

RUSSELL McVEAGH

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CASES

PANTELOS V WESTPAC NEW ZEALAND LIMITED

Pantelos v Westpac New Zealand Limited [HC, Christchurch, CIV-2007-409-260, 10 August 2007, Associate Judge Christiansen]

In this case the High Court declined to approve Mr Pantelos' proposal under Part XV of the Insolvency Act 1967. The case is a useful reference point for:

- a) when a court will discount the votes of particular creditors at a meeting of creditors; and
- b) the factors that a court will take into account when deciding whether to approve a proposal under Part XV (these factors will also be relevant under section 333 of the new Insolvency Act 2006).

Westpac New Zealand Limited ("**Westpac**"), a judgment creditor, had filed a bankruptcy notice against Mr Pantelos. The petition was adjourned to enable Mr Pantelos' Part XV proposal to progress. The proposal, dated 13 April 2007, offered a dividend of only five cents in the dollar on all unsecured claims. The dividend was to be funded from cash in the bank, the realisation of assets, and the balance from a loan of \$10,000 that Mr Pantelos proposed to obtain.

Westpac opposed the proposal on a number of grounds, including that the quorum requirements of the creditors' meeting were not satisfied, the proposal took into account the votes of "friendly creditors", and that the proposal was not reasonable or to the benefit of the general body of creditors.

The court held that the quorum requirements (two creditors, or their representatives, being present at the meeting) were met. Westpac claimed that it was the only creditor present. However, the court held that Mr Pantelos was entitled to be present not just as the insolvent person, but also in his capacity as a representative of other creditors (eg by being the sole director of a company that was a creditor).

The court discounted the votes of three related creditors which were described as "Mr Pantelos' alter egos". The court referred to a number of cases that held that a court may discount or discard the votes of creditors who have a special interest of their own that conflict with those of the class to which they belong.

The court's main reason for not approving the proposal was that it was unreasonable. The offered dividend of five

Cases continued ...

cents in the dollar was found to be negligible, and it was questionable as to whether it could actually be achieved (Mr Pantelos proposed to borrow further to fund the dividend). Therefore, there was no advantage to the general body of creditors in approving the proposal over Mr Pantelos going into bankruptcy. Furthermore, the court took into account Mr Pantelos' actions, and held that Mr Pantelos should not be allowed to escape the stigma of bankruptcy. The proposal was therefore rejected.

GE FINANCE & INSURANCE V MCPHERSON PROPERTIES & ANOR

GE Finance & Insurance v MacPherson Properties [HC, Christchurch, CIV-2006-409-2257, 23 July 2007, Associate Judge Christiansen]

Until its liquidation, MacPherson Marine Limited ("**MML**") sold boats and boating equipment. When trading, MML had an agreement with GE Finance ("**GE**") whereby GE bailed boats and boating equipment to MML. Under the agreement, MML had an option to purchase the bailed items and, if MML sold an item to a customer, it was deemed to have first purchased it from GE. There were two guarantors

of this agreement: MacPherson Properties Limited and Mr Powell, who was a director and shareholder of MML. This application for summary judgment arose because the two guarantors denied liability for the outstanding amount MML owed GE under the agreement after MML's liquidation.

An accountant's review suggested that a Mr Hynes, the managing director of MML, committed various types of fraud, some of which caused debts to be owed by MML to GE.

The guarantors contended that:

- (a) their liability under the guarantee was extinguished because GE did not carry out obligations under the bailment agreement (such as regular stocktakes and prompt payment demands) which, if carried out, would have prevented Mr Hynes' fraud and the consequent debts of MML to GE;
- (b) a duty arose on the part of GE to disclose to the guarantors that they were not carrying out these "checks and balances"; and

Cases continued ...

- (c) by suggesting in pre-contractual conduct and correspondence, that these checks and balances would be carried out, GE engaged in misleading and deceptive conduct in terms of section 9 of the Fair Trading Act 1986.

The court held that a creditor does not have an ongoing obligation to monitor compliance by the debtor and to contact the guarantor in relation to a debtor default. In equity, a guarantor would only be discharged if the creditor acted in a manner guilty of concealment or connivance, and GE did not. Consequently, the guarantor's liability was not extinguished.

ORIX NEW ZEALAND LTD V MILNE & ORS

Orix New Zealand Ltd v Milne [HC, Auckland, CIV-2005-404-4394, 17 May 2007, Rodney Hansen J]

Orix New Zealand Ltd ("**Orix**") made loans to a company to buy three machines. These loans were guaranteed by the company's sole shareholder, Mr Milne. The machines were transferred to a related company of which Mr Milne was also the sole shareholder. The machines were subsequently sold to third parties but the proceeds were not used to

repay Orix, nor were any repayments made. The High Court considered three issues in this case.

- The first issue was whether Milne was bound by the guarantees he had made in respect of the loans. Mr Milne claimed that Orix's actions when the machines were transferred to the related company gave rise to an estoppel which prevented Orix from relying on the guarantee. The court noted three requirements from *Gillies v Keogh* for estoppel to apply and concluded that these were not met. There had been no communication between Orix and Mr Milne which conveyed to Mr Milne that he was released from his obligations. Furthermore, there was no reliance by Mr Milne and there was nothing unconscionable about what occurred. Therefore the defence of estoppel failed and Milne was liable under the guarantees.
- The second issue was if Mr Milne was liable under the guarantees, did the company accountant, Mr Johnson, owe a duty of care to Mr Milne which entitled Mr Milne to an indemnity from Mr Johnson. Applying the two stage approach from *Rolls-Royce*

Cases continued...

New Zealand Ltd v Carter Holt Harvey Ltd the court held that Mr Johnson did not owe Mr Milne a duty of care. Mr Johnson was employed by the company so owed a duty of care to the company, but this did not extend to the Company's shareholders. Even if a duty did exist, Mr Johnson's failure to repay the loans did not cause Mr Milne's loss.

- The third issue was whether Orix could rely on the security registered under the Personal Property Securities Act 1999 ("**PPSA**") to recover a machine sold to a third party, Nicholls. Nicholls took the machine free of Orix's security interest if the sale occurred in the ordinary course of business, pursuant to section 53 of the PPSA. The court held that the sale was made in the ordinary course of business. The company was in the business of selling machines at the time, and the transfer of the machines to the related company did not alter this. The fact that sales were made infrequently did not affect this either. Further, there was no evidence to suggest the transaction was anything other than a straightforward transaction in the mainstream of the company's business.

LEGISLATION

REGULATION OF NON-BANK DEPOSIT TAKERS

In the wake of a number of recent high-profile collapses of finance companies, the Government has announced a number of new regulatory initiatives (including the Securities Amendment Regulations 2007 described below). On 12 September 2007, the Minister of Finance announced that non-bank deposit-takers, a class that includes finance companies, building societies and credit unions, will be subject to a new regulatory framework. The requirements for non-bank deposit-takers will include:

- registration with the Reserve Bank;
- a credit rating from an approved rating agency;
- a minimum capital amount of \$2 million;
- a specific capital ratio;
- restrictions on lending transactions to related parties; and
- "fit and proper person" requirements for directors and senior managers.

The proposed new regulatory framework will be progressed as part of the Government's current Review of Financial Products and Providers ("**RFPP**"), the most recent update of which was summarised in the June 2007 issue of Banking Law Update. The bulk of the changes to the regulation of non-bank deposit-takers announced by the Government this month have been previously considered as part of the consultation process of the RFPP.

It is expected that legislation introducing the new regulatory framework will be enacted in 2008, with some requirements coming into force in 2008.

SECURITIES AMENDMENT REGULATIONS 2007

The Government promulgated new regulations on 17 September 2007, the Securities Amendment Regulations 2007 ("**Regulations**"), which impose tighter controls on issuer of debt securities that meet certain criteria. Under the new Regulations, issuers of debt securities who are in the business of lending money or providing financial services must:

Legislation continued ...

- provide additional reports and certifications to the trustee of the relevant debt securities;
- keep the trustee informed of a number of specified facts and events;
- have their half-yearly financial statements audited in most circumstances;
- provide financial statements to the trustee; and
- consult with the trustee before appointing an auditor.

The trustee also has the right to engage an auditor or other expert to determine the true financial position of an issuer if necessary.

The Regulations came into force on 21 September 2007.

SNIPPETS

INVESTOR DIRECTED PORTFOLIO SERVICES

Issue 13, 2007 issue of the *Australian Corporate News* contains the article **Investor directed portfolio services** editor Andrew Chan. This article outlines ASIC's broad review of its policy on investor directed portfolio services ("**IDPS**") and its proposal for greater regulation of these services.

IDPS are administration services that usually operate through a financial adviser and enable investors to bundle a number of services while still making all the investment decisions. IDPS allows investors access to a wide variety of investments.

The proposals aim to:

- reduce complexity, barriers to entry and regulatory burden by removing most of the regulation of IDPS operators;
- adopt a more principles-based approach to regulation;
- treat the operation of IDPS and IDPS-like schemes similarly where there is no basis to treat them differently;

- maintain adequate consumer protection by ensuring good advice, adequate disclosure, reliable client reporting and effective compliance controls.

Submissions on the proposals close on 4 September 2007.

UNDUE INFLUENCE IN BANK-LENDING TRANSACTIONS

Issue 7, 2007 of the *Journal of International Banking Law and Regulation* contains an article by Noor Inayah Yaakub and Andrew McGee entitled **Undue influence in bank-lending transactions - confusions continue.**

This article studies the principles of undue influence in bank lending transactions coming out of recent appeal cases in the United Kingdom.

The authors discuss the "elusiveness" of the doctrine of undue influence and comment on the continued reluctance of the courts, post-*Etridge*, to give a comprehensive definition of undue influence.

The article examines the various categories of undue influence and their burden of proof. In particular, the article

Snippets continued ...

gives a comprehensive analysis of the two groups of undue influence - actual undue influence and presumed undue influence.

The article then discusses the decision by the House of Lords in *Royal Bank of Scotland Plc v Etridge (No.2)* and comments on how the House of Lords questioned the sensibility of classifications of undue influence. The authors go on to examine the possible implications this approach has towards the field of undue influence.

The authors conclude by noting that the role of "manifest disadvantage" has been reduced in presumed undue influence, merely performing a *sifting* function for the operation of the presumption of undue influence. They go on to note that this has resulted in a blurring between Class 1 (actual) and Class 2 (presumed) undue influence.

Finally, the authors examine post-*Etridge* cases to see whether the position has been clarified. They point out that the usage of the label of "manifest disadvantage" continues in the later decisions and that the nature of undue influence in bank-lending transactions remains obscure.

SECOND LIEN DEBT

THE GERMAN REAL ESTATE INVESTMENT TRUST

UNITED KINGDOM IMPLEMENTING A "PRINCIPLES BASED" APPROACH TO FINANCIAL REGULATION

RECENT CANADIAN DEVELOPMENTS: SECURITIES TRANSFER ACT; LEGISLATIVE FIX FOR DERIVATIVES INDUSTRY

Issue 8, 2007 of the *Journal of International Banking Law and Regulation* contains four articles of interest.

- The first is an article by Clive Wells and Neil Devaney entitled **Is the future secure for second lien lenders in Europe?**

The article (which we assume was written before the current credit squeeze) introduces the established and expanding second lien financing market in the United States and compares it against the emergence of an altered market model in Europe, which has no standard, settled form for second lien financing.

Snippets continued ...

Second lien debt is secured debt ranking behind that of senior lenders. Second lien debt may be in the form of a separate subordinated loan or a second tranche to the senior lender's debt facility. In recent times contractual subordination has not been a common element in European second lien debt.

The authors note that price and flexibility are the two key factors attracting borrowers to second lien deals. Second lien debt is less expensive than traditional mezzanine loans and often includes flexible prepayment options more favourable than its mezzanine cousin.

Lenders are attracted to second lien debt as it provides for priority over general unsecured creditors. Furthermore, second lien lenders may have rights to influence insolvency proceedings. Institutional investors restricted from lending contractually subordinated debt are also attracted to second lien debt as subordination only occurs on enforcement of the security. Senior lenders have also embraced second lien investors allowing

them to reduce the senior lender's exposure to the riskiest elements of the secured collateral.

The article concludes that buoyant credit markets and high investor liquidity in Europe tends to promote a cheap, technically unsubordinated, secured loan that can be refinanced in the short term as a very attractive option to searching investors. Nevertheless, uncertainty as to insolvency laws and lack of a coherent second lien structure may lead to varying recovery rates in a default scenario.

The article also contains a note on issues to be considered when deciding how the second lien debt fits into the capital structure, including:

- intercreditor and priority arrangements;
- turnover provisions enabling flow of funds;
- waiver of secured creditor rights, whether silent or quiet;
- voting rights; and

Snippets continued ...

- payment blockage and stand still provisions presenting payment to a second lien lender where a default exists under the senior agreement.
- The second is an article by Dr Herbert Harrer and Dr Florian Schultz entitled **The German Real Estate Investment Trust**. The article considers both the backdrop to Germany's recent implementation of Real Estate Investment Trusts ("**REITs**"), and what the likely implications of this will be for the market, the government, and investors alike.

Germany, due to its size and economic strength, has the largest real estate market in Europe, with an estimated total value of approximately €2,200 billion. However, owners are typically deterred from realising this wealth (through selling the land and buildings) because of taxation. The recent implementation of REITs sought to effectively remove this tax disincentive and mobilise a considerable chunk of this immense real estate asset.

The article begins by discussing the German market environment, and what the main forms of indirect real estate investments in Germany have been prior to the adoption of REITs. This is followed by a detailed discussion of the legal backdrop surrounding the implementation of REITs, and how alternative land investment vehicles have been regulated in the past.

The authors then set out: (a) the special rules of capital market law, (b) the approval procedure, including the preparation of the securities prospectus, (c) the admission requirements, and (d) the ongoing obligations prescribed by Germany's leading stock exchange.

The article concludes by summarising the benefits of the adoption of REITs for Germany both domestically in terms of an increase in liquidity, and internationally in terms of the revitalisation of foreign investment into Germany's real estate market.

Snippets continued ...

- The third is an article by Julie Patient entitled **Treating customers fairly: the challenges of principles-based regulation**. This article discusses the rationale for moving to a "principles-based" approach to financial regulation, the principled outcomes sought, and the challenges posed to firms and their advisors as a result.

The current Financial Services Authority (FSA) Handbook consists of detailed rules and guidance for firms, but the FSA believes there are a number of problems with prescriptive standards, and that experience to date has shown them to be unable to prevent misconduct. In moving to a principles-based regulation, the FSA views The Treating Customers Fairly Initiative ("**TCF**") as an appropriate model.

TCF, consistent with a principles-based approach, focuses on six outcomes relating to the fair treatment of consumers. These outcomes are to be achieved through five recurring phases. This results in a process that defines strategies and principles, assesses gaps between current performance and desired outcome, plans (and implements) action

to address identified weaknesses, and monitors and reviews lessons learned. This requires robust systems for capturing and assessing management information.

A number of issues result from the principles espoused in the draft statement. For example, providers are expected to review product performance and consider advising customers when performance is expected to be significantly different from what was originally communicated.

Furthermore, a principles-based approach may result in enforcement action being driven by governmental or public pressure, and to some extent hindsight. There is an underlying theme that even if the FSA cannot identify a specific breach of rules, it could find a breach of principle if it considered the behaviour of the firm to be to the consumer's detriment.

After issuing a deadline in July 2006 for all firms to be implementing TCF in a substantial part of their business by March 2007, the FSA has indicated that

Snippets continued ...

significant progress has been made in larger and medium-sized firms to make the principles-based approach work, although concern was expressed over the progress of small firms.

- The fourth is an article by Neil Guthrie about Canada's new legislative framework governing the law surrounding securities that are held indirectly through securities intermediaries such as a clearing agency holding securities for its participants, or a bank or trust company which acts as a custodian or as a broker.

The new legislation is the Securities Transfer Act ("**STA**"). It widely defines "financial assets" and provides rules with respect to acquiring, transferring and taking security over them. The rules apply to all issuers of securities and all parties which hold interests either directly for their own account or indirectly for others.

The STA provides that the transfer of a security entitlement is effected through an "entitlement order", which is defined in the STA as a notice

communicated to a securities intermediary directing the transfer or redemption of the financial asset to which an entitlement holder has a security entitlement.

An entitlement holder's property interest in a particular financial asset is a proportionate interest in all interests in that financial asset held by the securities intermediary, regardless of the time that the entitlement holder acquired the security entitlement or the time that the securities intermediary acquired the interest in the financial asset.

The STA also deals with the issues of conflicts of laws, seizure of securities, enforceability of contracts and evidentiary matters are also dealt with.

ISDA/FPML FOR FINANCIAL DERIVATIVES

Issue 9, 2007 of the *Journal of International Banking Law and Regulation* contains an article by Andrew Parry entitled **ISDA/FpML for financial derivatives**.

Snippets continued ...

The article provides an overview of the definition of financial derivatives and the work of the International Swaps and Derivatives Association (ISDA), the global trade association for the privately negotiated "over the counter" derivatives industry, especially as regards their work on standardised legal definitions. After having established this background, the article goes on to consider the evolution of these products, which is driven by the need for automation in response to market growth and regulatory requirements.

Derivatives

The definition of a financial derivative product is that it is derived from an underlying asset's value, according to some agreed payoff function, rather than directly from the value of the underlying asset. Market participants enter into an agreement according to the payoff function, to exchange money, assets or some other value at a future date. Examples of underlying assets include bonds, equities, interest rates and commodities.

The ISDA

The International Swaps and Derivatives Association represents participants in the privately negotiated derivatives industry. Its members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, the ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business.

The article then goes on to an in-depth look at how financial derivative products develop as an innovation, gradually become standardised, and then finally become automated.

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