2003, [1304]. See also: C Band above n 2 at p678 where she says '[the] fiduciary element is often missing because… the parties recognise that each is acting in its own interests and not trusting the other to look after theirs.'

[7] See: *Hospital Products Limited v United States Surgical Corporation* (1984) 156 CLR 41(**Hospital Products**) at 119 per Wilson J and at 149 per Dawson J

[8] Michael Vrisakis, *Two (un)sound bytes?* Financial Services Newsletter, Vol. 5 Nos. 6 & 7, Lexis Nexis Butterworths, pp 80 - 81

[9] See: *Hospital Products* at 97 per Mason J, *Kelly v Cooper* [1993] A.C. 205 at 215 per the Board citing Mason J in *Hospital Products* with approval and *Henderson v Merrett Syndicates Ltd* [1995] 2 A.C. 145 at 206 per Lord Browne – Wilkinson who said 'The existence of a contract does not exclude the co-existence of concurrent fiduciary duties'

[10] Tuch 2005, p479

whether a stockbroker could be regarded as a fiduciary. Gibbs CJ held [11] that the stockbroking firm owed a fiduciary duty and acted in breach of that duty.

Justice Brennan held:

> 'Whenever a stockbroker or other person who holds himself out as having expertise in advising on investments is approached for advice on investments and undertakes to give it, in giving that advice the adviser stands in a fiduciary relationship to the person whom he advises.'[12]

Having established that the stockbroking firm was in a fiduciary relationship with its client, Brennan J went on to state:

> 'The adviser cannot assume a position where his self-interest might conflict with the honest and impartial giving of advice….The duty of an investment adviser who is approached by a client for advice and undertakes to give it, and who proposes to offer the client an investment in which the adviser has a financial interest is a heavy one. His duty is to furnish the client with all relevant knowledge which the adviser possesses, concealing nothing that might reasonably be regarded as relevant to the making of the investment decision including the identity of the buyer or seller of the investment when that identity is relevant, to give the best advice which the adviser could give if he did not have but a third party did have a financial interest in the investment to be offered, to reveal fully the adviser's financial interest, and to obtain the for the client the best terms which the client would obtain from a third party if the adviser were to exercise due diligence on behalf of his client in such a transaction.'[13]

The decision in *Daly* has been followed subsequently in Australia by courts, which have held that a fiduciary duty exists in various situations involving financial services providers[14].

In *Aequitas*, Austin J in a very detailed judgment considered the dictum of Brennan J in *Daly* in the light of subsequent High Court decisions, most notably *Breen v Williams* (1996) 186 CLR 71. His Honour held that 'Brennan J's dictum should be taken to refer, for the most part, to the contractual aspects of the adviser-client relationship. The duty to provide 'best advice' and to disclose knowledge and information arise out of the adviser's 'undertaking', and are therefore implied terms of the contractual retainer'[15]. His Honour's analysis suggests that the terms are implied by law rather than by fact. That being the case, these terms will be implied into every contract where a fiduciary relationship exists between an adviser and its

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[11] *Daly* at 377
[12] *Daly* at 385
[13] *Daly* at 385
[14] *Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390 (banker and customer) but contra *Commonwealth Bank of Australia v Finding* [2001] 1 Qd R 168; *Aequitas Limited v Sparad No. 100 Ltd* (2001) 19 ACLC 1,006 (**Aequitas**) (corporate adviser and client)
[15] *Aequitas* at [287]

client[16]. Terms implied by law must be consistent with the express terms of the contract otherwise they will not be implied[17].

Whilst it is clearly possible to characterise a relationship between a licensee and its client as fiduciary, it should not be assumed that a given relationship would always give rise to a fiduciary relationship[18]. It is necessary to examine the ambit of the licensee's retainer to determine what duties have been accepted by the licensee and nature of the relationship between the licensee and the client[19]. Where there is more reliance by the client on the licensee or more discretion is reposed in the licensee to determine matters for the client, the more likely a fiduciary relationship will be found to exist.

The relationship between a financial planner and client does not fall into the class of recognised fiduciary relationships so much will depend on an examination of the facts and contractual arrangements between the planner and the client. A fiduciary relationship could arise in circumstances where personal advice or general financial advice is provided. Further, if the planner has other powers or discretions such as making investments on behalf of clients or acts as trustee of a client's discretionary trust, fiduciary duties are likely to arise.

CONTRACTUAL TECHNIQUES

As a result of the *Citigroup* case, opportunities arise to restrict or eliminate any fiduciary duty. Jacobson J held "it is open for parties to a contract to exclude or modify the operation of fiduciary duties."[20] Clearly, in a case such as *Citigroup* where there are sophisticated parties who are well advised, this is clearly possible.

It is suggested that with a financial planner such fiduciary duties can be excluded with "informed consent".[21] It is submitted that this may not be the case. Informed consent is only required where a fiduciary relationship already exists and the fiduciary needs informed consent in order to have a conflict of interest. However, contracting out of a fiduciary relationship only requires clear words that give effect to that desire.

If a fiduciary relationship is not excluded, consideration needs to be given as to the ambit of that duty in the context of a financial planner giving advice. Under s945A of the *Corporations Act* a planner is required to provide advice that is appropriate for the client. However, the general law duty is to provide 'best advice' so it is necessary for the planner's retainer to be clear as to what duties are being assumed if the planner is not be caught by Brennan J's dictum in *Daly.*

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[16] J. W. Carter, *Carter on Contract,* (2 vols) Lexis Nexis, 2002, Vol.1 at [11-120]
[17] J.W. Carter, above n14, Vol 1 at [11-160]
[18] As is suggested in Tuch 2005 and Tuch 2006 with respect to investment banks acting as corporate advisers
[19] Baxt et al, above n6, [1304]
[20] *ASIC v Citigroup Global Markets Australia Pty Limited*(2007) 25 ACLC 940 at 969
[21] Tony D'Aloisio, above n 1, at p17

PRE SECTION 912A (1) (aa) LANDSCAPE

Prior to the enactment of section 912A (1) (aa) of the *Corporations Act*, various statutory obligations required licensees to manage conflicts. In part, the need to manage conflicts of interest is covered by the licensee's obligation to provide financial services 'efficiently, honestly and fairly' within the meaning of s912A (1) (a) of the *Corporations Act*. ASIC sets out what it expects of licensees in this regard in Regulatory Guidance 164. At [RG 164.138A] ASIC states that it requires related party issues be dealt with so as to manage conflicts of interest. However, it is submitted that s912A (1) (a) is probably not sufficient to ensure that conflicts will be managed properly. In one case[22] dealing with the former legislation, the Administrative Appeals Tribunal found that a significant failure to disclose a conflict of interest was insufficient to support a finding that a licensee failed to act 'efficiently, honestly and fairly'. Further, as was pointed out in the explanatory memorandum when introducing s912A (1) (aa), '[while] industry has noted that [s912A (1) (a)] would include managing conflicts of interest, the duty was not express in its application to conflicts of interest'[23].

There are numerous other provisions in the *Corporations Act* dealing with conflicts of interest with respect to retail clients[24]. The method of dealing with conflicts or potential conflicts in each case is by disclosure. Whenever a licensee is to provide a financial service to a retail client, it must provide a financial services guide (**FSG**): s941A. Section 942B of the Corporations Act provides in part that a FSG must include statements and information about remuneration to be received by the providing entity, any related body corporate of the providing entity, any director or employee of the providing entity or its related bodies corporate and any associate of any of them. The section also requires that a FSG include statements and information 'about any associations or relationships between the providing entity, or any related body corporate, and the issuers of any financial products, being associations or relationships that might reasonably be expected to be capable of influencing the providing entity in providing any of the authorised services'[25]. Whilst these sorts of provisions can be characterised as dealing with pricing and transaction transparency so that clients can understand the true cost of the product or service they may be purchasing, they also deal with conflicts management issues.

Similarly with statements of advice (**SoA**), specific obligations exist in s947B of the *Corporations Act*. The requirement to give a SoA arises where there is the provision of personal advice and the person to whom it is provided is a retail client: s944A and s946A (1). Section 947B sets out the main requirements for a SoA. A similar provision exists where an authorised representative issues a SoA[26]. Section 947B has its origins in the former section 849 of the *Corporations Act*. That section was concerned with securities recommendations and was not restricted to the retail situation. More importantly, there was an information barrier defence available under

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[22] *Re Saxby Bridge Financial Planning Pty Ltd and Ors and Australian Securities and Investments Commission* [2003] AATA 480 at [309] – [310]

[23] Commonwealth Parliament, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 Explanatory Memorandum* (**Explanatory Memorandum**) Para. 5.595

[24] See definition of 'retail client' in s761G

[25] See s942B (2) (f) of the *Corporations Act* and regulations 7.7.04 and 7.7.04A.

[26] See s 947C (2) (e) and (f)

the former section 850 for a breach of the equivalent provisions of section 947B (2) (d) and (e) which is not available for a breach of section 947B. It is unclear why no such defence is allowed as it is arguable that information held behind a Chinese wall would not necessarily influence advice given to a client[27]. Whilst it may be justifiable to deny such a defence to a small financial services body where it would be difficult to erect meaningful information barriers, it is problematic for large financial services organisations, such organisations may seek to negotiate commercially sensitive arrangements with product issuers which would not influence the advice their employees or authorised representatives may give clients if they are unaware of the arrangements. In retail financial services, it is just as possible for a large conglomerate to organise efficient and effective information barriers as is it is for an investment bank operating in the wholesale markets.

ENACTMENT OF SECTION 912A (1) (aa)

In 2002, governments and financial regulators around the world became increasingly concerned about conflicts of interest in investment banking. This stemmed initially from investigations conducted by the New York attorney general's office into research practices carried out at the investment bank, Merrill Lynch. The investigation revealed that research was 'tainted and biased by the desire to aid Merrill Lynch's investment banking business…. [that resulted in the firm disseminating]… misleading information that helped its corporate clients but harmed individual investors'[28]. This investigation was followed by a joint investigation by the Securities and Exchange Commission, the New York attorney general, the National Association of Securities Dealers, Inc. (**NASD**) and others in 2002 that led to a US$1.4 billion settlement with ten major investment banks to resolve issues of conflicts of interest in investment banking research and other areas[29].

In Australia, the federal government responded as part of its corporate law economic reform program, commonly referred to as 'CLERP'[30]. In the series of proposals known as 'CLERP 9'[31], the federal government enacted s912A (1) (aa) of the *Corporations Act*. After considering various options, the government determined that having a specific licensing obligation to manage conflicts of interest, which was supplemented by ASIC guidance, was the best solution. It was also noted that industry supported a principles based approach to regulation[32]. To this end parliament enacted section 912 A (1) (aa) which provides that licensees must:

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[27] Baxt et al, above n6,[1326]
[28] Office of the New York State Attorney General Eliot Spitzer, 'Merrill Lynch stock rating system found biased by undisclosed conflicts of interest' Press Release 8 April 2002 found at www.oag.state.ny.us/press/2002/apr/apr08b_02.html
[29] Office of the New York State Attorney General Eliot Spitzer, '$1.4 Billion Global Settlement Includes Penalties and Funds For Investors' Press Release 20 December 2002 found at www.oag.state.ny.us/press/2002/dec/dec20b_02.html
[30] The federal government conceded it was responding to the overseas experience in its commentary that accompanied exposure draft of the bill which introduced s912A (1) (aa): see *CLERP (Audit Reform and Corporate Disclosure) Bill* Commentary on the draft provisions ,October 2003, (**CLERP 9 Commentary Paper**) p143
[31] *Corporate Law Economic Reform Program (Audit and Corporate Disclosure) Act 2004* (Cth)
[32] Explanatory Memorandum, [4.166]

> 'have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representative'

The Explanatory Memorandum highlighted the types of conflicts that the section was meant to cover. First, licensees must manage conflicts within the financial services business which would cover 'conflicts [arising] within one area of the financial services business … or across different areas of the business'[33]. Second, licensees also need to manage conflicts that arise between something within the financial services business and something outside the financial services business. Excluded from the statutory regulation were conflicts that arose entirely outside the financial services business although it was acknowledged that there may be other obligations to manage such conflicts[34].

Another significant point to note is that parliament required that licensees have in place arrangements for the 'management of conflicts of interest' rather than requiring licensees to avoid conflicts of interest. This ensured that financial conglomerates such as investment banks or large commercial banks with wealth management businesses would not need to disaggregate. The federal government recognised that financial conglomerates provide benefits to consumers in its commentary on the exposure draft of the bill[35]. Whilst the obligation to manage rather than avoid conflicts would be welcomed by industry, it is at odds with some of the other provisions highlighted above. Because of the obligation to disclose in FSGs and SoAs when dealing with retail clients, some financial services organisations are unable to avail themselves of other avenues for conflicts management. Therefore, there should be a reinstatement of the defences that existed in the former section 850 of the *Corporations Act.* This would bring consistency across the board to conflicts management in both the wholesale and retail sectors where comparable services are being provided.

CONCLUSION

The regulation of conflicts of interest in the Australian financial services industry does not provide a unifying principle that can guide industry clearly. By not being clear on the overall thrust on managing conflicts, it makes for a complex compliance regime that must increase the cost to industry in delivering financial products and services.

The enactment of s912A (1) (aa) is a necessary reform but it is somewhat limiting due to the scope of Chapter 7 of the *Corporations Act.* Further consideration of Chapter 7 needs to be given to bring the various conflicts management sections into alignment with the overall obligation placed on licensees in s912A (1) (aa).

The fact that a financial planner can be regarded as a fiduciary only makes matters more difficult. The issues that have been highlighted in respect of financial planners

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[33] Explanatory Memorandum, [5.599]
[34] Explanatory Memorandum, [5.600]
[35] CLERP 9 Commentary Paper, [580]

are not unique. These issues could apply equally to other advisers in financial services.

Saturday 26th July, 2008

Concurrent 4b
Copthorne Hotel

10.50am – 12.20pm

Chair:
Michael Robinson
Partner
Simpson Grierson
Auckland

Speakers:
Michael Harper
Partner
Chapman Tripp
Auckland

Kerryn Downey
Managing Partner
McGrathNicol
Auckland

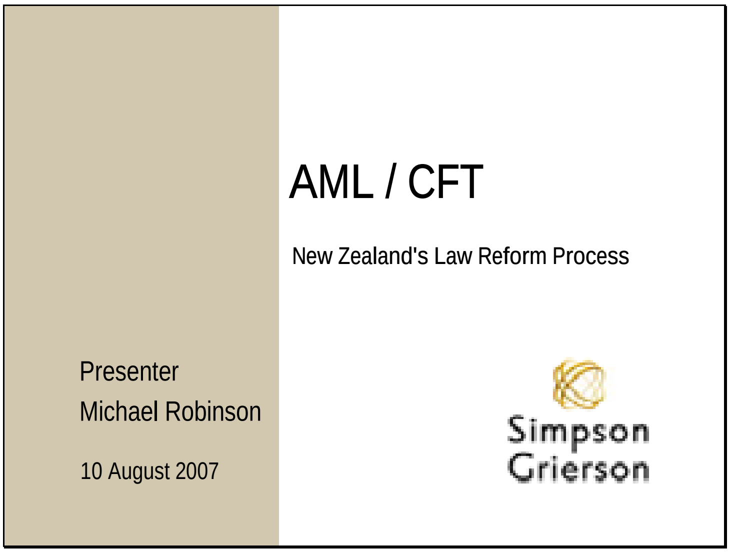
Colin Nicol
Partner
McGrathNicol
Melbourne

New Zealand Voluntary Administrators Regime and the Australian Experience

Chair/Commentary: Michael Robinson, Partner, Simpson Grierson, Auckland

AML/CFT - New Zealand's Law Reform Process

Slide 1



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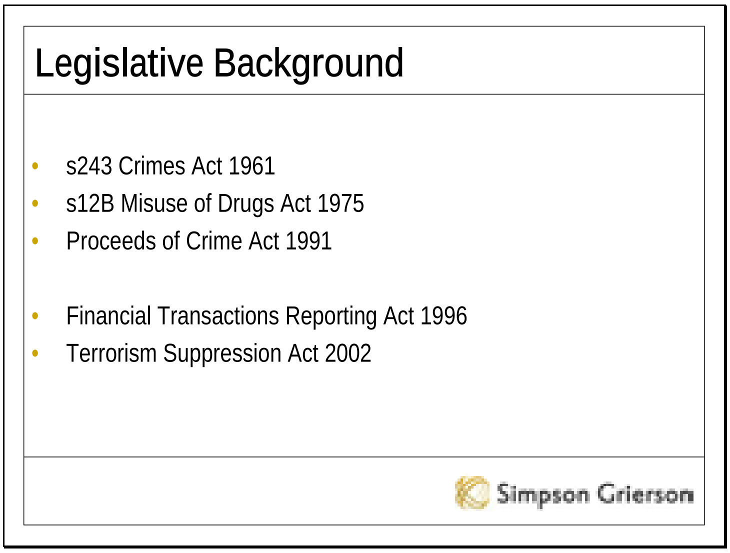

Slide 3

Financial Transactions Reporting Act ("FTRA")

- Verify identify of customers
  - New customer requests new facility
  - "Occasional transactions" in cash >$9,999.99
  - Occasional transactions on behalf of others
- Obligations to report suspicious transactions to FIU
- Retain records of transactions and customer verifications

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Slide 4

Number of Prosecutions / Convictions involving money laundering offences

Year	Engages in money laundering transaction (s257A(2)/243 Crimes Act)	Obtain/possess property with intent to launder (s257A(3)/243 Crimes Act)	Money laundering with proceeds of drugs
1995	0 (0)	0 (0)	0 (0)
1996	3 (3)	1 (0)	0 (0)
1997	5 (5)	2 (0)	0 (0)
1998	22 (11)	2 (1)	0 (0)
1999	18 (11)	2 (1)	0 (0)
2000	23 (13)	13 (1)	0 (0)
2001	24 (11)	8 (0)	0 (0)
2002	39 (15)	3 (0)	0 (0)
2003	43 (13)	2 (0)	0 (0)
2004	25 (8)	2 (1)	2 (0)
2005	22 (10)	3 (2)	3 (1)

Notes: Many cases involved multiple money laundering charges. In 2005 the 28 cases shown in the table involved a total of 193 charges with 13 convictions in respect of 38 charges.
Figures are provisional for 2005.
Source: Research & Evaluation Unit, Ministry of Justice (7 June 2006).

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Slide 5

Breaches of FTRA

Year	Failure to verify Identity s.13 FTRA		False or misleading statement in report s.22 FTRA		Other FTRA breaches	
	Reported*	Resolved**	Reported*	Resolved**	Reported*	Resolved**
1997	1	1	0	0	2	1
1998	1	1	0	0	0	0
1999	3	2	0	0	1	0
2000	0	0	0	0	0	0
2001	0	0	0	0	0	0
2002	1	1	1	1	3	0
2003	0	0	1	1	0	0
2004	0	0	1	1	1	0
2005	0	0	1	1	2	2
2006	0	0	3	2	1	0
TOTAL	6	5	7	6	9	3

* Reported includes all matters that have come to the attention of the police
** Resolved means all prosecutions warnings, cautions and diversions that have resulted from police investigations
Source: Statistics New Zealand

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Slide 6

Financial Action Task Force Review

- FATF's 40 recommendations
- Revised in 1996 and 2003
- 9 Special Recommendations Post 9/11
- Assessment in October 2003
- Benchmark – 1996 Recommendations
- APG/IMF Report – August 2005
- NZ's AML/CFT regime "generally sound"
- "Foundations for an effective preventive system were in place"
- No evidence of terrorist financing

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Slide 7

FATF – Compliance Gap

- CDD Requirements:
  - Identify / verify owners of companies and beneficiaries of trusts
  - "Occasional transactions" not just cash transactions
- Mandatory requirements for:
  - Internal AML procedures / employee training
  - Screening procedures when hiring
- Extend FIU's technology
- Most importantly: introduce an effective supervisory system

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Slide 8

Closing the Gap

- FATF Interagency Working Group
- Two years of consultation:
  - August 2005 – First Discussion Document
  - October 2006 – Third Discussion Document
  - 21 June 2007 – Working Group Response (+ 20 questions)
- Proposals not policy
  - Late 2007 – Draft Bill
  - End of 2008 – Implement Act

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Slide 9

Working Group Proposals - CDD

- Much more onerous CDD
  - Identify and verify all facility holders / beneficial owners
  - Extend CDD obligations to "non-cash" transactions
  - Verify power to act "on behalf of" companies and trusts
  - Investigate purpose / nature of business relationship
  - On-going due diligence
  - Retrospective application of CDD requirements

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Slide 10

Industry Response

- Why?
- Who?
- How? (risk based?)
- How much?

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Slide 11

Legislative Model

- Principles
  - Proportionality
  - Partnership
  - Effective compliance
- Options:
  1. Act / Regulation
  2. Act / Regulations / Rules
  3. Act / Regulations / Mandatory industry guidance
- Industry - Option 2 or 3
- Working Group – Option 1

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Slide 12

Supervisory Model

- Multi-Supervisor
  - Reserve Bank / Securities Commission / DIA
- Single-Supervisor
  - AUSTRAC model
- Costs / Efficiency / Flexibility

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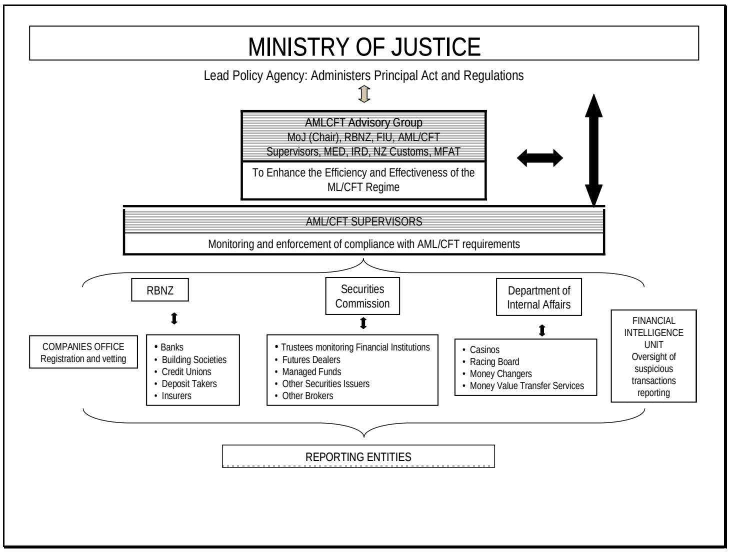
Slide 13



Slide 14

Trans-Tasman Issues

- 85% banking assets
- Compliance costs incurred anyway?
- Harmonisation in law and practice
- Regulatory arbitrage?

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Slide 15

Conclusions

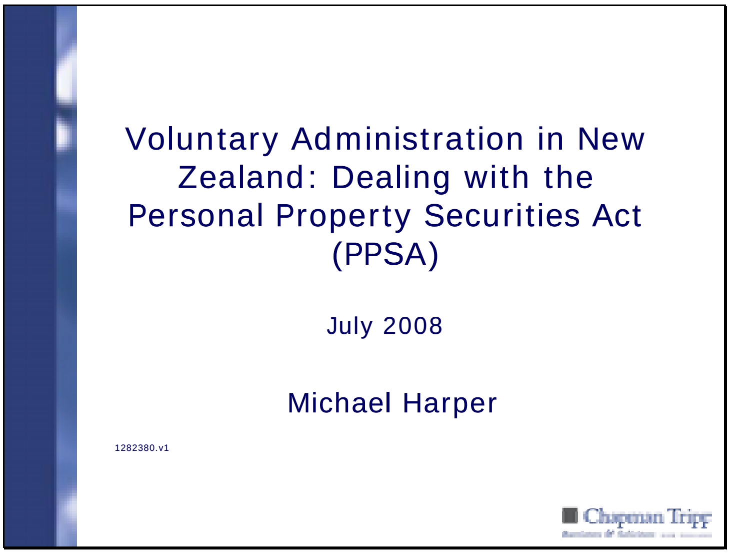
- Detail yet to come
- Potentially enormous costs
- Select committee process important
- Australian development important

Simpson Grierson

Michael Harper, Partner, Chapman Tripp, Auckland

Voluntary Administration in New Zealand: Dealing with the Personal Property Securities Act (PPSA)

Slide 1



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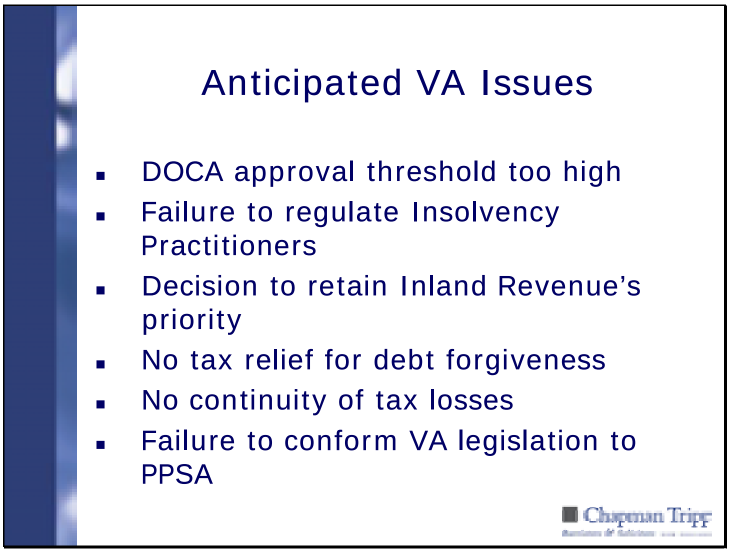

Slide 3

"Super Priority" PMSIs

- ROT suppliers will hold PMSI s74 (*inventory*) if:
  - ROT security interest has attached (ROT supplier has supplied goods, Debtor has rights in the goods and there is a valid security agreement); and
  - ROT security interest has perfected (by registering a financing statement on PPSR)
    - Such creditors obtain "super priority" ranking ahead of GSA holders for goods supplied **after** the date of the PPSR registration

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Slide 4

Icon Digital Entertainment Ltd

- Company established 2006
- Owned *Sounds, Blockbuster* and *Games Plus* stores
- Franchisor for further 15 stores
- No cash reserves – monthly losses
- 1st GSA \$13m, 2nd GSA \$2.7m
- Unsecured debts \$14m + landlords
- November 2007 unable to trade further

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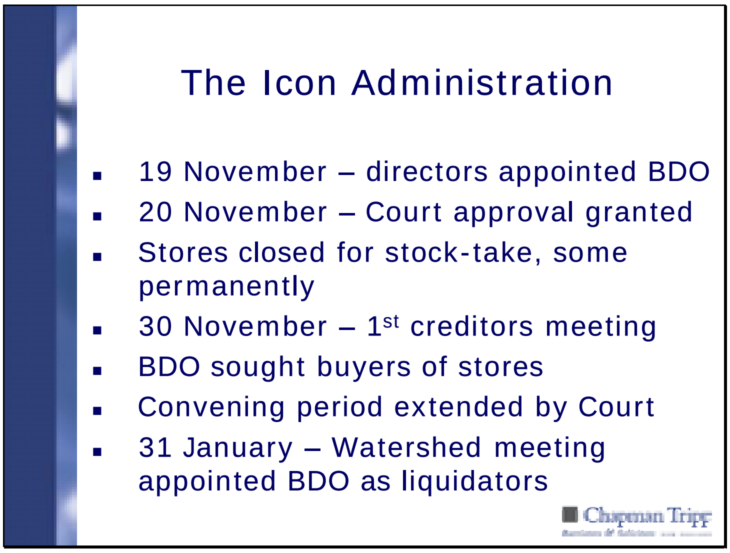
Slide 5



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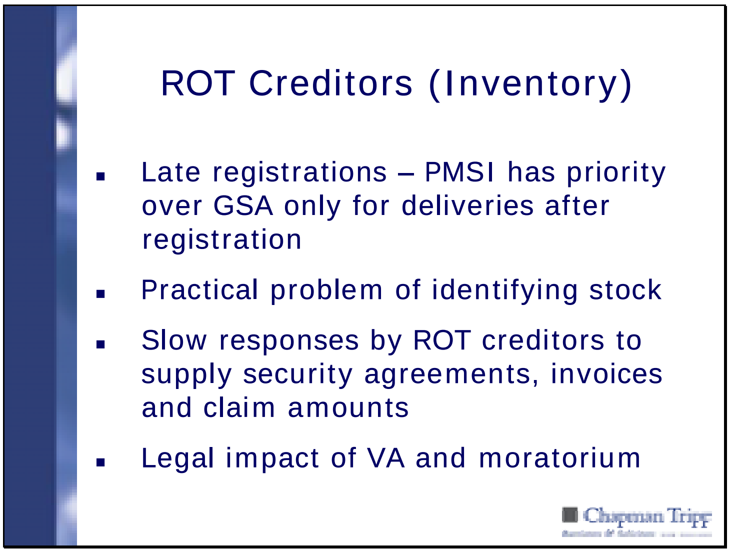

Slide 7

ROT Creditors (Inventory)

- ROT allows sales in the ordinary course of business
  - Goods ordinarily sold as part of usual trading
  - Goods sold subject to terms and conditions agreed between ROT supplier and the company
- Australia – sales in Administration are in ordinary course if contract complied with
- Administrators may therefore sell if contract allows it (must comply with contract (express or implied terms))
- Unless express provision, ROT creditor will have to revoke authority to sell if it doesn't want sales to occur
- Moratorium prevents repossession of goods supplied but not paid for (without the administrators' written consent or the permission of the courts) but does not give administrators mandate to sell
- Negotiate terms or seek court directions
  - Cost price? Retail price?

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Slide 8

Osborne Computer Corporation Pty v Riddell
(1995) 13 ACLC 1210

- *Issue: Whether administrator can sell goods subject to ROT clause, despite ROT suppliers requesting return of goods?*
- Administrator entitled to sell goods subject to ROT claims in "the ordinary course of business"
- Sale not in "the ordinary course of business" if made after owner had demanded their return in accordance with its contractual right to do so
- Administrator entitled to sell goods where sale "not" in ordinary course of business only on the condition that the invoice cost (the "price paid") for those goods was paid into a separate account upon receipt and ultimately remitted to ROT supplier
  - Allows business to continue – consistent with purpose of VA
  - Gives adequate protection to interests of suppliers

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Slide 9

Quantum

- *What if ROT creditors demand repayment of all the proceeds from sale of each good supplied?*
- Australian practice: Administrators can pay only the cost (invoice) price to ROT suppliers with perfected PMSIs in respect of goods supplied **after** the date of their PPSR registration
- To have to apply the entire proceeds of sale:
  - Would starve the company of cash needed to pay for expenses incurred in selling the goods
  - Does not reflect commercial reality. Would not do so in normal business practice
  - Unfairly advantages ROT suppliers at expense of all other creditors
  - Defeats objectives of VA – to permit a company to trade on with a view to maximising returns available to all creditors

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Slide 10

How should Administrators deal with ROT creditors?

- Treat all ROT suppliers with perfected PMSIs equally (not all ROT suppliers will be aware of need to make demand to bring license to deal to an end)
- Administrators should meet with ROT creditors
  - Discuss terms of payment and retention of monies
  - Set out amounts equal to invoice costs will be retained in separate account and paid to ROT suppliers for goods supplied after the date of each ROT supplier's PMSI registration
- Only sell goods subject to ROT PMSI once:
  - Arrangement agreed with ROT supplier (sales without consent, are not in the ordinary course of business)
  - With the leave or at the direction of the Court

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Slide 11

Can the assets of the Company be sold where there are subordinate security interests?

- *Australia*: Administrator can not dispose of:
  - Property subject to a charge; or
  - Property used, occupied or in the possession of Company but of which someone else is the owner or lessor;

  Unless the disposal is:
  - In the ordinary course of business;
  - With the written consent of the chargee, owner or lessor;
  - With the leave of the Court (if the Court is satisfied that arrangements have been made to protect adequately the interests of the chargee, owner or lessor)

Slide 12

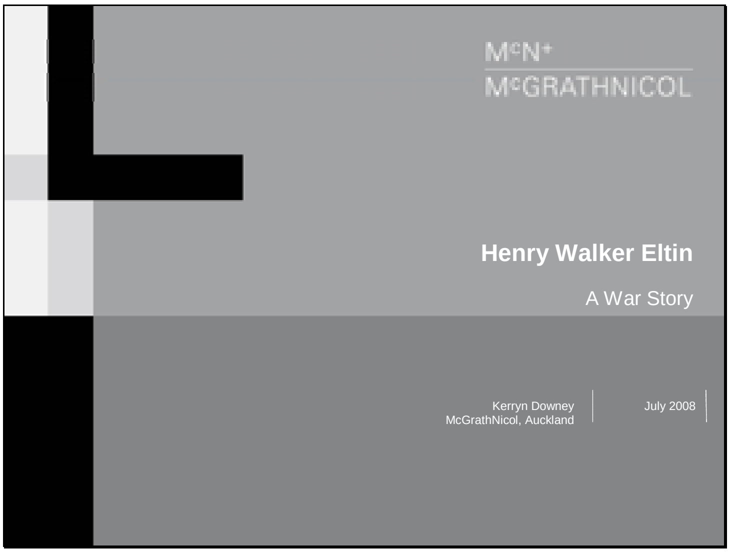
Can the assets of the Company be sold where there are subordinate security interests?

- *New Zealand*: No such provision
- Receivership – s30A subordinate security interests in property are extinguished on disposition of the property
- *Issue: VA does not extinguish subordinate security interests on disposition of the property*
  - Need a release of GSA holders security interests
  - Can negotiate to sell the business subject to ROT creditors security interests
- Same issue whether sell before or after Watershed Meeting
- Option: Seek court approval of sale and extinguishment of subordinate security interest?
  - Factors the Court will consider:
    - Is the sale in the interest of all the creditors
    - Have arrangements been made to protect adequately the interests of the chargee, owner or lessor

Kerryn Downey, Managing Partner, McGrathNicol, Auckland

Henry Walker Eltin – a War Story

Slide 1



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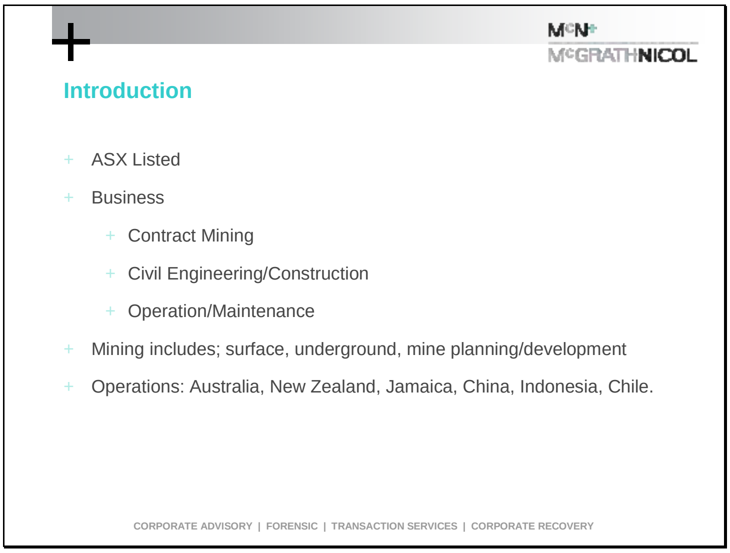

Slide 3

McGRATHNICOL

Introduction

- HWE – 31 January 2005 McGrathNicol partners appointed
- 42 Companies, 2 in New Zealand
- Registered in New Zealand as overseas company
- First major Voluntary Administration in New Zealand
- Unchartered waters

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McGRATHNICOL

HWE - Key Data

Total Assets	$730m
Net Profit	$15m
Bank Debt	$35m
Bondholders	$116m
Employees	4000
Creditors	7000+

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McGRATHNICOL

HWE - Reasons for Failure

+ Glencore refinancing withdrawn
+ Financing KPC Indonesia not committed
+ Weak financial planning/project management
+ Development of strategy at management, not board level
+ Deferral of essential CAPEX

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HWE - Key VA Strategies

- Sell non core assets and exit unprofitable contracts
- Improve operational performance of HWE Mining
- Implement profit improvement programmes
- Focus on capital requirements – Mining
- Align realisation strategies and explore alternatives under VA
- Structure DOCA pools

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HWE - NZ Business

- 2 Companies
- Profitable Contracts
- Revenues $6m per month
- 3 major contracts
  - Huntly – Solid Energy (New Zealand) Limited
  - Frasers – Oceana Gold (New Zealand) Limited
  - Waihi – Newmont Waihi Gold Limited

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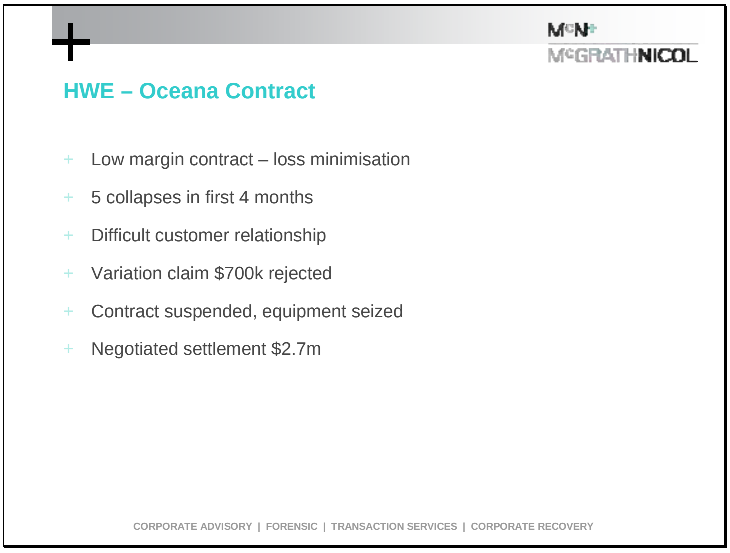
Slide 10



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HWE – Solid Energy

- $420m contract over 7.5 years
- Gross margin 13% - $55m over term
- Significantly behind in overburden stripping
- Weather, labour, equipment factors
- Remediation plan

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HWE – Solid Energy - Termination

- Default notice
- Termination notice 11 March 2005
- Stay under Australian law ineffective in NZ
- Extensive take over rights

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HWE – Solid Energy - Injunction

- Interim injunction obtained 11 March 2005
- Undertaking as to damages
- Further bond posted
- Work resumed within 48 hours
- Supplemental Agreement took 5 months
- Equity in contract preserved

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HWE – Business Improvement

- Exit Oceana Gold Contract
- Conversion Newmont to alliance
- Order new excavators
- Recruitment of additional labour
- Improve financial reporting
- Independent review of mine plan

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HWE – Sale of NZ Business

- Independent valuation of assets
- Macquarie Bank appointed as advisors
- Trade sale or recapitalisation
- Sale to Leighton Contractors Pty Limited $215m
- Novation of contracts

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HWE – Outcome for Creditors

- Convening period extended – 13 months
- Video linkup for meetings
- DOCA Approved – March 2006
- Early estimated outcome mining pool - 35-65 cents
- Final distribution all pools – 100 cents

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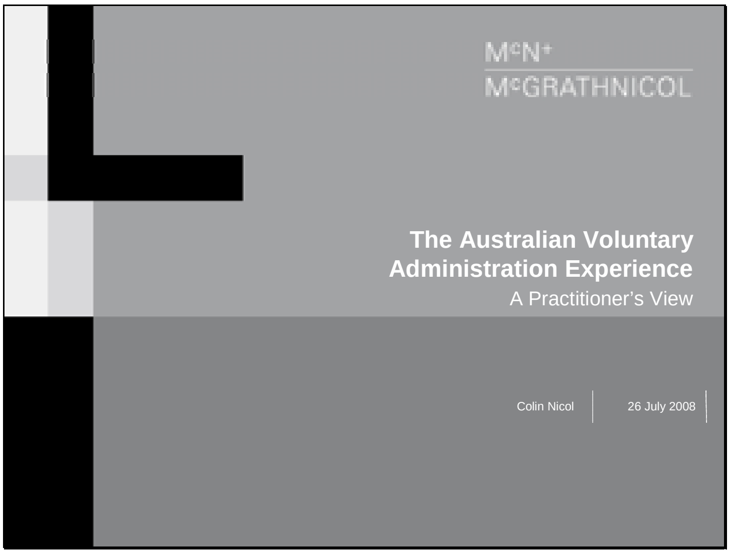
Colin Nicol, Partner, McGrathNicol, Melbourne

The Australian Voluntary Administration Experience - A Practitioner's View

Slide 1



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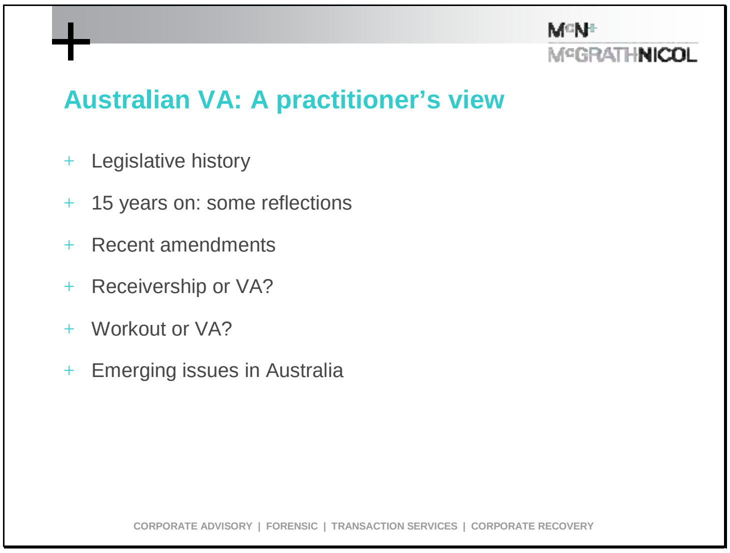

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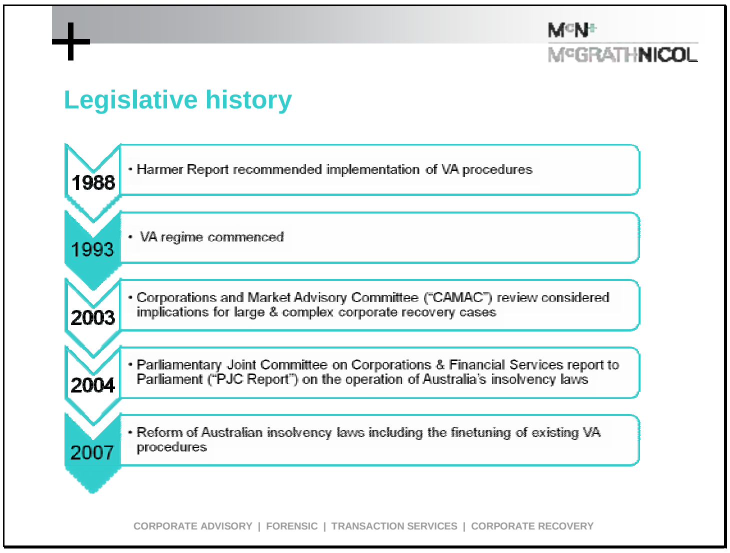

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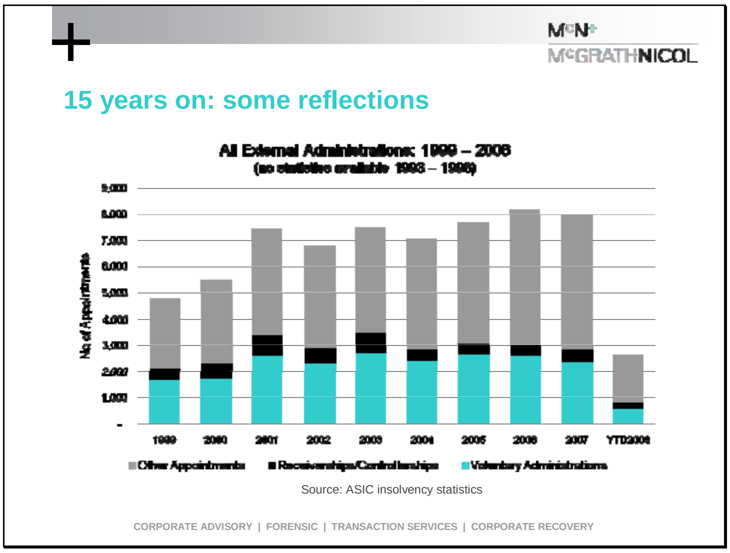

Slide 5

15 years on: some reflections

- High market acceptance from inception
- Embedded in corporate life
- Wide support across business community
- Nature of Deed of Company Arrangements (“DOCA”) proposals has evolved
  - Sale of business - quasi liquidation
  - Returns from profit of trading on
  - Pooling of assets and liabilities in corporate groups
  - “Holding” DOCAs
  - Creditors’ trusts

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Slide 6

15 years on: some reflections

- Fast and flexible means of dealing with corporate insolvency
  - Not Court reliant in the vast majority of cases
- Successfully applied in the largest of corporate collapses (although generally with assistance from the Courts)
  - Brashs Pty Ltd
  - ION Limited Group
  - Henry Walker Eltin Group Limited
  - Ansett Australia Group
  - Sons of Gwalia Limited

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Slide 7

15 years on: some reflections

- Problems with VAs
  - Owner managed businesses
    - can frequently be rehabilitated with new capital and a composition of creditors
  - Large companies
    - needs a new owner to survive
    - recapitalising/regearing companies out of VA is difficult/rare
  - Could therefore argue suits SME's better than large corporate collapses
  - Moratorium limited in comparison to US Chapter 11automatic stay
  - No "Debtor in Possession" finance market

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Recent amendments: PJC Report

Submissions advocating reform

- Statutory timeframes too tight and impractical
- Open to abuse (e.g. lack of independence of Administrator; DOCA used to aid phoenix activity)
- DOCA used as a mechanism for directors to avoid consequences of liquidation (investigations, insolvent trading claims)
- Arguments that it does not adequately support large/complex company failures

Conclusions of 2004 PJC report

- General view that VA process useful and valuable procedure
- Strikes reasonable balance between liquidation and reorganisation
- Flexibility adequately protects interests of debtors and creditors
- No general support for a change to a US Chapter 11 regime
- Range of reforms recommended

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Recent amendments: 31 December 2007 reform

+ Key changes for VA
  - Independence and remuneration – increased disclosure requirements
  - Option to appoint alternative administrator of ensuing DOCA or liquidation
  - Timeframes – longer convening timeframes and consistent referencing to business days
  - Entrenched protection of employee entitlements
  - Borrowing capacity – confirmation of indemnity and priority position
+ Concurrent legislative changes which may impact VA use
  - Fast track creditors voluntary liquidation process
  - Limited pooling of assets and liabilities in liquidations of corporate groups

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Receivership or VA?

+ Australian secured creditors are generally supportive of VAs
  - Independence of VA
  - Supporting customers and other creditors to find solutions
  - No indemnity required to be given
  - Not seen as bank driven (PR benefit)
+ When they won't support
  - Concerns about administrator's skills, independence or integrity
  - Contentious issues between creditor classes
  - Cost and publicity of creditor meetings
  - No money for lower ranking creditors

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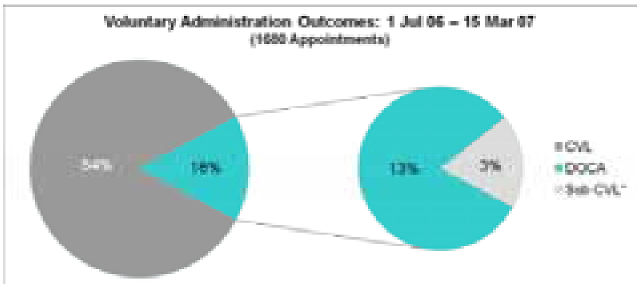
Workout or VA?

+ Few VAs result in viable DOCA



Source: ASIC, Report 129: Review of s439A reports for voluntary administrations
* Subsequent Creditors Voluntary Liquidation ("CVL") appointments as at 31 Dec 07

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Workout or VA?

+ Few DOCAs rehabilitate existing company
  - VAs can keep viable business going ,but frequently under new ownership
+ Why so few restructurings via DOCA?
  - Profound impact on company operations
  - Competitive position
  - Ability to maintain customers/market share
  - Costly
  - Obtaining credit is difficult
  - VAs focus on creditors not shareholders

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Workout or VA?

+ The Workout alternative
  - Workouts are less damaging to company's external standing
  - Large companies will usually exhaust workout options first
  - Key difficulties for distressed companies when deciding appropriate course are funding and solvency
  - Some workouts can be stymied by the difficulty in binding all creditors

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Emerging issues: International cases

+ Increase in distressed cases post credit market turmoil
  - Many of these are financed and/or have assets located internationally
  - UNCITRAL framework
    - Adopted in Australia on 1 July 2008; untested in Australian courts
    - Concept of COMI ("Centre of Main Interests") fundamental to the determination of where creditor rights can and can't be enforced

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Emerging issues: Shareholders as creditors

+ Sons of Gwalia decision established shareholders' rights to prove as creditors in relation to claims of deceptive or misleading conduct
+ Significant expansion in creditor numbers/class action lawyers
  - Impacts on meetings, voting as well as returns
    - e.g. ION Limited Group of Companies (Subject to DOCA)
      Provable unsecured creditors (excl s/h claims) $433 m
      3,200 shareholder claims (as at May 08) $122 m
+ Increased difficulty in identifying creditors and resolving claims
  - Basis for proof of claim unresolved legally - Causation/reliance or fraud on the market
  - How to deal with nominees and custodian holdings
  - Slow and costly with uncertainty of final outcome
+ CAMAC report on recommended legislative response anticipated in 2008

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Conclusions

+ Hard to remember life before VA
+ Much needed procedure, strongly adopted and largely successful
+ Not a panacea, particularly for large/complex cases
  - Courts have generally assisted where called upon whilst upholding the principles
  - Not the only solution – workouts are usually preferable where possible

CORPORATE ADVISORY | FORENSIC | TRANSACTION SERVICES | CORPORATE RECOVERY

Saturday 26th July, 2008

Plenary
Millennium Hotel

12.30pm – 1.30pm

Chair:
Nuncio D'Angelo
Partner
Mallesons Stephen Jaques
Sydney

Speaker:
Prof. John Carter
Professor of Commercial Law
University of Sydney
Consultant to Freehills Lawyers
Sydney

Indemnities - more than meets the eye?

Lawyers spend hours drafting and negotiating indemnities, when surprisingly little of their true effect is known or understood. Are those hours well spent? Issues include the nature of the obligation, the nature of the remedies and questions of mitigation and remoteness.

Chair/Commentary: Nuncio D'Angelo, Partner, Mallesons Stephen Jaques, Sydney

Indemnities, Gross Negligence and The 'Accidental Insurer' – A Commentary

"Despite the prevalence of indemnity clauses in modern contracts, it appears that the task of drafting, negotiating, reading and understanding indemnities may be getting more complex." [36]

"Indemnity clauses are within the common contracting experience of Australian business. Despite this commonality, there is little consistency in drafting, and their meaning is often misunderstood." [37]

"Express contractual indemnities are to be found in nearly all leases, contracts for sale, loan documents, security documents, services contracts and in many other agreements…yet despite this, their legal nature and effect are surprisingly nebulous." [38]

Introduction

The genesis of this session of the Conference lies in discussions Professor Carter and I had in the context of a paper I prepared on the subject of indemnities in early 2007.[39]

Without any empirical evidence whatsoever, I would venture to guess that almost every practitioner at this Conference has, in the last month, drafted, negotiated or reviewed a document that contained an indemnity. It may have been a major part of the document, or it may just have been an ancillary clause, sitting quietly, unnoticed and unloved, as part of the so-called "boilerplate".

Most of us in banking and finance practice like to consider ourselves competent and knowledgeable contract lawyers and drafters, who do a fine job for our clients. We know indemnities, we've worked with them for years, we surely have mastered them and their many useful and helpful ways. We know all the tricks and negotiating points, right?

It is trite to say that the main objective of a negotiated indemnity is to allocate risks as between consenting parties in a managed and certain way, but that is certainly the theory. That proposition, of course, assumes that the negotiating parties are aware of the variables, and that the law will support them with clear rules that are consistently applied. After all, business craves certainty.

But we have just heard Professor Carter, a leading contract law academic and commentator, use an analysis of one particular type of indemnity, the "party-party" indemnity, as a vehicle to demonstrate a somewhat worrying fact about indemnities generally - that, despite being widely used in Australian commerce:

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36 Lithgow, C and Neal, L "Contract Law in Practice - 2005 in review - penalties, indemnities and so much more"(2006) 2(10) CMP 148.

37 Gosewisch, D "Difficulties with indemnities between business entities" (2006) 34 ABLR 89.

38 Zakrzewski, R "The Nature of a Claim on an Indemnity" (2006) 22 JCL 54, at 54.

39 Subsequently published as D'Angelo, N, "The Indemnity: It's All in the Drafting" (2007) 35 ABLR 93.

- they have stubbornly defied attempts at precise definition and consistent analysis, largely because they are creatures of almost infinite flexibility;[40]
- the mere use of the word "indemnity" in a clause or document does not assure a certain outcome in relation to effect, operation or remedy;
- the quantity, quality and consistency of available judicial discussion does not reflect their degree of use and importance in Australasian commerce; and
- there is a surprising level of uncertainty at even the most basic level.

This is indeed, as Professor Carter observes, a rather alarming state of affairs.

In his conclusions, Professor Carter has very helpfully pulled together the various and disparate strands presented by the cases into a very useful summary of principles, at least in relation to indemnities where the promise is unqualified.

But, by his own admission, that summary is not, and cannot be, exhaustive - in this area, there are more questions than answers.

Indemnifying someone against their own negligence - including by "accident"

Even as the ripples from Professor Carter's presentation are making their way across the surface of the pond, I propose to throw in yet another stone.

I want to briefly consider further issues around what the Professor describes as "bare" indemnities,**[41]** using 2 examples in common enough use. The discussion raises the practical questions of whether to include a carve-out for negligence, and the related question whether it is it worth fighting over the difference between "negligence" and "gross negligence" in negotiating such carve-outs.

The core questions are these:

- to what extent can a person be indemnified for their own negligence and what rules apply to the drafting and interpretation of such indemnities?
- is there a difference between negligence and "gross negligence"?
- can you be held to indemnify someone against their own negligence without actually intending to do so?[42]

[40] As opposed to, say, "mortgages", a term which, within a narrow range of variation, is universally understood in the English common law world as to meaning and effect.

[41] A "bare" indemnity is where Party A indemnifies Party B against all liabilities or losses incurred in connection with given events or circumstances, but without setting out any specific limitations.

[42] Remember that the fundamental basis of contractual construction is the "objective rule", ie the analysis of the intention of the parties, and the legal rights and obligations under the contract, turn on what their words and would be reasonably understood to convey, not upon actual or subjective beliefs or intentions: *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd* (2004) 218 CLR 471. In other words (as counterintuitive as it may seem to commercial persons), in endeavouring to ascertain the intention of the parties, the actual intention of the parties is not only not determinative, it is indeed irrelevant: *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337.

The scenario

These questions come up in the context of qualifications or "carve-outs" (usually indemnifier-initiated) from what would otherwise be **"bare"** indemnities which are in **"third party"** form,[43] in an effort to stop them operating as **"reverse"** indemnities.[44]

In the banking and finance context, this scenario arises in (though not only in) a couple of interesting everyday contexts

- "guarantor indemnities"; and
- indemnities in mandate and engagement letters in favour of investment banks

(each described and exemplified more fully below).

But first - the executive summary:

Stop the presses: "Carve-outs can be bad for indemnifiers and good for financiers"

When it comes to coverage for negligence in indemnities in a financing context, let me make 2 counter-intuitive, and possibly controversial, statements:

- as an intending indemnifier, when faced with a "bare" indemnity (ie widely drafted coverage but with no carve-out for any kind of negligence), you may be better off staying silent and not pushing for a carve-out; and
- as a financier intending to receive an indemnity, you may be better off with a carve-out for "gross negligence" than no carve-out at all.

Why?

If there is no carve-out, and the indemnity is silent as to the matter of negligence, it is impossible to predict, on the current state of the authorities, whether the indemnity will be held to include the financier's own negligence. If an Australian court were asked to resolve the ambiguity today, there is real doubt as to the course it would take, the rules of interpretation it would apply and the result it will deliver - parties could end up with either result.

Of course, if either the word negligence is included in the body of the indemnity or, conversely, there is an express carve-out for it, the matter clarifies and the doubt is removed.

A carve-out for "gross negligence", however, is a different matter, because it raises the risk that the indemnity will apply in the case of "mere" negligence.

So, if you're an indemnifier…..

Thus, an intending indemnifier faced with a request for a "bare" indemnity, is confronted with a Catch 22. Without any sort of carve out at all, there is an opportunity to repel an argument that it has agreed to indemnify the financier against its own negligence. However, if the indemnifier pushes for a carve-out for negligence but fails, and is forced back to accepting "gross" negligence, then it may well be worse off than if it had not mentioned negligence at all. By such a carve-out, the court is given an additional signpost in its task of interpreting the indemnity, and is almost invited to regard the exclusion for "gross negligence" as evidencing an intention that the indemnity should

43 A "third party" indemnity is where Party A indemnifies Party B against claims brought against Party B by a third person, ie the relevant "event or circumstance" for "bare" indemnity purposes is the making by the third party of a claim against Party B.

44 A "reverse" indemnity is where Party A indemnifies Party B against losses incurred as a result of Party B's *own acts and/or omissions* eg negligence.

include "mere" negligence. Thus, an indemnifier, may be better off leaving it "bare" and taking their chances with the ambiguity.

And if you're a financier…

On the other hand, a financier intending to receive an indemnity in "bare" form faces an equal but opposite dilemma. It takes the chance that the indemnity may be held not to cover it for its own negligence, for the reasons mentioned above. On the other hand, conceding a carve-out for "gross negligence" significantly enhances its chances of gaining coverage for its own "mere" negligence.

Strange but true.[45]

Let's look at 2 real life examples.

"Guarantor indemnities"

This is the name Professor Carter gives to the more-or-less market standard indemnity which is coupled with and supports a guarantee in a financing context, and operates to protect the financier if the guarantee fails for any reason.46 A typical (short-form) formulation is as follows:

> As a separate undertaking, the Guarantor indemnifies the Financier against any liability or loss arising from, and any costs, charges or expenses incurred in connection with, the Guaranteed Money not being recoverable from the Guarantor under the Guarantee in clause X, or from the Debtor, because of any circumstance whatsoever.

(for the purposes of the following discussion, let's call this the **"Example Guarantor Indemnity"**)

In this form, this would be a classic **"bare"** indemnity, with clear potential for operation as a "reverse" indemnity, ie protecting the Financier from its own acts and/or omissions (including negligence). These indemnities are usually quite widely drafted and do not usually carve out the financier's own negligence. Well advised borrowers who are across the issue will often insist on a carve-out, and the negotiations often settle on something along the following lines:

> …but only to the extent that the liability, loss, costs, charge or expense does not arise as a result of wilful misconduct, fraud or **gross negligence** on the part of the Financier or any of its employees.[47]

A carve-out like this takes it into the realms of what can be described as a **"proportionate"** indemnity.48 In this case, the apportionment out of the indemnity is in respect of conduct which constitutes wilful misconduct, fraud or ***gross negligence***.

This, of course, leaves a question mark over "mere" negligence, ie negligence which is not so culpable as to be "gross".

Mandate letters and indemnities

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45 For completeness, the effect of a carve-out that mentions a range of matters like bad faith, wilful misconduct and fraud, but is silent on any kind of negligence, is unclear. There may be arguments either way, ie on the one hand, by not carving out negligence while they were at it, the parties may have intended the indemnity to include it. On the other hand, it is arguable that negligence wasn't carved out because the parties assumed, mutually, that the indemnity did not include it in the first place.

46 For a detailed discussion, see Berg A "Rethinking Indemnities, Part 1" (2002) JIBFL 360.

47 *En passant*, similar carve-outs are often seen in clauses limiting trustees' personal liability - raising corresponding issues in that context.

48 A term sometimes used to describe indemnities which are the opposite of "reverse" indemnities, ie Party A indemnifies Party B against losses *except* those incurred as a result of Party B's own acts and/or omissions. In other words, those acts/omissions are "apportioned out" of the indemnity.

In mandate or engagement letters for arranging and underwriting services (for both debt and equity fundings), the investment bank providing the services to the appointing company invariably requires a broad indemnity. A common formulation is as follows:

> You agree to indemnify and hold harmless the Arranger/Underwriter, any affiliates, subsidiaries or branches of the Arranger/Underwriter, each other person, if any, controlling the Arranger/Underwriter, and any of their directors, officers, agents, employees, advisers and representatives (each, an **"Indemnified Person"**) from and against any losses, claims, damages, liabilities, actions, proceedings, demands, costs and expenses (including legal fees on a full indemnity basis) **("Losses"**) related to, arising out of, or in connection with, the matters which are the subject of the commitment made under this letter, the Term Sheet, the Financing and the loans thereunder and the performance by any Indemnified Person of the services contemplated in this letter…, whether or not the Transaction is consummated. *You will not, however, be responsible for any Losses that are finally judicially determined by a court of competent jurisdiction to have resulted from the wilful misconduct, fraud or **gross negligence** of the relevant Indemnified Person.*

(let's call this the **"Example Mandate Indemnity"**)

Absent the last sentence, again this would be a "bare" indemnity, with clear potential for operation as a "reverse" indemnity. Again, the carve-out in the last sentence converts it into a **"proportionate"** indemnity, where the apportionment is in respect of conduct which constitutes, among other things, ***gross negligence***.

But, again, not "mere" negligence.

But is there such a thing as "gross" negligence?

First, let us cut to the chase and assume that "gross negligence" exists in Australasian law as a concept distinct from "mere" negligence. I realise that, in some quarters, a view is still harboured that it is a nonsense, but I do not agree with that view. I say this because:

- there is evidence in the authorities that there is a difference and that gross negligence exists, even if we acknowledge that there are some cases in Australia, UK and Canada that go the other way;[49]
- recently, Finkelstein J of the Federal Court assumed it does exist, saying that gross negligence *"must at least be carelessness of so aggravated a nature as to amount to the neglect of precautions which the ordinarily reasonable man would have observed and to indicate an attitude of mental indifference to obvious risks";* [50]
- other judges, in a variety of contexts (civil and criminal) have used the expression to denote a higher level of culpability than "mere" negligence

49 The cases are a mix of civil and criminal, and in the civil sphere deal with a range of contexts across professional negligence and personal injuries cases: see *Hinton v. Dibber* (1842) 2 QB 646; *Colonial Bank v. M'Conkey* (1870) 1 AJR 91; *City of Fitzroy v. National Australia Bank of Australasia Limited* (1890) 16 VLR 342; *Paul v Dauphin* [1941] 1 WWR 43; *McCulloch v Murray* [1942] SCR 141; *Scardina v LaRoche* [1951] 1 DLR; *Dalgety & Co. Limited v. Warden* [1954] QSR 251; *Hunter v Hanley* 1955 SLT 213; *Jackson v. Millar* [1973] 1 OR 399; *R v. Stephenson* [1976] VR 376.

50 *CMG Equity v ANZ Banking Group* (2008) 65 ACSR 650 (3 April 2008), at [28], citing *Hudston v Viney* [1921] 1 Ch 98 at 104.

(some equating it to "recklessness"), often completely unselfconsciously and without feeling the need to justify its use;[51]

- the expression is used in legislation;[52]
- "the market" seems to think there's a difference, because it is an expression in common use in Australasian documents and practice. Charlesworth on Negligence observes that *"[gross negligence] is an expression in regular use among lawyers, and to deny it a meaning would be pedantic. It is intended to denote a high degree of careless conduct…and is of considerable practical utility"*. [53]

There's no *per se* rule against indemnifying negligence - *Qantas v Aravco*

Next, even leaving aside contracts of insurance (such as professional indemnity insurance), there is nothing about a private person contracting to indemnify another for their own negligence that is repugnant in principle to Australasian law. The indemnity in Qantas Airways Ltd v Aravco Ltd[54] is an example of such an indemnity. There, Qantas entered into a contract with Aravco to perform certain services in relation to an aircraft operated by Aravco but owned by BAT Industries Plc ("BAT"). As a result of Qantas' negligence, the aircraft suffered damage. BAT sued Qantas for the damage to the aircraft. Qantas admitted liability for the damage, but, by a cross-claim, sought indemnity from Aravco for the damages that it had to pay to BAT. Qantas' claim for indemnity was based on clause 4 of its contract with Aravco, which provided as follows:

> *The Operator [Aravco] agrees* ***regardless of any negligence on the part of Qantas*** *to release, hold harmless and indemnify Qantas from and against all liabilities, claims, damages, losses, costs and expenses of whatever nature, howsoever occurring which may accrue against or be suffered by Qantas arising out of or in any way connected with the performance of the said services unless caused by wilful misconduct on the part of Qantas or any of its servants or agents acting within the scope of their employment* (emphasis added)

Leaving aside the detailed trade practices arguments which arose,[55] the High Court held that Qantas was entitled to an indemnity from Aravco for its (ie Qantas') liability to BAT.

In that case, the indemnity was quite explicit about the status of Qantas' negligence. But what if an indemnity does not expressly mention negligence, yet is wide enough on a reading of its terms to include it?

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51 See *Vacuum Oil Pty Co Ltd v Stockdale* (1942) 42 SR(NSW) 239*; Mauroux v Sociedade Comercial Abel Pereira da Fonseca SARL* [1972] 2 All ER 1085; *Red Sea Tankers Ltd v Papachristidis (The Hellespont Ardent)* [1997] 2 Lloyd's *Rep 547*; *Rankin v Marine Power International Pty Ltd* [2001] VSC 150; R v De'Zilwa (2002) 5 VR 408; *National Roads and Motorists Association Ltd ACN 000 010 506 v Nine Network Australia Pty Ltd* ACN 008 685 407 [2002] ACTSC 37; *R* v Leusenkamp [2003] VSCA 193; *DPP v Reynolds and Ors* [2004] VSC 533; *In the Marriage of Petrovic and Spanjic* (2004) 190 FLR 10; *Xue Mei Bai v Minister for Immigration (No 2)* [2006] FMCA 129; *Anderson v Hassett (No 2)* [2007] NSWSC 1444.

52 See section 15 of the Law Reform Act 1995 (Qld); section 318(2)(b) of the Crimes Act 1958 (Vic); section 19A(1) of the Occupational Safety and Health Act 1984 (WA).

53 Walton, C et al, *Charlesworth and Percy on Negligence* (London: Sweet and Maxwell, 11th ed, 2006), at [1-11].

54 (1996) 185 CLR 43.

55 This issue does throw up various questions under the Trade Practices Act 1974, including those traversed in this case, ie sections 68 and 74, but also sections 52, 68A and 75AZC(1)(k) and others. *Qantas v Aravco* is sometimes held out as deciding that section 52 liability for misleading and deceptive conduct can be sidestepped by use of a "reverse" indemnity, even if it cannot be excluded via a more traditional exclusion or limitation clause. The logic behind that assertion is flawed. TPA issues are not addressed in this paper.

On their face, what is the effect of the two example indemnities above?

If, as we have seen:

- it is possible under Australasian law to indemnify someone against their own negligence; and
- "gross negligence" does exist as a separate matter from "mere" negligence,

then:

- what is the effect of a "bare" indemnity that does not mention the word "negligence" but is wide enough on its terms, on at least one reading, to capture it anyway (as in the example indemnities set out above, absent the carve-outs)?
- what is the effect of a "gross negligence" carve-out (again, as in the example indemnities)?

Let us first put these questions in their true commercial context so that their impact is not lost in the legal technicalities.

In his paper, Professor Carter makes the startling, but clearly correct, observation that "where A contracts to indemnify B against the occurrence of an event, A is acting as B's 'insurer' in relation to the risk that the event will occur".[56]

On this analysis, the exclusion for "gross negligence" purports, on its face, to deliver a somewhat surprising result - the indemnifier is insuring the financier against its own negligence (so long as it is not "gross"). [57]

So, in the case of the Example Guarantor Indemnity, in effect the Guarantor could be insuring the Financier against its own negligence in, say, an act or an omission which undermines the enforceability of the guarantee,[58] or causes loss or damage to the borrower, so long as that negligence is not so culpable as to constitute "gross negligence".

In the case of the Example Mandate Indemnity, if in undertaking its duties under the arrangement, the investment bank (or any other "Indemnified Person") causes a loss to a third party (eg an intending investor) through its negligence, then provided again that negligence is not "gross", the investment bank might seek indemnification from its "insurer", the appointor.

These results might come as a surprise to the Boards and Senior Management of companies giving these indemnities, and yet these clauses are more or less market practice - and attempts during negotiations to rectify the situation are often met with a firm (and not always polite!) rejection, often on that basis alone. [59]

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56 Note, for example, that professional indemnity insurance constitutes, in effect, an indemnity from Party A (insurer) in favour of Party B (insured professional) against losses arising from a claim made against Party B by a third party (ie the client) as a result of Party B's negligence.

57 While this might seem a surprising result in a banking & finance context, in the building and construction context it has been argued "*there is nothing improbable in a construction which made the [indemnifier] liable to indemnify the [beneficiary] against the consequences of the [beneficiary's] own wrongdoing 'because the obligation would be backed by the insurance policies in the names of the [indemnifier] and the [beneficiary], which [another clause in the contract] required the appellant to effect*": *Ellington v Heinrich Constructions Pty Ltd* [2004] QCA 475. This, of course, assumes a perfect fit between the indemnity and the coverage provided by the insurance - a brave assumption indeed!

58 Noting that indemnities are not necessarily subject to the same fragility and rules regarding release of sureties as guarantees - indeed, as a general proposition, if someone is a "primary obligor", as an indemnifier usually is, then they will not be a "surety": *Heald v O'Connor* [1971] 2 All ER 1105.

59 At least in relation to the indemnities like the Example Mandate Indemnity, the outcome is sometimes justified by investment banks on "agency theory", ie it is consistent with the bank acting as the appointor's agent in going out into the market and seeking interest among investors. The countervailing arguments

"Are you serious? Am I really insuring the bank against its own negligence?"

In short - maybe. Following on from Professor Carter's observations, this is another example where the state of the law on indemnities is in such disarray that neither counsel to the financier nor the indemnifier's lawyers can advise their client with total confidence.

The problem is that the normal rules for contractual construction seem not to apply to indemnities, and some courts have even said that indemnities have their own peculiar set of rules for interpretation. The courts have had many attempts at defining how negligence should be treated in the context of an indemnity.**[60]** The problem is that, over time, the courts have offered up a multiplicity of "principles" and "rules" and other guidelines, which are inconsistent - indeed sometimes in direct conflict - and can actually lead to opposing results.

It appears that there is something of an internecine war afoot among Australian courts over the correct rules for the interpretation of indemnities, and the issue of negligence is one of the key battlefields.

It is not overstating the argument to say that we are left with an unworkable melange.

Let us now look at these "rules".

The interpretative rules for indemnities + negligence

The core Canada Steamship rule

Let us start with the traditional rule, familiar to us from cases on exclusion and limitation clauses, that, if a person is to be indemnified against their own negligence, the language of the indemnity must do so quite explicitly and unambiguously:

> *[because it is] inherently improbable that one party should agree to discharge the liability of the other party for acts for which [the other party] is responsible … the imposition by the proferens on the other party of liability to indemnify him against the consequences of his own negligence must be imposed by very clear words* [61]
>
> and
>
> *I do not see how a clause can 'expressly' … indemnify the proferens against his negligence unless it contains the word 'negligence' or some synonym for it* [62]

(for the following discussion, let's call this the **"core Canada Steamship rule"**[63]).

Commercial construction

Then we have the critical overlay of the concept of "commercial construction", which has been described as the most significant development in the modern law of contract

are that (a) if an agent wants coverage for its own negligence, it should ask for it directly, and (b) absent overt agreement, the appointor is unlikely to have intended implicitly to authorise the investment bank to act negligently on its behalf.

60 Those rules are closely related to, and in some cases come from, the rules that apply to exclusion and limitation clauses generally (indeed, indemnities can be and are often drafted to operate as an exclusion or limitation of liability). In *Smith & Ors v South Wales Switchgear Ltd* [1978] 1 All ER 18 the House of Lords stated that the *Canada Steamship rules* (discussed below) which related to an exemption clause, also applied to an indemnity provision: at 25. Similar statements have been made in the Australian courts.

61 *Smith & Ors v South Wales Switchgear Ltd* [1978] 1 All ER 18 per Viscount Dilhorne at 22, applying the principles in Canada *Steamship Lines Ltd v R* [1952] AC 192.

62 Ibid, per Lord Fraser of Tullybelton, at 25.

63 This is, in effect, a compression of the 3 so called "*Canada Steamship rules*", discussed further below.

construction.[64] Its objective is to construe the relevant words according to what a reasonable person would understand them to mean in the broader commercial context, rather than by reference to technical rules, so as to respect the substance of a bargain rather than its form. The incidents of commercial construction include:

- taking into account the surrounding circumstances or "factual matrix" of the contract, in all cases and not only in exceptional cases;
- approaching the matter in a practical manner, so as to give the contract a reasonable business operation;
- asserting a common sense approach, favouring a commercially sensible construction, even if it means ignoring a lack of clarity;
- adopting a construction that seeks to avoid the contract failing for want of certainty;
- adopting a uniform approach to all contracts, regardless of their type or nature (ie avoiding "special" rules for particular types of contract); and
- a preference for rejecting particular construction approaches such as "strict" or "literal" construction, in favour of an approach which a reasonable commercial person would take to be the intended meaning or application of a contract.[65]

(let's give this its correct name, **"commercial construction"**).

Commercial construction is closely related to the concept of "natural meaning" in the interpretation of contracts.[66] For example, the High Court has said, relevantly, that:

> *the interpretation of an exclusion clause is to be determined by construing the clause according to its natural and ordinary meaning, read in light of the contract as a whole…and, where appropriate, construing the clause contra proferentem in the case of ambiguity* [67]

That was a case to do with exclusion clauses generally, but it was acknowledged by the Victorian Supreme Court in 1990 that these principles can and should apply to indemnities.[68]

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64 Peden E and Carter JW "Taking Stock: the High Court and Contract Construction" (2005) 21 JCL 172, at 178.

65 This list is paraphrased from Peden and Carter, fn 64, at 178. Several of the cases on "commercial construction" are insurance cases. Contracts of insurance have been described as "the classic contract of indemnity": Carter JW and Yates D "Perspectives on Commercial Construction and the Canada SS Case" (2004) 20 JCL 233, at 245. See, too, the cases cited by Spigelman CJ in *Gardiner v Agricultural and Rural Finance Pty Ltd* [2007] NSWCA 235, at [7] - [13].

66 See the discussion in Carter JW and Peden E "The 'Natural Meaning' of Contracts" (2005) 21 JCL 277.

67 *Darlington Futures Ltd v Delco Australia Pty Ltd* (1986) 68 ALR 385, at 391.

68 *Schenker and Co (Aus) Pty Ltd v Maplas Equipment and Services Pty Ltd* [1990] VR 834.

(let's call this the **"Delco principle"**).

The Brambles rule

Then we have the High Court's decision in 2004 in *Andar Transport Pty Ltd v Brambles Ltd*[69] (discussed in more detail below), which cut right across the rules of commercial construction[70] and the Delco principle, concluding instead that there are "special" rules for indemnities as follows:

> [There are] *principles of construction applicable to contractual indemnities…Notwithstanding the differences in the operation of guarantees and indemnities, both are designed to satisfy a liability owed by someone other than the guarantor or indemnifier to a third person…[so therefore the principles applicable to construing guarantees are] relevant to the construction of indemnity clauses…Ambiguous contractual provisions should be construed in favour of the surety … A doubt as to the provision in a guarantee should therefore be resolved in favour of the surety* …[Accordingly, an ambiguity in an indemnity should] be construed in favour of [the party providing the indemnity][71]

(let's call this the **"Brambles rule"**)

Even the NSW Court of Appeal does not agree with itself

But wait, there's more. We have two decisions of the NSW Court of Appeal, delivered in 2007, which appear to take opposing views on the Brambles rule and its relationship with the core Canada Steamship rule, the Delco principle and commercial construction.

In *BI (Contracting) Pty Limited v AW Baulderstone Holdings Pty Limited* **[72]** the Court, in supporting and purporting to follow the Brambles rule, added a gloss:

> *where the parties have deliberately chosen to adopt wording of the widest possible import, that wording is not to be ignored, and where wording is susceptible of more than one meaning, regard may be had to the circumstances surrounding the execution of the document as an aid to construction* [73]

In that case, a subcontractor who agreed to *"indemnify the builder against all liability relating to the subcontract works"* was held liable to indemnify the builder for damages paid by the builder to an employee (of the builder) arising out of the builder's own negligence - a result the subcontractor sought to avoid by invoking the core Canada Steamship rule. Thus, despite the fact that the indemnity made no mention of *"the word 'negligence' or some synonym for it"*,**[74]** the subcontractor was, in effect, held to be the builder's "insurer" against its own negligence.

(let's call this the **"BI (Contracting) outcome"**)

What all of the above illustrates, according to Spigelman CJ of the NSW Court of Appeal (in a differently constituted Court from that which decided *BI (Contracting)*), is that there is more than one principle involved in the task of contractual interpretation of indemnities.**[75]** Clearly less than comfortable with the *Brambles*

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[69] (2004) 206 ALR 387.

[70] Including the Court's own decision earlier in the year in *Pacific Carriers Ltd v BNP Paribas* (2004) 218 CLR 451 - see the discussion below under "***The Andar v Brambles decision - the details***".

[71] (2004) 206 ALR 387, at [17], [18] and [29].

[72] [2007] NSWCA 173.

[73] *BI (Contracting) Pty Limited v AW Baulderstone Holdings Pty Limited* [2007] NSWCA 173.

[74] See footnote 62.

[75] *Gardiner v Agricultural and Rural Finance Pty Ltd* [2007] NSWCA 235.

decision, he thought the task ought be undertaken in accordance with the general approach as applicable to all commercial contracts (ie "commercial construction") rather than by reference to "special rules" applicable to indemnities.[76] His gloss on the Brambles rule was that:

> *the principle for construction of … indemnities that was adopted by the High Court in [Andar v Brambles] does not involve preparing a list of all the possible meanings of a clause that the language can bear without breaking, and choosing the meaning that is most favourable to the … indemnifier. Rather, the choice is limited to choosing amongst meanings that are fairly open by reason of the application of other rules of construction* [77]

He went further, saying that the Brambles rule may not apply to the benefit of an indemnifier if they were the draftsman of the indemnity, ie the contra proferentem rule should operate.[78]

Confused?

These distinctions are more than merely semantic because they can actually deliver opposing outcomes. For example, a bare indemnity that is in wide terms but does not expressly mention the beneficiary's negligence, would probably not cover the beneficiary's negligence under the core Canada Steamship rule or, indeed, the Brambles rule in its purest form. That same indemnity, under the Delco principle, commercial construction or the BI (Contracting) outcome, may well do so.

So - back to our two example indemnities

When taking the benefit of indemnities such as the Example Guarantor Indemnity and the Example Mandate Indemnity a financier might hope to have coverage for its own negligence either:

- (if there is no carve-out) via the use of words of sufficiently wide import to include it, even if not expressly mentioned; or
- (if there is a carve-out) via the exclusion of gross negligence,

rather than by an express inclusion.

Of course, if either indemnity had used, in the body of the indemnity, the expression *"including any losses [etc] that have resulted from the* ***negligence*** *of the Financier / relevant Indemnified Person"* (or its corresponding opposite in a carve-out), the matter would almost certainly be beyond doubt, on any of the "rules". But they do not (and traditionally these indemnities tend not to - perhaps for obvious reasons).

The question parties face is whether the rather opaque techniques of very wide drafting, or "inclusion via exclusion", as it were, can operate to include the beneficiary's own negligence.

I turn now to a more detailed analysis of the High Court's decision in *Brambles*.

The *Andar v Brambles* decision - the detail

76 Ibid, at [19].

77 Ibid, at 20, quoting Campbell JA in *Rava v Logan Wines* [2007] NSWCA 62.

78 Ibid, at [21]. The *contra proferentem* rule would have it that, if there is ambiguity in terms of a guarantee or indemnity, that term should be construed against the person relying on it and in favour of the guarantor/indemnifier: *Ankar Pty Ltd v National Westminster Finance (Australia) Ltd* (1987) 162 CLR 549. In *McCann v Switzerland Insurance Australia Ltd* (2000) 176 ALR 711 at 726, at 391, Kirby J went so far as to say that *contra proferentem* should only be applied as "a last resort", a sentiment that was echoed by Callinan J in his dissenting judgment in *Andar v Brambles* (2004) 206 ALR 387.

I do not dwell here on the facts and background of the case.[79] The relevant contract (prepared by Brambles) included a combination of indemnities and releases from Andar in favour of Brambles.[80] The critical indemnity (in clause 8) was a "bare" indemnity from Andar in favour of Brambles in relation to the conduct of a "Delivery Round". The indemnity was silent as to whether it included within its scope losses occasioned (or contributed to) by an act or omission of Brambles that was negligent - thus, on one reading, it *could* have operated as a "reverse" indemnity:

> *[Andar] shall Indemnify [Brambles] from and against all actions, claims, demands, losses, damages, proceedings, compensation, costs, charges and expenses for which [Brambles] shall or may be or become liable whether during or after the currency of the Agreement … in respect of or arising from … loss, damage, injury or accidental death from any cause to property or person caused or contributed to by the conduct of the Delivery Round by [Andar].*

On the other hand, an indemnity from Andar in clause 4.6, which related to losses arising from the "operation of the Vehicle", was "proportionate", in that it expressly excluded certain acts of Brambles:

> *[Andar agrees to] assume sole and entire responsibility for and indemnify [Brambles] against all claims liabilities losses expenses and damages arising from operation of the Vehicle by reason of any happening not attributable to the wilful,* ***negligent*** *or malicious act or omission of [Brambles]* (emphasis added)

The majority of the Court thought that clause 8 was ambiguous with respect to Brambles' own negligence. By application of strict rules of construction (ie rather than the Delco principle or commercial construction), and compressed reasoning that is far from clear, the Court, in effect, implied a "proportionate" limitation (or, putting it another way, a "carve-out" for Brambles' own negligence) in the clause 8 indemnity. This was critical because the courts below had found that the loss in question had been caused by Brambles negligence. By this reasoning, the High Court held that Andar was **not** required to make good Brambles' loss despite the breadth of the indemnity language.

Brambles v the other rules

One of the most puzzling aspects of *Brambles* is the way the Court applied the rules of construction to the terms of the clause 8 indemnity.

The most relevant aspect for present purposes is the absence of any direct discussion of the "rules" in the *Canada Steamship* case - or at least, the status of the contentious "third" rule.[81] These rules, as applied to indemnities, were stated succinctly in

[79] Brambles provided laundry delivery services to a number of hospitals. Those services involved, among other things, the delivery by truck of large trolleys of clean linen. Brambles contracted out its laundry delivery services to corporations that, in turn, employ drivers to load, deliver and unload the linen as directed by Brambles. Daryl Wail was one such driver. He was employed by the appellant, Andar (evidently his own family company). Prior to the change in business practice adopted by Brambles, Mr Wail had been employed directly by Brambles. On 26 July 1993, Mr Wail loaded a truck with 22 trolleys of clean linen at Brambles' laundry premises in Box Hill, Victoria and drove to Cotham Private Hospital in Kew. After reversing the truck into a driveway adjacent to the hospital's delivery bay, Mr Wail opened the rear of the truck and lowered the hydraulic tailgate. He then attempted to remove one of the trolleys. However, that trolley was jammed against another trolley and, in attempting to pull it free, Mr Wail damaged his lower back. Mr Wail commenced proceedings against Brambles alleging negligence, in that Brambles failed to ensure that the trolleys could be manoeuvred without risk of injury and to ensure that the trolleys could be manoeuvred having regard to their excessive weight when fully laden.

[80] Set out in (2004) 206 ALR 387 at 391-392.

[81] [1952] AC 192. The 3 "rules" are set out at 208.

Schenker and Co (Aus) Pty Ltd v Maplas Equipment and Services Pty Ltd,[82] as follows:

> 1. *If the clause expressly provides indemnity for the person in whose favour it is made for the consequence of negligence of that person …, effect must be given to it.*
>
> 2. *If there is no express reference to negligence the court must consider whether the words used are wide enough to cover negligence of the person…: if there is any doubt, it must be resolved against the person.*
>
> 3. *If the words are wide enough to cover the negligence of the person…, the court must consider whether the words also comprehend some other liability against which the person may have desired indemnity: if there is such a liability, the words are to be confined to it and not extended to negligence.*

This omission by the High Court is surprising because the Court below, consistent with its position over a decade earlier in *Schenker*, expressly rejected application of the "rules", and instead took a purely literal approach, saying that "*the third [rule] is not now the law in Australia in relation to the interpretation of exclusion and limitation clauses*".[83]

Nor is the decision consistent with the method of interpretation adopted in other cases, including other decisions of the High Court.[84] Apparently ignoring the Delco principle and the settled principles of commercial construction, the Court began its analysis by saying "*the proper construction of [the relevant clauses] cannot be undertaken without reference to the principles of construction* ***applicable to contractual indemnities***" (emphasis added),[85] implying that indemnities are indeed "special", with their own particular rules for construction.

Confusingly, in the same year that *Brambles* was handed down (ie 2004), the High Court said, in *Pacific Carriers*[86] (a case described as a "a triumph for commercial construction"[87]):

> *The construction of the letters of indemnity is to be determined by what a reasonable person in the position of [the indemnified party] would have understood them to mean. That requires consideration, not only of the text of the documents, but also the surrounding circumstances known to [the parties] and the purpose and object of the transaction* [88]

Some might argue that the Court did not need to address the *Canada Steamship* rules since they had long since been pronounced dead. Even apart from the repeated

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82 [1990] VR 834.

83 *Brambles v Wail* (2002) 5 VR 169, at 191 quoting from *Darlington Futures Ltd v Delco Australia Pty Ltd* (1986) 161 CLR 500. Although, with respect, it is arguable that this might be considered *obiter* since the *Canada Steamship* rules may not have been applicable in the case before the court – there was no finding of negligence as between the parties to the contract of indemnity such as would or could have triggered the debate.

84 As stated by Spigelman CJ in *Gardiner v Agricultural and Rural Finance Pty Ltd* [2007] NSWCA 235, "the general approach to the interpretation of commercial contracts applicable in the common law of Australia has been stated in a number of recent judgments of the High Court: see *McCann v Switzerland Insurance Australia Ltd* (2000) 203 CLR 579 at [22]; *Maggbury Pty Ltd v Hafele Australia Pty Ltd* (2001) 210 CLR 181 at [11]; *Pacific Carriers Ltd v BNP Paribas* (2004) 218 CLR 451 at 461–462; *Toll (FGCR) Pty Ltd v Alphapharm Pty Ltd* (2004) 219 CLR 165 at 179; *Wilkie v Gordian Runnoff Ltd* (2005) 221 CLR 522 at [15].

85 (2004) 206 ALR 387, at 392.

86 Fn 70.

87 Peden and Carter, fn 64, at 180.

88 (2004) 208 ALR 213, at 221.

rejection of the rules by Victorian Courts in *Shenker*[89] and *Brambles v Wail*,[90] several months before *Brambles* was decided in the High Court, Meagher JA of the NSW Court of Appeal stated, with characteristic directness, that:

> *…the decision of the Judicial Committee in Canada Steamship Lines Pty Limited v R [1952] AC 192, in light of Darlington Futures Limited v Delco Australia Pty Limited (1986) 161 CLR 500, is no longer good law.* [91]

But of course, none of those were decisions of the High Court.

BI (Contracting) - same indemnity as Brambles, opposite result

In July 2007, the NSW Court of Appeal concluded, after an exhaustive review of the cases and the history around the issue, both in Australia and the UK, that "*this Court is not obliged to apply the third principle in Canada Steamship SS and must apply the approach adopted by the High Court in [Andar v Brambles]"*.[92] And yet, ironically, the court went on to find that an indemnity in substantively the same terms as that in *Brambles* (ie a "bare" indemnity with no express mention of negligence) **did** include the beneficiary's negligence.

It was unfortunate that the High Court left the *Canada Steamship* issue unresolved when it had the opportunity to deal with it, particularly since one of the authorities embroiled in the debate is its own decision in *Darlington Futures* (see the text around fn 67). At least one superior court has asserted that "*by reason of the judgment in [Andar v Brambles], the approach in Darlington Futures Ltd v Delco Australia Pty Ltd can no longer be relied on in regard to indemnity clauses*" (ie whatever its status in relation to non-indemnity exclusion and limitation clauses).[93] Given the almost complete lack of analysis of the authorities in this aspect of the High Court's judgment in *Brambles*, but (despite that) the inherent "sense" in the outcome,[94] it is hard to resist the conclusion that the Court was "seeking to do justice".[95]

The risk with decisions that are made because they are the "right thing to do", but without the rigour of thorough analysis and due regard to the authorities, is that they appear *ad hoc* and result in uncertainty. They may even lead to what Chief Justice Gleeson has described as "individualised justice".[96]

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89 [1990] VR 834.

90 Fn 83.

91 *State of NSW v Tempo Services Ltd* [2004] NSWCA 4, per Meagher JA at [9].

92 *BI (Contracting) Pty Limited v AW Baulderstone Holdings Pty Limited* [2007] NSWCA 173, at [95]. But she also noted that "there was no reference in … *Andar* to the principles and, in particular, the third principle, in *Canada Steamship SS",* at [89].

93 *F and D Normoyle Pty Ltd v Transfield Pty Ltd T/as Transfield Bouygues Joint Venture* [2005] NSWCA 193, per Ipp JA (with whom McColl JA agreed), at [64].

94 It was an unsurprising outcome in the context of a transaction that was a mere change in status of an individual from employee to contractor (via an interposed company) for the convenience of Brambles, where a patently much stronger party imposed its will (via a standard form document) on a weaker party having no real ability to negotiate, in an attempt to shift liability for matters which, before the transaction, would have been Brambles' responsibility.

95 Certainly, one is left with this impression after reading Kirby J's judgment. It has been observed that "the *Brambles* case shows that a court will find a way around [an overly wide indemnity] clause if it wants to, particularly if it thinks there was an inequality in bargaining power between the contracting parties": Tumiati N and Verdnik A "Do your service contracts include an effective indemnity?" (2004) 7(8) IHC 87.

96 Gleeson CJ "Individualised Justice - the Holy Grail" (1995) 69 ALJ 421. Heydon J's presence in the majority in *Brambles* uncovers an interesting irony. In his article "Judicial Activism and the death of the rule of Law", ((2003) 23 ABR 110, then of the NSW Court of Appeal, published shortly before his elevation to the High Court), he noted, with evident displeasure, that the High Court's position on a whole range of matters has vacillated with changes to the composition of its membership, and argued that "if radical new statements [of the law] are routinely made, and *established law is almost nonchalantly departed from in later cases*, then they can be no more binding, and no more likely to survive, than the earlier statements which have been overthrown" (emphasis added).

Ironically, if it had applied the *Canada Steamship* rules, the High Court in *Brambles* would very likely have reached the same conclusion, since (as acknowledged by the Court of Appeal in the decision below[97]) the application of the rules tends to result in a "bare" indemnity being construed so as ***not to*** indemnify the beneficiary against its own negligence.

On the other hand, the decision of the NSW Court of Appeal in *BI (Contracting) Pty Limited v AW Baulderstone Holdings Pty Limited* [98] militates against that conclusion.

Ellington v Heinrich Constructions - back to the future

Finally, note the following comment of the Queensland Court of Appeal in *Ellington v Heinrich Constructions Pty Ltd*,[99] which involved a "bare" indemnity from a subcontractor in favour of a builder, not dissimilar in substance to that in *BI (Contracting)*, in which the court seemed to hark back to a simpler time when *Canada Steamship* ruled the waves:

> *It is … a fundamental consideration in the construction of contracts of this kind that it is inherently improbable that one party to the contract should intend to absolve the other party from the consequences of the latter's own negligence….It seems to me impossible to suppose that the parties were intending that the appellant should indemnify the respondent against claims based upon the respondent's negligence*. [100]

The court held the subcontractor's indemnity *not* to cover the builder for its own negligence (ie the opposite result to the *BI (Contracting)* outcome decided 3 years later), saying

> *[t]he [builder's] contention would make the [subcontractor] liable for the financial consequences of the [builder's] acts that could be seen to be in respect of the works, though the [subcontractor] had not authorised or performed the act, and was not insured for the loss. This is an unlikely construction*[101]

Conclusion

It is hard to argue with the common sense in the sentiments expressed by in *Ellington v Heinrich Constructions*. If something as intuitively unusual as a "reverse" indemnity has been consciously discussed and agreed between parties, then one might expect the drafting to be explicit in that regard. Even apart from judge-made rules and principles, logic itself operates in favour of a presumption that a person does not intend to indemnify another for his/her own negligence in giving a general indemnity against losses, unless that conclusion is inevitable on the wording.

Being no more than a requirement for absolute certainty, this conclusion is not inconsistent with:

- the observation in *Davis v Commissioner for Main Roads*[102] that, so long as clear language is used, a court is free to find that, say, a contractor has undertaken all the risk of carrying out a contract, including by reference to the other party's actions; or

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97 (2002) 5 VR 169, at [68].

98 [2007] NSWCA 173.

99 [2004] QCA 475. The case was decided shortly after *Brambles* (and cited and distinguished it).

100 [2004] QCA 475 per Chesterman J, at [19], quoting, with approval, from Buckley LJ in *Gillespie Brothers & Co Ltd v Roy Bowles Transport Ltd* [1973] QB 400 at 419, and Kitto J in *Davis v Commissioner for Main Roads* (1968) 117 CLR 529 at 534.

101 [2004] QCA 475, at [23].

102 (1968) 117 CLR 529.

- the principle stated in *F and D Normoyle Pty Ltd v Transfield Pty Ltd T/as Transfield Bouygues Joint Venture*[103] that it is not unreasonable for parties contractually to allocate the risk of liability in a given activity from one to the other in the exercise of their normal economic rights; or

- the statement of Sheller JA in *Glebe Island Terminals Pty Ltd v Continental Seagram Pty Ltd*[104] that businessmen are capable of looking after their own interests and of deciding how risks inherent in the performance of various kinds of contracts can be most economically borne.

All of which statements are well and good if the negotiating parties have sufficient knowledge of the variables, the drafting is unambiguous and the law supports them with clear rules that are consistently applied.

In the meantime, it is definitely worth carefully considering the use of carve-outs and fighting over the difference between "negligence" and "gross negligence" in negotiations over indemnities, because you never know…..

103 [2005] NSWCA 193.
104 (1993) 40 NSWLR 206.

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Indemnities against Breach of Contract

Indemnities against Breach of Contract

J W Carter*

Introduction

Background

I have been asked to explain the operation of one particular type of indemnity, namely, an indemnity against breach of contract. An example of such a clause would read:

> A must indemnify B against any breach of this agreement by A.

As explained below, the task of explaining the operation of such an indemnity is not an easy one.

Clauses under which one party to a contract agrees to indemnify the other against its own breach of contract are undoubtedly in general use. Normally with respect to contract provisions which are in general use, such as entire agreement clauses, liquidated damages provisions, exclusion clauses, termination clauses and so on, it is possible to find a line of modern authority to debate. Strangely, there is no such line of authority either in Australia or England in relation to an indemnity clause of this type. To say the least, from a legal as well as a commercial perspective, it is a rather alarming state of affairs that a provision which is found in many modern contracts is more or less untested in the courts. Of course, the conclusion might be drawn from the absence of authority that the operation of such clauses is well understood. If only that were the position.

Where there is no authoritative line of authority, it is usually appropriate to go back to first principles. However, we are blocked there as well. As recent discussions in the literature illustrate very clearly,[105] in relation to contractual indemnities it is

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105 See Rafal Zakrzewski, 'The Nature of a Claim on an Indemnity' (2006) 22 *JCL* 54; Nuncio D'Angelo, 'The Indemnity: It's All in the Drafting' (2007) 35 *ABLR* 93.

difficult to identify a common ground for such first principles. Different conclusions may therefore be reached. The overall result is a surprising level of uncertainty at the most basic level. There are, I think, two main reasons for this. The first is that any discussion tends to search for a set of characteristics common to all indemnities. There is an assumption that an indemnity is a particular animal. Although common characteristics may exist, they are not easy to isolate. Arguably, that is simply a reflection of the fact that, as explained below, indemnities come in all shapes and sizes.

Second, in so far as a set of characteristics common to all indemnities does exist, it is not clear which of these apply to an indemnity against breach of contract.

Categories of indemnity

The indemnity commonly found in contracts under which A agrees to indemnify B against A's breach of contract is an express indemnity. The closest analogy, somewhat surprisingly, is the indemnity provided by a liability insurer.

However, an indemnity need not be express. It may also be implied. But, except in unusual circumstances a general indemnity against breach of contract will not be implied. An implied indemnity against breach may be found in a contract under which a person undertakes fiduciary responsibilities.[106] However, the basis for the implication is the fiduciary duty. Since not every breach of contract will also be a breach of fiduciary duty, it would be incorrect to say — even in this context — that a court may imply an indemnity against breach of contract. Indemnities are often implied in favour of a person who acts on behalf of another. A specific illustration is where a charterer impliedly agrees to indemnify a shipowner against the consequences of complying with its orders in relation to the vessel.[107] A more general one is that a principal impliedly agrees to indemnify his or her agent in relation to authorised acts.[108]

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106 See, eg *Eastern Shipping Co Ltd v Quah Beng Kee* [1924] AC 177.

107 See *Sig Bergesen DY & Co v Mobil Shipping and Transportation Co (The Berge Sund)* [1993] 2 Lloyd's Rep 453 at 462; *Action Navigation Inc v Bottiglieri di Navigazione SpA (The Kitsa)* [2005] 1 Lloyd's Rep 432 at 437; [2005] EWHC 177 (Comm) at [15]. In some standard forms of charterparty the indemnity is express.

108 *Birmingham and District Land Co v London and North Western Railway* (1886) 34 Ch D 261 at 275. See also *Lane v Bushby* (2000) 50 NSWLR 404 (entitlement of partner under partnership legislation).

Indemnities may arise independently of contract. For example, even if an agency relationship is not contractual, the agent will have an implied right of indemnity from the principal, at least in relation to expenses. Again, an indemnity may arise under statute.[109] Again, a trustee is entitled to be indemnified out of trust assets where it acts in accordance with its powers. That is a different kind of indemnity again. Indemnities may also arise as an incident of a remedy. For example, in making orders to achieve restitutio in integrum a court may order that the plaintiff be indemnified by the defendant in relation to liabilities.[110]

Definition

Given the diversity of bases and contexts for indemnities, there is an obvious difficulty in defining an indemnity. In *Sunbird Plaza Pty Ltd v Maloney*[111] Mason CJ said:

> An indemnity is a promise by the promisor that he will keep the promisee harmless against loss as a result of entering into a transaction with a third party ...

However, that definition cannot possibly be accepted as a general definition. That is obvious, not only because an indemnity need not be contractual in nature but also because not all contractual indemnities relate to 'loss as a result of entering into a transaction with a third party'. The statement must therefore be seen (as it was intended to be seen) as a definition of a particular type of indemnity. Alternatively, and probably more accurately, it is simply a statement of a particular kind of promise.

In *Victorian Workcover Authority v Esso Australia Ltd*[112] Gleeson CJ, Gummow, Hayne and Callinan JJ defined an indemnity as an 'obligation imposed by contract or by the relation of the parties to save and keep harmless from loss'. This definition is more easily adapted to the range of circumstances in which indemnities may be found. It is also a useful starting point for the type of indemnity with which this paper is concerned.

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109 See, eg Trade Practices Act 1974 (Cth), s 74H (manufacturer must indemnify seller).

110 See *Newbigging v Adam* (1886) 34 Ch D 582, affirmed sub nom *Adam v Newbigging* (1888) 13 App Cas 308 (indemnity in respect of partnership liabilities).

111 (1988) 166 CLR 245 at 254; 77 ALR 205. Deane, Dawson and Toohey JJ agreed. See also *Andar Transport Pty Ltd v Brambles Ltd* (2004) 217 CLR 424 at 437; 206 ALR 387; [2004] HCA 28 at [23] per Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ (both guarantees and indemnities 'are designed to satisfy a liability owed by someone other than the guarantor or indemnifier to a third person').

112 (2001) 207 CLR 520 at 528; 182 ALR 321; [2001] HCA 53 at [16].

Categories of Contractual Indemnity

General

Merely defining a concept does not tell us the characteristics of the concept. Thus, the statement that the obligation of an indemnifier is to 'save and keep harmless from loss' does not explain how that is done, or what 'harmless' means. Moreover, given the range of situations in which indemnities operate, it must be difficult to identify common characteristics of indemnities. Indeed, it would seem self-evident that indemnities cannot all share the same characteristics. Logically, the most that can be said is that certain characteristics are common to particular kinds of indemnity. Since the present concern with a particular type of contractual indemnity, it is appropriate to identify the categories of contractual indemnity in common use.

Contractual indemnities are agreements, that is, promises of indemnity. They can nearly always be reduced to the form:

A promises to indemnify B against [X].

A is the promisor (indemnifier) and B is the promisee (indemnified party). In this generalised form, the indemnity is *against* the occurrence of an agreed event. 'X' is that agreed event. Therefore, to draft a contractual indemnity all we need to do is to replace X with the particular event against the occurrence of which A promises to indemnify B.

Consider for a moment a typical contract for the sale of goods. If a seller promises to sell goods to a buyer, and the buyer promises to accept the goods and pay the agreed price, two things may be noticed. First, the promises relate to events which the parties desire to occur. Second, the law regards the agreed return for each promise as equivalent. In other words, although in fact the seller may have made a good (or a bad) bargain, that is irrelevant to the validity of the contract terms.[113] The position is simply that *for the parties* the agreed return for each promise is equivalent to the agreed return of the other. That necessarily holds true, at least in the commercial context, if only one of the parties provides an indemnity against breach of contract.

If A promises to indemnify B 'against' the occurrence of an event (such as a breach of contract), the event is not something which either A or B desires to occur.

113 Cf Nick Sage, 'Should Contract Law Demand Equality in Exchange? Reflections on Substance, Procedure and Modus Vivendi' (2008) 24 *JCL* 28.

Such indemnities deal with *fortuitous* events. Indemnity promises are therefore examples of aleatory promises. That is why the classic example of a contractual indemnity is the indemnity promised by a liability insurer. Since litigation in relation to insurance is common, there is a vast body of law on indemnities under insurance contracts. In that context, the feature common to all bilateral contracts — equivalence of the agreed return for each promise — needs some explanation. If an insurer promises to indemnify an insured for the insured's negligence, and the insured pays a premium of, say, $10,000, the parties understand not only that the insurer may never come under an obligation to pay anything, but also that the insurer's liability on the indemnity may far exceed the premium paid by the insured. It is the element of risk — the risk that the event insured against will occur — which makes the payment of $10,000 'equivalent' to the insurer's promise to pay.

However, relying on insurance law as a guide to general principles immediately creates a problem for most lawyers. Insurance contracts are not like standard bilateral contracts. The features of insurance contracts are not replicated in contracts in general. The differences give rise to a quite specific philosophy in contract drafting. Insurance law is a specialised area. In fact, in many areas only those with an intimate knowledge of the type of insurance (and the relevant market) will have a full understanding of the legal effect of the contract and its exclusions and limitations. An indemnity against breach in a contract for the provision of services is simply one term of the contract. Under a contract for liability insurance, the indemnity is the contract.

There are, however, three common features:

(1) neither the indemnifier nor the indemnified party desires the relevant event to occur;

(2) neither the indemnifier nor the indemnified party promises that the relevant event will occur; and

(3) the scope of the indemnity may be the subject of express provision.

An analysis of indemnities against breach of contract must therefore pay some attention to the approach to promises of indemnity insurance. But it must equally be borne in mind that the case law in relation to indemnity insurance is not the general law of contract. For that, and other reasons, it is dangerous to generalise from the cases on insurance contracts to indemnities against breach of contract.

Four categories of contractual indemnity

Just as an insurer takes on a risk, so also does a contracting party who provides an indemnity against the occurrence of an event. Indeed, it seems to me quite correct to say that where A contracts to indemnify B against the occurrence of an event, A is acting as B's 'insurer' in relation to the risk that the event will occur.[114] And, just as there are various categories of indemnity insurance, so also are there various categories of contractual indemnity.

If the analysis of contractual indemnities is limited to indemnities against the occurrence of events, it is possible to identify four important categories of contractual indemnity. The first is the indemnity against breach of contract with which I am primarily concerned. This may be described as a 'party-party indemnity'.

The second category is the one most familiar to banking and finance lawyers, namely, that given by a guarantor. The relevant promise is the indemnity promise under a 'contract of guarantee and indemnity'. The promise relates to events arising under another contract, that is, between the creditor (promisee in relation to the indemnity promise) and the principal debtor. This may be termed a 'guarantor indemnity'.

Next there is the indemnity against claims by a third party. Although these are most commonly found in contexts such as software supply contracts, any commercial contract could include an indemnity against claims brought against the indemnified party by a 'third party', that is, a claim by anyone other than the indemnifier. This has been described as the 'primary meaning' of 'indemnity'.[115] I term it a 'third party claims indemnity'.

If A enters into a contract with B, the contract may require A to indemnify B in relation to B's liability to A. Because it is the reverse of a party-party indemnity, this fourth category may be termed a 'reverse indemnity'. It effectively operates as an exclusion of B's liability to A.[116] As recent decisions show,[117] such indemnities are

[114] This is perhaps a fact that a client who is willing to give an indemnity might not actually appreciate.

[115] *Total Transport Corp v Arcadia Petroleum Ltd (The Eurus)* [1998] 1 Lloyd's Rep 351 at 358 per Staughton LJ (with whom Auld LJ agreed).

[116] The infamous rules on exclusion of liability for negligence were stated in *Canada SS Lines Ltd v R* [1952] AC 192 at 208 in the context of such an indemnity.

sometimes used. The scope of the indemnity may extend to events which do not involve any breach of duty. In that respect, the indemnity may include a 'claims indemnity' under which the claimant may be anyone, *including* the indemnifier.

What's in a name?

If a contract includes a promise described as an 'indemnity' it is natural to think that it will be so construed. However, even if the promise is so described, that is clearly not conclusive.[118] There is a long line of cases on the distinction between guarantee and indemnity in the context of Statute of Frauds provisions which clearly shows that whether a promise is an indemnity (or a guarantee) is a question of construction.[119] This question is not a linguistic one. The point at issue is the *legal effect* of the promise.[120]

The importance of this extends beyond the need to distinguish a guarantee from an indemnity. There are three points. First, the parties' use of a word which has a particular legal significance, such as 'licence', 'agent' or 'indemnity' does not require a court to treat the clause as having the characteristics which might be thought to be inherent in the label. There may be a presumption that the parties have applied the right label to the promise, but the label itself cannot be conclusive. It is not uncommon for courts to speak of a right to damages as entitling a promisee to an 'indemnity' from the promisor.[121] The sense of the word is 'compensation'. Therefore, if a contract says that A must 'indemnify' B against A's breach of contract, the first question which must be asked is whether 'indemnify' simply means 'pay common law damages to'.

The second point is that even if a promise is otherwise accurately described as an indemnity, the detail of the clause may indicate that it has a different legal effect. For example, assume that a clause says:

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117 *Schenker & Co (Aust) Pty Ltd v Maplas Equipment and Services Pty Ltd* [1990] VR 834; *Andar Transport Pty Ltd v Brambles Ltd* (2004) 217 CLR 424; 206 ALR 387; [2004] HCA 28.

118 The converse is also true, although more difficult to establish. See, eg *Mediterranean Freight Services Ltd v BP Oil International Ltd (The Fiona)* [1994] 2 Lloyd's Rep 506 (Art IV, r 6 of the Hague-Visby Rules). Contrast *Commonwealth v Aurora Energy Pty Ltd* (2006) 235 ALR 644; [2006] FCAFC 148.

119 J W Carter, *Carter on Contract*, LexisNexis Butterworths, Sydney, §09-070.

120 *Yeoman Credit Ltd v Latter* [1961] 1 WLR 828.

121 See, eg *Addis v Gramophone Co Ltd* [1909l AC 488 at 491; *Total Transport Corp v Arcadia Petroleum Ltd (The Eurus)* [1998] 1 Lloyd's Rep 351 at 357.

> A must indemnify B against any Loss (other than a Consequential Loss) caused by breach of this agreement by A.

It may be argued that the qualification ('other than a Consequential Loss') prevents the clause operating as an indemnity. That would depend on the definition of 'Consequential Loss'. But the point is that if it is assumed that a promise has certain characteristics by reason of its status as an indemnity, drafting which is inconsistent with those characteristics will mean that the promise does not have the status of an indemnity. It will not therefore attract the attributes of an indemnity. I will return to this point later,[122] but it is appropriate to say that many clauses labelled as indemnities — and regarded as such by the parties and their lawyers — may not be indemnities at all.

The third point is also one which is discussed in more detail later. In *Moschi v Lep Air Services Ltd*[123] Lord Reid said:

> I would not proceed by saying this is a contract of guarantee and there is a general rule applicable to all guarantees. Parties are free to make any agreement they like and we must I think determine just what this agreement means.

Lord Reid's warning in relation to contracts of guarantee is equally applicable to indemnity promises. Ultimately, the legal characteristics of a promise of 'indemnity' is a matter of intention.

Objectives of Contractual Indemnities

Introduction

What are the objectives of a contractual indemnity? If the party-party indemnity is compared with other categories of contractual indemnity commonly found, one point which emerges is that the objective of a party-party indemnity is not nearly as clear as might generally be assumed.

It is, of course, trite to say that indemnities allocate risks. That is true of all contractual promises. However, as was noted above, where a contractual indemnity relates to a fortuitous event it allocates the risk of an undesired event occurring. A person who purchases liability insurance has the objective of allocating the

122 See below, text at n 63.

123 [1973] AC 331 at 344. See also *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245 at 256, 270; 77 ALR 205.

(undesired) risk to the insurer who is prepared to undertake the risk because it has assessed the chance of the risk occurring, and decided that the risk is a 'good' one to bear. Simply expressed, the insurer has done its sums in relation to the risk. The whole contract is drafted to define and regulate the risk.

The guarantor indemnity in a contract of guarantee and indemnity also has a specific objective. It is, in essence, designed to deal with the situation where the guarantor is not liable in that capacity.[124] If, for example, the contract between the principal debtor and the creditor is not enforceable by reason of the debtor's lack of contractual capacity, the guarantor's promise of guarantee is (as a collateral promise) also not enforceable. But since the guarantor indemnity is enforceable, the creditor may recover its loss on the principal contract.[125]

It is easy to see the objective of the third party claims indemnity. If the indemnified party is sued, the indemnifier must pay any loss suffered by the indemnified party. Like insurance contracts, such indemnities may be the subject of detailed drafting. For example, the indemnified party may be required to permit the indemnifier to take over the defence of the claim, there may be provisions designed to protect the commercial reputation of the indemnified party, restrictions on settlements and so on.

On the other hand, where there is a reverse indemnity the objective is that one party to the contract must not sue the other. The effect is that if the indemnifier does sue the indemnified party the claim must be dismissed, because any judgment would be met by an equal judgment going the other way. A court must not permit circuity of action.[126]

Objectives of a party-party indemnity

What, then, is the objective of the party-party indemnity? Since the indemnity is against breach of the agreement, the indemnifier would (as promisor under the agreement), even without the indemnity, be liable to the indemnified party (as promisee under the agreement). That liability is, of course, to pay common law

124 But it will not always be effective: *Citicorp Australia Ltd v Hendry* (1985) 4 NSWLR 1.

125 *Yeoman Credit Ltd v Latter* [1961] 1 WLR 828.

126 Of course, to the extent that the indemnity operates as an exclusion of liability, it may be invalid under provisions such as Trade Practices Act 1974 (Cth), s 68. Cf *Qantas Airways Ltd v Aravco Ltd* (1996) 185 CLR 43; 136 ALR 510. For an express provision to that effect see Fair Trading Act 1999 (Vic), s 32LA.

damages. Given that the cause of action for breach of contract will merge in any judgment for damages for breach of the agreement, there is (on the face of it) little point in having an indemnity against breach of the agreement.

From this apparent lack of utility three inferences concerning the intention of the parties may be drawn. First, it is noted that an indemnity is generally conceived of as a primary obligation. Therefore, the intention should be inferred that the reason for the indemnity is the creation of a *primary obligation* in addition to the secondary obligation which arises on breach of the agreement. There is, in other words, a parallel with a guarantor indemnity and the agreement creates a primary obligation to pay money in addition to the secondary obligation which arises on breach of the agreement by the promisor.

Second, as an alternative inference, the intention is to create two breaches of contract. The reason for the indemnity is the creation of a *secondary obligation* additional to that which arises on breach of the agreement and which arises at the same time. Since the breach of any primary obligation gives rise to a secondary obligation, if the indemnity promise is not performed there is an additional cause of action. This view has its attractions. The form of the indemnity promise suggests that the indemnifier is in breach of the indemnity promise from the moment that the agreement is breached.

The third inference is that the parties intend to create a liability having a *broader scope* than liability for contract damages. This may, perhaps, be combined with either of the first two inferences. Some support for this is found (superficially at least) in a contrast sometimes drawn in the context of claims for contract damages. Thus, in *Victoria Laundry (Windsor) Ltd v Newman Industries Ltd*[127] Asquith LJ (for the English Court of Appeal) said:

> It is well settled that the governing purpose of damages is to put the party whose rights have been violated in the same position, so far as money can do so, as if his rights had been observed: (*Wertheim v Chicoutimi Pulp Co* [1911] AC 301). This purpose, if relentlessly pursued, would provide him with a complete indemnity for all loss de facto resulting from a particular breach, however improbable, however unpredictable.

[127] [1949] 2 KB 528 at 539.

Asquith LJ went on to relate the principles of remoteness of damage applied to claims for contract damages. It is the operation of those principles which prevents such a claim being a 'complete indemnity'.

Of course, each such inference of intention embodies one or more particular conclusions of law.

(1) The conclusion of law under the first inference is that a party-party indemnity may be enforced by an action for a liquidated sum.

(2) The conclusion of law under the second inference is that under a party-party indemnity the indemnifier is in breach of the indemnity when the agreement is breached.

(3) The conclusion of law under the third inference is that the rules on remoteness of damage applicable to the breach of the agreement do not govern a claim on the indemnity.

These conclusions cannot all be correct. But it is difficult to find clear authority to support any of them in the cases.[128] There are, moreover, other possibilities to be considered. These include:

- that a party-party indemnity eliminates from consideration the rules on remoteness of damage in an action for breach of the agreement, that is, in relation to any breach to which the indemnity applies;
- that a party-party indemnity is an agreement on what damages are recoverable for breach of the agreement; and
- that a party-party indemnity provides the promisee with an additional cause of action (on the indemnity) which arises when breach of the agreement causes loss.

In one way or another, all such inferences of intention and conclusions of law rely on an assumption that there is something 'special' about an indemnity promise. That special feature (or features) must lie in the legal nature or characteristics of an indemnity.

Characteristics of a Party-party Indemnity

Introduction

It seems reasonable to say that where a party-party indemnity is inserted in a contract the parties assume that the promise has certain legal characteristics. Just what those

[128] See *Total Transport Corp v Arcadia Petroleum Ltd (The Eurus)* [1998] 1 Lloyd's Rep 351 at 357 per Staughton LJ, with whom Auld LJ agreed ('precious little authority to support' a meaning under which the indemnifier is liable for all loss 'attributable to a specified cause, whether or not it was in the reasonable contemplation of the parties').

characteristics are is not usually articulated in the clause itself. However, there is little direct guidance on the legal characteristics in the case law.

One answer to this is to say that the legal effect of any promise in any contract is simply a question of construction — the point which Lord Reid made in relation to guarantees in *Moschi*. Unfortunately, that is not a complete answer. Assume that an indemnity is drafted in the form identified at the beginning of this paper:

> A must indemnify B against any breach of this agreement by A.

What is there to construe? The clause does not state any legal effect. That work is assumed to be done by the word 'indemnity' — a mere label.

Such a 'bare' indemnity is not usually employed. More commonly, the indemnity is expressed as:

> A must indemnify B against *any Loss caused by* breach of this agreement by A.

If the words in italics are included, there will be more to construe. A familiar definition of 'Loss' is 'any loss, damage, expense or liability'. However, that does not really take us much further. The words 'indemnify B against' could easily be replaced with 'pay B'. Would that change the legal effect of the clause?

Five questions may be raised in an attempt to identify the characteristics of a party-party indemnity:[129]

(1) Is an action to enforce the promise an action in 'debt' or one for damages?

(2) Is the promisee entitled to be put in funds prior to actual loss being suffered?

(3) When does the cause of action on the promise arise?

(4) Do the rules of contract damages on remoteness apply to a claim on the indemnity?

(5) Does the indemnified party have the choice of suing on the indemnity or suing for breach of the agreement?

These are very important questions. But they are not easy to answer. In fact, so far as an indemnity against breach of contract is concerned, it is impossible to deduce clear answers from the cases. Logically, therefore, in order to settle these matters the indemnity should expressly state what legal effect the clause is intended to have.

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[129] Another characteristic which might be considered is an indemnifier's right of subrogation.

Debt or damages?

One thing that does seem to be clear from the cases is that an action on an indemnity is generally conceived as an action for damages.[130] For example, the conventional view is that an action on a policy of liability insurance is an action for damages.[131] However, that probably sounds absurd. A professional indemnity insurer does not promise that a solicitor will not be negligent. The promise is an indemnity in relation to a loss if the solicitor is negligent. That looks to be simply a promise to pay money. Thus, it is sometimes suggested that an action on an indemnity is a claim in 'debt' to recover the amount to which the indemnified party is entitled.[132]

To deal with this issue it is necessary to make a short diversion into legal history. The action in debt was abolished well over a hundred years ago. Prior to its abolition it would have been impossible to frame an action on an indemnity against breach of a simple contract as an action in debt because the form of action assumed an agreement or obligation to pay a sum certain. After the abolition of debt as a form of action, it became common to contrast claims for unliquidated damages with claims for debts or other liquidated sums. But in relation to simple contracts, all such actions were merely varieties of assumpsit. There were three varieties:

(1) common assumpsit;
(2) special assumpsit; and
(3) indebitatus assumpsit.

In order to facilitate pleading of claims to recover debts or other liquidated sums, the common counts were employed.[133] These accommodated both contractual claims (for example, for the price of goods sold and delivered) and what we now regard as restitutionary claims (for example, a reasonable sum for work requested and accepted independently of contract). There was, however, no common count to recover 'money payable under any indemnity'. The only common count likely to have

[130] See, eg *Wren v Mahony* (1972) 126 CLR 212 at 227.

[131] *Hobartville Stud Pty Ltd v Union Insurance Co Ltd* (1991) 25 NSWLR 358 at 361; *Ventouris v Mountain (The Italia Express) (No 3)* [1992] 2 Lloyd's Rep 281 at 285. But cf *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997) 187 CLR 384 at 402; 141 ALR 618 (term used 'loosely').

[132] I do not subscribe to the view that whether a claim is for a debt or damages can be explained in terms of a distinction between redressing loss and preventing loss.

[133] These can still be found in the Uniform Civil Procedure Rules 2005 (NSW), r 14.12.

any general application was the count for money paid.[134] But that assumes that the indemnified party has paid a sum of money to a third party.[135] This all clearly suggests that, in most cases at least, an action on an indemnity was not regarded as a claim in the nature of (what we now refer to as) 'debt'. Inevitably, therefore, the origin of a claim on an indemnity is common or special assumpsit, that is, a claim for damages.[136]

If there is a technical point to make it is that the failure to pay money due under a promise of indemnity is generally a failure to pay a damages liability. Of course, it seems pointless today to try to work out what the old common law regarded as a claim in debt. The more modern perspective — the use of expressions such as 'debt or liquidated demand' or 'liquidated sum' in rules of court and statutory provisions — does not depend on the characterisation of the claim under the old forms of action.[137] Equally, the relevance of the discussion is not entirely technical. From a more practical perspective the discussion shows that an indemnity promise has generally been conceived as a *non-monetary promise*.[138]

Equally, merely drafting a contractual promise as a promise to pay money does not of itself prevent a claim to enforce the promise being regarded as a claim for damages. Three examples may be given. First, where A and B contract that A will pay $100 beneficially to C, failure by A to pay the $100 to C provides B with a claim for damages, not a claim in debt.[139]

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134 See *Victorian Workcover Authority v Esso Australia Ltd* (2001) 207 CLR 520 at 528; 182 ALR 321; [2001] HCA 53 at [16]. Of course, the ingenuity of pleaders was such that on occasions a claim on an indemnity might be squeezed into another category, such as a quantum meruit for work done or an account stated.

135 The short description in the count was 'money laid out (or paid) by the plaintiff to the use of the defendant'. See Keith Mason and J W Carter, *Restitution Law in Australia*, Butterworths, Sydney, 1995, §111. In the Uniform Civil Procedure Rules 2005 (NSW), r 14.12 it is expressed as 'money paid by the plaintiff for the defendant at the defendant's request'.

136 Cf *Alexander v Ajax Insurance Co Ltd* [1956] VLR 436 at 443-6. See also *Rothenberger Australia Pty Ltd v Poulsen* (2003) 58 NSWLR 289 at 296-8; [2003] NSWSC 788 at [19]-[27].

137 *Workman Clark & Co Ltd v Brazileño* [1908] 1 KB 968; *Victorian Workcover Authority v Esso Australia Ltd* (2001) 207 CLR 520 at 533; 182 ALR 321; [2001] HCA 53 at [29].

138 Cf *Moschi v Lep Air Services Ltd* [1973] AC 331 at 347-8 (nature of guarantor's liability where the guarantee relates to a debt).

139 *Tradigrain SA v King Diamond Shipping SA (The Spiros C)* [2000] 2 Lloyd's Rep 319 at 330-2. The fact that B may in some cases obtain specific performance of the contract (see *Coulls v Bagot's Executor and Trustee Co Ltd* (1967) 119 CLR 460 at

Second, if A is (or may be) indebted to B, breach of a promise made by C to A, to pay the debt, generally sounds only in damages.[140]

Third, a liquidated damages provision, although it quantifies the promisee's claim for damages does not alter the nature of the claim. It remains one for the payment of damages.[141] In that context it may be noted that an action on a valued policy of marine insurance has been characterised as a claim for liquidated damages.[142]

Ultimately, the indemnified party will — as in a conventional action for damages — be entitled to recover a money sum. But the indemnified party's claim is no more a claim for a debt than a claim for damages for breach of warranty is a claim for a debt.[143] The only relevant amount must therefore be a 'loss'. Accordingly, where a contract provides:

> A must indemnify B against any breach of this agreement by A

this will usually be interpreted as a statement:

> A must indemnify B against *any loss caused by* breach of this agreement by A.

Now it might be said: 'So what, that is how any lawyer would interpret the clause.' But the point is that an indemnity cannot be said to relate to a loss while the amount is unliquidated or unascertained.[144] That means that if the parties define 'loss' to include a 'liability' the focus of the indemnity must, as a matter of construction, be the liability of the indemnified party *to a third party*. It cannot be the liability of the indemnifier to the indemnified party. Until quantified or ascertained, that 'liability' is, in money terms, an indeterminate amount and cannot amount either to a loss sustained by the indemnified party or a debt due from the indemnifier.

478, 503; *Beswick v Beswick* [1968] AC 58) shows a parallel with the equitable approach to the enforcement of indemnities.

140 *Wren v Mahony* (1972) 126 CLR 212 at 226.

141 *President of India v Lips Maritime Corp* [1988] AC 395; *Hungerfords v Walker* (1989) 171 CLR 125 at 139; 84 ALR 119. Cf *Sempra Metals Ltd (formerly Metallgesellschaft Ltd) v Inland Revenue Commissioners* [2007] 3 WLR 354 at 381, 424; [2007] UKHL 34 at [88], [214].

142 See *Ventouris v Mountain (The Italia Express) (No 3)* [1992] 2 Lloyd's Rep 281 at 286-92.

143 Of course, success on the claim gives rise to a judgment debt.

144 See *Telfair Shipping Corp v Inersea Carriers SA (The Caroline P)* [1985] 1 WLR 553 at 568, 569.

Applying this to a party-party indemnity, in order for the indemnifier (A) to be liable to pay a liquidated sum to the indemnified party (B), the amount of the loss must have crystalised. What is the loss in money terms? It cannot be whatever amount B says it has lost. Unless the contract itself quantifies the loss, the idea that B may sue for a liquidated sum must generally assume one of the following:

- that B has paid (or perhaps has become liable to pay) a particular sum to C;
- that A and B have agreed the amount of the loss; or
- that there has been a decision that A owes a particular sum to B.

Is the promisee entitled to be put in funds immediately?

The cases on the application of statutes of limitation suggest that another general characteristic of an indemnity is that the indemnity is not enforceable until a loss has been suffered by the indemnified party.[145] There is, in other words, no cause of action until the event against the occurrence of which the indemnity was provided has caused loss. It is that feature (a quantified loss) which tends to give the appearance that an action on an indemnity is an action in 'debt'.

In recent years the view has gained currency that the indemnified party is entitled to be put in funds before a loss is suffered so as to ensure that the indemnified party never suffers the loss. Credence has been given to this view from two considerations.[146] The first is that the traditional language of indemnity promises includes the words 'and hold harmless'. But that language is hardly ever used today. That must be because — probably correctly — the words are regarded as redundant. To indemnify *means* 'to hold harmless'.

Second, prior to the fusion of law and equity it appears that a court of equity would intervene to prevent the indemnified party being out of pocket. Therefore, the position today (following fusion) is that the indemnified party is entitled to be put in funds prior to suffering any loss. This view may well be correct in some contexts. For example, a person who is entitled to be indemnified for expenses may be entitled to claim those expenses prior to paying a third party, and the beneficiary of a third party claims indemnity may be entitled to be put in funds prior to meeting a judgment

145 See further below, text at n 48.

146 The leading modern authority is *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti)* [1991] 2 AC 1 at 35, 42.

against it. However, the question is always one of construction,[147] and the 'equitable approach' may be excluded by agreement.[148]

If this approach is correct — and it does seem to be generally accepted[149] — it must at least confirm that an action on an indemnity is not an action to recover a debt. Courts of equity exercised no general discretion to order specific performance of an obligation to pay money: damages would be an adequate remedy. However, it would be wrong to say that the order must be for specific performance. The more usual relief is a declaration of an entitlement to be indemnified.[150] In any event, in the contractual context at least, it seems clear that an indemnity promise is regarded as a promise to do an act, not a promise to pay money. So it is relatively easy to understand the role of equity.

For present purposes it is unnecessary to resolve this issue. Whatever may be the position in relation to indemnities in general, it is difficult to see how the idea of putting the beneficiary of an indemnity in funds prior to the suffering of a loss can have any general relevance to a party-party indemnity. The basis for a claim on such an indemnity is that breach of the agreement has caused the indemnified party to suffer a loss, not an expense. The loss is the loss of a promised benefit, and the amount of the loss is at large. Moreover, since a promisee cannot pay itself, logically the issue of being put in funds is likely to arise only if there is an obligation to pay money to a third party or the amount of a loss (or a liability)[151] has been agreed or determined by action. Moreover, to treat relief by way of specific performance or declaration as generally available under a party-party indemnity would seem to imply

147 *Wren v Mahony* (1972) 126 CLR 212 at 227.

148 That was the position in *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti)* [1991] 2 AC 1 (indemnity drafted as 'pay to be paid' indemnity).

149 See *Ventouris v Mountain (The Italia Express) (No 3)* [1992] 2 Lloyd's Rep 281 at 291-2; *Thanh v Hoang* (1994) 63 SASR 276 at 284; *Yorkshire Water Services Ltd v Sun Alliance and London Insurance Plc* [1997] 2 Lloyd's Rep 21 at 29; *Callaghan v Dominion Insurance Co Ltd* [1997] 2 Lloyd's Rep 541 at 543-4; *Victorian Workcover Authority v Esso Australia Ltd* (2001) 207 CLR 520 at 529; 182 ALR 321; [2001] HCA 53 at [17]; *C Inc Plc v L* [2001] 2 Lloyd's Rep 459 at 464.

150 *Rankin v Palmer* (1912) 16 CLR 285; *R & H Green & Silley Weir Ltd v British Railways Board* (1980) [1985] 1 WLR 570n at 573; *Thanh v Hoang* (1994) 63 SASR 276; *Victorian Workcover Authority v Esso Australia Ltd* (2001) 207 CLR 520 at 529; 182 ALR 321; [2001] HCA 53 at [17].

151 Cf *C Inc Plc v L* [2001] 2 Lloyd's Rep 459 at 464, 474. But see *Total Liban SA v Vitol Energy SA* [2001] QB 643 (damages claim).

a general right to specific performance (or analogous relief) in relation to *the agreement*.

When does the cause of action arise?

The normal rule in relation to breach of contract is that because suffering loss or damage is not an element of the cause of action, a breach of contract gives rise to an immediate right to sue. However, the discussion above suggests, as a general characteristic of indemnities, that the cause of action does not accrue immediately on the occurrence of the event to which the indemnity refers. It must follow that the mere occurrence of the event cannot be a breach of the indemnity promise. Rather, unless the parties have agreed otherwise, the breach occurs when the indemnified party suffers loss.[152]

This conclusion is not in every respect an obvious one. If an indemnity is drafted in the form 'A must indemnify B against X', the occurrence of the event (X) looks to activate the indemnity. Moreover, it seems clear that the commercial perspective on an indemnity against breach of contract is that the occurrence of a breach of the agreement immediately activates the indemnity even if the contract does not expressly say so.

The common law approach must, it seems, be rationalised on the basis that an indemnity drafted in the form 'A must indemnify B against X' is to be interpreted as meaning 'A must indemnify B against *loss caused by* X'. Therefore, the cause of action is not complete when X occurs, it is only complete when B sustains some quantifiable loss.[153] In other words, the promise is not that the event will not occur, the promise is that the indemnified party will not suffer loss by reason of the occurrence of the event. It follows that the equitable approach to an indemnity involves relief on a quia timet basis, so that the equitable right is not a 'debt'.[154]

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152 See, eg *County and District Properties Ltd v C Jenner & Son Ltd* [1976] 2 Lloyd's Rep 728 at 734, 735-6; *Telfair Shipping Corp v Intersea Carriers SA* [1985] 1 WLR 553 at 565, 567; *R & H Green & Silley Weir Ltd v British Railways Board* (1980) [1985] 1 WLR 570n at 572; *Wardley Australia Ltd v State of Western Australia* (1992) 175 CLR 514; 109 ALR 247. See also *Law Society v Sephton & Co (a firm)* [2005] QB 1013; [2004] EWCA Civ 1627 at [146] (affirmed [2006] 2 AC 543; [2006] UKHL 22).

153 See also *Heath Lambert v Sociedad de Corretaje de Seguros* [2004] 1 WLR 2820 (position where indemnity is in respect of a payment deemed to be made).

154 *R & H Green & Silley Weir Ltd v British Railways Board* (1980) [1985] 1 WLR 570n at 572.

This does help to explain the treatment of liability insurance. Where an insurer agrees to indemnify an insured against fire, it is obvious that the insurer is not promising that fire will not occur. Thus, the occurrence of a fire does not amount to a breach of contract. Rather, the promise of the insurer is to indemnify against loss caused by fire. It is, therefore, the suffering of a loss which puts the insurer in breach of contract.[155] It would therefore seem correct to say that breach of the indemnity promise occurs when the loss is suffered, rather than when the indemnifier refuses to pay the loss.

Do the remoteness rules apply?

If an action on an indemnity is an action for contract damages it is logically subject to the rules on remoteness of damage. However, actions against liability insurers have never been approached (overtly at least) from the perspective of the rule in *Hadley v Baxendale*. Indeed, there is precious little discussion of the remoteness issue in the cases. That is perhaps easily explained in the insurance context because the amount of the indemnity is closely defined, either in terms of an amount or the characteristics of a loss or liability. Thus, the need for consideration of remoteness of damage does not logically arise until the insurer fails to pay the loss. However, at that stage there is a legal obstacle to a consideration of remoteness, namely, that there is no such thing as a cause of action in damages (including to recover interest) for a failure to pay damages.[156]

Where remoteness might be seen as having a genuine role — that is, outside the context of insurance — the most that can be said is that in some cases it has been *assumed* that the remoteness rules do not apply to an action on the indemnity.[157] If

155 An alternative view is that the insurer has a reasonable time to pay, and is not in breach until that period has expired.

156 *Hungerfords v Walker* (1989) 171 CLR 125; 84 ALR 119. For application of the rule in the marine insurance context see *Ventouris v Mountain (The Italia Express) (No 3)* [1992] 2 Lloyd's Rep 281 at 292; *Bank of America National Trust and Savings Association v Chrismas (The Kyriaki)* [1993] 1 Lloyd's Rep 137 at 150-1. But note Insurance Contracts Act 1984 (Cth), s 57 (interest on claims — general insurance). Cf *Sempra Metals Ltd (formerly Metallgesellschaft Ltd) v Inland Revenue Commissioners* [2007] 1 AC 558; [2007] 3 WLR 354; [2007] UKHL 34 (see Chris Nicoll, (2008) 124 *LQR* 199; Malcolm Clarke, [2008] *JBL* 291).

157 As in *Total Transport Corp v Arcadia Petroleum Ltd (The Eurus)* [1998] 1 Lloyd's Rep 351.

that assumption is correct then the basic criterion for liability is causation.[158] That seems to be the thinking behind Asquith LJ's statement in *Victoria Laundry (Windsor) Ltd v Newman Industries Ltd*.[159] However, Asquith LJ's perspective was the breach of contract, *not* the breach of an indemnity promise. He was simply saying that, but for the rules on remoteness, a promisor would be liable for all loss caused by its breach of contract, no matter how 'improbable' or 'unpredictable'. There is, in other words, a distinction between whether damages should be assessed on an indemnity basis and whether the remoteness rules apply to an action on an indemnity. Although the distinction sounds subtle, it is important.

In terms of perception, if there is one thing which is clear about party-party indemnities it is that an action on an indemnity promise is perceived as *more valuable* than a common law action for damages for breach of contract. In contract negotiations, an indemnity against breach is sought (and challenged) on the basis that it states a liability which is more extensive than a liability to pay common law damages in respect of the breach. The only (obvious) reason for including the indemnity is that the promisee (also the indemnified party) desires perfect or complete compensation untrammelled by considerations such as the rule in *Hadley v Baxendale*. Still at the level of perception, there is nevertheless ambiguity as to why an indemnity is preferred. There are three views:

(1) An indemnity is preferable because it permits the recovery of damages for breach of the agreement, determined in accordance with the remoteness principle, under an independent (primary) promise of indemnity.

(2) An indemnity is preferable because it prevents the application of remoteness rules to any breach which activates the indemnity.

(3) An indemnity is preferable because remoteness principles do not apply to an action on an indemnity promise.

Where A agrees to indemnify B against breach of contract, the first view suggests that the purpose of a party-party indemnity is simply to provide a specific means of recovering (perhaps as a liquidated sum) a loss which is otherwise recoverable under damages principles.

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[158] See *Mediterranean Freight Services Ltd v BP Oil International Ltd (The Fiona)* [1994] 2 Lloyd's Rep 506 at 522.

[159] [1949] 2 KB 528 at 539 (see above, text at n 23).

The second view suggests that the indemnity is designed to quantify loss. Accordingly, if a party-party indemnity is stated in clause 2 of an agreement and clause 1 is breached, the promisee's claim is for breach of clause 1 and the function of clause 2 is to state the basis on which loss must be quantified. The indemnity functions as a separate promise only for the purpose of giving effect to the parties' agreement about how damages for breach of the agreement must be assessed.

Under the third view, the indemnity is a second promise activated when breach of the agreement occurs or causes loss. On this approach it is irrelevant to ask whether the remoteness rules apply. It is irrelevant either because it is difficult to see how any loss could be said to be too remote where such a promise is breached or because (an action on an indemnity being an action for damages) the law does not permit an action for damages for the failure to pay damages.

At present the cases do not provide a basis for choosing between these views. Similarly, they do not rule out other views. However, three points may be made. First, although I think that most contract lawyers would not have the first or the second view in mind when they draft indemnities, the way in which qualifications to indemnities are expressed suggests otherwise.[160]

Second, the third view is consistent with the cases which treat an action on an indemnity as an action for damages and (unless the cause of action is regarded as arising when the agreement is breached) it is also consistent with the general approach of treating the cause of action as arising when the promisee sustains loss.[161]

Third, the issue need not arise. If the drafter of a party-party indemnity has the courage of his or her convictions, the drafting should make plain how the indemnity is to be applied. For example, the indemnity might read:

> A must indemnify B against any loss caused by breach of this agreement by A whether or not such loss was a foreseeable consequence of the breach of the agreement or a foreseeable consequence of A's failure to indemnify B.

Does the indemnified party have a choice?

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[160] See below, text at n 63.

[161] Cf *County and District Properties Ltd v C Jenner & Son Ltd* [1976] 2 Lloyd's Rep 728 at 737.

A party-party indemnity looks to assume the existence of a distinct promise. For example, if A warrants in favour of B that goods are fit for their purpose, and also promises to indemnify B against breach of the warranty, there are clearly two promises. Since there are two promises, there is an obvious potential for A to be subject to two bases for liability.

In the cases in which the question has arisen whether the contract is one of guarantee or indemnity, the contrast has often been between an accessory liability (to compensate the creditor) and a primary liability (to indemnify). Conventionally,[162] this has been seen as a difference between a promise (guarantee) that someone else (the principal debtor) will do something (perform the principal contract) and a promise (indemnity) that the promisor will do something (keep the promisee harmless against loss). Although the conception of a guarantee of a monetary obligation as a promise that the principal debtor will do something has been questioned in recent years,[163] this distinction may be accepted for the purpose of considering whether breach of a party-party indemnity creates a separate cause of action.

In one sense it might seem obvious that a party-party indemnity creates two causes of action. Normally, if there are two promises each may be breached by the same act. For example, if A warrants in favour of B that goods are fit for their purpose, and also warrants that the goods are of good quality, goods delivered by A may be both unfit for their purpose and not of good quality. There are then two causes of action. Therefore, where A agrees to indemnify B against breach of the agreement, and B suffers loss as a result of A's breach of contract, B looks to have two claims against A.

Whether a party-party indemnity provides an additional cause of action may be very important. For example, the contract may limit A's liability for breach of warranty but not limit A's liability on an indemnity. (The converse may also be true.) If it is correct to say that breach of a party-party indemnity provides an additional

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[162] See, eg *Moschi v Lep Air Services Ltd* [1973] AC 331 at 348; *Marubeni Hong Kong & South China Ltd v Mongolia* [2005] 1 WLR 2497 at 2504; [2005] EWCA Civ 395 at [20].

[163] See *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245; 77 ALR 205.

cause of action, the indemnifier must ensure that limitations of liability in the contract apply both to breach of the agreement and any action on the indemnity.[164]

Again, the cases do not resolve this issue. However, it is more consistent with the cases to say that a promise of indemnity is breached when a loss crystalises rather than when the agreement is breached. Where a breach of the agreement occurs this may not immediately crystalise a loss. It is, however, actionable immediately and the promisee is entitled to have damages assessed in the normal way. And, as the beneficiary of an indemnity, the promisee is entitled to wait for the loss to crystalise and to bring a claim on the indemnity because, until the loss crystalises, there is no cause of action.

Notwithstanding the inherent logic in the above approach, and notwithstanding that many people may think it correct on the authorities, in my view it is wrong both at the level of principle and at the level of practice. At the level of principle, where there is a party-party indemnity the action for breach of the agreement is subsumed in the action on the indemnity.[165] In other words, the parties have agreed to accept the indemnity as the measure of compensation for breach of the agreement.[166] The only questions are what that measure is and how the indemnity promise operates.

At the level of practice, the approach to drafting qualifications to indemnities virtually ensures either that the only cause of action is for breach of the agreement or that the only cause of action is on the indemnity. Therefore, if the issue is looked at from the perspective of the parties' intention, this will usually be disclosed by the agreed qualifications on the right of 'indemnity'.

'Clean' and Qualified Indemnities

It seems uncommon for a party-party indemnity to be a 'clean' indemnity, that is, an unconditional and unqualified indemnity. Many indemnities are qualified (these are usually termed 'carve-outs'). A simple (and very common) qualification is for

164 Cf *Caledonia North Sea Ltd v British Telecommunications Plc* [2002] 1 Lloyd's Rep 553 at 572-3; [2002] UKHL 4 at [99]-[101].

165 Cf *Telfair Shipping Corp v Inersea Carriers SA (The Caroline P)* [1985] 1 WLR 553 at 568 (position where indemnity is implied).

166 *Burkard & Co Ltd v Wahlen* (1928) 41 CLR 508 (indemnity provision in contract for sale of quantity of tin clippings displaced action for common law damages).

'consequential loss' — whatever that means.[167] Another common carve-out is for loss of profit. It is also reasonably common for the indemnity to be limited in amount, for claims to be enforceable only if they exceed a certain threshold and for claims to be restricted to particular categories of breach or the breach of particular terms.

I have already hinted at two points which may be made in relation to qualifications such as these. The first is that their presence may deprive the promise of one or more of the characteristics which the parties may have assumed to be implied from invocation of the indemnity concept. If that is the case then all the theorising about the nature of indemnities and their essential characteristics may be set at naught. That may come as a surprise, but it is in my view inherently inconsistent with the idea of 'indemnity' for breach of an agreement for the promise of indemnity to be limited to losses which cannot be described as 'consequential'. If is, of course, a truism that the extent of any indemnity may be defined. An insurer rarely undertakes an unqualified and unlimited indemnity. We have no difficulty in such a case in saying that there is an indemnity. However, an indemnity against breach is different. The promise is to compensate for a loss caused by breach. But that breach is already the subject of a measure of damages, which may well include liability for 'consequential loss'. If an indemnity is a promise to hold a person harmless, how can a promise be regarded as an indemnity if the promisor's liability is narrower in scope than the liability it would have but for the 'indemnity'? If, as Asquith LJ said in *Victoria Laundry (Windsor) Ltd v Newman Industries Ltd*, an action for contract damages is a claim for something less than an indemnity, how can a claim for something less than an action for contract damages be called 'an indemnity'?

The second is that the way in which the qualifications are framed may settle the question of whether the rules on remoteness of damage apply, and also their reference point. Assume that the indemnity takes the form:

> A must indemnify B against any Loss (other than a Consequential Loss) caused by breach of this agreement by A.

The reference point for the concept of Consequential Loss looks to be breach of the agreement, not breach of the promise of indemnity. Since the concept of Consequential Loss is applied to 'breach of this agreement', it seems clear that it is

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167 It is unnecessary for present purposes to analyse the meaning of the expression. But note *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* [2008] VSCA 26.

loss caused by breach of the agreement, not breach of the indemnity promise, which must be the basis for any claim by B.

These points may be said to reinforce each other. Since the presence of qualifications may disclose that the reference point for determining loss is breach of the agreement rather than breach of the indemnity, it is logical to say that the indemnity is no more than an agreement about how contract damages must be assessed. The 'indemnity' is then an agreement about compensation for breach of the agreement. The one and only cause of action is for breach of the agreement. If the qualifications are significant, the word 'indemnity' may simply mean 'pay such damages as are recoverable at common law but subject to the limitations set out in this clause'.

The third point is that the qualifications may make it very difficult to determine the precise scope of the indemnity. And it follows that the (so-called) indemnity may provide for payment of a sum of money which is in fact less than the loss which would have been recoverable for common law damages. The message is clear. A party who is forced to give an indemnity should do its best to undermine the clause by insisting on qualifications. But it must be hard for a lawyer to face his or her client by saying 'you have an indemnity, but I don't know whether it is worth having or whether the $300,000 you spent in the negotiation of the indemnity was money down the drain'.

Conclusions

The discussion above suggests that there is very little which can be regarded as settled law in relation to indemnities against breach of contract. The burden of the discussion is that even if correct decisions can be made in relation to the operation of such an indemnity, these are likely to apply only to 'clean' indemnities.

Although when I agreed to present this paper I said that I would not be expressing any conclusions about how indemnities against breach operate, I would venture the following suggestions as being logical deductions from the authorities. First, a claim on a party-party indemnity is a claim for damages for breach of contract. A failure to indemnify does not give rise to a separate claim for damages because the law does not (at present) recognise a cause of action for the late payment of damages.

Second, unless it is clear that the parties have agreed otherwise, the cause of action on the indemnity arises when loss is suffered by reason of occurrence of the event referred to in the indemnity. Therefore, under an indemnity against breach of contract, the cause of action arises when the indemnified party suffers loss because of the indemnifier's breach of the agreement.

Third, while it may be true to say that the beneficiary of an indemnity is in some cases entitled to be put in funds immediately, so as to prevent loss arising, that idea has little relevance to a party-party indemnity for breach of an agreement.

Fourth, the objective of an indemnity is to express agreement on how damages for breach of the agreement are to be assessed. The concept of remoteness of damage is not applicable because the parties have contracted out of that rule.

Fifth, the means by which the parties contract out of the concept of remoteness of damage is by the insertion of a promise of indemnity. The only right of action enjoyed by the promisee for breach of the agreement is therefore to sue on the indemnity.

For what they are worth, the suggestions above express the essential characteristics of an indemnity where the promise is unqualified. It is impossible to explain the impact of qualifications to the indemnity without knowing what those qualifications are. However, on one view, once it is clear that there is no promise to hold the indemnified party harmless, for example, because the indemnity is stated not to apply to 'consequential loss', the promise is not an indemnity at all. Whether the characteristics which indemnity promises generally have are applicable depends on construction of the contract. Reliance on the label may be misplaced. Personally, I doubt whether this matters a great deal. Even if it is correct to say that there is no separate promise — so that the only cause of action available to the promisee is for breach of the agreement — content can still be given to the 'indemnity' as an agreement on how damages must be assessed. The position is simply that the only cause of action available to the promisee is an action for breach of the promise which activates the 'indemnity'.

Near the beginning of the paper I made the point that construction is the process by which the meaning and legal effect of any promise — including an indemnity promise — is determined. It necessarily follows that it is always open to the parties to put back in those characteristics of an indemnity which have otherwise been lost by reason of qualifications. For example, whatever view a court comes to on whether a so-called ‘indemnity’ is in law an indemnity, it is open to the parties to agree that it is unnecessary for the promisee to incur a loss or expense prior to claiming on the indemnity, Similarly, they may agree that no cause of action arises until loss is suffered.

Assuming the suggestions made above are correct, what is the nature of an indemnity against breach of contract? To answer that question we might ask, ‘What type of contractual promise has the following characteristics?’:

(1) an action on the promise is an action for damages;

(2) an action on the promise is not available unless another promise in the agreement has been breached;

(3) an action on the promise may lead to recovery of a money sum which is greater than that which would have been recovered as damages for breach of the other promise; and

(4) the right of action on the promise replaces the right of action which would otherwise have been available in relation to the other promise.

Saturday 26th July, 2008

Plenary
Millennium Hotel

3.00pm – 4.30pm

Chair:
John Evans
Partner
Henry Davis York
Sydney

Speakers:

Justice Reg Barrett
Supreme Court NSW
Sydney

Michael Dineen
Partner
Buddle Findlay
Auckland

Roger Dobson
Partner
Henry Davis York
Sydney

Collapsing collective investment vehicles:
Insolvency of Trusts & Managed Investment Schemes – uncertain territory for lenders and lawyers

Justice Reg Barrett, Supreme Court NSW, Sydney
Insolvency Of Registered Managed Investment Schemes

INSOLVENCY OF REGISTERED MANAGED INVESTMENT SCHEMES
by
R. I. Barrett*

To Australians and New Zealanders, "collective investment vehicle" is synonymous with "trust". Both countries have long been familiar with the unit trust structure under which property is held by a trustee and turned to account by a management company; and the beneficial interest in the trust fund is divided into units evidenced by certificates held by investors. This is the model that the High Court had before it more than half a century ago in *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598.

Tom Hadden says in his book "Company Law and Capitalism" that, in England, unit trusts were popular in the mid-nineteenth century but declined after *Sykes v Beadon* (1879) 11 ChD 170 and did not revive when that decision was reversed in *Smith v Anderson* (1880) 15 ChD 247. The revival came in the 1930s as a means of avoiding the increasing controls which were being imposed on the flotation of new issues on the stock market. It was this revival that prompted the *Prevention of Fraud (Investments) Act* 1939.

In Australia, responsibility for the growth and popularity of unit trusts probably rests with the tax system and its separate taxation of the income of companies without, until more recent years, related tax credits for shareholders on their dividends.

Today in Australia, the "single responsible entity" model holds sway as a result of the reforms that came from the report "Collective Investments: Other People's Money" (1993). But trust principles remain at the forefront. Indeed, the resultant legislation (now reflected in Chapter 5C of the *Corporations Act* 2001 (Cth), "Managed Investment Schemes") says in unambiguous terms in s 601FC(2):

* A Judge of the Supreme Court of New South Wales

> "The responsible entity holds scheme property on trust for scheme members."

This, of course, refers to a registered managed investment scheme. The effect of s 601FC(2) is that adoption of the registered managed investment scheme structure brings with it an unavoidable overlay of trust law: *Investa Properties Ltd v Westpac Property Funds Management Ltd* (2001) 187 ALR 462. I do not say this in any negative way. The trust concept imposes requirements of good stewardship and selfless attention to beneficiaries' interests. That can only be good. But it brings with it the need in some areas to reconcile the statutory scheme with principles of trust law – including those sourced in trustee legislation. It was held in *Re Mirvac Ltd* (1999) 32 ACSR 107 and a number of later cases that the responsible entity under a registered managed investment scheme is a "trustee" for the purposes of that legislation.

My focus in this presentation – ten years after the enactment of the *Managed Investments Act* - will be upon financial stress and the registered managed investment scheme, the particular form of collective investment arrangement that the legislature has cast in the trust mould. I shall leave to one side the now quite extensive case law about winding up unregistered schemes.

How meaningful is it to speak of the insolvency of a registered managed investment scheme? The truth is that a trust or a managed investment scheme cannot become insolvent. It is not a person. It cannot sue or be sued. It does not own property. It is the trustee (or responsible entity, in registered scheme terminology) that owns property and owes money. Debts are incurred by the responsible entity and it is to that entity that creditors must look for payment. The responsible entity, as trustee, in turn, looks to rights of indemnity and reimbursement once the creditor's demand is made.

The *Corporations Act* flirts with a concept of insolvency of a registered managed investment scheme. Section 601ND(1)(b) allows the court to intervene where, in summary, there is unsatisfied execution on a judgment against the responsible entity "in its capacity as the scheme's responsible entity". In such a case, the court may make an order directing that the responsible entity wind up the scheme. The legislation does not say what winding up a scheme is or entails. Nor does it prescribe a method of winding up. The legislation says that a scheme's constitution may state circumstances in which winding up is to occur: s 601NA. It also says that the constitution must make adequate provision for winding up the scheme: s 601GA.

Under the general law, there is no such thing as the winding up of a trust – if, by winding up, we mean a compulsory process which sees assets collected, claims ascertained and paid and any surplus passed to beneficiaries. A court of equity has no jurisdiction to put an end to a trust. On the contrary, it must protect and uphold a trust pending vesting of trust property in beneficiaries. There is valuable discussion of these matters in the recent judgment of Einstein J in *Westfield Queensland No 1 Pty Ltd v Lend Lease Real Estate Investments Ltd* [2008] NSWSC 516. The registered scheme provisions change this. They make specific provision for the winding up of such a scheme, making it clear, at the same time, that a winding up, however initiated, will be undertaken by the responsible entity (or perhaps another person appointed by the court); and that the mode of winding up will come mainly from the constitution, with the possibility of supplementation by orders of the court: s 601NE(1), s 601NF(1) and s 601NF(2).

Let us look more closely at the situation dealt with by s 601ND(1)(b), that is, where there is a judgment and unsatisfied execution against the responsible entity "in its capacity as the scheme's responsible entity". To act in its "capacity" as trustee, an entity must, at the least, act in due execution of the trusts of which it is trustee. It must exercise some power exercisable by it as trustee. And it must act for some purpose related to the trust property. Where the act is the making of a contract, it must be clear from the contract itself or from the surrounding circumstances that the entity contracted as trustee: *Re Interwest Hotels Pty Ltd* (1994) 12 ACSR 78.

But one wonders about the significance of the return unsatisfied of a writ of execution following a judgment against a responsible entity in its responsible entity capacity. Trust property itself cannot be taken in execution by the creditors of a trustee: *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 367. The trustee's own beneficial interest in the whole of the trust assets (to which I shall come in a moment) is an equitable interest that is, of its nature, inseparable from the obligations of the trustee. That interest is therefore, I suggest, incapable of being taken in execution even in jurisdictions where the sheriff is empowered by statute to take equitable interests in specific property under the common law process of execution of a writ of attachment.

It follows, in my view, that an unsuccessful attempt at execution at law says nothing about the sufficiency of the trustee's rights against the trust property to meet the creditor's claim established by judgment. It merely shows that the trustee has no non-trust assets; and while that may indicate that the responsible entity itself is financially stressed and perhaps should be replaced, it says nothing about the financial health of the scheme or venture.

Section 601ND has a second leg to it: s 601ND(1)(a). It allows a court ordered winding up of the scheme on the just and equitable ground. An application under that part of the section was refused in *Re Stacks Managed Investments Ltd* (2005) 219 ALR 532. The scheme was already being wound up. An order was made in the subsequent case of *Re Orchard Aginvest Ltd* [2008] QSC 2. Interestingly, I think, the view that winding up of the scheme was just and equitable was based on what the judge unambiguously described as the insolvency of the scheme. Despite this, it is too early to say that a concept of insolvency of a managed investment scheme is meaningful or to see the alternative ground in s 601ND as allowing some form of winding up in insolvency. Conflicts of interest and other aspects of malaise of concern to equity were also at work.

What is the trustee's interest in the trust property? It is an interest that comes from the right to resort to the trust property to defray liabilities properly incurred in the execution of the trust or for reimbursement where the trustee has paid out of the trustee's own money. Although it now finds statutory expression in trustee legislation, the right was said by Lord Eldon in *Worrall v Harford* (1802) 8 Ves Jun 4 to be an incident of the office of trustee. In the case of a registered managed investment scheme, there is a statutory requirement that the responsible entity's rights to be indemnified out of scheme property for liabilities or expenses incurred in relation to the performance of its duties must be specified in the constitution and must be available only in relation to the proper performance of those duties: s 601GA(2)

This right in respect of trust property is often described as a charge or lien: see, for example, *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319. In *Chief Commissioner of Stamp Duties v Buckle* (1998) 192 CLR 226, the High Court preferred to regard it as a proprietary right constituting a beneficial interest enjoying priority over the beneficial interests of the beneficiaries. And as was emphasised by the High Court subsequently in *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 224 CLR 98, the "trust fund" enjoyed by the beneficiaries cannot be identified or quantified until the trustee's superior right has been quantified and satisfied. And the trustee's right is inseparable from and co-extensive with the trustee's obligations, both those already discharged and those incurred but not yet discharged.

The trustee's rights in the respects just mentioned are fragile things. And their fragility may rebound upon creditors. The beneficiaries' interest in trust property will not be postponed to a beneficial interest of the trustee unless the trustee's interest exists. If the trustee's interest does not exist, the trust property is shielded from the claims of the trustee's creditors.

The trustee's rights arise and exist only to cover or recover expenses incurred in conformity with certain conditions. Those conditions, according to Brooking J in *RWG Management Ltd v Commissioner for Corporate Affairs* [1985] VR 385, require that the expenses are properly incurred in the execution of the trust, so that the right is lost if the trustee's powers are exceeded or there is a breach of the duty of reasonable diligence and care.

This duty of reasonable diligence and care can pose problems. On principle, one might think, a trustee does not exercise reasonable diligence and care if the trustee's conduct is negligent in the tortious sense. But that is not so. It has long been recognised that a trustee's liability for damages in tort may be recouped out of trust property, as long as the relevant acts or omissions occurred in the pursuit of activities within the scope of the trust: *Bennett v Wyndham* (1862) 4 DJ&J 259; *Re Raybould; Raybould v Turner* [1900] 1 Ch 199.

The line of demarcation was considered by the New South Wales Court of Appeal in *Gatsios Holdings Pty Ltd v Nick Kritharas Holdings Pty Ltd* [2002] NSWCA 29. The trustee of a trading trust was found to have engaged in misleading or deceptive conduct in the course of carrying on the business. A statutory liability for damages arose accordingly. In addressing the availability of the trustee's right to resort to trust property, Meagher JA said that the right of indemnity does not exist if the conduct in question is a breach of trust or is criminal in nature or fraudulent. He found it "difficult to formulate any other limitations". In particular, he did not consider that there is any limitation defined by reference to what is "reasonable" or "proper".

The other members of the court agreed that the trustee's breach of the consumer protection statute did not make unavailable the right to resort to trust property. But they expressed reservations about Meagher JA's rejection of the "reasonable" and "proper" criteria. Mason P was not persuaded that those criteria are meaningless. Spigelman CJ, by contrast, found "more helpful than the use of conclusionary terminology of whether or not conduct was 'proper' or 'reasonable'" the nineteenth century approach in *Cotterell v Stratton* (1872) LR 8 Ch App 295 and *Corrigan v Farrelly* (1896) 7 QLJ 105: whether the trustee's conduct amounts to "a violation or culpable neglect of his duty".

This decision was sharply criticised by the Court of Appeal of Victoria in *Nolan v Collie* (2003) 7 VR 287. It was seen as leaving "this important area of trust law rudderless and in a state where mischievous trustees might seize upon an almost unfettered right to indemnity as justifying improper depredation of trust funds, contrary to their obligation not to abuse their position by making it 'a means of profit or benefit' to themselves". Ormiston JA, who delivered the judgment of the court, then said:

> "To my way of thinking the conventionally stated test as to expenses 'properly incurred' is merely a convenient shorthand to describe those restraints applicable to trustees who would seek to look to trust funds for the payment of their expenses and other trust liabilities. It also has the advantage of succinctly expressing the notion of propriety as underpinning a trustee's relationship with the trust estate and the beneficiaries. One must not forget, moreover, that in *Re Beddoe*, seen as one of the leading authorities, Lindley LJ explained that in cases of doubt the trust estate should bear the trustee's

> costs, and that: 'The words "properly incurred" in the ordinary form of order are equivalent to "not improperly incurred"'. The proposition was converted by another respected judge, Bowen LJ, who was perhaps more familiar with courts of common law, into 'a proposition in which the word "properly" means reasonably as well as honestly incurred'. His Lordship added that, while trustees ought not to bear expenses and liabilities personally 'on account of mere errors in judgment which fall short of negligence or unreasonableness', nevertheless 'mere *bona fides* is not the test'. A L Smith LJ concurred with the other members of the court."

In the case of a registered scheme, it is provided, as already noted, that the responsible entity's right of indemnity out of scheme property must be available only in relation to the "proper performance" of the responsible entity's duties. It seems to me that this "proper performance" test is likely to take its content from the general law approaches.

What might in some cases be an added dimension comes from s 601FH. It deals with the situation where the company that is the registered scheme's responsible entity is being wound up. The section does two things. It makes void against the liquidator any provision of the scheme's constitution or another instrument that purports to deny the company a right to be indemnified out of scheme property that the company would have had if it were not being wound up. It then says that a right of the company to be indemnified out of scheme property may only be exercised by the liquidator.

Section 601FH does not create any right of indemnity. The first aspect of it merely preserves for the liquidator a right that the company would have had if it were not being wound up. The preservation is against the effects of any contrary provision in the constitution or another instrument.

The underlying assumption here is that a trustee can be deprived of the right of indemnity by a provision in the trust instrument or some other instrument. That is an assumption that should be examined.

It is said in "Halsbury's Laws of Australia" (at 430-3795):

> "Except in Queensland and South Australia the trust instrument may expressly provide that the trustee's right to indemnity and reimbursement may be denied or reduced in specific circumstances, or generally."

Halsbury goes on to say more about particular provisions.

It is true that in all States and Territories, there is a statutory provision which, in effect, confirms or restates the general law right of resort to trust property. In Queensland, it is provided that the statutory right applies whether or not a contrary intention is stated in the trust instrument. It was this that led McPherson J to observe in *Kemtron Industries Pty Ltd v Commissioner of Stamp Duties* [1984] 1 Qd R 576 (and to confirm in *Ron Kingham Real Estate Pty Ltd v Edgar* [1999] 2 Qd R 439 and *Jessup v Queensland Housing Commission* [2002] 2 Qd R 270) that the right of indemnity cannot be excluded. In some jurisdictions, by contrast, it is provided that the statutory right applies subject to any contrary expression in the trust instrument.

The third possibility is reflected in the law of South Australia where the statutory right is conferred in terms, which say nothing either way about the capacity of the trust instrument to exclude or modify it. In *Moyes v J & L Developments Pty Ltd (No 2)* [2007] SASC 261, Debelle J concluded that, as a result, the indemnity could not be excluded by the trust instrument; nor could the trustee waive it as it existed for the benefit of the trustee's creditors as well.

I am not at all sure that the position in New South Wales is as portrayed by Halsbury. The provision creating or conferring the right of indemnity is s 59(4) of the *Trustee Act* 1925 which does not appear to be supplemented or qualified by either an entrenching provision or one allowing exclusion or modification by the trust instrument. Section 59(3) is a provision of the latter kind but applies only to s 59(1) and s 59(2). It must follow that s 59(3) takes effect in the way described by Debelle J in relation to the South Australia equivalent. That may well explain Santow J's preference in *J A Pty Ltd v Jonco Holdings Pty Ltd* (2000) 33 ACSR 691 for the approach taken in *Kemtron*. In *Metropolitan Petar v Macedonian Orthodox Community Church St Petka Inc* (No 2) [2007] NSWCA 287, Ipp JA described s 59(4) as "an empowering provision of general application".

Returning to the registered scheme and the first aspect of s 601FH of the *Corporations Act* – the aspect that preserves the right of indemnity out of trust property when the responsible entity is subject to winding up – the position seems to be that the section potentially has work to do where the operative law is that of an Australian jurisdiction other than Queensland, South Australia and New South Wales – or, perhaps, the law of some place outside Australia.

Nothing has been said to this point about a trustee's right to be indemnified by the beneficiaries. It was said by Lord Lindley for the Privy Council in *Hardoon v Belilios* [1901] AC 118 that "the plainest principles of justice require that the cestui que trust who gets all the benefit of the property should bear its burdens unless he can shew some good reason why his trustee should bear them himself". His Lordship was speaking of a beneficiary of full capacity.

It was recognized in *Hardoon v Belilios* itself that the trustee's right of recourse to beneficiaries may be excluded by the trust instrument or surrounding circumstances. As to the latter, Lord Lindley himself, in *Wise v Perpetual Trustee Co Ltd* [1903] AC 139, saw a social club in which members were perpetually changing and were required to pay no more than their annual subscriptions as an example of excluding circumstances.

One might be inclined to consider the circumstances of a widely held unit trust to be similar. But it appears that they are not. Perhaps the commercial aspect makes the difference. Unitholders were held liable to indemnify the trustee of a unit trust scheme in both *Causley v Countryside (No 3) Pty Ltd* (unreported NSWCA 2 September 1996) and *Fitzwood Pty Ltd v Unique Goal Pty Ltd* [2002] FCAFC 285. This was consistent with the earlier case of *J W Broomhead (Vic) Pty Ltd v J W Broomhead Pty Ltd* [1985] VR 891. In each case, however, the units were closely held.

If investment is sought from passive investors, the managed investment scheme constitution will almost certainly contain a provision excluding the trustee's right of indemnity against beneficiaries personally. According to *Hardoon v Belilios*, such provisions mean what they say and are effective. But this may be subject to a public policy exception discussed by Young J in *McLean v Burns Philp Trustee Co Ltd*

(1985) 2 NSWLR 623. An example there given was "a trust which is so geared to enable a person to avoid his creditors by hiding behind the vehicle of a trust".

Uncertainty of the kind that comes from such a broad statement is anathema to the investment community. On three occasions in the last quarter of a century, Australian law reform bodies have advised lawmakers that limited liability of unitholders should be legislated for registered schemes or those exempt from registration. In August 1984, the Companies and Securities Law Review Committee recommended to the Ministerial Council that the liability of unit holders in public unit trusts be limited in the same way as the liability of shareholders of companies. In 1993, the Australian Law Reform Commission and the Companies and Securities Advisory Committee, in their joint report "Other People's Money", made the same recommendation to government. The recommendation was repeated by CASAC in its own report "Liability of Members of Managed Investment Schemes" in 2000.

On each occasion, the concern was the same: that the general law left an uncertainty that served neither the interests of investors nor the interests of creditors. And on each occasion, the reaction was the same: the law was not changed.

I should mention, for completeness, the third possible source of recoupment for the corporate trustee. Under s 197 of the *Corporations Act*, a director of the trustee company will be required to discharge a liability incurred by the company as trustee where the company cannot do so and is not entitled to indemnity out of trust assets because of breach of trust, exceeding of powers or denial of indemnity by the trust instrument.

Let us now trace through what might actually happen when a registered managed investment scheme assets are insufficient to meet liabilities, the venture is trading unprofitably and cash flow is negative. The outcome will differ according to whether the responsible entity is rich or poor in its own right; whether it has substantial free assets apart altogether from the managed investment scheme.

Take the case of the independently wealthy responsible entity. As a trustee, it is personally responsible for the debts referable to the scheme (I am assuming here that creditors have not agreed to limit their recourse against the trustee personally so that they can resort to the trust assets only). Its right of recoupment out of trust property will ensure that whatever can be obtained from that source will be obtained and used to pay debts. If, by some chance, the right of recourse to beneficiaries has not been excluded, the responsible entity will resort to that also. And if any balance remains unrecouped, the rich responsible entity will ruefully put its hand into its own pocket and be poorer to the extent of that balance.

This is the result dictated by the law of trusts. Does the statutory scheme indicate any other result? The analysis just outlined supposes that it is consistent with the duties of the responsible entity as a trustee simply to realize what can be realized to enable creditors' pressing claims to be reduced. That does not fit with the idea of an ongoing venture that was no doubt envisaged by the founders and embedded in the constitution. But even if the constitution does not allow an early termination or vesting in case of financial stress, the *Corporations Act* probably does, either on the basis adopted in *Re Orchard Aginvest Ltd* or under s 601NC which allows the responsible entity to initiate action directed towards winding up of the scheme if it considers that its purpose cannot be accomplished – a view likely to be clearly open if the scheme is no longer financially viable.

Consider next the case of a financially non-viable scheme with a poor responsible entity – a company with only just enough independent financial substance to support its licensed status and which has the operation of the particular scheme as its sole activity. In this case, it will not be long before a pressing creditor obtains an order for the winding up of the company in insolvency. That will permit ASIC to cancel the company's licence (s 915B(3)(b)) so that it no longer meets a basic requirement for being a responsible entity (s 601FA). There will then be grounds for ASIC or a member of the scheme to apply to the court for the appointment of a temporary responsible entity (s 601FN). The court may make an appointment if it is satisfied that it is in the interests of members to do so (s 601FP).

The Act makes it clear that a temporary responsible entity is just that: a responsible entity which holds office on a temporary basis only and has the specific task of calling a meeting of the scheme's members with a view to the appointment of a new responsible entity: s 601FQ. But a temporary responsible entity is still a responsible entity, at least from the time at which it is named in ASIC's registration of the scheme. That is made very clear by the s 9 definition of "responsible entity".

If there is going to be an appointment of a temporary responsible entity, there must first be some qualified company willing to be appointed, even if only temporarily. That, I suggest, will be a problem. When a new responsible entity takes office, it becomes, under s 601FS, the statutory inheritor of the rights, obligations and liabilities of the old responsible entity in relation to the scheme. The workings of that section were examined in both *Investa Properties Ltd v Westpac Property Funds Management Ltd* (above) and *Syncap Management (Rural) Australia Ltd v Lyford* (2004) 51 ACSR 223. In our postulated situation, the successor will come to owe the debts that brought the old responsible entity undone and to have the rights of recoupment that were insufficient to allow it to continue. Simple replacement of the responsible entity in liquidation therefore does not seem a practical possibility. The automatic vesting of the non-viable combination of liabilities and inadequate rights of recoupment must mean that, in the real world, there will never be a new responsible entity.

A possibility that would then spring to mind is that the court, in exercise of its general jurisdiction, might appoint a new trustee. White J recently observed in *Dreiberg v Bettles and Carter* [2007] NSWSC 1204 that "it is undesirable for an insolvent company in liquidation to remain as trustee". In that case, the liquidators of the corporate trustee in liquidation were themselves appointed to be new trustees. But in the case of a registered managed investment scheme, it seems that a solution by way of appointment of a new trustee by the court is ruled out by s 601FJ(2) which makes ineffective any purported change of responsible entity that is not in accordance with Division 2 of Part 5C.2.

Is there a case for the liquidator's seeking the appointment of a receiver by the court, as in, for example, *Bastion v Gideon Investments Pty Ltd* (2000) 35 ACSR 466? That, I suppose, would be a possibility if the trust assets were seen to be in some kind of jeopardy. There might then be a case for appointing a receiver to bring them into court to ensure that they were appropriately dealt with in the winding up. The appointment of a receiver, as such, would not seem to cut across the prohibition on the replacement of the responsible entity except as the statutory provisions allow. A receiver's functions would complement those of the responsible entity which, although in liquidation, would remain as responsible entity.

Any scope there might otherwise be for the appointment of a receiver of the responsible entity's own beneficial interest, as trustee, in the scheme assets would seem to be ruled out by the second aspect of s 601FH which says that the responsible entity's right to scheme property can only be exercised by the responsible entity's liquidator in case of winding up.

The only really feasible outcome in the situation of the independently impecunious responsible entity seems to be for the company in liquidation to remain the responsible entity. That raises the issue already noticed. A liquidator's duty is to wind up the affairs of the company. To the extent that the affairs include the holding of property on trust, with ongoing duties, the liquidator's first task, it seems to me, will be to find a way to bring the managed investment scheme to an end, either by the *Orchard Aginvest* means (if it is truly viable) or by resort to s 601NC.

There will be, in the winding up of the responsible entity company (whether it is independently rich or poor), a question about how the company's beneficial interest in the trust property – the interest that comes from the right of recoupment – should be applied in the winding up.

In this connection, the conflict between the appellate decisions in *Re Enhill Pty Ltd* [1983] 1 VR 561 and *Re Suco Gold Pty Ltd* (1983) 33 SASR 99 seems to be on the wane. I do not want to go into this matter in any depth. It will be recalled that the Full Court of the Supreme Court of Victoria held in *Enhill* that the fruits of the right or indemnity – or what was later characterised in *Buckle's* case as the preferred beneficial interest in the trust property – was available to the trustee's liquidator for application in the winding up generally; while the Full Court of the Supreme Court of South Australia held in *Suco Gold* that this was so only to the extent that anything remained after prior payment of the trust creditors.

The matter has not since been directly considered by an appellate court. The conflict was mentioned by the Court of Appeal of Victoria in *Arjon Pty Ltd v Commissioner of State Revenue* [2003] VSCA 213 and in *Nolan v Collie* (above). In the latter case, the judgment included the pregnant words, "if *Enhill* be correct".

The preponderance of opinion backs *Suco Gold*. Trust creditors are subrogated to the trustee's right of recoupment out of trust property. That right is measured by and applicable only towards the claims of trust creditors. In a winding up of the trustee, therefore, the trust creditors should enjoy the benefit of the trustee's preferred beneficial interest to the exclusion of the non-trust creditors. If there were no winding up, the non-trust creditors would have no expectation of sharing in the benefit of the right of recoupment; and there is no reason why that should change when winding up intervenes.

The case I have not considered is that where the responsible entity has separate and independent activities that cause it to become insolvent, even though the scheme or trust remains on a financially healthy footing. That is not really a case of insolvency central to the collective investment and a simple replacement of the responsible entity under the statutory provisions should be feasible.

So there we have it. The provisions about managed investment schemes do not attempt to deal in any comprehensive way with insolvency. To the extent that they approach the matter at all, they do so on the basis of two of the foundations of the scheme of regulation: first, that the responsible entity must be a company of a particular kind; and, second, that the scheme property is held by the responsible entity as a trustee. From there, matters of insolvency are left to be dealt with according to company law and the law of trusts.

Lack of financial viability of the venture carried on as a registered managed investment scheme is likely, it seems, to lead to a winding up in insolvency of the company that is the responsible entity. And the winding up of the company will, in some way, have to prompt a winding up of the scheme. It will be impracticable to replace the responsible entity in liquidation because any successor responsible entity will become the statutory inheritor of the financially non-viable venture. It will be impracticable to resort to the general jurisdiction of the court to appoint a new trustee because the provisions about managed schemes displaces it. And it will be impracticable to seek to secure the right of indemnity out of trust property in the hands of a receiver because it is exercisable only by the liquidator of the responsible entity. Subject to all that, ordinary principles of equity and company law will determine the course of the administration of the company's insolvent winding up.

Michael Dineen, Partner, Buddle Findlay, Auckland
Collapsing Collective Investment Vehicles - A New Zealand Perspective

COLLAPSING COLLECTIVE INVESTMENT VEHICLES - A NEW ZEALAND PERSPECTIVE

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COLLAPSING COLLECTIVE INVESTMENT VEHICLES: INSOLVENCY OF TRUSTS AND MANAGED INVESTMENT SCHEMES – UNCERTAIN TERRITORY FOR LENDERS AND LAWYERS

Background – the Current Investment Climate

1. It is certainly topical right now to be considering the insolvency of collective investment vehicles. In the last 6 months we have seen[168]:

   Citigroup Inc. suspending investor withdrawals from a London-based US$500 million credit hedge fund to give it a chance to "stabilise";

   Bear Sterns (in its last days) closing a hedge fund that had invested nearly US$1 billion in asset-backed securities;

   Knight Capital Group Inc. liquidating two poorly performing hedge funds and returning their assets to investors;

   DB Zwirn & Co LP liquidating two of its largest funds involving US$4 billion in assets after investors tried to redeem approximately half of their investments;

   Peloton Partners telling investors that its Peloton ABS Master Fund was to be liquidated;

   GO Capital Asset Management suspending investor withdrawals from its €600 million Global Opportunities Fund for one year for liquidity reasons;

   Polar Capital Holdings plc closing three funds after a 11% fall (US$400 million) in assets under management; and

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[168] "*Hedge Funds Stagger Through First Quarter '08*", Lipper HedgeWorld, Chicago, *Alternative Investment Quarterly*, First Quarter 2008.

Pardus Capital Management suspending investor withdrawals due to declining values of its holdings in order "to protect the funds and their investors from external short-term pressure".

2. The low water mark had been set ten years ago with the collapse of the hedge fund Long-Term Capital Management. Founded in 1994, its capital by early 1997 had risen to US$4.7 billion. The markets then turned horrifyingly against it, triggered by Russia defaulting on its bonds in August 1997. LTCM lost virtually all of its capital and was bailed out by a consortium of banks arranged by the Federal Reserve so as to avoid a failure that could have threatened the global financial system[169].

3. By these standards, problems in New Zealand are insignificant:

in March 2008 ING NZ froze withdrawals from its Diversified Yield and Regular Income Funds indefinitely, with NZ$520 million of retail investors' money at stake. The funds had invested in CDOs and CLOs in the USA and Europe. While the value of the Funds' investments had declined heavily due to the absence of buyers, there is considerable optimism that the underlying credit quality of the loans is such that over time they will be largely repaid and the two funds will return to something like their previous value;

in early April 2008 TOWER announced that its NZ$220 million MortgagePlus Fund was to be liquidated after TOWER decided, among other things, that it was "uncompetitive" in the current interest rate environment. It is not clear how long it will take to wind the fund up[170], but a first payment of 10% to investors was made in May and further distributions are expected quarterly; and

in July 2008 Canterbury Mortgage Trust suspended withdrawals owing to "an unprecedented number" of withdrawal requests, leaving its 5,000 investors unable to withdraw their investments totalling NZ$250 million until at least March 2009[171].

4. The problems for managed funds represent only the tip of the investing iceberg. As is well known, other products and institutions around the world[172] and in New Zealand have had their problems. As far as New Zealand is concerned, in the last two years we have seen more than 20

[169] For the full story see "*When Genius Failed – The Rise and Fall of Long-Term Capital Management*", Roger Lowenstein, Random House 2000.
[170] On the TOWER website investors are told the fund is being wound up "as quickly as possible".
[171] CMT is telling investors their quarterly interest payment due in October 2008 will still be paid, although the amount might be lower than expected. Since the fund is a group investment fund the reference to paying "interest" is incongruous.
[172] The collapse late last year of Britain's fifth largest mortgage lender Northern Rock, the rescue earlier this year of Bear Sterns by JPMorgan Chase after intervention by the Federal Reserve, and the more recent and ongoing 'rescue of the rescuers' Fannie Mae and Freddie Mac have all been widely publicised.

finance companies either put in receivership, reach an arrangement with creditors or stop lending and withdraw their prospectuses. In addition other, more sophisticated, debt products have been in the news - the Australian manager of PINs Securities has been placed in voluntary administration and is now to be wound up, with considerable uncertainty for noteholders in terms of what and when they will be paid, and Macquarie New Zealand Fortress Notes have traded for some time at less than half of their face value and although they now have improved financing facilities available they will not be paying investors interest for some time173.

5. So what are collective investment vehicles and what is the nature of "insolvency" when applied to them?

Collective Investment Vehicles in New Zealand

6. Collective investment vehicles take many forms. They can be companies, partnerships, limited partnerships and trusts. Basically they are just vehicles which enable a group of investors to invest together, often in an aggregated way which would not be available to them each individually. They also have different names in different jurisdictions – they can be called unit trusts, mutual funds, investment trusts, open-ended investment companies, unit investment trusts, closed-end funds and any number of variations on those themes. Some would say they include superannuation schemes and life insurance products but this paper will deal with unit trusts and their lesser known colleagues, group investment funds174.

7. Group investment funds are a creature of statute. Section 29 of the Trustee Companies Act 1967 allows trustee companies (Trustees Executors, NZ Guardian Trust, Perpetual Trust and Public Trust) to establish group investment funds. This was effectively a statutory authorisation to trustee companies to mix trust funds, thereby aggregating investments and enabling enhanced returns to their beneficiaries. However, during the 1970s and 80s it became fashionable for trustee companies to create group investment funds as an external managed fund for retail investors.175

[173] Four years, according to the *National Business Review* (1 July 2008). The new loan does not require asset sales if their value declines.
[174] Superannuation schemes and life insurance products have their own statutory regimes and it would seem that most of the problems with superannuation schemes have arisen not because of any kind of insolvency but exactly the opposite – what to do with the surplus. One could also include securitisation vehicles here, since trusts are invariably used in their structuring, but the end investor is almost always holding a debt instrument, rather than a unitised interest in any trust.
[175] It is questionable whether they were ever intended to be used for this purpose but there were advantages, often tax-related, in creating retail GIFs instead of unit trusts.

8. The units in retail group investment funds are “participatory securities” for the purposes of the Securities Act 1978 and their offer to the public is regulated by the participatory securities regime in that Act. Although similar in nature, they are not unit trusts and they are considered to be a “trustee’s fund” rather than a “manager’s fund” as is the case with unit trusts. In other words, it is the trustee which is primarily responsible for their creation and management, as well as custodianship of the assets, although the investment management and administration responsibilities are often contracted out.

9. However, most collective investment schemes in New Zealand are unit trusts established under the Unit Trusts Act 1960. This Act was subsequently considered insufficiently rigorous for the protection of investors and it is now necessary for offerings of units in unit trusts to comply with the Securities Act requirements as well[176]. There is a separate regime within the Securities Act dealing with unit trusts.

10. The unit trust is, as mentioned previously, considered to be a “manager’s fund” in the sense that the manager, who will be independent of the trustee, makes all investment decisions relating to the scheme[177]. The trustee’s responsibility is to hold and protect the assets of the fund for investors, although the trustee does have an obligation, implied in trust deeds by section 12 of the Unit Trusts Act, not to act on any direction of the manager to buy or sell an asset of the trust if in the trustee’s opinion the proposed purchase or sale is “manifestly not in the interests of the unit holders”. This “power of veto”[178] is seldom used.

11. A discussion of unit trusts would not be complete without a brief reference to the “PIE” (portfolio investment entity) regime introduced in April 2008, by way of amendment to the Income Tax Act 2007. While unit trusts were fashionable in the 1980s, it soon became apparent that they suffered from something of an uneven playing field in terms of their tax treatment. Because by their very nature they bought and sold assets as investments, they were subject to tax not only on the income derived from their assets but also on any capital gain made on the sale of their assets. This is to be compared with the normal situation of an investor in New Zealand who would not be subject to capital gains tax unless he or she was a trader in those assets or had specifically bought the asset with the intention of reselling it.

[176] *Securities Act 1978* and *Securities Regulations 1983*.
[177] Unlike in Australia, there is no ‘responsible entity’ regime in New Zealand so each unit trust must have a trustee and a manager. Under section 4 of the *Unit Trusts Act*, the manager must post a bond of $40,000 with the Crown to secure the due discharge of its obligations before it can act as manager.
[178] So described by Durie J in *Re Flat Rock Forests Trust* [2000] 3 NZLR 207.

12. After many years' lobbying, this uneven playing field has now been sharply tilted the other way – through the introduction of the PIE regime. Now, subject to compliance with the detailed PIE criteria contained in the Act, investors in a managed fund which is a PIE pay a final tax of 30 cents in the dollar on their income from the fund. Since the top marginal tax rate in New Zealand is 39 cents in the dollar, managers of unit trusts and other managed funds have been quick to comply with the PIE regime[179] to give investors on the top marginal rate an effective 9 cents in the dollar tax saving on the income from their investment.[180]

Liability of Unit Trustees

13. Section 24 of the Unit Trusts Act deals with the statutory liability of a trustee of a unit trust and provides as follows:

> "The trustee of a unit trust and the manager thereof shall each have the same duty to observe care and diligence in the performance of its duties as any other trustee, and shall each be entitled to the same indemnities and relief as any other trustee.
>
> Any provision in a trust deed governing a unit trust or any other instrument shall be void so far as it would have the effect of –
>
> > Exempting the trustee or manager or any director or officer of the trustee or manager from liability for breach of trust where it or he fails to show the degree of care and diligence required of it or him in that capacity, having regard to the provisions of the trust deed and the powers, authorities, or discretions conferred thereby:
> >
> > Indemnifying the trustee or manager or any such director or officer from any such liability."

14. So the trustee is not to be exempted from, or indemnified against, liability for breach of trust where it fails to show the degree of care and diligence required of a trustee. Trustees invariably seek to be exempted from liability as much as possible and it has become standard for unit trust deeds in New Zealand to provide that the trustee is liable only where the

[179] Indeed the difficulty in converting the TOWER MortgagePlus Fund (see paragraph 3(b) above), which is a group investment fund, into a PIE is stated by TOWER to be one of the reasons for winding it up.

[180] Traditional issuers of debt securities in New Zealand, such as banks, have been quick to take advantage of the PIE regime as well. Most of the banks in New Zealand have now created "cash PIEs" in order to protect their depositor base, so that depositors who previously invested in debt securities issued by their bank now invest in units in a PIE (often managed by a subsidiary of their bank), thereby effectively receiving a higher return on their "deposit". Anecdotal evidence is that the IRD is "surprised" that banks and other issuers of debt securities have reacted in this manner.

liability is attributable to its "own wilful act, gross negligence or wilful default"[181], or wording to similar effect.

15. This provision is then invariably accompanied by wording to the effect that it does not limit the trustee's statutory "duty of care and diligence and vigilance in carrying out its duties…."[182]. It is also a requirement of the Securities Regulations that a unit trust prospectus state the extent if any to which the trustee is indemnified by the trust.

16. Given the extent of these indemnities and exemptions, one might be forgiven for wondering how a trustee under a unit trust can be liable to anyone for anything, unless it has been grossly negligent or has wilfully defaulted in its obligations. The answer is that liability can arise in a number of different ways:

by entering into contracts on behalf of the trust; and

through statute.

Contractual Liability

17. Quite often it is the trustee rather than the manager who will enter into a contract on behalf of a unit trust. Most unit trustees will be careful to obtain legal advice on any significant or sizable contracts entered into on behalf of the trust. Unit trustees and their lawyers are unlikely to forget to include in any such contract a provision limiting the liability of the trustee to the assets of the trust[183].

[181] While "gross negligence" has become the standard, there is considerable debate about the distinction between "negligence" and "gross negligence" and indeed whether there is any distinction at all – see *Wilson v Brett* (1843) 11M & W 113, *Pentecost v London District Auditor* [1951] 2 ALL ER 330, *Armitage v Nurse* [1998] Ch 241, *Walker v Stones* [2001] QB 902, *Barraclough v Mell* [2005] EWHC 3387 (Ch), [2006] WTLR 203, *Baker v JE Clark & Co (Transport) UK Limited* [2006] EWCA Civ 464 and the New Zealand case of *Rickard & Ors v The Council of New Zealand Veterinary Association Inc.* (High Court, 1 October 1987, Greig J). Also see the comments made by the New Zealand Law Commission in its report entitled *Some Problems in the Law of Trusts: Report 79* (NZLC R79, April 2002) which recommended the introduction of such a distinction in New Zealand in relation to the liability of trustees. The Government responded to this recommendation by noting that it was controversial and therefore required further investigation. To date, no such recommended legislative action has been taken.

[182] This approach could be criticised as resulting in something of a drafting shambles and it could well be a challenge for any judicial mind tasked with having to work through it. Nevertheless, it has become the 'standard' approach.

[183] The form of the limitation clause is a topic in itself. Each bank in NZ seems to have its own clause and every lawyer has his or her own opinion on all of those clauses. There are often lengthy negotiations between a bank and the NZ Law Society on that bank's standard form limitation clause. The limitation tends to be ineffective to the extent the trustee has been in breach of trust caused by his or her "wilful default or dishonesty" but there is seldom any sign of the "grossly negligent" wording enjoyed by the lucky corporate trustees. Essentially these clauses are up for negotiation on all the larger transactions. For a case where a trustee was held personally liable, despite being described as a trustee, because there was no proper limitation wording see *NZHB Holdings v Friedlander & Ors* (High Court Auckland, 10 June 2004).

18. The main contractual liability of a unit trustee will arise through borrowing. Indeed it is here where most true cases of "insolvency" of unit trusts will arise.

19. Although there are no strictly legal limitations, it has traditionally been the case with New Zealand unit trusts that the ability of the manager to 'gear up' the trust is severely limited. Although it will be the manager's decision to borrow, it will be the trustee who enters into the loan agreement, at least in the capacity of 'borrower'. Traditionally the type of trust most likely to borrow would be a property trust, and normally trustees at the time of preparing the trust deed would limit the amount of borrowing in a property trust to a fairly low level. Whereas banks and other property lenders are prepared to lend well in excess of the traditional 70% or so of valuation[184], corporate trustees have successfully sought to limit property trusts to a loan to valuation ratio of about 35%. Unit trusts investing in other types of property do from time to time have borrowing facilities available but they tend to be for liquidity rather than gearing purposes.

20. Thanks to the relatively low levels of gearing in unit trusts in New Zealand, there have been few instances[185] of trusts being insolvent in the sense that they are unable to pay their creditors. Nevertheless, it is worth mentioning in a paper such as this the remedies available to a lender to a unit trust. These remedies are much the same as the remedies available to a lender to a company. Although the unit trust is not a separate legal entity for general legal purposes[186], a lender to a unit trust (or more correctly a lender to the trustee as borrower) will, subject to the terms of the trust deed[187], be able to take security directly over the assets, eg. by way of mortgage, and more generally by way of a general security interest (equivalent under the PPSA[188] regime to what used to be called a debenture or, in Australia, a fixed and floating charge). The remedies available to a secured lender by way of enforcement of its securities granted by a unit trustee are the same as those available to a lender to

[184] Market commentators considered it an eye-opener when lending institutions started going to 90% of valuation but as we all know the excesses of the last decade or so have seen loans granted at 100%, and even higher than that, of valuation.

[185] Few, but not none. The Flat Rock Forests Trust, a unit trust, had receivers appointed by Countrywide Bank in 1998 and its manager was put into liquidation. This was a case of assets declining in value (or perhaps more correctly being bought at an overvalue) and the bank acting to recover its loan. There was no return to unitholders.

[186] For tax purposes, however, a unit trust is treated as a company.

[187] While it is undoubtedly good practice for the lender to check the terms of the trust deed to ensure the borrowing is within the trustee's powers and that the borrowing is for a proper purpose, lenders will take some comfort from section 22 of the *Trustee Act 1956*. This provides that where a trustee grants a mortgage, the mortgagee's interest will not be impeachable "except on the ground of fraud, or be affected on the ground that no case has arisen to authorise the mortgage, or that the power was otherwise improperly or irregularly exercised" – although the trustee can still be liable to the "person damnified" for its improper actions.

[188] *Personal Property Securities Act 1999.*

any other corporate entity[189], i.e. mortgagee sale, appointment of a receiver, and enforcement of rights personally. In addition there are various remedies available under the Unit Trusts Act to unitholders which are not generally available to creditors[190].

21. Lending can sometimes be on an unsecured basis, although this is rare. In this situation the lender will depend heavily on the trustee's right to be indemnified out of the trust fund[191], and the loan agreement will incorporate a number of covenants by the trustee in relation to this right of indemnity , in particular maintaining that right at all times and not doing anything which could cause that right to be lost[192].

22. Trustees these days have to take special care as a result of the increasing sophistication of financial products. This is especially so in unit trusts investing in derivative contracts where the 'asset' can also have a liability linked to it. Often the ill-informed trustee can find that what he thought was an investment ends up costing the trust a substantial sum.

Statutory Liability

23. It has always been a concern for trustees and their advisers that they can assume liability in certain circumstances by operation of law. In the absence of a contract, the trustee has no way of limiting its liability. Most often a statutory liability will arise associated with the holding by the trustee of an asset. For example, by holding land the trustee can be liable:

for the payment of rates; and

under statutes such as the Building Act 1991 and the Resource Management Act 1991 which can impose strict liability for certain offences[193].

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[189] Note that under the PPSA a general security interest can be taken from any type of entity, including an individual, which was not the case under previous law.

[190] For example the power to remove the manager (s19), the right to appoint inspectors (s21) and rights against delinquent directors of the manager (s27).

[191] Section 38(2) of the *Trustee Act* allows a trustee to reimburse himself from the trust fund for all expenses reasonably incurred in the execution of the trusts or powers. The trust deed will invariably repeat this right and go further to allow the payment of fees to professional trustees. For what is reasonable and what is not, see Hammond J in *O'Donoghue v Farmer* [1998] 1 NZLR 116.

[192] Special care should always be taken when lending unsecured to a trust, not the least to satisfy the lender that the trustee has the power to borrow, that the borrowing is for a proper purpose and that the trustee is not in breach of trust. A loss of the trustee's right of indemnity through a wilful or other serious breach of trust could obviously be catastrophic for the lender. Unsecured lenders will not be protected by s 22 of the Trustee Act (see note 20 above) which only applies to powers to sell, exchange, lease or mortgage.

[193] The RMA, for example, imposes both civil and criminal liability on the owner of land and in some cases (where it can be said they personally contributed to the relevant act or omission) its directors. Local authorities can issue abatement notices requiring action to be taken to ensure compliance with the Act or conditions of a plan or consent, and the Environment Court can issue enforcement orders requiring or restraining certain action. Criminal liability can arise in certain circumstances, such as the accidental release of contaminants. Although these are strict liability offences, local authorities tend to

24. Obviously trustees, like any other property owners, will seek to monitor and minimise any potential liabilities they have in these circumstances such as through environmental audits prior to purchase, but clearly it is possible in extreme cases for trusts to become insolvent if their assets are insufficient to meet these liabilities. Many trustee companies will use a nominated subsidiary company to hold real property assets in an attempt to shield the trustee company itself, and its directors, from these statutory liabilities. Often the directors of the subsidiary will be officers of the manager rather than of the trustee, with the trustee having ultimate control of the company through a carefully drafted constitution. However it is yet to be seen if these attempts at protection will survive judicial scrutiny.

What is the "insolvency" of a managed fund?

25. Obviously insolvency can arise in different ways. The most obvious case is an inability to meet debts as they fall due, ie. cashflow insolvency. Because of the nature of a managed fund, which in most cases is an investing rather than a trading vehicle, an inability to pay creditors will most often arise where the creditor is a lender. This suggests that debt is the main insolvency danger for trustees, and in normal market conditions this may well be right.

26. However, as we have seen recently, the other main cashflow danger to a managed fund is an unanticipated and unusually high demand from investors for redemptions. The reasons for investors wanting to withdraw can be many and varied. For example, if the fund starts to decline in value, more investors will want to withdraw their units and this can lead to a serious "run" on the fund, in some cases to an extent which exceeds the fund's liquidity to enable it to pay them out. On the other hand, the reason for the run on the fund can have no relationship at all with its performance or the underlying soundness of its assets. Indeed, the very recent plight of Canterbury Mortgage Trust[194] is a good example of this – it seems that certain investors in the Trust are wanting to get their investments out simply because of current conditions in the financial markets, in particular in the finance company sector.

Suspension of withdrawals

27. It is here that collective investment schemes have developed a way of managing this type of cashflow insolvency which is not normally[195]

be sensible when prosecuting them, often adopting a 'scattergun' approach at first but then gradually releasing from the proceedings those not personally responsible for the breach.

[194] See paragraph 3(c) above.

[195] Actually in some debt issues, capital or mezzanine debt in particular, the issuer does have the right, and indeed in certain circumstances the obligation, under the trust deed to suspend certain payments such as interest.

available to the issuers of debt securities. To combat potential cashflow insolvency arising from high demand for withdrawals, managed funds around the world have developed[196] suspension rights whereby the manager can suspend withdrawals in certain circumstances. The trust deed may set out the circumstances in which, and the time for which, the suspension is effective but essentially the suspension rights will allow the manager to suspend withdrawals so as to protect the interests of the existing unitholders generally and in particular to avoid diminution in unit value through the need to sell assets at unfavourable prices, often in a declining market, in order to fund withdrawals. There can be constraints and conditions on the manager's ability to suspend and the trustee will often have a role.

Winding-Up

28. The other form of insolvency is of course balance sheet insolvency, ie. the trust's liabilities exceed the value of its assets. However, unless there are creditors (for example an unusually high level of borrowing) it will seldom be the case that the trust will be insolvent. The trust's net assets, and the unit value, may decline to virtually nil, but the fund itself will not be insolvent on a balance sheet basis. This is almost unheard of in New Zealand because of historically conservative debt levels.

29. The option is always open to the manager, in this type of scenario as well as where the manager considers there is no real future for the fund[197], to wind it up. Normally the trust deed will provide that the manager will have the right to wind up the fund after a period of notice to unitholders, and the unitholders themselves will have the right through an extraordinary resolution to vote to wind the fund up. On a winding-up of the fund, the net assets after payment of all creditors are paid pro rata to the unitholders.

Conclusion

30. The ability to suspend withdrawals, combined with historically low debt levels in New Zealand unit trusts, has resulted in very few truly "insolvent" unit trusts and invites the conclusion that "insolvency", when applied to unit trusts in New Zealand , is something of a misnomer. However in true cases of insolvency, the territory for the trustee, lenders, other creditors and unitholders is perhaps not as 'uncertain' as one might first think.

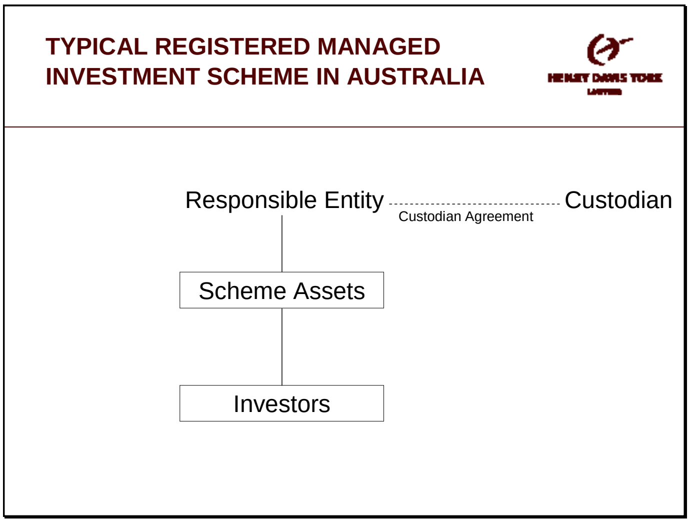
[196] This has not always been the case. Unit trusts in the late 1980s in New Zealand sometimes did not provide for there to be a suspension on withdrawals of units – indeed they often provided that the manager was under no obligation to repurchase or redeem units.
[197] As, for example, happened with the TOWER MortgagePlus Fund (see paragraph 3(b) above).

Roger Dobson, Partner, Henry Davis York, Sydney
Collapsing collective investment vehicles: Insolvency of Trusts and Managed Investments Schemes – Uncertain Territory for Lenders and Lawyers

Slide 1

Slide 2

Slide 3



Slide 4

Points to Note

- The RE must be a public company and must hold an Australian Financial Services Licence (AFSL) which must authorise it to operate a managed investment scheme
- The RE is trustee of the Scheme assets and has statutory duties, including under Section 601 FC of the Corporations Act to:
  - Act honestly
  - Exercise the degree of care and diligence that a reasonable person would exercise if they were in the responsible entity's position
  - Act in the best interests of the scheme members
  - Hold scheme property separately from the REs property and property of other schemes

Slide 5

The Scheme Constitution

- The scheme must have a constitution which contains certain requirements and a compliance plan, both of which must be registered with ASIC
- The constitution must contain the REs right of indemnity and the right of indemnity can only be available in relation to the proper performance of its duties.
- The power to borrow or raise money must be specified in the Scheme Constitution.
- Typically the offer to investors will be in a product disclosure statement which must satisfy the requirements of the Corporations Act

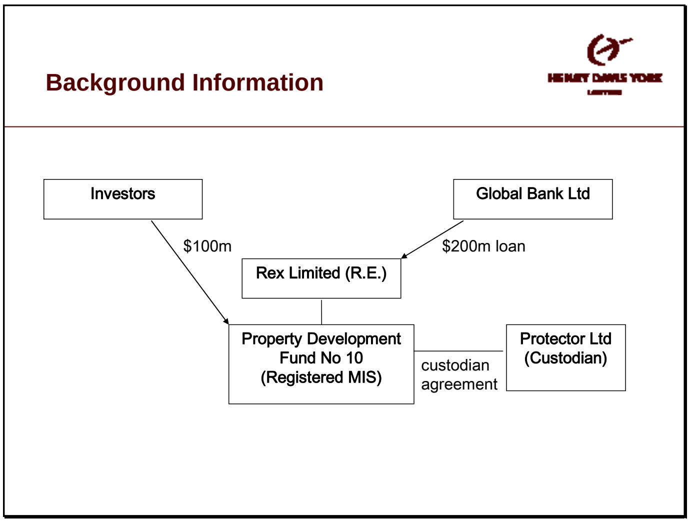
Slide 6

Custodian

- Typically scheme assets are held by a custodian, which is another trustee. The RE is liable for the actions of the custodian.
- Where the assets are held by a custodian, then legal title will be held by the custodian and in the case of assets such as real property, will be registered in the name of the custodian.
- Typically, custodians are bare trustees and have a very limited role, confined to holding the assets and acting entirely in accordance to directions from the RE.

Slide 7

Slide 8



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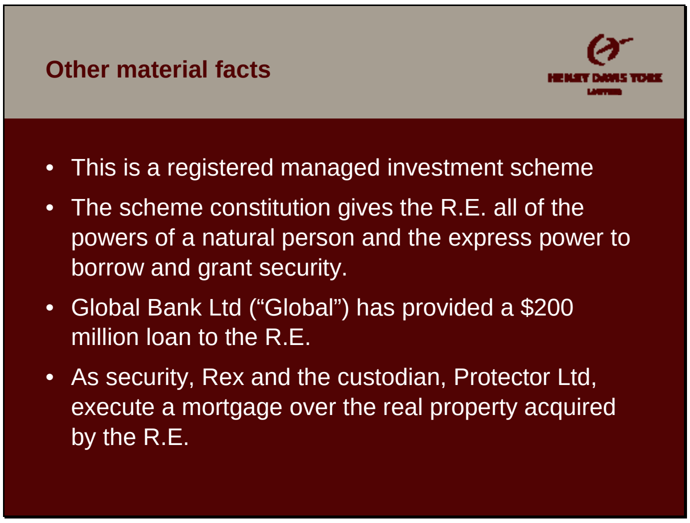

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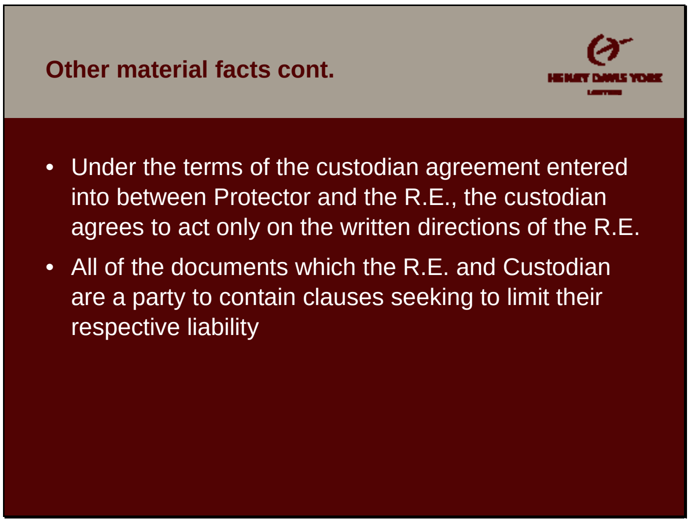

Slide 11

Other material facts cont.

- Limitation of Liability of the R.E.
  - Any liability of the R.E. arising out of or in connection with the Transaction Documents can be enforced against the R.E. only to the extent to which it can be satisfied out of the property of the Scheme out of which the R.E. is actually indemnified for the liability.

Slide 12

Other material facts cont.

- Limitation of Liability of the Custodian
  - The liability of the Custodian under the Transaction Documents is limited to its interest in the assets of the Scheme and its right to be indemnified
- Rex, as R.E. of the Scheme is a "professional trustee/R.E."
- Similarly, Protector, as the Custodian, provides custodial services in connection with a number of other managed investment schemes

Slide 13

Other material facts cont.

- Very significant cost overruns occur on the development which Global Bank refuses to finance
- Independently of its involvement in the Scheme, Rex Limited experiences a “run” on a number of its funds and finds itself in breach of its obligations to the syndicate of banks
- As a consequence of these things, the directors of Rex Ltd vote to appoint voluntary administrators to Rex

Slide 14

Legal Issues

- The ability of Global Bank to take action under its security, bearing in mind section 441A(1)
- The impact of the limitation of liability provisions on the rights of Global Bank to recover its loan.
- The ability of Global Bank to seek recourse beyond the assets of the Scheme.
- The extent to which an administrator or liquidator appointed to Rex Limited can recover costs and expenses of the administration and liquidation from Scheme assets.

4.30pm **Closing Panel:**
Lessons from the ‘school of hard knocks’ from a panel of battle scarred veterans
As this was an informal discussion no formal papers are available.