BUDDLE FINDLAY

Legal update on banking and commercial - November 2013

14 November 2013

Why does everyone have to pay for the sins of a few? Credit Contracts and Consumer Finance Act changes

The Credit Contracts and Financial Services Law Reform Bill contains the amendments proposed by the Ministry of Consumer Affairs to the Credit Contracts and Consumer Finance Act 2003 (CCCFA). Submissions closed on 1 November 2013.

Given the pressures on parliamentary time, it is difficult to see why the proposed changes to the CCCFA have been given priority. To the extent that there is a problem with the CCCFA, it would seem that it is only really with a small number of lenders in particular communities (Review of the Operation of the Credit Contracts and Consumer Finance Act 2003 (September 2009, Wellington) Ministry of Consumer Affairs). While the social intent of protecting the most vulnerable borrowers from unscrupulous lenders is, of course, laudable, in our view such issues could have been better addressed by more active enforcement of existing provisions or specifically targeted prohibitions and stronger sanctions. Instead we now have amendments that will only add cost and uncertainty for mainstream lenders – and are highly unlikely to add any real tangible benefit to their customers (ie to the vast majority of people who actually borrow money).

As a result of the proposed changes:

- Even more disclosure to customers will be required – most of which will only add to spam they receive or to the paper that will go straight into the rubbish bin.
- Disclosure and advisory obligations on lenders to assist borrowers and guarantors to be aware of the full implications of their transactions will be arguably even greater than obligations on those who issue securities to the public – effectively, obligations when lending money will be greater than when taking money from the public. This is a significant intrusion on the common law position that lenders neither owe a duty of care nor have a fiduciary duty to borrowers – who, after all, approach lenders asking for money. It is hard to see how it can be justified.
- The flexibility to borrow on short notice will be reduced because the time period in which disclosure must be made will no longer have the flexibility to permit disclosure shortly after the loan (but within a post-disclosure cooling off period).
- Lenders will need to comply with "principles" of responsible lending. However these principles will be in force before they are clarified and fleshed out in a Responsible Lending Code – leaving it potentially unclear as to how to comply with those principles for up to two years. Two key groups of lenders, banks belonging to the New Zealand Bankers' Association and members of the Financial Services Federation already effectively have their own responsible lending codes, which seem to be working.
- There will be restrictions on the security which lenders can take over some consumer goods. This is not restricted to consumer lending but could cover business lending and affect some companies' ability to give security over stock (eg appliance stores).

All of these changes fail to deal with the significant issues that actually arise in practice - the uncertainty which has arisen under the CCCFA in relation to what costs can be incorporated into fees and what is a credit contract. The recent High Court decision of *Commerce Commission v Sportzone Motorcycles Limited* was the first case to consider the fees provisions (see article below for case summary). While the Commerce Commission's approach was affirmed, there are still uncertainties as to the extent certain fixed costs may be recovered.

The changes in the Bill still do not deal with the fact that it is not possible for consumers to make an 'apples for apples' comparison between lenders. Some lenders are currently charging fees for things that other lenders are recovering via the interest rate. The parameters of what costs may be acceptably recovered through fees is not clarified and as a result differences in fees will persist so that borrowers cannot readily determine the cost of borrowing and which lender is overall cheapest.

The inability of lenders to recover their costs of capital will only create incentives at the margins to outsource. Why, for example, would a lender insource the issuing of Property Law Act notices or making statutory demands on customers (and incur the capital and other indirect costs and risks of doing so) even if it could do this substantially cheaper than third party suppliers like law firms?

The changes also do not clarify whether prepaying for goods and services is a credit contract. The Ministry of Consumer Affairs

has said that you could not interpret the current definition of "credit" to include prepaid contracts. Our view is that you should not be able to, but that is exactly how the Commerce Commission has previously interpreted the definition in a case in which we have been involved.

Overall the proposed changes to the CCCFA do not help the vast majority of mainstream lenders and their customers (indeed it is probably counterproductive for them) and do not address some of the interpretation provisions that it would have been helpful to deal with. While the new requirements will all be capable of being complied with, there will be additional initial and ongoing costs in doing so without identifiable corresponding benefits.

Court provides clarity around "unreasonable" credit fees under the CCCFA

A recent High Court decision (*Commerce Commission v Sportzone Motorcycles Ltd* (in liq) [2013] NZHC 2531) has affirmed the Commerce Commission's approach (in its "Draft Guidelines for Consumer Credit Fees") in considering whether credit fees charged by lenders under credit contracts are "unreasonable" for the purposes of the CCCFA.

This is the first case where the test of unreasonableness in section 41 of the CCCFA has been substantively considered by the courts. However, we understand that the defendant will appeal this decision. We look forward to any guidance the Court of Appeal may provide on this issue.

Facts

Sportzone Motorcycles Limited (Sportzone) sold new and used motorcycles. Motor Trade Finance Limited (MTFL) provided financial services to its associated dealers, of which Sportzone was one. Under the arrangement between Sportzone and MTFL, Sportzone provided finance to purchasers of motorbikes, and assigned the loans to MTFL.

The loans provided for a number of credit fees:

- Establishment fee of $200 charged by Sportzone
- Establishment fee of $190 charged by MTFL
- Monthly account maintenance fee of $5 charged by Sportzone
- Monthly account maintenance fee of $3 charged by MTFL
- Prepayment administration fee of $50 charged by MTFL.

The Commerce Commission alleged that the above fees were "unreasonable" pursuant to section 41 of the CCCFA.

Relevant provisions of the CCCFA

Section 41 of the CCCFA provides that a "consumer credit contract must not provide for a credit fee or a default fee that is unreasonable."

Sections 42 and 44 of the CCCFA set out what a court must have regard to when considering whether an establishment fee and a credit fee is unreasonable:

- In relation to establishment fees, this includes whether the amount of the fee is equal to or less than the creditor's reasonable costs in connection with:
  - the application for credit
  - processing and considering that application
  - documenting the consumer credit contract, and/or
  - advancing the credit
- In relation to credit fees, this includes in relation to the matter giving rise to the fee, whether the fee reasonably compensates the creditor for any cost incurred by the creditor.

Decision and reasoning

When considering whether a credit fee is unreasonable under sections 42 and 44 of the CCCFA, the court must consider whether the fee compensates the creditor for costs it has incurred. Accordingly, the central question that the court had to determine in this case was: What is the required degree of connection between a cost and a fee before a creditor can include that cost in a credit fee under the CCCFA?

The court held that the test for whether a fee is unreasonable is:

"To be reasonable, the cost the creditor seeks to recover must be sufficiently close and relevant to the establishment of the particular loan, to the administration and maintenance of the particular loan, or to the actual consequences of the particular default, such that it can reasonably be said that the cost was incurred in connection with or in relation to the relevant matter."

The court noted that while the test is capable of relatively straight-forward expression, applying it to particular cases is less easy – there is no bright line test. However, the court accepted that in applying the "sufficiently close and relevant" test, management or cost accounting principles will be useful.

On the basis of this decision, the correct accounting approach will be to assess the fees against the direct and indirect variable costs of the activity giving rise to the fee (ie those costs which change in proportion to the volume of the activity). In addition, some direct fixed costs (eg IT costs) may also be included, provided a sufficiently close and relevant connection can be proved.

Generally, the approach adopted by the court in this case will not allow imposition of fees to recover costs associated with the general business of lending money – ie general overheads will not be recoverable. However, this does not mean that general business overheads of the creditor are not recoverable. Those costs can be recovered through the interest component charged by the creditor, without any issues. The reason for this is that the intention of the CCCFA (as stated by the Ministry of Consumer Affairs) is that creditors should primarily compete on interest rates, and fees should only be used by lenders to recover specific costs and losses.

Conclusion

This case reinforces the Commission's current approach in determining whether credit fees charged by lenders are unreasonable (as set out in its "Draft Guidelines for Consumer Credit Fees").

Pending any appeal, lenders will need to ensure that

- They are only passing on as fees variable costs incurred for that particular transaction
- They have clear accounting evidence linking the costs they are claiming to the fees imposed.

To the extent a lender wants to recover any fixed costs through fees, those costs must be direct and have a clear and close connection to the fee.

Lenders should also note that the CCCFA is subject to a number of proposed amendments under the Credit Contracts and Financial Services Law Reform Bill. That Bill will make further changes in this area, but it is not apparent that the changes currently proposed will do anything to address the significant uncertainty that remains in this area. See our commentary above for more on the proposed changes.

If you have any questions or concerns about this case or any fees or charges you may be charging, please contact us.

A clear run at the customers - Incoming franchise gets a month's head start

In the judgment of *Cookright Filtering Services Ltd v Wallis* [2013] NZHC 2535 the High Court recently demonstrated a readiness to protect the interests of new business owners by shutting down for a month a third party competitor that conspired with the outgoing owners to frustrate the customer handover process.

"Vat Tech" was a kitchen-vat cleaning franchise, which the franchisors (Cookright) were taking back over. The franchisees (the Wallises) agreed that they would assist with transitioning Vat Tech's customers to the new owners, in particular by sending the customers letters explaining the takeover, thereby ensuring the "smooth transition of the business operation". They then failed to send the letters, and instead deliberately delayed the customer handover process. Meanwhile Ms Tily, with whom the Wallises had a close business relationship, set up a competing vat cleaning company (Vat 2013), and began contacting Vat Tech's customers with promises of a "fresh start" with "familiar faces". Concerned that it was about to lose its chance to acquire the customers, Cookright applied to the High Court for an interim injunction prohibiting Ms Tily and Vat 2013 from carrying on the business of vat cleaning.

Cookright made four claims against Ms Tily and Vat 2013:

- That they had induced the Wallises to breach the handover agreement
- That, with the Wallises, they had conspired to injure Cookright
- That they were passing off Vat 2013 as a successor to Vat Tech
- That their actions were misleading and deceptive under the Fair Trading Act.

The High Court accepted that, for each of the claims, the facts justified an interim injunction prohibiting Ms Tily and Vat 2013 from carrying on the vat cleaning business in the relevant area. Crucially, the Court accepted as probable the fact that Ms Tily and the

Wallises had a "common design" to move Vat Tech customers to Vat 2013 by denying Cookright the opportunity to introduce itself to those customers in a timely way. A month-long injunction would therefore enable Cookright to make a fresh approach to the customers and invite them to switch back.

Ms Tily was not party to any restraint of trade in favour of Cookright, and was perfectly entitled to start a competing business. However, in conspiring with the outgoing owners to frustrate that handover, Ms Tily and Vat 2013 crossed from acceptable competition to actionable tort, and have given Cookright a month's head start in the process.

Cartel criminalisation - Commerce Commission issues draft competitor collaboration guidelines

The Commerce Commission has issued a draft version of the guidelines that will be used when new legislation that criminalises cartel conduct is passed. Under the Commerce (Cartels and Other Matters) Amendment Bill, the current price fixing prohibition in the Commerce Act will be replaced with a new prohibition on entering into or giving effect to a "cartel provision" (ie a provision in an arrangement between competitors that has the purpose, effect, or likely effect of price fixing, restricting output, or market allocating).

The guidelines provide useful guidance about how the Commission interprets the proposed new cartel prohibition, as well as its proposed approach to the new exemptions to the cartel prohibition for collaborative activities, vertical supply contracts, and joint buying arrangements. They also include the Commission's proposed approach to, and the process for, clearance applications for cartel provisions relating to collaborative activities, and some guidance on the application of the proposed new provisions to franchises. The draft guidelines are available here.

Cadbury loses purple in the UK, and Mattel Scrabbles on the tiles

The UK Court of Appeal recently overturned the UK High Court's decision to grant Cadbury a trade mark registration for the colour purple for milk chocolate, and other chocolate-related goods. The appeal related to Nestle's opposition to Cadbury's trade mark application. The description of the mark applied for was considered to be a combination of the swatch filed of the colour as part of the application, the Pantone Index for the relevant shade of purple, and this written description:

“The colour purple (Pantone 2685C), as shown on the form of application, applied to the whole visible surface, or being the predominant colour applied to the whole visible surface, of the packaging of the goods.”

Despite the fact that this "predominant" type wording had been endorsed in UK IP Office practice guidelines, the Court of Appeal unanimously decided that the written description of the mark was imprecise and thus the mark applied for by Cadbury offended the principles of certainty and fairness. The Court considered the "predominant colour" wording meant that Cadbury was in fact trying to register multiple signs (marks) which were not, as required by the UK Act, represented graphically in the application, nor in accordance with the criteria established in the Sieckmann case. The Sieckmann case had considered the registration of a smell as a trade mark and held that a smell could be a sign if it could be represented graphically and thereby be identified as having the qualities of clarity, precision, objectivity and durability. The court stated that Cadbury's application was "for the registration of a shade of colour 'plus' other material, not of just an unchanging application of a single colour". The fact that Cadbury's purple colour was in fact distinctive in relation to its chocolate goods was irrelevant if the mark was not in fact represented graphically in the application.

The Cadbury decision would on its face seem to suggest applicants for colour marks might be better served to file just a swatch of the relevant colour and its Pantone Index shade, and omit a written description altogether. However the decision also gives a strong indication that colour applications will still require a clear explanation of how the colour will be applied to the applicant's goods or services in order to meet the Sieckmann criteria.

Scrabble on the tiles

On the same day the same UK Court of Appeal also cancelled Mattel's (maker of the Scrabble board game) UK trade mark registration for a representation of a Scrabble "tile". The registered mark was depicted as an ivory-coloured tile with the additional written description, "on the top surface of which is shown a letter of the Roman alphabet and a numeral in the range 1 to 10". The Court of Appeal agreed with the applicant for cancellation that this did not describe a single sign or a sign that was identified clearly, precisely and objectively enough to meet the criteria established in the Sieckmann case.

What about New Zealand? The New Zealand Trade Marks Act also requires that marks be capable of being represented graphically. Also, given the similarity of the UK and NZ trade mark regimes, the criteria for describing "unconventional marks" set out in the Sieckmann case are likely to be applied in New Zealand. Following these two UK cases any existing New Zealand trade mark registrations for colour marks that include imprecise wording like the "predominant" wording in the Cadbury case may be vulnerable to revocation (cancellation) on the application of suitably aggrieved third parties.

Health and Safety Law Reform

On 31 October 2013 the Government released an exposure draft of the Health and Safety Reform Bill (the HSRBill) which, among other things, places specific health and safety obligations on directors of companies and those in similar roles in other types of organisations.

In particular, the HSR Bill will, if passed, create a positive duty on "officers" of the relevant "person conducting a business or undertaking" (PCBU) to exercise due diligence to ensure that the PCBU complies with its duties or obligations under the Act.

This new positive and personal duty will extend to directors (and similar officers in organisations that are not companies), chief executives and other senior managers, and requires the officer to take reasonable steps to:

- Understand the PCBU's operations and associated hazards
- Ensure that the PCBU has, and implements, appropriate health and safety processes, and that these processes are sufficiently resourced and verified.

Failure to comply with the duties imposed on officers will be an offence (unless the officer is a volunteer, ie is not paid for being an officer, other than compensation for out-of-pocket expenses). The maximum penalty for officers will be a sentence of five years' imprisonment and/or a fine of $600,000, which represents a substantial increase in the level of penalties from the Health and Safety in Employment Act.

It is also worth noting that Andrew Little has a member's bill in the ballot which would introduce the offence of corporate manslaughter into the Crimes Act 1961 (as the law currently stands, corporate bodies cannot be convicted of manslaughter in New Zealand). In the United Kingdom, where the offence of corporate manslaughter under common law was confirmed in 1991, there has been a recent conviction for corporate manslaughter, with a company in Northern Ireland pleading guilty and being fined £110,000.

Financial Markets Conduct Regulations consultation

On 31 October 2013 the Ministry of Business, Innovation and Employment released a first consultation draft of parts of the Financial Markets Conduct Regulations and exposure drafts of disclosure documents. These will flesh out the provisions of the Financial Markets Conduct Act in advance of that legislation coming into force in April and December 2014.

NZX announcement - Public censure of Energy Mad Limited

On 14 October 2013 NZX Limited (NZX) announced a public censure of listed company Energy Mad Limited (Energy Mad) for a breach of NZX's Continuous Disclosure Rules (Listing Rule 10.1.1.).

Energy Mad's securities began trading on the NZX's Main Board in October 2011. On 23 January 2012 Energy Mad made an announcement downgrading its forecast for its 2012 financial year EBITDA from $3.5 million to $1.1 million. This caused a substantial overnight decline in Energy Mad's share price, and NZX Regulation subsequently undertook an investigation to determine whether Energy Mad had made the announcement in a sufficiently timely fashion.

NZX Regulation concluded that Energy Mad possessed sufficient information as of 20 December 2011 to trigger its continuous disclosure obligations and that the announcement should have been made at that date. The matter was referred to the NZ Markets Disciplinary Tribunal, who approved a settlement agreement between NZX and Energy Mad, with Energy Mad agreeing to accept a public censure, and pay a $30,000 penalty together with costs.

The NZX announcement of the public censure can be accessed online here. We see the decision as reinforcing the importance of the continuous disclosure regime, and the need for issuers to continually assess information against any previous announcements or forecasts, to decide whether they possess material information that must be notified.

Government decisions on default KiwiSaver providers

On 17 October 2013 the Government announced its decisions on the review of KiwiSaver default provider arrangements.

This is important as it determines the criteria that will be used to evaluate new default provider applications, for the seven year period beginning 1 July 2014. These default providers are used when new employees are auto-enrolled into KiwiSaver and do not select a provider – these new employees are allotted to one of the five currently approved default providers. This represents a

large percentage of the New Zealand workforce. Officials advised the Cabinet that around 37% of current KiwiSaver members (780,000 people) initially entered KiwiSaver through being allocated to a default provider, and more than 450,000 of these people remain with these default providers.

Cabinet has agreed to retain the same general investment approach for default KiwiSaver providers as adopted in the 2006/07 tender process – a conservative approach focusing on savings preservation. In addition, Cabinet has agreed to high-level criteria for selecting default providers which again follow the same general approach as the 2006/07 process, but with the addition of evaluating applicants on their provision of investor education and advice.

Based on Cabinet's decisions, the Government will undertake a tender process for the period from 2014 to 2021. In the event that any of the current default providers are unsuccessful in their applications, their default members will be given the opportunity to either stay with that provider (but ceasing to be a default member), or be reallocated to another provider.

Auckland

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