

RUSSELL McVEAGH

BANKING LAW UPDATE

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## CASES

### DUTIES OF NZX AS INSPECTOR

*Bank of New Zealand and Access Brokerage Ltd (in liquidation) v Deloitte Touche Tohmatsu and New Zealand Exchange Ltd [2007] 1 NZLR 663*

Access Brokerage Limited ("**Access**") was a stockbroker and a member of New Zealand Exchange Limited ("**NZX**"). On 6 September 2004 Access was placed in liquidation after its directors advised NZX that it was unable to meet obligations to clients of about \$4.5 million. Bank of New Zealand ("**BNZ**"), as Access's banker, met the obligations and took assignment of the clients' rights of action.

BNZ and Access issued proceedings against NZX and Deloitte Touche Tohmatsu (Access's former auditor). Each alleged that NZX, in its capacity as an Inspector of the Stock Exchange, owed and breached duties of care in tort to protect them against their losses suffered following Access's liquidation. Access separately pleaded breach of the same duties in contract. Both claims focussed upon NZX's performance of its statutory functions of inspection of financial information provided by Access in the years prior to its failure.

Access's claims in both contract and tort were struck out, with Harrison J holding that Access was unable to show that NZX's breach of duty, if proven, caused its loss. The reasons for this finding were:

- responsibility for Access's many and substantial breaches rested squarely with the company, its directors and management. The law does not allow a party in breach of its contractual obligations to take advantage of its wrongs;
- NZX did not participate in any way in Access's management or control, in particular in its use of client funds or maintenance of liquid capital levels;
- it cannot be within the scope of an Inspector's duties to protect a broker from its own failure to perform an agreement to correct or remedy its own pre-existing breaches. Again, the same principle applies that the law does not allow a party in breach of its contractual obligations to take advantage of its wrongs;

*Cases continued ...*

- the purpose of the Inspector's function of reporting on any situation which could give rise to a claim on the Fidelity Guarantee Fund was plainly to protect the Fund, not the broker responsible for creating the situation; and
- the Inspector's function was significantly more limited than that of an auditor, whose role includes protection of a company from loss caused by a director acting dishonestly or unlawfully.

BNZ's claim that NZX owed Access's clients a duty in tort was also struck out, as BNZ was unable to establish the necessary degree of proximity or relationship to recognise a duty of care.

Additionally, Harrison J held that reasons of policy negate the existence of a duty, and it would not be just and reasonable to impose one.

Access has appealed the High Court's decision.

### DISCLOSURE BY BANKS UNDER THE PROCEEDS OF CRIME ACT 2002 (UK)

*K Ltd v National Westminster Bank plc (Revenue and Customs Commissioners and another intervening) [2007] 1 WLR 311*

This case considered the United Kingdom Proceeds of Crime Act 2002, specifically whether a bank is justified in freezing a customer's account because it suspects that transferring money from the customer's account will facilitate criminal activity.

K Ltd ("**K**") had an account with National Westminster Bank plc ("**NWB**"). K requested that NWB transfer £235,000 to another party. Suspecting money laundering, NWB refused to comply, and lodged an "authorised disclosure" under the Proceeds of Crime Act 2002 ("**Act**"). The lodging of an authorised disclosure requires either consent to be given by the Serious Organised Crime Agency or other government agencies (the "**Authorities**") or the lapsing of a certain time period before the suspicious transaction can be performed.

*Cases continued ...*

K applied to the court for an injunction to restrain the bank from breaching its contractual duty to perform K's instructions. The time period lapsed before the final case was heard and the transaction was, in fact, performed but the appeal was heard in order to decide costs and to clarify issues surrounding the Act.

K's claim was dismissed. The court found that it was clear that NWB could not be compelled to perform the transaction once it suspected that the money involved was criminal property, since doing so would then be illegal under the Act. On whether NWB should have been required to demonstrate the grounds on which it formed its suspicion, including letting the relevant bank official be cross-examined, the court found that the suspicion required was purely subjective and such cross-examination would be pointless as the official would simply confirm that he or she did indeed have the suspicion.

The court found that the Act's purpose was to strike an appropriate balance between interfering with trade on one hand and achieving the goal of stopping money laundering on the other. It noted that the time periods delaying

transactions were not overly onerous and there was always the option of judicial review if a party was concerned that the Authorities were unlawfully exercising their power to withhold consent.

## LEGISLATION

### INCOME TAX - REFORM OF DEFINITIONS OF "ASSOCIATED PERSONS"

On 29 March 2007 the Inland Revenue Department ("IRD") released an officials' paper outlining the scope of a proposed review of the various definitions of associated persons in the Income Tax Act 2004.

The IRD sees two basic problems with the current associated persons definitions. First, there are several different definitions of associated persons, which apply in different circumstances. These circumstances are found in sections OD 8(1) (mainly relating to petroleum mining), OD 8(3) (which applies in various miscellaneous circumstances) and OD 8(4) (land transactions). There is also the general definition of associated persons found in section OD 7, which applies in all other circumstances. The IRD considers that this fragmentation of definitions is unhelpful and could be made clearer and more consistent.

Second, the general definition of associated persons does not take into account several situations where parties to a transaction are considered by IRD not to be at arm's length. These include a settlor/trustee relationship, trustee/

beneficiary relationship, settlor/beneficiary relationship and the relationship between trustees of different trusts that share a common settlor.

In order to address these concerns the IRD has proposed reform of the associated persons definitions. The proposed changes would create one standard "associated persons" definition.

The new definition would specifically include those relationships referred to above and it would create a "tripartite" test for association, whereby two persons would be associated if they are each associated with the same third person. Furthermore, the paper proposes an aggregation test to determine whether a person and a company or a company and another company are associated. This would involve adding the interests of the relevant shareholder in those companies to the interests held by persons associated with that shareholder.

The IRD proposes to maintain certain exceptions found in the current legislation, as well as reducing the degrees of relationship necessary to be considered a relative from four degrees to two.

*Legislation continued ...*

The officials' paper is available from [www.taxpolicy.govt.nz](http://www.taxpolicy.govt.nz). Submissions close 11 May 2007. Legislative changes resulting from the consultation process are expected to be introduced in November 2007, with the changes having effect from the 2008-09 income year.

**TAKEOVERS CODE: "LOOPHOLE" FOR SCHEMES OF ARRANGEMENT AND AMALGAMATIONS**

The Takeovers Panel issued a media release on 28 March 2007 stating that the Panel is to undertake further work to resolve the problem of schemes of arrangement and amalgamations potentially used to undermine the Takeovers Code.

Chairman David Jones noted that while the Panel does not want to prevent the use of schemes of arrangement and amalgamations, it wants to ensure that shareholders have similar protections in a change of control as shareholders have in a takeover made under the Takeovers Code.

This latest work follows the Panel's discussion paper on exemptions for schemes of arrangement dated 4 April 2006 (see April 2006 Issue of BLU). After releasing this discussion

document, the Panel decided that the issues that need to be addressed are the inconsistencies inherent in the use of amalgamations and schemes to effect mergers or acquisitions involving code companies outside the jurisdiction of the Code.

**DISCUSSION DOCUMENT ON CONTRACTS FOR DIFFERENCE**

On 5 April 2007 the Securities Commission released a discussion document entitled Proposal to declare certain derivative contracts to be futures contracts under the Securities Markets Act 1988, which examines the application of the law to contracts for difference ("**CFDs**").

This paper arises from the uncertainty surrounding the statutory definition of "futures contracts". The Commission often receives requests for clarification from market participants of whether CFDs are "futures contracts" under the Securities Market Act.

The Securities Market Act requires people who carry on the business of dealing in futures contracts to be authorised by the Securities Commission, with heavy penalties imposed

*Legislation Continued*

if they do not have authorisation. Therefore, it is essential there is certainty about the status of derivative products.

While the Government will consider regulation of derivatives as part of its review of securities law, the Commission believes it is necessary to clarify the position in the interim.

The Commission proposes to use its power under the Securities Markets Act to declare CFDs in respect of shares or other securities to be futures contracts. This will mean people dealing in CFDs will need to obtain authorisation under the Securities Markets Act to deal in futures contracts. As futures dealers they can take advantage of the Securities Act (Authorised Futures Dealers) Exemption Notice 2002 which exempts the CFDs from the disclosure provisions of the Securities Act to the extent that these products are securities. This proposal provides certainty as to the status of the product and the compliance obligations on futures dealers.

The proposed declaration will supersede any current declarations in respect of individual equity CFDs.

The discussion document is available from [www.sec-com.govt.nz](http://www.sec-com.govt.nz). Submissions close on Friday 4 May 2007.

**CHANGES TO TAX LAW RESULTING FROM ADOPTION OF IFRS**

Adoption of International Financial Reporting Standards ("**IFRS**") for financial reporting purposes has been allowed since 1 January 2005 but will become mandatory from 1 January 2007 for entities that have to comply with generally accepted accounting practice. The adoption of IFRS for financial reporting purposes will have flow-on consequences for taxation purposes. A tax bill containing the technical changes to deal with these consequences will be introduced in May 2007.

The main legislative change in the bill will be the circumstances in which IFRS timing of income from financial arrangements can be adopted for tax purposes. Taxpayers who adopt IFRS for financial reporting must also adopt IFRS for tax purposes; this must generally be done contemporaneously. However, early adopters of IFRS will

*Legislation continued ...*

not be required to use the new rules until they become mandatory in the 2007-2008 income year.

Income and expenditure relating to financial arrangements are calculated before their maturity using either the "fair value method" or the "effective interest method" under IFRS. Taxpayers who prepare IFRS accounts will be required to follow the IFRS timing rules for taxation purposes, instead of applying the specific tax timing rules to spread the income and expenditure of financial arrangements. Taxpayers who do not prepare IFRS accounts will continue to apply the current tax timing rules for financial arrangements, except that they will not have the option of using the financial reporting method that is currently available.

The proposed tax change is only to the income spreading rules and not to the definition of a "financial arrangement".

A technical annex setting out the proposed changes is available from [www.taxpolicy.ird.govt.nz](http://www.taxpolicy.ird.govt.nz).

## SNIPPETS

### BANKER LIABILITY

The February 2007 issue of the *Australian Banking and Finance Law Bulletin* contains the article **Banker liability: silence and misleading and deceptive conduct (Part 1 of 2)**, written by Rhett Martin at Monash University.

The article examines a bank's duty to refrain from misleading or deceptive conduct as imposed by both s 52 of the Trade Practices Act 1974 ("**TPA**") and s 12DA of the Australian Securities and Investments Commission Act 2001 ("**ASIC Act**"). In particular the author looks at whether a bank's silence can breach this duty.

Several banking cases dealing with the duty as imposed by the TPA are examined (the TPA is more frequently litigated than ASIC Act, although both sections are equivalent):

- *Kimberley NZI Finance Ltd v Toner Pty Ltd* (1989) ASC 55-943 held that silence is not misleading conduct unless there is some reasonable expectation that if some pertinent fact exists, it will be disclosed.

- In *Kabwand Pty Ltd v National Australia Bank Ltd* a purchaser of a business alleged that the bank had deliberately not informed him that the business was unprofitable and that the vendor was indebted to the bank. The Court held the bank not to have engaged in misleading or deceptive conduct as it had a positive duty to keep its customers' information confidential and that, even if there had been an obligation to speak out, the plaintiff would need to show that he or she had been induced by the bank into action/inaction leading to the loss.
- *Plum v Commonwealth Bank of Australia* held that a common law or equitable duty to disclose is not required in order to render silence misleading. A banker must consider whether the customer at hand has been or could be misled.
- In *David John Crisp v Australian and New Zealand Banking Group Ltd*, all the plaintiff was required to show for there to be a breach of s 52 was that he had in fact been misled.

*Snippets continued ...*

- *Raymond George Sonell v National Australia Bank Ltd* offers a summary of the s 52 duty: if a bank knows a customer misunderstands something then the bank must speak up.

Part 2 (in the next issue) discusses the policy issues involved in silence being considered misleading or deceptive conduct.

### **COURT FINDS MORTGAGE UNJUST DESPITE FALSE STATEMENTS BY BORROWERS**

The February 2007 issue of the *Australian Banking and Finance Law Bulletin* contains the article **Court finds mortgage unjust despite false statements by borrowers** by Graeme Howatson and Dioni Perera. This article examines when a loan may be considered unjust.

In the recent case of *Permanent Mortgages Pty Ltd v Cook* [2006] NSWSC 1104, the NSW Supreme court considered the operation of s 70 of the NSW Consumer Credit Code which allows the court to reopen unjust transactions. The borrowers had provided a number of false documents to obtain a loan. While the false declarations were considered to be significant, the court found that the credit provider

was aware or ought to have been aware that the borrowers were not capable of servicing the loan, so the mortgage was put aside. Had the credit provider made even the most perfunctory of inquiries it would have appreciated the borrowers' inability to service the mortgage. The mortgage was therefore unjust even though there was nothing particularly unjust in its actual terms.

The court referred to *Perpetual Trustees v Khoshaba*, in which a contract was held to be unjust, despite the borrower providing false documents, because the lenders had not adequately considered the borrowers ability to make payments. The contract was set aside under the NSW Contracts Review Act 1980.

*Permanent Mortgages* extends *Khoshaba* to apply to the Code and confirms that credit providers need to prove they have taken adequate steps to verify the service capabilities of the borrower. Relying solely on the documents provided by the borrower may not prevent the court finding a loan unjust.

*Snippets continued ...*

### **THE LEGAL ASPECTS OF VENTURE CAPITAL AGREEMENTS: PART I**

The March 2007 issue of the *Company and Securities Law Journal* contains the article **The legal aspects of venture capital agreements: Part 1** by Dylan Democrat Damon.

This two-part article analyses venture capital investments in the context of the Australian corporate and commercial law environment. Part I provides an overview of the venture capital process.

It offers a definition of venture capital applicable to Australia, a definition of "angel capital" and outlines the role of the venture capitalist ("**VC**"). In discussing this role, the author describes how venture capital contracts allocate and distinguish between various corporate rights divided into four broad categories: control rights; cash-flow rights; voting and board rights; and liquidation rights.

The factors that influence the choice of legal structure and investment vehicle within the portfolio firm are examined. The proprietary company is identified as the preferred choice of corporate vehicle for the portfolio firm. A comprehensive

examination of the securities that a VC may use is provided including ordinary, preferred ordinary, preference, super voting, golden and deferred shares as well as convertible notes and subordinated debt. The type of shares held by the VC will be influenced by the mode of exit and the stage in the venture capital cycle at which the investment takes place.

Finally, there is a substantive analysis of the provisions and covenants that the VC will bargain for in the venture capital agreement. Covenants such as rights of pre-emption, drag-along and tag-along as well as anti-dilution provisions are designed to protect the VC's investment and to facilitate the VC's mode of exit.

### **THE LINE BETWEEN MEMBERSHIP AND CREDITOR RIGHTS IN CORPORATE INSOLVENCIES IN AUSTRALIA**

The March 2007 Issue of the *Companies and Securities Law Journal* contains an article by Jason Harris and Anil Hargovan entitled **Sons of Gwalia: Navigating the line between membership and creditor rights in corporate insolvencies**.

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This article examines the case *Sons of Gwalia Ltd (admin appt) v Margaretic* (2005) 55 ACSR 365; 24 ACLC 244; [2005] FCA 1305 and looks at how this case tests the boundaries of the rule that membership interests in a liquidation are deferred until after creditors are paid in full (known as the *Houldsworth* rule).

In *Sons of Gwalia* it was held that a transferee member's claim for misrepresentation against the insolvent company was not deferred as the member could be classified as a contingent creditor. The article criticises this decision for being legally flawed as it fails to recognise that the impact of the transferee's action on the company is still to diminish the company's capital and that there is a causal nexus between the purchase of shares and the statutory claim. As such, it is argued that this decision results in tension and logical inconsistencies in the law.

The article goes on to look at the implications of the decision for unsecured creditors, for the efficient administration of the insolvency regime and for Australia's debt capital markets. It also examines the policy considerations surrounding the allocation of risk between creditors and members in insolvent administrations. In addition, the article sets out

various models for law reform which would help address the relevance of the *Houldsworth* rule, each of which has differing impacts on members and creditors.

The article concludes that the High Court or Parliament needs to revisit policy on competing member and creditor claims in insolvency to reflect the modern regulatory regime, which confers additional benefits on members and relaxes the primacy of the maintenance of capital rule designed for creditor protection.

#### **VOIDABLE PREFERENCES - IS THE NEW LAW ACTUALLY AN IMPROVEMENT?**

The 16 March 2007 issue of the *NZLawyer* contains the article **Voidable preferences - is the new law actually an improvement?** by David Brown and Tom Telfer. This article examines the proposed voidable preference provisions in the Companies Amendment Act 2006, expected to come into force later this year.

The amending Act introduces a new test for when a transaction with an insolvent debtor is protected from being set aside, replacing the current test, which refers to

*Snippets continued ...*

transactions carried out in the ordinary course of business. The new test in section 293(3) contains 4 cumulative elements: entry into a transaction in good faith; no reasonable grounds to believe a company is or would become insolvent; whether a reasonable person would suspect insolvency; and whether there has been valuable consideration provided or a change in position in reliance on the transaction. The onus of proof is on the creditor, which would appear to be a major obstacle, although there are a number of Australian cases where the defence has succeeded.

Section 294 has also been amended so that when a liquidator serves notice to a creditor, the creditor may now choose to serve a counter notice within 20 days stating an objection to the liquidator's claims. This will require the liquidator to take proceedings. This procedure will help redress the procedural imbalance between the creditor and liquidator.

The article concludes that while the Government has removed the current "ordinary course of business" test, the lack of suspicion defence combined with the running account test will result in litigation around similar facts.

However, the article considers the new provisions are more conceptually consistent and clearer than the "ordinary course of business test". The existing Australian jurisprudence will also help clarify the application of the provisions in New Zealand.

#### **RECENT COMMON LAW DEVELOPMENTS**

Issue 3 2007 of the *Journal of International Banking Law and Regulation* contains an article by Andrew McKnight entitled **A review of developments in English law during 2006: Part 1.**

The article summarises some areas of the law that have been changed by recent decisions or statutes. The main areas discussed are:

- a bank's duty of care concerning an asset freezing order;
- misrepresentation in relation to investment products;
- an arranger's liability on the syndication and sell down of a facility;

*Snippets continued ...*

- restrictions on transfers of loan participants;
- contractual discretion to refuse consent to an assignment or sub licence;
- summary judgment in relation to a counter indemnity to a performance bond or a letter of credit;
- guarantees: duty of the creditor when realising the debtor's security and variation of the underlying agreement;
- misappropriated cheques: the liability of the collecting bank;
- money laundering and banks freezing accounts;
- trustee exemption clauses;
- sham transactions: piercing the corporate veil;
- worldwide freezing orders; and
- freezing orders obtained by a creditor in aid or a winding up or other insolvency proceedings.

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