Banking and Financial Services Law Association Annual Conference

Case Law Update — New Zealand

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Justice Raynor Asher — Court of Appeal New Zealand

This paper discusses four recent decisions of New Zealand courts that are likely to be of interest to practitioners in the banking and financial services fields. The factual background and subject matter of the decisions is diverse, covering issues ranging from market manipulation to voidable preferences. Whilst I have deliberately focussed on appellate decisions, a recent High Court decision will also be discussed.

McIntosh v Fisk:[1] Voidable preferences and Ponzi schemes

In *McIntosh v Fisk* the Supreme Court was asked to decide issues arising from the collapse of a group of companies run as a Ponzi scheme. A Ponzi scheme is a fraudulent investment scam whereby returns are generated for original investors by misappropriating funds paid in by new investors. New investors are enticed by the promise of significant returns for little to no risk. Such schemes have been used by fraudsters in the past to accumulate significant funds before the inevitable collapse of the scheme, leaving the newest investors out of pocket.

The company at the heart of this particular Ponzi scheme was Ross Asset Management Ltd (Ross). Ross purported to provide investment management services. According to the contract between Ross and its investors, Ross was appointed as the investor's agent and would manage the investor's portfolio on their behalf. Ross was to hold the investor's funds in a separate account in the name of the particular investor, and securities purchased from the fund would be held by an associated company as nominee. The terms of the contract were not fulfilled. Ross misappropriated all investor funds.

1 *McIntosh v Fisk* [2017] NZSC 78.

Mr McIntosh paid Ross $500,000 in 2007, having borrowed that sum from his bank. Unbeknownst to Mr McIntosh, his money was misappropriated within days of his making the "investment" and became part of a co-mingled pool of cash and securities held by Ross.

Ross perpetuated the fraud by sending its clients quarterly reports stating that investments had been made in securities in accordance with the management contract. The reports listed the client's fictional securities and reported movement in accordance with what was occurring in the market for that security. These reports led Mr McIntosh to believe that his portfolio was increasing in value and was yielding an attractive rate of return.

In order to maintain the illusion of a legitimate scheme, when investors sought to cash up their investments they were paid from the co-mingled pool of misappropriated investor funds. In September 2011 Mr McIntosh decided to cash up his portfolio. Mr McIntosh ultimately received $954,047 — $500,000 for his original investment and $454,047 in fictional profit.

In December 2012 Ross was placed into liquidation. The subsequent investigation revealed a large-scale fraud. The liquidators of Ross sought to claw back the $954,047 paid to Mr McIntosh. They relied on:

(a) the provisions of the Property Law Act 2007 that provide for the setting aside of dispositions that prejudice creditors (ss 344–350);

(b) the voidable preference provisions of the Companies Act 1993 (ss 292–296); and

(c) s 297 of the Companies Act, dealing with transactions at undervalue.

In the High Court and Court of Appeal Mr McIntosh was ordered to repay the fictional profit of $454,047, but was allowed to keep the $500,000 value of his original investment. The matter came before the Supreme Court. Mr McIntosh, a Wellington lawyer, represented himself.

The unusual facts of this case, namely the presence of a Ponzi scheme, created various hurdles when it came to applying the relevant legislation. Unlike other jurisdictions such as the United States, New Zealand does not have specific legislation dealing with the distribution of assets following the collapse of a Ponzi scheme. The claw back provisions of the Property Law Act and Companies Act, which are drafted with orthodox creditor/debtor relationships in mind, were awkward to apply to the situation, throwing up a range of interpretive difficulties.

For example, was the relationship between Ross and Mr McIntosh properly characterised as a creditor/debtor relationship such that the legislation could even apply? On the terms of the management contract, Mr McIntosh did not deposit or lend money to Ross. Rather, he appointed Ross as the manager of his investment funds, but he remained the beneficial owner of those funds. Ross was a bare trustee. There was no intention that there would be a creditor/debtor relationship, or that Ross would ever have a beneficial entitlement to the money paid to it. These facts raised the prospect that the action for recovery of money paid to Mr McIntosh should have been brought in equity. However, the Court found that after the misappropriation occurred Mr McIntosh had a claim against Ross for the restoration of the misappropriated funds. By virtue of that claim, Mr McIntosh had a beneficial interest in the co-mingled pool of investor funds *and* became a creditor of Ross able to prove in Ross's liquidation. Therefore, the legislative provisions relied upon by the liquidators applied.

The Supreme Court found that, subject to any defences, the payment to Mr McIntosh could be set aside under s 346 of the Property Law Act on the basis that it was a disposition made when Ross was insolvent with intent to prejudice a creditor or without receiving reasonably equivalent value in exchange. The payment was also an insolvent transaction and was therefore voidable under s 292(1) of the Companies Act.

The bulk of the Court's reasoning focuses on the defences relied upon by Mr McIntosh. Of most interest is Mr McIntosh's defence that he was a bona fide purchaser for value, such that he had a defence under both the Property Law Act and Companies Act. The key issue here was whether Mr McIntosh gave "value" or "valuable consideration" for the $954,047 he received.

Mr McIntosh argued that the $500,000 that he paid in to Ross was valuable consideration for the payment that he later received. This was problematic, firstly in that Mr McIntosh had never intended to confer beneficial ownership of the $500,000 to Ross; Ross held the money on trust on Mr McIntosh's behalf. Once the funds were misappropriated, the value was derived by the co-mingled pool of investor funds held on trust by Ross for the benefit of the victims of the fraud, rather than the unsecured asset pool available to Ross's general creditors. Nonetheless, the majority considered that the concept of value needed to be adapted to the unusual facts of the case.[2] Therefore, Mr McIntosh had given value by way of his original $500,000 investment.

Another issue was whether, objectively, a payment of money to the operator of a Ponzi scheme could constitute "value", given that the effect of the payment is simply the perpetuation of the scheme and the deferral of its inevitable collapse. The majority considered that the fact that, after receipt, the recipient company acts fraudulently and in a way that destroys the value of what was received should not undermine the nature of the value given. To hold otherwise would involve differentiating between creditors fortunate enough to give value to merely mismanaged insolvent companies and those unfortunate enough to give value to fraudulent ones. Glazebrook J dissented, reasoning that to treat the $500,000 as value (thereby allowing Mr McIntosh to keep that amount when his funds were withdrawn) effectively meant that the accident in timing as to when Mr McIntosh withdrew his funds meant that he was favoured over other defrauded investors.

Whilst the majority was prepared to accept that at least some value had been given by Mr McIntosh by way of his initial $500,000 "investment", that amount was not valuable consideration for the far greater sum of $954,047 that he later received, for obvious reasons. Therefore, Mr McIntosh had a defence to the liquidators claims, but only to the extent of his initial investment of $500,000. As such, he was still required to pay back the fictional profit of $454,047. The majority noted that this result was broadly consistent with the outcome that typically applies under United States legislation enacted with Ponzi schemes in mind.

[2] Glazebrook J dissenting.

Financial Markets Authority v Warminger: [3] The line between legitimate trading and market manipulation

Financial Markets Authority v Warminger is New Zealand's first major trade market manipulation decision. The High Court judgment brings valuable clarity to the boundaries between trade market manipulation and legitimate trading strategy. An appeal was filed in the Court of Appeal but has since been abandoned.

The trader at the centre of the investigation was Mr Mark Warminger, an employee of Milford Asset Management with 16 years experience in equity markets. As at 31 August 2014 the total value of assets under Mr Warminger's management was approximately $669 million.

The Financial Markets Authority (FMA) alleged that, on 10 occasions between January and September 2014, Mr Warminger abused his privileged position as a portfolio manager to manipulate the trading of a number of stocks on the NZX. In order to make out its case the FMA had to establish on the balance of probabilities that:[4]

(a) Mr Warminger's trades were likely to have the effect of creating a false or misleading appearance:

(i) with respect to the extent of active trading in the securities; or

(ii) with respect to the supply of, demand for, price for trading in, or value of those securities; and

(b) Mr Warminger knew or ought reasonably to have known that his trading was likely to have that effect.

The fact of the impugned trading was not in dispute. The FMA argued that the trading was manipulative, whereas Mr Warminger maintained that all of the trading was done for legitimate reasons.

3 *Financial Markets Authority v Warminger* [2017] NZHC 327, [2017] NZCCLR 8.

4 Securities Markets Act 1988, s 11B. This provision has since been repealed and replaced with s 265 of the Financial Markets Conduct Act 2013, which is in essentially the same terms.

The FMA chose to take civil rather than criminal action against Mr Warminger, presumably because of the lower standard of proof in civil cases. The FMA claimed that Mr Warminger had manipulated the market on 10 different occasions by:

(a) placing small trades directly on-market in one direction, followed by large off-market trades in the opposite direction;

(b) trading that manipulated the closing price; and

(c) trading conducted in order to set the price.

The High Court upheld two of the FMA's 10 claims.

The first instance of market manipulation occurred on 27 May 2014. Email correspondence between Mr Warminger and other traders that day established that Mr Warminger was aware that there were off-market buyers for significant volumes of Fisher and Paykel Healthcare (FPH) shares. The funds managed by Mr Warminger were overweight in FPH stock. Having received the information about the existence of the buyers, Mr Warminger entered the market through the direct market access system and placed buy orders at an ascending price, with the result that the price of FPH shares rose from $4.32 at market open to a last-traded price of $4.35. Mr Warminger was then able to sell large volumes to the off-market buyers identified by other traders at a price of $4.35.

The second instance of market manipulation occurred on 9 July 2014. On this date Mr Warminger's funds were heavily overweight in shares in the A2 Milk Company Ltd (ATM). Since January 2014 the price of ATM shares had fallen from $0.97 to around $0.69. On 9 July 2014 Mr Warminger entered 26 direct market buy orders for a total of 70,900 shares throughout the day. The trades were numerous, and were for very small volumes in the context of the fund's total ATM holdings. The effect of Mr Warminger's trades was to repeatedly increase the last traded price of ATM shares in response other trades that brought the last traded price down. The trades also created the impression of a greater extent of active trading in ATM shares than was actually the case. The High Court found that Mr Warminger traded in this way to maintain or push the ATM price higher, given his overweight position in the stock. A minute of a meeting between Mr Warmigner and his managers around this time recorded that Mr Warminger was underperforming against his benchmark. The falling price of ATM shares would undoubtedly have been contributing to that underperformance, thereby providing a motivation for the manipulative trading.

What set these trades apart from the eight other alleged instances of manipulation that the Court ultimately dismissed? The other eight instances involved similar trading behaviour. However, Mr Warminger was able to offer a plausible explanation for his trading behaviour on these occasions. In addition, unlike the two instances above, there was no direct evidence of a motive for the manipulative trades. For example, in relation to one of the dismissed trades, there was evidence that Mr Warmginer had phone conversations with people who were aware of off-market buyers for certain shares, following which Mr Warminger traded directly on the market to increase the price of those shares. However, without details of the content of those conversations, Venning J was not willing to infer that Mr Warminger was told about the off-market buyers.

In reaching his decisions Venning J made a number of important observations about the requirements of market manipulation in New Zealand. It is not necessary that the FMA establish that anyone in the market was actually misled as a result of the impugned trades. Venning J rejected an argument for Mr Warminger that the FMA had to establish that the trades induced a pattern of new trading in volumes or at prices that would not otherwise have occurred. Venning J also found that, whilst an intention to manipulate was not a requirement, it will almost always be a relevant consideration. Often, the purpose of the trade will be the key factor that distinguishes culpable manipulation from a legitimate trade. In most cases the context of the trading, as evidenced by letters, emails or telephone communications, will be an important indicator of the opportunity and/or motive for manipulation, as this case demonstrates.

The maximum penalty for trade market manipulation is the greater of:[5]

> (d) the consideration for the transaction that constituted the contravention (if any);

[5] Securities Markets Act, s 42W. Repealed and replaced with s 385 of the Financial Markets Conduct Act, which is in essentially the same terms.

(e) three times the amount of the gain made or loss avoided as a result of the transaction; or

(f) $1,000,000.

On 29 June 2017 Mr Warminger was ordered to pay a $400,000 penalty.[6] Venning J emphasised that Mr Warminger's behaviour could have misled traders on the days in question and could affect the reliance that investors (both domestic and international) can place on the market. He also noted the need for a penalty that would deter others from engaging in similar behaviour.

***David Browne Contractors Ltd v Petterson*:[7] The concept of a "due debt"**

In *David Browne Contractors Ltd v Petterson* the Supreme Court considered the meaning of the words "due debt" in the voidable preference provisions of the Companies Act.[8]

Mr Browne operated a group of some 20 companies, including David Browne Contractors Ltd (Contractors), David Browne Mechanical Ltd (Mechanical) and Polyethylene Pipe Systems Ltd (Polyethylene). In March 2007, Polyethylene was subcontracted by McConnell Dowell Constructors Ltd (McConnell) to weld pipes that were to be laid on the Lyttelton Harbour seabed as part of a major sewer outfall project for Christchurch City Council. The pipes were manufactured by another company related to Mr Browne who then supplied them to Polyethylene. During the seabed installation process the welds on the pipes began to fail. An expert report obtained by McConnell following the first weld failure indicated that the weld was faulty. McConnell subsequently advised Polyethylene that it held it responsible for all losses under an indemnity clause in the subcontract.

Further reports were obtained by McConnell that confirmed that the welds were faulty. These reports were forwarded to Polyethylene. In the meantime, two more welds failed. In August 2008 McConnell sent Polyethylene a detailed breakdown of the losses claimed as a consequence of the first weld failure. These totalled $2,552,671. In September 2008

6 *Financial Markets Authority v Warminger* [2017] NZHC 1471.
7 *David Browne Contractors Ltd v Petterson* [2017] NZSC 116.
8 Companies Act, s 292.

McConnell provided a breakdown for the losses for the second and third weld failures. The amounts claimed were $449,524 and $394,558 respectively.

Mr Browne had been advised earlier that year that Polyethylene would not be covered by its own insurance. A chartered loss adjustor had advised Mr Browne that Polyethylene could argue that the loss fell within the contract works policy organised by McConnell. However, Mr Browne was slow to confirm the insurance position with his solicitors. When they were eventually consulted, the solicitors advised that Polyethylene could not claim under McConnell's insurance.

In June 2008 Mr and Mrs Browne met with their solicitor and their accountant. It was agreed that unsecured advances made to Polyethylene by Contractors, Mechanical and Mr Browne should be repaid. Polyethylene would then enter into a general security agreement with Mr Browne to secure a fresh advance of $450,000 to support Polyethylene's ongoing operations. Mr and Mrs Browne signed a solvency certificate for Polyethylene in early July 2008. At that time the company's net assets totalled $597,010 at most. The prospect of the McConnell claim was not taken into account. The transactions were executed in September 2008.

Following adjudication under the Construction Contracts Act 2002 it was determined that McConnell had a compelling case and Polyethylene's denial of liability for the weld failures was without substantial merit. Polyethylene was placed into receivership, and was subsequently liquidated. In April 2013 the liquidators served notices on Contractors, Mechanical and Mr Browne seeking to set aside the payments made to them by Polyethylene.

Mr Browne experienced somewhat of a landslide victory in the High Court. However, that decision was overturned in the Court of Appeal, and Mr Browne, Contractors and Mechanical were ordered to repay the amounts received and join the unsecured creditors claiming in the liquidation. The GSA between Mr Browne and Polyethylene was set aside on the basis that it was just and equitable to do so.[9] The payments to Contractors and Mechanical were voided on the basis that they were insolvent transactions that enabled creditors associated with

[9] Section 299.

Mr Browne to receive more than they would be likely to receive in the company's liquidation.[10]

The Supreme Court granted Contractors and Mechanical leave to appeal. Mr Browne was denied leave to appeal in respect of the setting aside of the GSA.

The main issue was whether the repayment of the debts to Contractors and Mechanical occurred at a time when Polyethylene was unable to pay its "due debts". In particular, was the prospect of the claim by McConnell for loss caused by the faulty welding a "due debt" that should have been taken into consideration before the payments to Contractors and Mechanical were made?

Contractors and Mechanical argued that the debt to McConnell was not "due" when the payments were made. At that stage, the debt to McConnell was prospective only. Although McConnell had notified Polyethylene of its claim, the claim had not yet been adjudicated. In order to be a "due debt", the debt must be legally due. To include contingent or prospective claims would require companies to cease trading whenever faced with a threatened claim with an indeterminate outcome, however specious the claim. Therefore, Polyethylene was not obliged to consider the prospect of liability to McConnell when certifying Polyethylene's insolvency.

The liquidator argued that contingent or prospective claims are "due debts" where the claim is temporally proximate to the impugned transaction and there is a real likelihood that the claim will crystallise into an actual debt. Given that McConnell had notified Polyethylene of its claim, particularised its losses, and would be seeking swift adjudication under the Construction Contracts Act, there was a real likelihood that the claim would crystallise into an actual debt in the near future. Therefore, Polyethylene was obliged to consider the prospect of liability to McConnell when certifying Polyethylene's insolvency.

The Court accepted the submissions of the liquidator. It considered that solvency must be assessed by taking a practical business perspective. If a reasonable and prudent business person would be satisfied that there is sufficient certainty that the debt will, within a

[10] Section 292.

temporally proximate period, become legally due that debt must be taken into account. The Court regarded this practical business approach to be consistent with the policy underlying the voidable preference rule, namely the protection of an insolvent company's creditors and the pari passu principle. The Court rejected the argument that including prospective claims would require companies to cease trading when faced with a specious claims. A reasonable and prudent business person would not consider that a specious claim would be likely to crystallise into a debt, therefore the claim need not be taken into account.

Applying that approach to the facts, the Court found that when the payments to Contractors and Mechanical were made a reasonable and prudent business person would have considered that McConnell's claim for indemnity was sufficiently certain and would be likely to crystallise into a debt in the near future. Although Polyethylene was disputing the debt at that time, it had no proper reason for doing so in the light of the overwhelming weight of expert opinion. Although the prospect of a claim under McConnell's insurance had been raised, Polyethylene did not promptly seek legal advice to clarify the position. When the payments were made the insurance position was uncertain at best. Therefore, a prudent business person would not have relied on there being insurance cover. The payments to Contractors and Mechanical were therefore voidable preferences.

The key takeaway for practitioners is the test adopted by the Court in determining whether a contingent or prospective liability is a "due debt" for the purposes of s 292 of the Companies Act: if there is sufficient certainty that a claim will crystallise in the near future, then it must be taken into account in the solvency assessment. The consequence is that companies cannot plunge their heads into the sand when faced with a claim that threatens their solvency. Rather, they must undertake a reasonable and prudent assessment of the likelihood of the success of the claim in order to determine whether the claim should be taken into account before paying other creditors.

Ebert Construction Ltd v Sanson:[11] Payments "by" a company

The decision of the Court of Appeal in *Ebert Construction Ltd v Sanson* concerns a method of construction project financing called a "direct agreement". Direct agreements started being used in the New Zealand construction finance sector in the mid-1990s. A direct agreement is

11 *Ebert Construction Ltd v Sanson* [2017] NZCA 239.

a three-way agreement between developer, builder and financier. During the ordinary life of the project, the financier is empowered to make payments directly to the builder on behalf of the developer. The advantage for the financier is that the financier is empowered to step in and require the builder to complete the project if the developer defaults. This avoids the risk that, in the event of the developer's default, the financier will be left with only a partially developed site. Although builders initially resisted these agreements, many major financiers began refusing to finance construction projects in the absence of a direct agreement. As a result, direct agreements have become a major feature of construction project financing in New Zealand. The question that arose in this case was: if the developer is put into liquidation, are payments by the financier directly to the builder voidable preferences recoverable by the liquidator?

The characters in this case are:

(a) BOS International (Australia) Ltd (BOSI): financier.

(b) Ebert Construction Ltd (Ebert): builder.

(c) Takapuna Procurement Ltd (TPL): developer.

The project was a 134-unit apartment complex in Takapuna. The development involved a matrix of contracts. The important ones for present purposes are:

(a) A construction contract between TPL and Ebert under which Ebert would construct the apartments for a fixed lump sum of $32,497,188 plus GST.

(b) A loan contract between TPL and BOSI whereby BOSI would provide a cash advance facility with a limit of $36.9 million.

(c) A direct agreement between TPL, BOSI and Ebert. Under this agreement, BOSI would directly pay Ebert the progress payment amounts payable by TPL to Ebert under the construction contract.

Ebert completed construction of the apartments in April 2008. At least from that date, and possibly earlier, TPL was in default under its loan contract with BOSI. Unusually, the direct agreement did not contain a provision absolving BOSI of the obligation to make payments to Ebert if TPL was in default under the loan contract. In November 2008 the parties agreed that TPL still owed Ebert a total of approximately $1.6 million under the construction contract. Later that month BOSI made two payments to Ebert: one for $499,226 and another for $564,665. TPL was placed into liquidation within a week of the payments being made. The liquidators sought to recover the sums paid on the basis that they were voidable insolvent transactions that preferred Ebert over other creditors of TPL.

The issue was whether the payments were made "by" TPL. Ebert argued that the payments were not made by TPL. Rather they were made by BOSI direct to Ebert, discharging liabilities of TPL to Ebert. The payments were not made out of funds belonging to TPL, and did not decrease the funds available for TPL to pay other creditors. The liquidators argued that the funds belonged to TPL as a result of its loan agreement with BOSI. The payments were made on TPL's behalf, TPL being the party who was primarily liable to pay Ebert under the construction contract.

The Court ultimately found that the payments from BOSI to Ebert were not payments "by" TPL. The Court gave the following reasons:

(a) Under the direct agreement, BOSI was directly liable to Ebert; there was contractual privity between BOSI and Ebert.

(b) BOSI's liability to Ebert was as principal in its own right, not merely as an agent for TPL. TPL was not empowered to direct BOSI not to pay Ebert. Moreover, there was (unusually) no condition that discharged BOSI's liability to make payments to Ebert in the event of TPL's default under the loan contract.

(c) The obligations owed by BOSI to Ebert under the direct agreement were discrete from the obligations BOSI owed TPL under the loan contract.

(d) BOSI's obligation to make payments under the direct agreement was owed to Ebert, not TPL.

(e) The essence of the voidable preference provisions is the avoidance of payments by a company from resources available to the company to pay its general creditors. Where BOSI was obliged to make payments to Ebert, and its facility could not have been used by TPL to make payments to any other creditor, it was artificial and inconsistent with the purposes of the voidable preference provisions to treat the payment as having been made by TPL.

The Court discussed three examples that it considered to be analogous to the present case:

(a) Payment by a guarantor to a creditor of a company. This would not be a payment by the company, even though the result is that the guarantor has a claim against the company for the sum paid.

(b) A third party agrees to indemnify a creditor against a failure of a company to perform an obligation (eg a parent company or shareholder). The payment of the third party to the creditor could not sensibly be challenged as a payment by the company.

(c) Two companies A and B are jointly liable to a creditor, and full payment is made by A. If B went into liquidation, its liquidator could not recover the payment by A even though the effect of the payment is to discharge a liability of B to the creditor.

The Court of Appeal heard expert evidence about whether direct agreements were intended to avoid the risk of payments to builders being voidable preferences. The experts differed on the point. One expert took the view that the agreements were financier-focussed and the voidability of the payments was irrelevant. However, another expert opined that from a builder's perspective a direct payment obligation offered security for payment in the event of a developer's insolvency, because the payment was not actually being made by the developer, but by a third party financier.

The liquidators have applied for leave to appeal to the Supreme Court, so there may be more to come on this issue.

***Trends Publishing International Ltd v Advicewise People Ltd*[12]: Compromises with creditors**

Trends Publishing International Ltd v Advicewise is a very recent judgment of the Court of Appeal, written by myself. It concerns a compromise between Trends Publishing International Ltd (Trends) and its creditors that effectively cancelled part of Trends' debts.

Compromises with creditors are provided for by pt 14 of the Companies Act. The effect of the compromise, if passed, is that all or part of the debt of the company is cancelled. The benefit for the company is that it gets the opportunity to attempt to trade out of insolvency and avoid liquidation. The benefit for creditors is that, if the company can trade out of insolvency, they can expect further trading with the company in the future, making the compromise economically beneficial in the long-term. Even if the company cannot trade out of insolvency, creditors may judge that they will receive more under the compromise than they would be likely to receive in a liquidation. If the compromise passes by the requisite majorities, it binds all creditors with notice of the compromise, including those who voted against it.[13] The consequence of the compromise is significant; creditors effectively lose the right to claim the full extent of their debts.

Trends is a global marketing and publishing brand with a focus on print and digital media products. Trends ran into financial difficulties following the global financial crisis. Those difficulties were ameliorated to some extent when it obtained a research and development grant from Callaghan Innovation, a Crown entity that provides financial grants for scientific and technology-based research. In early-2014 Callaghan paid Trends close to $400,000 under the grant. By late-2014 Callaghan had formed the view that its grant had been induced by false representations as to Trends' financial position.[14] Callaghan then terminated the grant and demanded repayment of the moneys advanced. This put Trends at risk of insolvency.

12 *Trends Publishing International Ltd v Advicewise People Ltd* [2017] NZCA 365.
13 Companies Act, s 230.
14 The Serious Fraud Office became involved, but has since decided to take no further action on the matter.

Trends decided to put a proposal to creditors to compromise the company's debts under pt 14 of the Companies Act. The proposal was put to 62 unsecured creditors whose debts totalled $4,267,347.41. Of those creditors, three had particular associations with Trends:

(a) Thecircle.co.nz (Thecircle) was owed $3,080,361.80 representing unpaid rent. Mr Johnson, founder and director of Trends, was also the controlling shareholder and sole director of Thecircle.

(b) Ms Messer was owed $120,030. Ms Messer was Trends' general manager. She had worked for Mr Johnson for over 30 years.

(c) Mr Taylor was owed $30,000. Mr Taylor was a director of Trends (until he resigned on the day the compromise was adopted).

Under the compromise, creditors would receive one hundred cents on the dollar for the first $1,000 owed. Subsequent payments would come from a separate pool of funds, presumably from the cash flow of Trends. Creditors owed more than $1,000 would ultimately receive significantly less than the amount they were owed. Importantly, the insider creditors were not to receive any payments under the compromise. However, those creditors still maintained the right to vote on the compromise. No satisfactory explanation was offered as to why this should be the case.

Under cl 2 of sch 5 of the Act, a compromise will pass if it is adopted by a majority in number representing 75 per cent in value of the affected creditors. Thecircle's vote, along with votes in favour by the other insider creditors, represented 75.73 per cent. So, on the basis of the insider creditor's votes, the 75 per cent in value requirement to adopt the compromise was met. The majority in number requirement was met largely as a result of the support of minor creditors owed $1,000 or less, who would receive full repayment of their debt under the compromise.

The respondents in this case (the challenging creditors) brought proceedings arguing that the compromise was unfairly prejudicial and ought to be set aside under s 232(3)(c) of the Act. The challenging creditor's primary argument was that the insider creditors should have been separated into a different class for the purposes of voting on the compromise, given that their economic interests were likely to differ from those of third party creditors. Trends argued that separate classification was only warranted where creditors have different legal rights, and that classification based on economic interests would be commercially impractical and unduly complex. Over-classification could also raise the prospect of minority veto, given that each class must pass the compromise by the requisite majorities. Trends submitted that this would undermine the utility of the pt 14 process.

We found that the test for separation into different classes for the purposes of voting on a pt 14 compromise must take into account both legal rights and economic interests. Plainly an insider creditor who is likely to have a stake in the company not going into liquidation will be in a conflict position with third party trade creditors, even if it has the same rights. A rigid pure legal rights test would enable creditors compromises to be used as instruments of injustice, as this case demonstrated. Although this approach departs somewhat from the position in other jurisdictions such as England and Australia, we considered that a broad and more flexible approach to classification was consistent with the court's jurisdiction to intervene on the basis of unfair prejudice under s 232(3)(c) of the Act. Concerns about a plethora of classes and minority veto will be avoided where the classifications are robust and fair, and the compromise is genuinely put forward in the interests of the creditors and the company.

Applying this test to the compromise in this case, clearly the insider creditors were motivated by different economic interests than other creditors. Their motivation was to protect Trends from a liquidation. In contrast, third party creditors could conceivably have anticipated greater recoveries in a liquidation than what they would receive under the compromise. As such, the insider creditors should have been put into a different class for voting purposes.

Another interesting issue that arose was whether Callaghan should also have been placed in a separate class. The debt to Callaghan arose out of Callaghan's termination of its grant and its demand for repayment of funds already advanced. Before proposing the compromise, Trends advised Callaghan that it intended to issue proceedings claiming that Callaghan's suspension of the grant was unlawful, and claiming damages for the financial fallout that Callaghan's allegations of misrepresentations by Trends had allegedly caused. However, for the purposes of the compromise Trends appeared to admit the debt to Callaghan, and included Callaghan in the proposal. The compromise included a term to the effect that no compromise creditor could issue proceedings against the company claiming anything beyond what they would receive under the compromise. The term also prevented any compromise creditor from raising the full extent of its debt as a set-off or counterclaim in any proceedings.

The effect of Callaghan's inclusion in the compromise meant that, once passed, the compromise prevented Callaghan from raising the full extent of its debt as a counterclaim if and when Trends pursued the claims it had earlier notified to Callaghan. In our view, it is an improper use of a creditors compromise to include a creditor whose right to payment is disputed, and against whom the proposing company intends to issue proceedings, with the result that the creditor's debt is compromised and their right of counterclaim is extinguished. If Callaghan was to be included within the compromise, it needed to be put into a separate class. As a creditor whose debt was disputed, Callaghan was in a fundamentally different position than other creditors. That would be so even if we were applying the strict legal rights test urged upon us by Trends.

As a result of the inadequate classification of creditors for voting purposes, we found that the compromise was unfairly prejudicial. Consequently, we upheld Heath J's decision in the High Court to set the compromise aside.