

RUSSELL McVEAGH

BANKING LAW UPDATE

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CASES

PRINCIPLES OF APPOINTING AN INTERIM LIQUIDATOR

In the recent High Court case of *Kwok v Chinese Business Yearbook Ltd* (HC, Auckland, CIV-2007-404-3382, 22 June 2007 Abbott J) discussed the principles of appointing an interim liquidator under s 246 Companies Act 1993.

The judge identified three main pre-conditions to appointment of an interim liquidator from *Robert Bryce & Co Ltd v Chicken & Food Distributors Ltd* and *Carter Holt Harvey Ltd v Timbalok New Zealand Ltd*. The applicant must demonstrate that there is a valid application for liquidation underway; the application will in all probability succeed; and there is a need for interim control of the company pending an order for liquidation.

Abbott J also outlined three factors in particular which might justify an appointment from *Robert Bryce*. These factors were whether company assets were in jeopardy, whether the status quo should be maintained, and whether interests of creditors were being safeguarded. The court may also consider further factors it considers relevant.

The court in *Kwok* considered the plaintiff had made out grounds for appointing an interim liquidator.

DUTIES OF LOAN ARRANGERS

In the case of *IFE Fund SA v Goldman Sachs International* [2007] EWCA Civ 811, Goldman Sachs International ("**GSI**") were arrangers and underwriters of a syndicated loan used to provide funds to Autodis SA ("**Autodis**") for its purchase of a listed UK company, Finelist Plc ("**Finelist**"). GSI distributed a Syndication Information Memorandum ("**SIM**") on 30 March 2000 to possible participants including IFE Fund SA ("**IFE**"). In reliance on the SIM, IFE invested £20 million purchasing bonds and warrants issued by Autodis from GSI on 30 May 2000. Between sending out the SIM and 30 May 2000, GSI received other information which indicated Finelist's financial performance as described in the SIM was or might have been incorrect in a material way. In September 2000 following discovery of accounting frauds committed by the management of Finelist, a receiver was appointed over the company.

GSI relied on the terms of a notice under which the SIM was provided. The terms stated that:

Cases continued ...

- IFE acknowledged it had not relied on anything other than the terms of the facility agreements;
- GSI had not independently verified the SIM and that GSI accepted no express or implied representation or warranty as to the accuracy or completeness of the SIM; and
- the SIM would not be updated and GSI need not review the financial condition of Finelist.

IFE argued that by sending the SIM, GSI represented that it was not aware statements in the SIM were or might be incorrect and that this representation was continuing and that GSI owed IFE a duty to take reasonable care before completion to inform IFE if it suspected Finelist's financials were incorrect in any material way.

The United Kingdom Court of Appeal dismissed IFE's claims on the basis that:

- to comply with a duty to disclose material changes would involve GSI evaluating Finelist's financial performance, which was inconsistent with the language of the SIM (see above);

- the evidence did not show GSI made an implied representation as to the veracity of information. It did make a representation that it was acting in good faith, which would mean if, after the issue of information but before a recipient acted on it, GSI became aware the information was misleading it would be under a duty to disclose this. But this was different to GSI acquiring information that merely gave rise to a possibility that the SIM was misleading;
- no duty arose on the basis that:
 - the syndication system involved complex contractual relationships drafted by specialist lawyers and the courts should be careful to impose obligations on top of those carefully defined in the contracts; and
 - GSI were acting for the sponsors and not IFE. In general a party involved in negotiations towards a commercial venture owes no positive duty of disclosure towards a prospective party.

Cases continued ...

FIDUCIARY OBLIGATIONS IN JOINT VENTURES

Maruha Corporation v Amaltal Corporation Limited [2007]
3 NZLR 192

Maruha Corporation ("**Maruha**") was a Japanese fishing company that entered into a joint venture with Amaltal Corporation Limited ("**Amaltal**"), a New Zealand company. The joint venture took the form of a company, Amaltal Taiyo Fishery Co Limited ("**ATL**"), of which Maruha and Amaltal were shareholders. ATL conducted fisheries operations in New Zealand.

Under an agreement between the shareholders, Amaltal was responsible for ATL's accounting and tax responsibilities. Amaltal misrepresented certain of ATL's tax liabilities to Maruha, with the result that Maruha was induced to pay more than was necessary. Amaltal then shifted the extra payments from ATL to itself.

Maruha eventually discovered that it had been making overpayments, and sued Amaltal for deceit and breach of fiduciary duty. The High Court found in favour of Maruha on both counts, but on appeal to the Court of Appeal

only the finding of deceit was upheld. Maruha appealed to the Supreme Court on the issue of whether Amaltal had breached a fiduciary duty to Maruha.

The Supreme Court held that (1) Amaltal owed a fiduciary duty to Maruha and (2) it had breached that duty. Although the joint venture agreement between Maruha and Amaltal did not create general fiduciary duties between the parties, certain elements of the relationship, in particular Amaltal's taking responsibility for tax and accounting duties, did involve fiduciary obligations. The judgment sum against Amaltal was consequently increased.

LITIGATION

COMMENCEMENT OF VOLUNTARY ADMINISTRATION REGIME

On 24 September 2007 the Governor-General made the Companies Amendment Act 2006 Commencement Order 2007 ("**Order**"), fixing the commencement dated of the Companies Amendment Act 2006 as 1 November 2007. The Companies Amendment Act 2006 was passed towards the end of last year, and introduced a number of changes to New Zealand's corporate insolvency regime including the new "phoenix company" prohibitions, amendments to the voidable transaction provisions and the introduction of the voluntary administration procedure.

The introduction of the voluntary administration procedure is significant. The most notable aspect of voluntary administration regime for creditors is that the administration brings with it an automatic moratorium for the duration of the administration, which prevents a secured creditor from enforcing security over the company's property. The purpose of the moratorium is to provide the company with "breathing space" during which it can continue to operate, without interference, while the administrator can take stock of the situation and decide what to do.

However, secured creditors who hold charges over the whole, or substantially the whole, of the company's property can effectively frustrate or block the administration by choosing to enforce their security within 10 days after being notified of an administrator's appointment - this is referred to in the Act as the "decision period". This constitutes the most important exception to the moratorium under the procedure. There is also an obligation on administrators to notify substantial secured creditors of their right to enforce.

The Companies (Voluntary Administration) Regulations 2007 ("**Regulations**") were made concurrently with the Order. The Regulations prescribe provisions to be included in a deed of arrangement (a component of the voluntary administration regime), and also prescribe the form in which the accounts of an administrator (also a component of the regime) must be presented. The Regulations also come into force on 1 November 2007.

TWO NEW SECURITIES ACT EXEMPTION NOTICES

The Securities Commission has published two new exemption notices:

LEGISLATION

- **The Securities Act (Rights, Options, and Convertible Securities) Exemption Amendment Notice 2007**, which extends the application of the existing Securities Act (Rights, Options, and Convertible Securities) Exemption Notice 2002. The existing notice grants exemptions from certain of the requirements of the Securities Act 1978 to issuers of specified convertible securities. The existing notice would have expired on 1 October 2007, but now expires on 1 October 2012.
- **The Securities Act (Group Investment Index Funds) Exemption Amendment Notice 2007**, which again extends the application of an existing notice. The Securities Act (Group Investment Index Funds) Exemption Notice 2002 grants exemptions from certain of the requirements of the Securities Act to trustees and managers of entities that satisfy the definition of "fund". As well as extending the application of the existing notice, the amendment notice also makes some amendments, the most significant of which is the definition of "fund", which is now restricted to the entities set out in Schedule 2 to the amending notice.

SECURITIES (LOCAL AUTHORITY EXEMPTION) AMENDMENT BILL

The Securities (Local Authority Exemption) Amendment Bill was introduced on 12 September 2007. The Bill amends the Securities Act 1978 to deal with two perceived problems with the way that the Securities Act applies to local authorities: first, differences and duplication between the disclosure requirements in the Securities Act and those in the Local Government Act 2002, and secondly, the inappropriateness of the corporate governance principle of collective responsibility when applied to local authorities.

SNIPPETS

SECURITIES AND MORTGAGES

THE LEGAL NATURE OF INTERNATIONAL PAYMENTS

The June 2007 issue of the *Journal of Banking and Finance Law and Practice* contains two articles of interest.

- The first is an article by Angela Flannery and Greta Burkett describing the upcoming changes to Australian personal property securities law in their article (*Australian Personal property securities law reforms: An update*).

Australia is currently proposing to establish an online national register for personal property securities. The reforms are expected to be in place by 2009, although the transitional phase could be as long as two years.

The intention of the reforms is to establish a single national register to replace the many systems that operate at State and Territory level. The new system is to be closely modelled on the New Zealand regime contained in the Personal Property Securities Act 1999. The proposed changes include:

- A "conceptual shift" in the interests covered by the term "security". A registrable security interest will extend to any transaction which is intended to secure debt, regardless of whether title to the secured property vests in the debtor or the secured creditor.
- The introduction of a new, and more complex, priority regime. Although there will be a new registration system, covering a broader range of security interests, registration will not determine priority in all cases. Priority may, for example, be determined by the nature of the security interest held and whether the security holder has possession or control of the secured property.
- The introduction of new rules relating to:
 - (a) security rights over "accessions", that is terms of personal property that are affixed to or installed in other items of personal property (eg, a car engine installed in a car body);

Snippets continued ...

- (b) security rights over "commingled goods", which refer to goods which are the subject of Romalpa clauses; and
- (c) enforcement of security interests.
- The removal of the distinction between fixed and floating charges.
- The second is an article by Rhys Bollen entitled ***The legal nature of international payments***.

This article examines the legal structure of international payments, providing an analysis of international payments from a legal perspective and looking at a number of key issues such as payment finality and revocability.

The article shows that the law in this area relies heavily on the law of agency and contract. In particular, payment facilities rely on contracts to set out the rights and responsibilities of each party. The key contracts governing a payment system are the contracts between the financial institutions and their payer/payee clients and the contracts between the participating financial institutions

themselves. Within the confines of these contracts, each institution acts as agent for its customer. As such, each institution owes the customer a duty to use reasonable care and skill when carrying out that customer's instructions.

Industry and the courts have built on this to establish the rights and responsibilities of each party to an international payment, and to deal with risk allocation, payment completion and finality issues. The article reviews the key cases on payment completion and finality, and its associated issue of revocation or countermand and shows that the latest time at which practical finality can be said to have occurred is by the time the buyer can no longer cancel the payment (under general agency law, the buyer can revoke a mandate to pay before the agent has acted on it), the seller has unconditional access to the funds, and the payment has been cleared and settled between the financial institutions involved.

Finally, by analysing common business and consumer international payments, the author shows the practical implications of the law of international payments.

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SIX KEY INTERCREDITOR PRINCIPLES FOR EUROPEAN INFRASTRUCTURE FINANCE DEALS

HEDGE FUND SIDE LETTERS

AGENCY PROBLEMS AND THE BOARD OF DIRECTORS

CREDIT POOLING

COV-LITE - THE NEW CUTTING EDGE IN ACQUISITION FINANCE

EXPOSURE MANAGEMENT: KEY ISSUES AFFECTING ENERGY EXCHANGE CREDIT RISK POLICY AND PROCEDURES

The 2007 July/August Issue of the *Butterworths Journal of International Banking and Financial Law* contains six articles of interest:

- The first is an article by Trevor Wood entitled **Six key intercreditor principles for European infrastructure finance deals**. This article discusses the structural differences between the intercreditor models for

infrastructure finance and traditional acquisition finance, and the six principles reflected in the intercreditor model for infrastructure transactions as a result.

Whether in traditional acquisition finance or the infrastructure finance context, the Intercreditor Agreement governs the relationship between a range of creditors providing finance to the same borrower, seeking to rank their debt and any guarantees or security, and to regulate their behaviour. The article focuses on the position of senior lenders and mezzanine lenders, coming to the conclusion that the intercreditor position in respect of infrastructure transactions is downward looking. That is, the senior lenders are largely unconcerned with what happens above them in the structure, leaving the mezzanine lenders free to repay/amend/accelerate the mezzanine facility with little or no interference from the senior lenders. The exception to this is that where common security is granted to both sets of lenders, enforcement of such security will be restricted.

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- The second is an article by Kit Jarvis and Jay Sahota entitled **Side letters - are funds hedging their bets?**

Side letters are used to amend the normal terms and conditions for an individual investor with a hedge fund. This practice is drawing increased scrutiny from regulatory authorities in the UK and US as it raises a number of issues.

A side letter may cover aspects of an investment such as:

- reduced fees and/or performance bonuses;
- assurances the investor will have terms equal to the best offered to any other investor (often referred to as a "Most Favoured Nations" ("**MFN**") clause);
- allowing additional investment;
- preferential liquidity such as withdrawal on more dates or on shorter notice;
- increased/early access to information about the fund and the fund manager; and

- further representations and warranties.

The Financial Services Authority ("**FSA**") in the UK has raised concerns over the "fairness" of such side letters, particularly when they are not disclosed. Similarly, in the US the Securities Exchange Commission ("**SEC**") has noted it is troubled by terms which give increased liquidity rights or preferential information access. In response, the Alternative Investment Management Association ("**AIMA**") released on 27 September 2006 a guidance note recommending the disclosure of side letters which contain 'material terms', defined as any term which can reasonably be expected to provide more favourable treatment than other holders of the same class in terms of redeem their interest or in deciding whether to redeem their interest. This has been endorsed by the FSA.

From a practical perspective, the article notes that keeping track of side letters and ensuring compliance (particularly with regard to MFN clauses) can add significantly to the administrative duties of the fund manager. Legally, dangers are the possible violation of fund establishment or offering documents, requirements in certain jurisdictions to ensure identical treatment for

Snippets continued ...

shareholders in the same class and non-disclosure of side letters leading to misrepresentation claims by other investors.

With the prospect of increased regulation or litigation by other investors, the article notes that hedge funds are now reducing their usage of side letters and suggests they be used sparingly with clear guidelines established for their usage and disclosure to other investors in the fund.

- The third is an article by Andres E Onetto entitled **Agency problems and the board of directors**. The article analyses (i) the role of the board of directors, (ii) the agency relationship between directors, managers and shareholders, and then (iii) briefly analyses corporate governance in the context of the Enron board of directors.

In general, the article addresses the relationship between the directors, managers and shareholders of a company and considers the corporate governance issues that result from the interaction of each of these roles. In canvassing the various relationships that exist within a company,

Onetto notes that:

- (i) a fiduciary relationship exists between a director and the company;
 - (ii) conflicts of interest may exist between the role of CEO and that of director;
 - (iii) agency problems may result if the interests of directors conflict with the interests of shareholders (for example, in relation to directors' remuneration); and
 - (iv) it is important for directors to act independently of the entity they seek to monitor and discipline.
- The fourth is an article by Okko Hendrik Behrends and Frank Bierwirth entitled **Credit pooling**, which discusses the relatively new technique of credit pooling to manage credit portfolios.

As banks are increasingly conscious of the need to actively manage their credit portfolios in order to diversify

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credit risk, they are looking for new and innovative ways to do so where the more traditional methods such as syndication, hedging in the credit derivatives markets or simply selling to specialist investors for whatever reasons are not effective or appropriate.

It is against this background that the technique of credit pooling has been developed. It uses derivatives and results in the securitisation of credit portfolios, but also adds some new elements, making it different from both traditional credit derivatives and securitisation structures. It allows banks to hedge, diversify and securitise credit risks in scenarios where this was not previously possible.

In traditional securitisation portfolios, transactions are selected by reference to eligibility criteria, i.e. criteria with which loans or specific credit risks need to comply in order to be permitted into the portfolio. Determining the eligibility criteria is a particular challenge for a credit pooling structure which comprises a great number of originators and does not relate to any given portfolio but which, instead, creates the portfolio itself.

Credit pooling has specifically demonstrated its potential through a number of successful transactions in the German savings bank sector.

- The fifth is an article by John Markland of Kirkland & Ellis International LLP entitled **Cov-lite - the new cutting edge in acquisition finance**.*

* Editor's Note – we assume this article was written before the current credit squeeze.

The article outlines the recent development in Europe of a model of financial transactions based on loan documentation with relaxed covenants and greater freedoms as compared to traditional syndicated bank loan transactions. These "cov-lite" deals are being implemented in the European leveraged buyout finance market after popularity in the US has seen the deals account for a third of new issuance in acquisition financings. The borrower-friendly terms seen in cov-lite deals have traditionally been restricted to bond indentures but unprecedented levels of liquidity in the market have seen deals close in Europe where whole areas

Snippets continued ...

of the senior bank loan agreement have been devoid of full covenant backed lender protection.

Standard financial maintenance covenants have historically included tests and restrictions on leverage, cash cover, interest cover and occasionally capital expenditure. These covenants act as warning triggers for lenders if the borrower cannot meet certain requirements. Rights on breach of the covenants may include significant control rights such as the power to re-negotiate the terms of the agreement under threat of the calling of an event of default. In cov-lite deals the cash cover, interest cover and capital expenditure limits may be dropped entirely. The author notes however that the leverage test is not necessarily abandoned altogether, but may be maintained for the benefit of revolving facility lenders.

In order to maintain certain levels of comfort lenders generally ensure adequate information is provided (or available) to enable them to monitor a borrower's performance and, more importantly, to what extent they will be free to quickly trade out of their cov-lite investment if it is discovered borrower performance is sub-standard. In some recent cov-lite deals lending banks

have retained the right to transfer commitments without borrower consent, an option expected to be exercised by alert lenders on indications of underperformance.

As well as financial covenants being altered in cov-lite deals, many of the restrictive undertakings will be quite different, with clauses such as restrictions on indebtedness and negative pledge tending towards more flexible, incurrence-based covenants usually seen in a bond indenture deal as opposed to a traditional senior bank deal.

The article provides guidance as to the proposed impact of cov-lite deals on the European LBO market. The author notes that cov-lite is terrific for borrowers, for whom the deals incorporate the best aspects of bank deals and some of the best aspects of bond deals without a huge impact on pricing. The concessions granted by borrowers for these benefits are relatively minor with control restrictions which, in practice, are hardly conciliatory.

Lenders on the other hand will feel more exposed and it remains to be seen whether this will be reflected in margin compensation or bond-style call protection.

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The article concludes by offering other options to sponsor banks to account for performance volatility (such as 'two strike' covenant testing) which previously would be considered aggressive but now do not seem so unreasonable in this evolving (and in certain circumstances, covenant-free) LBO market.

- The sixth is an article by Doron Ezickson, Andrea Kramer and Prajakt Samant entitled: **Exposure management: key issues affecting energy exchange credit risk policy and procedures.**

The article explores the key considerations shaping the credit risk policies and risk assessment procedures in the energy commodity markets; focussing mainly on the European Powers' day-ahead markets and exchanges.

The recent exponential growth in the energy commodity markets - with record risks and record returns - has attracted a new class of investor to what was once a specialist market. The appearance of players such as pension funds, hedge funds and high net worth individuals has led to calls for greater regulatory supervision. Whilst most energy exchanges formulate systems to provide

themselves and their trading members with protection against less scrupulous members or volatile markets, increasingly regulators have begun policing the commodity markets with the same end in mind.

Different methods of credit risk management have been adopted by commodity exchanges, including collateral arrangements, margin calls, mutual default funds, credit-rating tests and position limits. The article looks at each of these methods in turn, and discusses some of the finer points of the different strategies.

Following this, the high-level insolvencies of LTCM, Ashanti and Amaranth are analysed, and their impacts assessed.

The article concludes that as scrutiny of the commodity markets from a European regulatory perspective increases, exchanges will come under pressure to evolve with the deepening sophistication and diversification of their customers. A significant part of this will involve the formulation of effective policies to manage credit risk in markets that have seen exponential growth in recent years.

PARTITION RIGHTS AND COMPANY LAW

The August 2007 issue of the *Company and Securities Law Bulletin* contains an article by Neil Campbell entitled **Partition rights and company law**. In this article, the author looks at the right a co-owner of land has to partition his or her ownership interest from the common ownership, and makes interesting comparisons between this right and the rights of shareholders in a company.

In the recent case *Ko v Chamberlain* (21 May 2007, High Court, Auckland), the High Court held (following the views of the High Court of Australia) that a person cannot contract out of his or her right to partition, as this right has not been created solely for the benefit of that person but for public policy reasons (the alienability of land). In his article, Campbell suggests that if shareholders can be conceived as co-owners of the company's property, they would have statutory rights of partition that could not be contracted away. However, by forming a company to hold the property the shareholders effectively contract out of that right. This is because the only way a shareholder can force the withdrawal of his or her share in the company's property is to put the company into liquidation, which requires 75 per cent shareholder support.

Although the concern of a shareholder losing partition rights (that would be otherwise available if a company structure was not used) is largely alleviated by the right a shareholder has to sell his or her shares, Campbell notes that the ability of a shareholder to exit the company can be very limited in closely held companies. Closely held companies often have constitutions imposing tight restrictions on share transferability, and minority shareholders in such companies often find themselves in a situation where they have no liquidation rights and no practical ability to sell their shares.

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