Legal update on litigation and dispute resolution - December 2015

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A recent New Zealand statement on the law of penalties: Torchlight Fund No. 1 LP (In rec) v Johnstone [2015] NZHC 2559

Torchlight was a private equity fund investing in distressed assets. One of its investments was the purchase of a debt from Bank of Scotland International totalling $185m, of which Torchlight had repaid all but $37m. Being in a difficult liquidity position to pay off the debt, Torchlight sought bridging finance from a Mr Grill. Torchlight and Mr Grill entered into a 60-day contract in which Mr Grill would provide $37m to discharge the debt. In return Torchlight would repay the principal with interest at 5.25% callable on day 60 (a total of $320,000), and an additional $5m due 120 days from the day of the advance. The contract then stipulated for a 'late fee' of $500,000 per week for each week past the due date in which the principal was not repaid. Torchlight failed to make repayments and was placed into receivership. Torchlight then disputed the payment of the 'late fee'. Two issues arose, namely whether the penalty doctrine was engaged by the 'late fee' clause, and secondly whether the clause was properly described as a penalty instead of a genuine pre-estimate of loss.

The Court considered the clause engaged the penalty doctrine because it was collateral to the breach and therefore an obligation arising secondary to the obligation to repay. The defendant's claim that the fee provided for flexible repayment failed because the debt was callable upon day 60 under the contract.

Whilst the Court acknowledged the freedom to contract, it ultimately imposed the doctrine and held the clause unenforceable. On interpretation the Court considered the surrounding circumstances and the intention of the parties. Although reluctant to deem the clause a penalty, the Court considered it was inserted 'in terrorem' for the collateral purpose of enforcing repayment of the principal sum. Furthermore, the amount stipulated was considered disproportionate to any conceivable loss flowing from a breach. The clause was deemed a penalty clause and therefore was unenforceable.

It should be noted that this decision applied the law of New South Wales, rather than the law of New Zealand in relation to the penalties issue. The judgment is under appeal.

See Court decision here.

Pre-paid rent not recoverable upon cancellation of commercial lease

The UK Supreme Court in *Marks and Spencer Plc v BNP Paribas Securities Services Trust Company (Jersey) Ltd & Anor* (Rev 1) [2015] UKSC 72 was asked to consider an appeal concerning a break clause within a commercial lease.

A commercial lease between the parties required that rent be pre-paid by the tenant to the landlord. Before the conclusion of the rent period, the tenant validly cancelled the lease by ensuring rent was settled and by giving six months' notice to the landlord. The tenant then sought a refund of its rent for the period between 24 January 2012 (when their lease determined) and March 2012 (the date up to which they had paid rent). The lower Courts first found in favour of the tenant, then on appeal, in favour of the landlord. In the Supreme Court, the appeal was unanimously dismissed, holding that neither the common law nor statute apportion rent payable in advance on a time basis, save in a clear case where the lease agreement provides for apportionment. The terms of the lease must show that the landlord and tenant intended that the tenant should be refunded an apportioned part of the rent payable and paid in advance, especially in professionally drafted commercial leases.

This case highlights the significance of careful drafting in commercial agreements, as the Courts will usually hold parties to the express words of their agreement.

See Court decision here.

Court confirms parties' intentions evident from contractual language

In *Mortgage Express v Countrywide Surveyors Limited* [2015] EWCA Civ 1110, Countrywide Surveyors appealed a decision of the preliminary Court regarding the construction of a written agreement (Standstill Agreement).

Mortgage Express, a mortgage lender, contracted Countrywide Surveyors, a valuer, to produce valuation reports. Mortgage Express alleged these reports were not completed with the expected level of skill, care and diligence of a reasonably competent surveyor. It was alleged that Countrywide Surveyor's was at fault in relation to 47 properties, and deceitfully so in relation to 41 of them.

The Standstill Agreement entered into by the parties stated that time would be suspended from the date of the Standstill Agreement for any defence or argument in connection with a 'dispute'. Dispute was defined in the Standstill Agreement as 'any claim or claims directly or indirectly arising out of or in any way connected with the matters referred to in paragraphs 1, 2 and 3' (Background Preamble).

The issue was whether Mortgage Express's claim of deceit fell within the meaning of 'dispute' in the Standstill Agreement, so as to trigger the suspension of time.

The Court determined the correct approach to the issue of construction was to determine what the parties intended by the contractual language used, by ascertaining what a reasonable person would have understood the parties to have meant.

The Court referred to Paragraph 3 of the Background Preamble which expressly mentioned allegations of breach of contract and negligence. Lord Justice Simon determined the definition of 'dispute' was drafted in sufficiently wide terms to extend beyond allegations of negligence and breach of contract alone and as such, deceit must be taken to fall within the meaning of dispute.

The Court concluded the proper construction of the Standstill Agreement was such that if the claims arising 'indirectly' are based upon dishonesty, they will fall within the suspension provisions as they are connected with Paragraphs 1 to 3 and form a 'dispute'.

See Court decision here.

Digital files are property

The Supreme Court has recently considered the definition of "property" under section 249 of the Crimes Act 1961 in *Dixon v R* [2015] NZSC 147. The case arose as a result of Mr Dixon's actions during his employment as a security officer at a bar during the Rugby World Cup. Mr Dixon obtained CCTV footage of a member of the English rugby football team leaving a bar with a woman, and posted it to social media, after failed attempts to sell it to media outlets. In this decision the Court held that a digital file consisting of CCTV footage does constitute "property" for the purposes of the provision, resulting in the conviction of Mr Dixon for "*accessing a computer system for a dishonest purpose*" by obtaining property without claim of right.

The Supreme Court overturned the decision of the Court of Appeal, which had held that digital files are "*pure information*" and thus, following the orthodox view, could not be property. The Supreme Court found that the digital files could be identified, had a value, and were capable of being transferred to others; they also had a physical presence.

The Court took a purposive approach to interpretation, looking at the scheme of Part 10 of the Act. Part 10 introduced four new offences relating to crimes involving computers that reference software and data. It also contains a wide definition of "*computer system*" and an extended definition of "*document*" which includes any "*device…on which information, sounds, or other data are recorded*". These characteristics indicated that Parliament had stored data in mind when the provisions were drafted. In this context, the Court found that the fundamental characteristics of property are that it is capable of being owned and transferred.

American authorities on the status of software also provided some assistance. Although the Courts differ in their view of whether software is tangible or intangible, there is general agreement that it constitutes "property". What is obtained is not merely intangible knowledge, but a record of knowledge stored in some kind of physical form. After a review of these authorities, the Court concluded that data should be treated in the same way.

See Court decision here.

Developments in the law of remedies for unjust enrichment

In a decision to be welcomed by lenders, the UK Supreme Court has recently confirmed the availability of subrogation to the unpaid seller's lien as a remedy in the context of unjust enrichment.

The appellant, Ms Menelaou, owned a property purchased for her by her parents, which she was to hold for the benefit of her siblings. That property had been purchased by her parents using the proceeds of the previous family home. The respondent bank had two charges over that previous family home. It was agreed between the parents and the bank at the time of purchase of the new property that the bank would take security over the new property.

Through, it seems, undisclosed fraud the bank was granted a charge over Ms Menelaou's new property, without Ms Menelaou ever having executed the necessary documents.

The case therefore concerned the unjust enrichment of Ms Menelaou. The critical question was whether she was enriched at the expense of the bank. If so, the enrichment must clearly have been unjust. The Court thought that was plainly so; she had become the owner of the new property thanks to the bank's agreement to release a part of the debt in return for that charge. Since the charge was void, the value of the new property to Ms Menelaou was considerably greater at the expense of the bank. And, since the purchase of the new property was part of one overall scheme, whether the Court adopted a broad or narrow approach to the causal test, there was a sufficient causal connection between the bank's loss and Ms Menelaou's benefit.

The Court held the appropriate equitable remedy to be the bank's subrogation to the unpaid seller's lien. This had the effect of reinstating Ms Menelaou's liability under the charge, reversing her unjust enrichment, and allowing the bank to enforce its equitable interest in the property by sale.

See Court decision here.

Court rejects 'halfway house' on security for costs

In *Erwood v Official Assignee* [2015] NZCA 478 an application was made to review a decision declining to dispense with security for costs. The applicant, Mr Erwood, argued that he had demonstrated impecuniosity, and that the Registrar had erred in finding to the contrary.

Mr Erwood held nearly $800,000 on deposit with a bank. His account had been frozen by the bank on the basis that Mr Erwood lacked the capacity to give the bank authority for the account. The bank had formed this view on information provided to them by Mr Erwood.

The Court noted that in taking this approach, the bank had effectively appointed itself manager of the monies Mr Erwood had deposited with them, and in doing so usurped the jurisdiction of the Family Court under the Protection of Personal and Property Rights Act 1988 (Act).

The Court concluded that Mr Erwood had a large amount of money on deposit with the bank and was easily able to give security for costs. If Mr Erwood lacked the capacity to give proper instructions in relation to his account, the proper course should have been to apply to the Family Court under the Act for an order appointing a suitable person to act as manager of the money Mr Erwood had with the bank. The Court would not accept a 'halfway house' where Mr Erwood could claim he had no access to the substantial sum of money deposited with the bank, while not making an application under the Act. Impecuniosity could not be claimed in these circumstances and the original decision was upheld.

See Court decision here.

Property valuation duties and valuers' margins of error

In *Titan Europe 2006-3 Plc v Colliers International UK Plc* the UK Court of Appeal heard an appeal by Colliers against a decision of the High Court concerning the allowable margin of error in property valuation and the right of suit under a securitised loan.

Colliers provided a commercial property valuation of €135m to the property's owner. The owner borrowed €110m, using the property as security. The loan was purchased by Titan under securitisation. Titan then issued investors with mortgage backed securities under the loan.

In its action, Titan claimed Colliers had been negligent in valuing the property at €135m, claiming €135m was outside allowable margins of error. Titan claimed the difference of the adjusted High Court valuation of €103m.

On appeal, Colliers claimed the High Court valuation was incorrect, and that the €135m was within an allowable margin of error under a correct valuation of the property. Colliers also claimed Titan did not have a right of suit under the securitised loan, which it said belonged to noteholders of the mortgage backed securities.

As to permissible margins of error in property valuation, the Court of Appeal held the value of the property was €118m. The Court then upheld the High Court's decision that 15% was an acceptable margin of error for a sufficiently unusual building. On the adjusted €118m valuation, the €135m Colliers valuation was within a 15% margin of error.

As to the right of suit, the Court held that Titan retained the right to sue Colliers, stating that the owner of property has rights of suit for substantial damages in respect of any actionable negligence. This applied to rights of suit in relation to loans and the securities underlying them.

Although Titan retained the right of suit, as the valuation was within the 15% margin of error the Court allowed the appeal.

See Court decision here.

No change in attitude means no change in advice

The English High Court recently heard a case concerning the duties upon banks and financial advisers when they are advising customers to make investments.

The claimants in this case, Mr and Mrs Worthing were customers of Lloyds Bank Plc. The claimants had invested £700,000 in an investment portfolio after having been advised by Lloyds' advisors. The claimants signed standard form terms and conditions and other risk and planning documentation, acknowledging the risk of the investment.

The portfolio underwent a series of initial losses. Despite these losses Lloyds discussed the portfolio with the claimants and advised them to retain the portfolio.

The claimants commenced proceedings, seeking compensation for losses incurred under the portfolio. Due to the expiry of a limitation period, the claimants' allegations were confined to the claim that Lloyds had a duty to correct the advice it had initially given after the initial losses were incurred under the portfolio.

The Judge dismissed the claim, finding that Lloyds had not been negligent in advising the claimants.

First, Lloyds was entitled to use standardised documentation for explaining the nature of its products and associated risks. Secondly, this documentation was sufficient to outline and explain the risks of the investment to the claimants. The Court found that although Lloyds did owe the claimants a duty to exercise reasonable care and skill in relation to the investment, the claimants understood the risks and there had been no change in their attitude to risk, despite the initial losses. The Court held that it was reasonable for Lloyds to give advice that no immediate decision should be made to sell the portfolio and that there was therefore no duty on Lloyds to advise that the portfolio was no longer suitable.

See Court decision here.

The availability of a pre-emptive indemnity for costs in double derivative claims

The English High Court recently dealt with the controversial issue of double derivative claims and the availability of a pre-emptive indemnity for costs. Morgan J in *Bhullar v Bhullar* [2015] EWHC 1943 (Ch) gave permission for derivative claims to be continued on behalf of two companies, Bhullar Developments Limited and Bhullar Bros Limited (subsidiaries of Bhullar Limited). The judge held that the statutory regime did not apply and a double derivative claim could be brought at common law, following the recent case of *Universal Project Management Services Ltd v Fort Gillicker Ltd* [2013] Ch 551. The judge emphasised relevant common law principles, specifically the requirement to establish a prima facie case. Whilst the judge commented that this lacked some clarity, in practice the Court would have to form a view as to the strength of the claim in the context of its assessment of whether a reasonable board of directors of the company might consider it appropriate to bring a claim against the defendant.

In deciding whether the applicant should be granted a pre-emptive indemnity in respect of costs of the proceedings, the judge held that such an order would not be appropriate, partly because it would give the applicant a considerable advantage in the context of the broader shareholder dispute. However, the prospect of the Court granting an indemnity for costs at the proceeding's end was left open. The judge concluded that after analysing the relevant authorities concerning pre-emptive indemnities for costs in derivative claims "*the Court should exercise considerable care when deciding whether to order a pre-emptive indemnity. The Court should have a high degree of assurance that such an indemnity would be the proper order to make following a trial on the merits of the claim*". This decision provides a useful reminder that under the common law "double derivative" action remains available and minority shareholders do have the option of challenging wrongs done to companies further down the chain, regardless of the precise nature of the overall corporate structure.

See Court decision here.

Attempted stay of $25m Court order dismissed

Mr Kidd issued proceedings in the High Court alleging that Mr van Heeren had misappropriated funds from an equal partnership the two had operated out of South Africa, which had included New Zealand's iconic Huka Lodge. Mr Kidd claimed that Mr van Heeren had purchased assets in New Zealand with those funds and accordingly, Mr Kidd sought the taking of accounts.

Following a defended hearing the High Court issued orders for an account to be taken to determine the amount due to Mr Kidd. The orders also provided a framework for how the accounts were to be taken including that Mr van Heeren was required to complete a list of all assets of the partnership and, if any assets had been disposed they were to be listed with details of who had control of the assets and their current estimated value. Mr van Heeren was also ordered to pay $25m into the High Court, a measure described by the Court of Appeal as designed to secure Mr van Heeren's performance of the primary remedy of taking of accounts.

Mr van Heeren filed an appeal against the High Court's judgment, including the orders and applied for a stay pending determination of his substantive appeal. In support of his application for a stay Mr van Heeren asserted that he no longer owned or had possession of the assets allegedly acquired by the misuse of partnership funds in New Zealand. Rather, he said he had transferred ownership of the relevant assets to the trustees of two trusts based in Liechtenstein. Mr van Heeren also claimed that he did not have assets available to satisfy the order for payment into Court of the $25m.

The Court of Appeal found that Mr Kidd was entitled to the benefits of a favourable judgment, even if its terms were largely unprecedented in New Zealand.

See Court decision here.

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