BUDDLEFINDLAY

Legal update on insolvency law - March 2015

David Perry, Scott Barker, Willie Palmer, Jan Etwell, Scott Abel, Seb Bisley, Susan Rowe, David Broadmore, Myles O'Brien, Kelly Paterson, Peter Niven

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Continuing business relationships – measuring the preference

There has been some uncertainty in New Zealand about what the starting point should be for the purpose of measuring a preference in liquidation when the transactions form part of a continuing business relationship (for example, a running account). In *Farrell and Rogan v Max Birt Sawmills Limited [2014]* NZHC 3391, in a departure from several earlier decisions, and pending a Court of Appeal decision on point, the Court took the view that the starting point for such transactions should be the point of peak indebtedness. In doing so, the Court rejected the suggestion that the starting point should be the beginning of the specified period.

Associate Judge Bell justified the application of the peak indebtedness rule on the following grounds:

- Given that the continuing business relationship section replicates the text of the Australian provision, the Australian approach to determining the starting point for these transactions (which is to apply the peak indebtedness rule) should be applied
- Suppliers in continuing business relationships do not suffer any particular unfairness that would justify deviating from the policy of creditor equality in liquidation and the peak indebtedness rule was consistent with that policy outcome.

See Court decision here.

Equitable assignment and voidable transactions

In October 2006 St George Developments Ltd formally assigned to West City Construction Ltd (WCCL) a bond held by the North Shore City Council (the Council). St George was later liquidated. The liquidators argued that the assignment was voidable under section 292 of the Companies Act 1993, and sought to recover money that the Council had paid to WCCL under the bond.

In *West City Construction Ltd v Levin & Anor* [2014] NZSC 183, the Supreme Court held that the bond had been effectively assigned in equity before the specified period under section 292 and therefore the money was not recoverable. It reversed the Court of Appeal judgment and reinstated the decision of the High Court.

The Supreme Court found that the substance of an oral agreement to assign could be established, even if the precise wording used was unclear. Thus the transaction was not voidable; it was "made" before the specified period commenced, even though the deed of assignment was executed after that date.

If there had not been an equitable assignment before the specified period commenced, it would have been appropriate to order full repayment of the money WCCL received from the Council.

See Supreme Court decision here. See Court of Appeal judgment here.

Secured creditor did not surrender security by voting

Grant v Waipareira Investments Ltd involved an unsuccessful appeal by Messrs Grant and Khov (Liquidators) against a High Court declaration that respondent Waipareira Investments Ltd (Waipareira) did not surrender its security in liquidation of West Harbour Holdings Ltd by voting at a creditors meeting.

The Court of Appeal confirmed that Waipareira, a secured creditor, was not entitled to vote at the creditors meeting because it had not made a claim as an unsecured creditor and had made it clear to the liquidators that it intended to exercise its power of sale under its mortgage securities. Any vote case on its behalf was of no legal effect. As a result, Waipareira had not surrendered its charge and remained a secured creditor.

See Court decision here.

Putting the brakes on the acceleration of debts

The recent decision of Associate Judge Bell in *ANZ Bank New Zealand Limited v Boyce & Ors* [2014] NZHC 3185 clarifies the process for accelerating a debt which is not automatically accelerated under a loan contract.

In each transaction in question the relevant bank issued a notice pursuant to section 119 of the Property Law Act (section 119 Notice) following the borrower's default and later relied upon the section 119 Notice as notice of acceleration of the debt. After selling the mortgaged properties, each bank sought summary judgment against the relevant borrower for the shortfall.

Associate Judge Bell raised an issue with whether the banks had actually accelerated the debts. The outcomes depended on the terms of the acceleration clause in the relevant documents. However, the following key points were common to each transaction.

- Associate Judge Bell held that when loan and security contracts contain a 'call-up' acceleration clause, a section 119 Notice cannot be used as a conditional call-up notice for accelerating a debt. Rather, an acceleration notice must be issued following expiry of the section 119 Notice (when unremedied default continues)
- Sections 119 and 120 of the Act do not alter the method of accelerating debt provided for under the loan contract
- In the absence of an effective acceleration, banks may find themselves applying proceeds of sale in prepayment of future loan instalments, without the ability to accelerate after the fact and obtain judgment for a 'shortfall'
- It is important to consider the acceleration methods provided for in both the loan contract and the security documents and be alive to dealing with inconsistencies between the two.

See Court decision here.

Debt to be repaid after director makes fraudulent changes to company accounts

Mr James set up a family trust (Trust) and purchased land at Jacks Point. One of his companies, James Developments Limited (JDL), advanced $740,000 to the Trust to assist with the purchase. The advance was recorded as an asset in JDL's accounts. In April 2009, summary judgment was entered against JDL for over $4m. JDL appealed but the shareholders resolved to place JDL into liquidation. Before its liquidation, Mr James, as JDL's director, resolved to amend the company's accounts so that the transaction was recorded as JDL repaying earlier advances rather than making a loan. The Trust's accounts were amended so that the $740,000 became part of the debt owed by Mr James, thereby removing the liability of JDL. The defendants admitted the sum was owed and incorrectly recorded, but argued that recovery was statute barred.

The High Court found that there had been a fraudulent concealment of the debt through the alteration of the accounts of JDL and the Trust. As a result, applying section 28(b) of the Limitation Act 1950, the limitation period did not begin to run until the concealment was reasonably discoverable. The Court held that on that basis the action was filed within the six year limitation period and judgment was entered against the Trust for $740,000.

See Court decision here.

Continuing to untangle Hubbard Management Funds

In *Simpson v Carr* [2015] NZHC 155, the statutory managers of various entities associated with the late Mr Allan Hubbard sought directions on how to calculate the entitlement of Graham Carr (NZ) Ltd (GCNZL) in the capital pool of Hubbard Management Funds (HMF), an unincorporated entity.

In 2012, GCNZL was advised of its capital entitlement. However, the statutory managers subsequently discovered certain adjustments in HMF's accounts which, if treated for the purposes of the calculation as "cash withdrawals", effectively reduced this entitlement to zero.

Justice Dunningham concluded that the four disputed transactions did not comprise "cash withdrawals" as defined, because they did not transfer value from one investor to another investor, or to another Hubbard entity. The Court's analysis turned on whether or not Mr Hubbard was a HMF "investor", as the disputed transactions all ended up in accounts that formed the portion of HMF owned by Mr Hubbard himself.

In finding that Mr Hubbard was not an investor, the Court agreed with GCNZL that the term must be interpreted

consistently with its use elsewhere in the definition of "cash" adopted by the statutory managers and implicitly agreed to by the investors. The Court held that its interpretation and application of the definition of "cash withdrawal" did not lead to any element of unjust enrichment. Any benefit received by GCNZL was simply a consequence of applying the Court's earlier directions as to distribution of the fund (in *Forresters Nominee Company Ltd v Hubbard Churcher Trust Management Ltd* [2012] NZHC 1216).

Bankruptcy when insolvency beyond a debtor's control

The Supreme Court, in denying an application for leave to appeal, has provided authority for the proposition that the judicial exercise of discretion under sections 36 and 37 of the Insolvency Act 2006 (Act) is not subject to any rule preventing bankruptcy when the debtor's insolvency is largely due to circumstances beyond the debtor's control.

That proposition arose in the context of a failed property development. Robert (better known as 'Rocky') Cribb had guaranteed a loan granted by Evia Rural Finance Limited (Evia) to a company that he controlled - Kaimai Palms Gold Resort Ltd (Kaimai). When Kaimai failed to secure refinancing, Evia obtained summary judgment against Mr Cribb and was then successful in its application to have Mr Cribb adjudicated bankrupt.

Mr Cribb appealed twice against that adjudication. He raised a number of arguments, two of which related to factual findings that were not disturbed in either appeal. As to his lack of blameworthiness, the Supreme Court upheld the judgment at first instance, which held a lack of blameworthiness to be outweighed by the desire for: accountability; the administration of Mr Cribb's affairs; and the discharge of indebtedness.

See Court decision here.

Recovery from trust following bankruptcy

This Australian case considered whether a bankrupt was a creditor of a trust of which she had once been a trustee. The bankrupt's trustee in bankruptcy argued that the bankrupt was a creditor by virtue of payments that had been made in respect of the trust property, and therefore the trustee in bankruptcy was entitled to the proceeds of the sale of that property, by virtue of an equitable lien.

In holding that the bankrupt was a creditor of the trust, the Court was careful to point out that it is the substance, and not merely the form, of payments made by the bankrupt that are important. The fact that payments to the trust were not made by the bankrupt personally was not determinative, because the bankrupt was beneficially entitled to the money paid by three corporate entities to discharge her liabilities.

The court confirmed that the bankrupt's right to be indemnified out of trust assets is secured by an equitable lien over those assets, and that right is transferred to the trustee in bankruptcy. All of these rights were held to take priority ahead of the beneficiaries of the trust.

See Court decision here.

No liability for Lloyds despite failure to pay causing liquidation

This case concerned the liability of Lloyds TSB Bank Plc (Lloyds) for failure to make an overdraft drawing available to Global Travel Agency Limited (Global) which subsequently went into liquidation. Global was a travel agency and member of the International Air Transport Association (IATA). IATA membership allowed Global to sell IATA tickets on the basis that the IATA was repaid by direct debit by the 17th of each month.

Global made each repayment to IATA by drawing on an overdraft facility provided by Lloyds and had often exceeded the facility limit. On 17 January 2011 Global attempted to draw about £50,000 over the facility limit, in order to pay IATA, and this was rejected by Lloyds. IATA requested proof that the non-payment was due to a bank error and gave a final payment deadline of 19 January 2011. Lloyds eventually authorised the full payment on 19 January 2011, but did not process the payment until 20 January 2011. Global was declared by IATA to be in default and was unable to continue selling IATA tickets.

Upon request, Lloyds provided an apology letter to Global for the late payment on 20 January 2011. IATA still refused to reinstate Global due to the original failure to pay on 17 January 2011 and Global was subsequently placed into liquidation.

Global's director sued Lloyds claiming that the late payment had caused Global's liquidation. The High Court found that, based on the apology letter, Lloyds was in breach of contract for not honouring the payment instruction given on 19

January 2011. However, the Court held that any harm caused to Global was too remote to be recovered. There was no evidence that Lloyds knew of or accepted liability in respect of all consequences for failing to pay due to bank error.

See Court decision here.

Investors should specify their intentions clearly to prevent funding being treated as "no strings attached" lending

The respondents in *Challinor & Ors v Juliet Bellis & Co and Anor* [2015] EWCA Civ 59 were a group of investors who brought a proceeding against a law firm that had paid money out to its client, a "single purpose vehicle" utilised to acquire land in the investor's investment. The investors made payments to the law firm's trust account, which the investors argued the firm held on trust for them. When the law firm paid this money out to the vehicle, the investors brought a proceeding alleging breach of trust.

The investors were initially successful, with the Court concluding that a Quistclose trust had arisen in respect of the investor's funds. A Quistclose trust is a class of resulting trust which arises when funds are transferred on terms that do not leave the funds at the free disposal of the transferee. A restriction on the use of funds held on Quistclose trust is usually created by an arrangement that the funds should be used exclusively for a stated purpose. Where such a trust is created, the beneficial interest in the funds remains in the transferor unless and until the purpose for which the funds have been transferred have been fulfilled (or certain conditions met). The Court concluded that a Quistclose trust had been created, requiring certain (poorly defined) conditions to be met prior to the funds being dealt with. Prior to these conditions being met, the firm paid the funds out as the vehicle's agent, and the funds were lost.

The firm appealed the Court's conclusion that any trust had been created in favour of the investors, arguing that each payment to the firm had constituted a loan to the firm as agent of the vehicle, with no strings attached. Given that none of the investors had stated the basis upon which they were paying the funds into the firm's trust account, the Court of Appeal considered the invitation upon which the investors had made their respective payments. The Court of Appeal found that no Quistclose trust had been created because the investors had, on an objective view, paid the money with no strings attached to the lending to the firm as an agent of the vehicle.

This case serves as a reminder to investors to expressly record their intentions with respect to money they advance to fund investments. Otherwise, funds may be treated as immediate loans payable into the investment.

See Court decision here.

Materiality clauses in contracts

The English High Court recently articulated the effect and meaning of the word "*material*" in an agreement. In *Decura IM Investments LLP and Others v UBS AG, London Branch* [2015] EWHC 171 (Comm), Decura IM Investments LLP (Decura) and UBS AG, London Branch (UBS) entered into an exclusive agreement where Decura would provide financial products and services to UBS. The agreement could be terminated where:

- UBS stopped carrying on a "*material part*" of its investment banking business
- This cessation had a "*material adverse effect*" on UBS's ability to market Decura's financial products and services.

UBS announced a restructuring plan to reduce the size and scope of its investment bank. Decura sought to terminate the agreement.

The court held that "*material*" meant "*substantial*" or "*significant*", in the context of the agreement. While UBS's restructuring plan involved "*significant changes*" and a "*shrinking of the business*", the court found that UBS had not stopped carrying on a part of its investment banking business. Decura also failed to provide sufficient evidence of a material adverse effect on UBS's ability to market Decura's financial products and services. The court noted that Decura did not produce evidence of an expert and the claim was brought before seeing whether UBS was unable or less able to market Decura's products. The agreement could therefore not be terminated.

See Court decision here.

Dodgy debt collectors top complaint of American elderly

The Consumer Financial Protection Bureau (CFPB) released a report in November 2014 underlining debt collection as the top complaint for older Americans. Many elderly say they struggle with debt in retirement, particularly when faced with

debt collectors who use overly aggressive techniques to hound them for debt that often they have no right to.

Common complaints included:

- **Collectors attempting to collect debts of deceased family members:** Many older consumers described that debt collectors continued to attempt to collect debts from family members even after they have informed debt collectors that they are not personally responsible for the debt, or that there is no money left in the deceased debtor's estate. In some cases, this continues for years after probate has been concluded.
- **Collectors harassing elderly about medical debt either already insured, or in dispute:** Elderly American consumers described being exasperated and confused by debt collectors trying to collect medical expenses that:
  - they have not previously been notified of
  - are in the process of having billing mistakes corrected
  - are already covered by insurance.
- **Collectors illegally threatening to garnish older Americans' federal benefits:** Elderly consumers reported many cases of debt collectors threaten to obtain garnishment orders (attachment orders) against Social Security, Supplemental Security Income or Veterans' benefits, despite the fact that such income is not typically subject to such orders. In many cases, this occurs when the debtor has no other source of income and relies on federal benefits to pay essential living costs. Needless to say, these threats cause older consumers significant distress.

The scale of the problem is vast, considering that 42 million Americans have medical debt, 35% of Americans have debt in collections and 18% of Americans expect to die owing money. Consumer advisory groups are working to ensure older Americans are better informed as to their rights when dealing with dodgy debt collectors.

Auckland

PwC Tower
188 Quay Street
Auckland 1010

PO Box 1433
Auckland 1140
New Zealand

P: +64 9 358 2555
F: +64 9 358 2055

Wellington

Aon Centre
1 Willis Street
Wellington 6011

PO Box 2694
Wellington 6140
New Zealand

P: +64 4 499 4242
F: +64 4 499 4141

Christchurch

83 Victoria Street
Christchurch 8013

PO Box 322
Christchurch 8140
New Zealand

P: +64 3 379 1747
F: +64 3 379 5659