

RUSSELL McVEAGH

BANKING LAW UPDATE

DATE | JULY 2007

PRINT

## CASES

### INSIDER TRADING

*Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited (No 4)* [2007] FCA 963

This case addressed Australia's insider trading laws, and is of particular relevance to large financial organisations that have different arms for different activities that operate relatively independently of each other. Citigroup Inc ("**Citigroup**") is a global bank that is divided into a number of different operational areas. In its Australian operations, two of its divisions are its financial advisory and investment banking divisions and its equities (or trading) division. Employees in the financial advisory division are likely to come into contact with confidential market information and are referred to as "private side" employees. Employees in its equities division are unlikely to do so, and are referred to as "public side" employees. Citigroup has a number of Chinese wall procedures in place to prevent public side employees gaining access to information held by private side employees.

This case arose when Citigroup's private side employees were advising Toll Holdings Limited ("**Toll**") on a proposed takeover of Patrick Corporation Limited ("**Patrick**"). On

the eve of Toll's takeover bid, a public side employee of Citigroup from the equities division, Andrew Manchee, bought over 1 million shares in Patrick. It was not suggested that Mr Manchee knew of the takeover bid at the time of buying the shares. However, after Mr Manchee purchased the shares, one of his supervisors suggested that he stop buying Patrick shares. Mr Manchee did so, and in fact sold many of the shares that he had initially acquired.

The Australian Securities and Investments Commission ("**ASIC**") brought insider trading charges against Citigroup. The crux of ASIC's argument was that Citigroup, as an advisor to Toll, was in a fiduciary relationship to Toll. Consequently, it owed a duty to Toll to ensure that no information flowed from its private side employees to its public side ones. ASIC argued that if an organisation such as Citigroup is intending to trade in the shares of a client with which it has a fiduciary relationship, it must first obtain the informed consent of that client.

ASIC's argument ultimately failed because of the nature of Citigroup's relationship with Toll. In the letter of engagement it was expressly stated that Citigroup was not engaged as a fiduciary. Although ASIC sought to superimpose a fiduciary

*Cases continued ...*

relationship despite the words of the letter of engagement, the Federal Court of Australia held that there was no fiduciary relationship in this situation and ASIC's argument that Citigroup was guilty of insider trading failed.

ASIC had two other main arguments to support its claim of insider trading by Citigroup, but these also failed. First, the Federal Court found that Mr Manchee was not an "officer" of Citigroup within the meaning of section 9 of the Corporations Act 2001, so his knowledge could not be imputed to Citigroup. Secondly, the Federal Court found that Citigroup's Chinese wall systems were adequate, meaning that no claim could be brought under section 1043F of the Corporations Act.

#### **DEFINITION OF SECURITY INTERESTS**

*Dunphy v Sleepyhead Manufacturing Company Limited* (Court of Appeal, CA63/06, 14 June 2007, Glazebrook, Hammond and O'Regan JJ).

This case, which was an appeal from the High Court (the High Court case was discussed in the April 2006 issue of BLU), considered the question of whether a security

agreement that has not been signed or assented to by the debtor is enforceable against the liquidator of the debtor. Sleepyhead supplied beds to King Robb, retaining title to the beds until fully paid. This retention of title was set out in the invoices Sleepyhead supplied to King Robb, but King Robb never signed and returned the invoices as it was directed. Sleepyhead registered a financing statement in respect of its security interest in the beds. King Robb was put into liquidation, owing money to Sleepyhead for beds supplied. Sleepyhead attempted to enforce its security interest against King Robb's liquidators. The liquidators rejected Sleepyhead's attempt on the grounds that it did not have an enforceable security interest, and treated Sleepyhead as an unsecured creditor for the purposes of distributing the proceeds of the liquidation.

Section 36 of the Personal Property Securities Act ("**PPSA**") provides that:

- (1) A security agreement is enforceable against a third party in respect of a particular collateral only if -

...

*Cases continued ...*

- (b) the debtor has signed, or has assented to by letter, telegram, cable, telex message, facsimile, electronic mail, or other similar means of communication, a security agreement...

Also relevant is section 40 of the PPSA, which governs attachment of security interests. Section 40 relevantly provides:

- (1) A security interest attaches to collateral when -
  - (a) value is given by the secured party; and
  - (b) the debtor has rights in the collateral; and
  - (c) except for the purpose of enforcing rights between the parties to the security agreement, the security agreement is enforceable against third parties within the meaning of section 36.

Since King Robb had not been signing the invoices for the beds, the security agreement between King Robb and

Sleepyhead would not be enforceable against a third party. The question that arises is, therefore, whether a liquidator is a third party for the purposes of section 36 of the PPSA. Also, whether section 40 was satisfied as between Sleepyhead and the liquidators and therefore whether the security interest had attached, hinged on whether the liquidators were third parties.

The Court of Appeal found that for the purposes of section 36, a liquidator acts as agent of the company in liquidation and is therefore not a third party. Consequently, the security agreement was enforceable as between Sleepyhead and the liquidators of King Robb. Furthermore, for the purposes of enforcing rights between Sleepyhead and the liquidators, Sleepyhead's security interest had attached to the collateral.

However, there was a further complicating factor in this case: Bank of New Zealand ("**BNZ**") had a security interest in respect of all of King Robb's present and future property, in respect of which BNZ had registered a financing statement. If Sleepyhead had complied with section 36, its security interest would have had priority over BNZ's by virtue of section 75 of the PPSA, which gives priority to perfected

*Cases continued...*

purchase money security interests. Sleepyhead lost its priority however by not complying with section 36. Also, under section 40, Sleepyhead's security interest had not attached for the purposes of enforcing rights against third parties.

The Court of Appeal held that in the absence of BNZ's prior ranking security interest, the liquidators of King Robb would have been bound to grant possession of the goods in which Sleepyhead had a security interest to Sleepyhead. However, since BNZ had a prior security interest in the goods, the liquidators (acting as BNZ's agents) were entitled to retain the goods, therefore protecting BNZ's interest. However, since Sleepyhead did in fact have a security interest in the goods, section 117 of the PPSA provided that Sleepyhead was entitled to the surplus from the liquidation process after BNZ's claim had been satisfied. The surplus amount was \$26,225, and judgment was given against the liquidators for that sum plus interest and costs.

## SECURITY INTERESTS IN SHIPS

*KeyBank National Association v The Ship "Blaze" [2007] 2 NZLR 271.*

Blaze was a yacht under 24m in length that was registered on the United States Coast Guard ship register. The owner of the ship registered a mortgage over Blaze to KeyBank National Association ("**KeyBank**") which, under United States law, meant that KeyBank took title of the yacht. The owner of the ship fell into arrears on his mortgage payments and whilst in arrears KeyBank became aware that the yacht was for sale in New Zealand. Mr Walters bought the yacht and on-sold it to his company. Mr Walters registered a financing statement on the Personal Property Securities Register ("**PPSR**") two days before KeyBank. Mr Walters argued that:

- he had priority as he had taken the personal property free of a perfected security interest (s52);
- the Personal Property Securities Act 1999 ("**PPSA**") applied to collateral in New Zealand (s26);

*Cases continued...*

- the PPSA only excluded the transfer, assignment, mortgage or assignment of a mortgage of a ship exceeding 24m in length (s23(e)(xi)); and
- KeyBank's priority was lost because they acquiesced or knew of the original owner transferring his interest in the yacht (s90).

KeyBank argued that it had priority under the Ship Registration Act 1992 ("**SRA**"), which states that registered instruments creating securities and charges in respect of a ship registered in a foreign country have the same effect and priority as a mortgage registered under the SRA (s70).

The High Court held that KeyBank's mortgage was to be treated as a mortgage registered under the SRA (s70 SRA) and that the PPSA does not apply to securities falling directly or indirectly within the SRA. This was despite the wording of s23(e)(xi) of the PPSA, which excludes the registering of interests in ships over 24m in length - the court held that this does not necessarily import the construction that the PPSA includes ships under the length of 24m. Such a construction would invalidate securities over a large number of ships registered under the SRA and would mean that all foreign owners of ships under 24m would need to register

their interest on the PPSR when they entered New Zealand waters. The PPSA must be applied according to reasonable standards of commercial practice (s25(1)) and should not conflict with deep-seated principles of international law including the protection conferred by the state of a ship's flag. The courts will not lightly impute to Parliament the purpose of bringing about an unreasonable result.

The High Court further held that as the PPSA does not apply to securities falling within the SRA, knowledge and acquiescence of the transfer to Mr Walters did not provide a defence under s90 of the PPSA. However, this defence was arguable on the basis that equity may follow the law and have regard to KeyBank's conduct in deciding whether, and if so on what terms, to grant discretionary relief to enforce a charge rather than a simple declaration of entitlement to a chattel.

## LEGISLATION

### **BANKING CODE OF PRACTICE REVISED**

A revision of the banking industry's code of practice was unveiled on 20 June 2007. The code is reviewed by the Bankers' Association every three years. This year it features a new section on internet banking, in response to customer use that saw 80 million online transactions in 2006. The section sets out the circumstances in which member banks or customers will be responsible for losses and makes a commitment to provide information about online fraud, scams and other details.

An online version of the code is available at the New Zealand Bankers' Association website, [www.nzba.org.nz](http://www.nzba.org.nz)

### **ACCEPTABLE SECURITY IN THE OVERNIGHT REVERSE REPO FACILITY**

The Reserve Bank released a statement on 17 July 2007 announcing that supra bonds are now eligible to be used in its Overnight Reverse Repo Facility ("**ORRF**"). The Reserve Bank offers the ORRF service as a last resort facility for counterparties who have signed a Master

Repurchase Agreement to access cash in exchange for security. The cash is made available at a margin to the Official Cash Rate. Prior to this announcement, the only securities eligible to be used in this facility were government securities. From 3 September 2007, however, supra bonds (being bonds issued by supranational banks, for example the World Bank and the European Investment Bank) that meet certain criteria will be eligible for the ORRF facility.

The Reserve Bank's full statement is available from [www.rbnz.govt.nz](http://www.rbnz.govt.nz)

### **INCOME TAX BILL REPORTED BACK**

The Finance and Expenditure Committee reported back on the Income Tax Bill on 17 July 2007. The Bill completes the rewrite of the Income Tax Act, which has been ongoing since the early 1990s. The Bill rewrites parts F to Z, the rewrite of the earlier parts having been completed already.

The purpose of the rewrite is to clarify the law as it exists, not to make substantial policy changes. To the extent that the Bill does make minor policy changes, these are

*Legislation continued ...*

set out in the officials' report presented to the Finance and Expenditure Committee by the Inland Revenue Department.

The officials' report and the Bill as reported back are available from [www.taxpolicy.ird.govt.nz](http://www.taxpolicy.ird.govt.nz)

## SNIPPETS

### AMALGAMATION DOES NOT TRANSFER ASSETS

The May 2007 *New Zealand Company Law and Practice Report* contains an article entitled **Amalgamation does not transfer assets** by Lucy Ellis.

This article provides a review of the recent case of *Elders New Zealand Ltd v PGG Wrightson Ltd* in which it was held that an amalgamation approved by the Court under part 15 of the Companies Act 1993 does not result in the assets of the amalgamating companies being transferred to the amalgamated company.

Wrightson Ltd ("**Wrightson**") and Elders NZ Ltd ("**Elders**") together owned a number of stock saleyards with agreements prohibiting the transfer by either party of its interest in the saleyards. When Wrightson and Pyne Gould Guinness amalgamated, Elders applied for a declaration that due to the agreements, Wrightson's interest in the saleyards could not be transferred to the amalgamated company PGG Wrightson. The Court however held that on amalgamation, Wrightson's assets and liabilities continued as part of Wrightson PGG and therefore there was no transfer in breach of the agreements.

### COMPLEX STRUCTURED FINANCE TRANSACTION GUIDELINES

The Spring 2007 issue of *The Journal of Structured Finance* contains an article by Brandon Becker, Russell Bruemmer, Soo Yim, David Luigs and Clare Schmitt entitled **Regulatory fallout from Enron: final guidance on complex structured finance transactions**.

The article looks at the statement ("**Statement**") issued in the United States on 11 January 2007 by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission (the "**Agencies**") which sets out guidelines for dealing with complex structured finance transactions ("**CSFTs**").

In response to the Enron collapse, the Agencies entered into agreements about risk management controls and procedures with various banks that had entered into CSFTs with Enron. These agreements formed the basis of an initial draft statement issued in May 2004. After consultation, a heavily revised statement was issued in May 2006 and then finalised and released at the start of this year.

*Snippets continued ...*

The Statement applies to a range of financial institutions; national and state banks, bank holding companies (excluding foreign organisations), federal and state savings associations, savings and loan holding companies, US branches/agencies of foreign banks, and SEC-registered broker-dealers and investment advisers. It aims to provide guidelines for financial institutions to:

- identify CSFTs that pose above average risks;
- once identified, provide processes for analysing those risks and approving entry into the CSFT, including appropriate documentation of the CSFT; and
- introduce broader programmes of risk management.

Identification is the first step. The Statement provides a number of features that should alert institutions to transactions that may require closer scrutiny. These include questionable accounting, regulatory or tax objectives, circular transfers of risk, economic terms inconsistent with market norms and disproportionate compensation for services rendered. The list of features was shortened after comments

that it was initially too broad and would capture many structured finance products that were commonplace and did not pose elevated risks. Features that were cut included transactions that were highly leveraged or crossed multiple geographic and regulatory borders.

In order to approve the CSFT, the institution needs to go through a more rigorous due diligence. This could involve seeking more information from the client than normal or obtaining specialised advice from accounting, tax or legal professionals. Approval of the CSFT should involve people with appropriate experience and training and the Agencies note this may mean senior management, though this is not expressly required. The CSFT should be carefully documented, including the internal approval and monitoring processes it goes through.

The final part of the Statement refers to broad principles of risk management that should be in place generally but can also assist with an institution's handling of CSFTs. Institutions should aim to foster an atmosphere that promotes good business ethics and legal compliance. This starts with the board and management, who should ensure that they receive appropriate levels of information about any CSFTs.

*Snippets continued ...*

Periodic audits should also be carried out to ensure compliance with the institution's guidelines on CSFTs and that staff working on them have all necessary training.

Overall, the Statement has relaxed some of the measures proposed in earlier drafts but continues to put financial institutions on notice that they need to be vigilant when entering into CSFTs and to ensure that they have appropriate processes in place to deal with the higher risks they bring.

#### **MODEL LAW: A LIMITED IMPACT?**

#### **ISDA MASTER AGREEMENT: SOME KEY FEATURES**

#### **ON SECURITY TRUSTEES' POWERS AND THEIR CONTROL: CITIBANK V MBIA ASSURANCE.**

The May 2007 issue of *Butterworths Journal of International Banking and Financial Law* contains three articles of interest.

- The first is an article by Adam Gallagher and Ben Jones entitled **Model law: a limited impact?**

This article comments on the extent to which the UK's adoption of the UNCITRAL Model Law on cross-border insolvency ("**Model Law**") has had an impact on cross-border insolvency and takes a glimpse into the future of this increasingly interesting aspect of the restructuring arena.

The Model Law is designed to be a "doorway" through which an insolvency representative of any nation can pass, so as to gain recognition and relief regardless of whether that representative's home nation has already adopted the Model Law. To date, the Model Law (which applies only if it is voluntarily adopted into national laws) has been adopted by 12 countries including the UK and the USA.

The authors comment that the two countries between whom the Model Law may have the least effect are probably the UK and the USA. They argue that this is because there already exists a strong history of international co-operation between these two countries. Moreover, it is noted that in the UK the Model Law is likely to have only a limited impact

*Snippets continued ...*

because, as regards pan-European insolvencies, the EC Regulation on Insolvency Proceedings 2000 is doing much the same job. In contrast, the authors argue that the Model Law might have a real impact when it is adopted by civil law countries.

The authors conclude by saying that although the market has so far been too soft to give the Model Law much of a report, it does at least have the potential to be a star performer in an increasingly globalised economy.

- The second is an article by Mathew Chandy and Shinoj Koshy entitled **ISDA Master Agreement: some key features**. This article outlines some key features of the 1992 and 2002 ISDA Master Agreements, including:

Close out netting where an event of default has occurred under the ISDA Master Agreement: Close out netting provisions enable Party A to set off amounts due to it under the ISDA arrangements from Party B against amounts due to Party B from Party A under the same ISDA arrangements. This

avoids Party A paying Party B and then, where Party B is insolvent or unable to pay its debts, Party A having to line up with other creditors of Party B to claim for the amounts due to Party A under the ISDA arrangements. A consequential benefit to banks is that they are able to set aside less regulatory capital for hedging transactions.

The introduction of two additional events of default/ termination events in the 2002 Master Agreement, being illegality and *force majeure* provision: The authors note important distinctions between events of default and termination events, being: termination events generally do not imply any degree of culpability; in a close out following a termination event only the affected transactions are terminated. Whereas all outstanding transactions are terminated in an event of default; for certain termination events either party can close out the affected transactions, and both parties are responsible for calculating the close out payments for a termination event whereas the non-defaulting party has this ability in an event of default. Where

*Snippets continued ...*

automatic close out is specified in the ISDA Schedule parties should consider the benefits of this against any potential disadvantage arising from an inability to close out back-to-back hedging.

The calculation of the close out amount differs in the 1992 and 2002 versions. Under the 1992 ISDA Master Agreement the parties must elect a between a "market quotation" or a "loss" method to calculate the close out amount. Essentially, the "market quotation" method involves obtaining quotations from dealers in the relevant market for the cost of entering into a transaction that would have the effect of preserving the effective payment or delivery that the parties would have made had the agreement continued. This method, in times of stress, may be difficult to implement. The 2002 ISDA Master Agreement provides for a single calculation method - a hybrid of the "market quotation" and "loss" methods - whereby the close out amount is calculated on the cost that would be incurred in replacing the rights and obligations that have been terminated.

- Finally, the journal contains an interesting critique by Look Chan Ho of a recent English Court of Appeal case (*Citibank v MBIA Assurance* [2007] 1 All ER (Comm) 475) on the scope of a security trustee's powers in a securitisation context. The article is entitled **On security trustees' powers and their control: *Citibank v MBIA Assurance***.

*Citibank v MBIA Assurance* is said to be the first time courts have had to consider the scope of a security trustee's powers in a securitisation. FLF had issued a series of notes to investors which were secured by a debt (known as the Eurotunnel tier 3 debt) held by FLF. Citibank was the security trustee. QVT, as the holder of C2 notes issued by FLF and MBIA, was the guarantor of certain of the notes issued by FLF. The security trust deed provided for MBIA to be able to give directions in relation to matters that would otherwise be Citibank's duties and discretions as a trustee.

A French court approved a restructuring of the Eurotunnel debt which would assign the Eurotunnel tier 3 debt to a Eurotunnel company in

*Snippets continued ...*

consideration for the issue of notes redeemable in shares in the Eurotunnel company plus cash, with an option to receive cash instead of the notes. MBIA directed Citibank to exercise the cash option. QVT contested. Citibank sought directions from the court as to whether it had to comply with MBIA's direction. The court at first instance and the Court of Appeal both held that:

- (a) Citibank had the power to require FLF to exercise the cash option despite the absence of an event of default or any requirement to preserve the security; and
- (b) MBIA had the power to direct Citibank to exercise the cash option.

Look Chan Ho submits that the decisions cannot be correct as a matter of first principles. Look Chan Ho states that a security interest "is a proprietary interest in an asset beneficially owned by the security grantor", and that "unless contractually stipulated otherwise, a chargee is not entitled to direct the management of the charged asset prior

to enforcement and in the absence of any threat of impairment to the security". Look Chan Ho argues that Citibank had no power to require FLF to exercise the cash option and that by holding that it did, the courts confused the "elementary concepts of beneficial ownership and security interest".

Look Chan Ho also argues that the decision of the Court of Appeal is internally inconsistent. In particular, Look Chan Ho questions certain statements by the court that it was not determining (a) the propriety of the exercise by Citibank or MBIA of any power, or (b) whether MBIA would be acting in breach of any implied term of the security trust deed. By finding that Citibank had the power to direct FLF to exercise the cash option, and that MBIA had the power to direct Citibank, Look Chan Ho argues that the court necessarily held that the exercise of those powers would not be improper or in breach the security trust deed.

*Snippets continued ...*

### **DISHONEST ASSISTANCE - THE LATEST PERSPECTIVE FROM THE COURT OF APPEAL**

### **CHINA AND THE WTO**

### **AUSTRALIAN ANTI-MONEY LAUNDERING REFORM**

### **SECURITY INTERESTS IN SHARES AND THE RIGHT TO REDEEM**

The 2007 Issue 6 of the *Journal of International Banking Law and Regulation* contains four articles of interest.

- The first is an article by Nikunj Kiri entitled **Dishonest assistance - the latest perspective from the Court of Appeal**. It examines the impact of the recent English Court of Appeal decision in *Abou-Rahmah v Abacha* [2006] EWCA Civ 1492; [2007] 1 Lloyd's Rep.115 in the areas of dishonest assistance and money had and received in relation to money laundering transactions.

The facts of this case involved a Nigerian scam on a Kuwaiti property developer. The funds flowed

through a Nigerian bank, which suspected the general purpose of the account was for laundering money for corrupt politicians but had no specific knowledge of this transaction. The court had to decide if this was enough to implicate the bank. The following issues were examined:

1. **The test for "dishonesty" in relation to dishonest assistance**  
The court addressed the issue of whether "honesty" should be judged subjectively or objectively. In the end a mixed test was put forward but it is still relatively unclear of the balance between the two.
2. **What knowledge will suffice to establish dishonest assistance?**  
The main issue here was whether "willing blindness" constitutes dishonesty. The court was reluctant to find dishonesty in this case from the mere general suspicion of dubious activity in relation to the account, but this finding will vary widely depending on individual facts.

*Snippets continued ...*

### 3. Dishonesty, bad faith and the change of position defence

The court ruled that the general suspicions held by the bank were not enough to remove their change of position defence. Specific concern about the transaction was required.

This article highlights a number of shortcomings and grey areas in this area of the law. The main piece of practical advice to come from it is for lending institutions to always lean on the side of caution in relation to such matters.

- The second is an article by J. Teo and B.S. Suresh entitled **WTO - Waiting time's over - China opens its domestic banking market to foreign banks after recent changes to its banking law and regulations make them WTO compliant.**

This article looks at the changes that have been made to China's banking laws and regulations to make its banking industry WTO compliant since its accession to the WTO on December 11 2001. In pursuit of the WTO's objective of ensuring trade

flows freely and predictably, China has now opened up its domestic banking market to foreign banks permitting foreign financial institutions to provide financial services without client and geographic restrictions.

In order to reform the banking industry, China also set up industry associations and banking regulators such as the China Banking Regulatory Commission ("**CBRC**"). The CBRC has the task of reforming the banking sector through benchmarking its supervisory and regulatory activities to international best practices.

The article then examines the difficulties that the CBRC is facing due to the state-owned commercial banks' oligopoly that had previously made it "virtually impossible" to introduce and implement modern banking practices. However, the Chinese government appears to show a strong commitment to the continued liberalisation of the banking industry with many of the proposed reforms having now been successfully implemented.

*Snippets continued ...*

- The third is an article by Chris McNeil entitled **The Australian anti-money laundering reform in the international context**. This article analyses the pending anti-money laundering ("AML") reforms in Australia against the approach taken to AML in various other jurisdictions.

The article begins by reviewing the international developments which gave rise to the reforms in Australia. Chief among these developments was a 2005 Financial Action Task Force ("FATF") report, which criticised the low level of compliance with FATF's 40 recommendations by Australia's existing AML system.

The author then discusses what he considers to be the three core areas which must be implemented by reporting entities in order for AML compliance to be effective - customer due diligence, suspicious transaction reporting and adequate systems and controls including staff training to prevent money laundering. The approach of the Australian AML reforms in each of these areas is then compared against the approach taken in various other

jurisdictions (and in particular the United Kingdom).

The consequences of the Australian reforms for AML supervisors and regulators are discussed, with a particular focus on the Australian Transaction Reports and Analysis Centre ("**AUSTRAC**"). Under the reforms, AUSTRAC will be required to develop into a full supervisory regulator with a wide ranging inspection programme, whereas previously it had only peripheral supervisory capacity in supervising cash dealers in meeting their obligations.

In McNeil's opinion, how the rules set out in the reforms are applied in practice will be the key to their success. That practical application will be the responsibility of the regulatory compliance group at AUSTRAC, who face the difficult task of providing regulated entities with the necessary guidance for their systems and controls while also allowing those entities the necessary freedom to manage their own risks.

*Snippets continued ...*

- Finally, the journal contains an article by Simon Beale entitled **David Hague v (1) Nam Tai Electronics Inc., (2) Tele Art Inc. (in liquidation) and (3) Bank of China (Hong Kong) Limited** written by Simon Beale. This article discusses the Privy Council judgment in the Nam Tai case referred to in the title. It is relevant to lenders that advance money in reliance on a borrower granting a charge over shares held by it in a company "X". The lender's security may be lost if company X changes its constitution to grant itself a right of redemption and set off.

A bare right of redemption will not present a problem for such a lender, even though the borrower is insolvent, because company X will pay the redemption price and the lender's charge will attach to that. The problem will arise where the redemption amount is set-off (via a right to do so in company X's constitution) against debts owed to it by the borrower, and there are no redemption proceeds to which a charge may attach. The case discussed in the article is an example of exactly this situation: a company in whose shares a lender had

a security interest granted itself a right of set off in relation to the redemption of its own shares, then exercised that right. In that case, however, the right of set-off under the constitution was restricted to judgment debts, and on the facts this allowed the court to find that the redemption was invalid and it was the lender the owned the shares.

#### **ENFORCEABILITY OF DEFAULT INTEREST RATE**

The May/June 2007 issue of the *Australian Banking and Finance Law Bulletin* contains the article **Enforceability of default interest rates - the Pacific View case** by Wills Chun.

The article outlines the August 2006 decision of the Supreme Court of Queensland in *Beil v Pacific View (Qld) Pty Ltd* [2006] QSC 119; BC 2006 06442 regarding the enforceability of a clause in a loan agreement that provided for the payment of a higher rate of interest on default by the borrower. The case provides guidance as to when such default interest rate provisions will be considered a penalty and therefore unenforceable.

*Snippets continued ...*

The factual scenario involved a borrower entering into a loan agreement with a lender, and the lender taking security over the loan in the form of a mortgage. A guarantee was also given by several guarantors in favour of the lender. Interest was payable on the outstanding moneys at 16% per annum, with the rate to increase to 25% per annum if the full amount was not repaid on the repayment date. When the loan was not repaid on the stipulated date the lender commenced proceedings against the guarantors to recover the moneys owed, including the additional interest at 25% per annum. The guarantors contended that the requirement to pay interest at 25% per annum was a penalty and, as such, unenforceable. Chesterman J found in favour of the guarantors.

In reaching this conclusion, his Honour considered the leading authority on the law concerning penalties: *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79. In that case the court held that the conventional sum is a penalty if it is extravagant and unconscionable in amount in comparison with the greatest loss that could possibly flow from the breach. Following on from *Dunlop*, Chesterman J applied the recent Australian High Court decision of *Ringover Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR

656; 222 ALR 306 which declared that for a payment to be considered a penalty, it must be extravagant, unconscionable and out of all proportion to a genuine pre-estimate of the damages likely to be caused by the breach.

In giving his decision, Chesterman J focussed on whether the default interest rate was a deterrent to late payment or a compensatory payment to account for additional costs in managing increased risk. His Honour found that default was foreseen by the lender at the time of entry into the separate agreement. There was no greater risk to the lender in recovering the loan and the lender suffered no greater loss due to default. Furthermore, the default rate increase of 9% was excessive and exorbitant when referenced to market standards and was not underwritten by an increase in risk. Chesterman J found the function of the default interest rate clause to be deterrent rather than compensatory, declaring it a penalty and therefore unenforceable.

The author concludes with a key point of note being the requirement that the default interest rate be proportionately linked to a genuine pre-estimate of the damage likely to be suffered.

*Snippets continued ...*

### **RANKING OF SHAREHOLDERS UPON A LIQUIDATION**

The May 2007 issue of the *Australian Journal of Corporate Law* contains an article by Anil Hargovan and Jason Harris entitled **Sons of Gwalia and statutory debt subordination: An appraisal of the North American experience.**

This article considers the landmark Australian High Court decision in *Sons of Gwalia Ltd v Margaretic*, a case which centred on an uncertain provision in the Australian Corporations Act 2001 (Cth) relating to debt subordination. The key issue in *Sons of Gwalia* concerned the extent to which shareholder claims for statutory misrepresentation and defective market disclosure against an insolvent company are to be subordinated, if at all, to unsecured creditors' claims. In a decision which the authors state has resulted in adverse reactions from major financial ratings agencies, the Australian Bankers Association and insolvency practitioners, the Australian High Court found in favour of shareholders, allowing them to rank alongside ordinary creditors under certain circumstances.

The main focus of this article is a comparative examination of American and Canadian experiences with statutory rules subordinating shareholder claims in insolvency, with the aim of assessing what lessons may be learnt from those experiences for Australian insolvency law.

The authors begin with an overview of the current state of the law in Australia, with particular reference to the *Sons of Gwalia* decision and its implications for the stakeholders upon insolvency. Hargovan and Harris then examine section 510(b) of the US Bankruptcy Code, which provides for blanket subordination of shareholders, and the recently announced Canadian reforms which introduce provisions similar to section 510(b) of the US Bankruptcy Code. The article concludes that, based on policy considerations, the US model of blanket subordination of shareholders should be rejected as a law reform option for Australia. In the authors' opinion, while there is a need for clear legislative policy in Australia, that should not involve an uncritical wholesale adoption of the imperfect US model on statutory debt subordination.

**This publication is included in Russell McVeagh's website on the internet:**

[www.russellmcveagh.com](http://www.russellmcveagh.com)

The transmission/publication is intended only to provide a summary of the subject covered. It does not purport to be comprehensive or to provide legal advice. No person should act in reliance to any statement contained in this publication without first obtaining specific professional advice. If you require any advice or further information on the subject matter of this newsletter, please contact the partner/solicitor in the firm who normally advises you, or alternatively contact:

**Prue Flacks or Guy Lethbridge | WELLINGTON**

**John Powell or Ross Pennington | AUCKLAND**

**ISO 9001 Certified – Quality Assured Supplier**

**WELLINGTON**

VODAFONE ON THE QUAY 157 LAMBTON QUAY  
PO BOX 10-214 WELLINGTON NEW ZEALAND  
PHONE 64 4 499 9555 FAX 64 4 499 9556

**AUCKLAND**

VERO CENTRE 48 SHORTLAND STREET  
PO BOX 8 AUCKLAND NEW ZEALAND  
PHONE 64 9 367 8000 FAX 64 9 367 8613

PRINT