

FINANCIAL LAW >>UPDATE

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Banking and finance >>

Tinkering with the Retail Deposit Guarantee Scheme

The Treasury announced on 18 November that it was changing the terms and conditions of the Retail Deposit Guarantee Scheme by introducing a new form of deed of guarantee. Ostensibly, the purpose of the new form of deed is to provide greater flexibility for deposit takers and improve consistency between the current scheme and the extension scheme announced on 25 August. However, The Treasury has taken the opportunity to make a substantial number of more technical changes to the guarantee terms.

Non-guaranteed securities

The stated purpose of the new form of deed is to provide greater flexibility for deposit takers and improve consistency between the current scheme and the extended scheme announced on 25 August, to come into effect from October 2010.

In particular, the new deed will allow participating institutions to offer both guaranteed and non-guaranteed securities. It is expected that this change will help participating institutions transition out of the guarantee scheme entirely by allowing them to offer non-guaranteed longer-term deposits (with a risk premium) that mature after the end of the scheme.

Other changes

In addition to the 'headline' change, the new form of deed addresses a number of technical points,

adds certainty to some concepts, and, indirectly, limits the Crown's obligations.

Some of the other key changes in the new form of guarantee include:

- the introduction of a 14 day period following a default for indebtedness to be paid before the Crown's obligation under the guarantee takes effect;
- an interest cap, under which the Crown may (in its sole discretion) decline to pay interest on any indebtedness if it considers that an adequate time has elapsed between the date the indebtedness fell due and the submitting by a creditor of a notice of claim;
- an ability for the Crown to limit its liability under the guarantee if the participating institution enters into a moratorium or similar;
- a range of additional covenants to be provided by a participating institution, for example, a requirement to use best endeavours to keep shareholders' funds at a prudent level; and
- an ability for the Crown to request, in certain circumstances, information about an investor.

Mechanics of replacement

Under clause 10.3(b) of the current form of guarantee deed, the Crown has the right to withdraw its guarantee by written notice if it considers it appropriate to do so, but only after it has offered the deposit taker the opportunity to enter into a new guarantee.

Deposit takers participating in the scheme have been given until 4 December 2009 to accept the revised deed, which will then become effective from 1 January 2010.

If the deposit taker elects not to enter into the new form of deed, all deposits accepted before 1 January will continue to be covered by the

scheme but deposits accepted after that date will not be guaranteed.

Our view

The new form of deed provides welcome clarity on some key issues which have arisen since the scheme was introduced. These include, as an example, the issue which arose following the receivership of Mascot Finance as to the Crown's liability for interest after a default but before the creditor submits a notice of claim.

Unfortunately, the deed also leaves ongoing uncertainty in some areas, particularly to the extent that so many aspects are left for the Crown to determine in its discretion. For those currently participating in the scheme, the 'offer' of the revised deed is effectively made on a 'take it or leave it' basis. Many will feel a gun has been placed to their heads to accept the new terms, which contain some significant limitations on the extent of the Crown's obligations.

Provisions in the Crown's accounts make it clear that Treasury is preparing itself for substantial defaults by guaranteed institutions. Inevitably this will create a large number of practical and legal issues, and it will be interesting to see whether the revised form of guarantee is able to deal with them effectively. It will also be interesting to see how many of those currently guaranteed take the option of walking away from the scheme for new deposits, citing the less than reasonable approach taken by Treasury in seeking to force a revised deed upon them.

Start a conversation...

If you would like further information in relation to the Crown Retail Deposit Guarantee Scheme or how the most recent changes to the Scheme might impact on your business, please contact [Gerald Fitzgerald](#) on (04) 498 0835 or [Stuart Stevens](#) on (04) 498 0886, or contact the team at financiallawupdate@kensingtonswan.com.



Recent cases

Since our last quarterly update there have been a number of significant court decisions, including the first case concerning the Retail Deposit Guarantee Scheme. We review these cases below.

Taking security over businesses in Australia?

All New Zealand businesses that have taken security, or intend to take security, over businesses in Australia must be aware of *Re Octaviar Administration Pty Ltd*.

The basic facts are as follows. In 2007 Octaviar took a loan from Fortress and granted Fortress a charge over its assets which secured all amounts owed under any 'Transaction Document'. Fortress and Octaviar could designate any document in addition to the loan and charge as a Transaction Document. That being so, in 2008 Fortress and Octaviar agreed to designate a previously unsecured guarantee for Fortress' loan to Young Village Estates (YVE) as a Transaction Document.

Under the Corporations Act 2001, where a variation to a charge occurs that variation must be lodged with ASIC within 45 days. Prior to this case, market practice did not consider the securing of a guarantee to be a variation that required lodgement. However, the Public Trustee of Queensland contended that the new liabilities under the YVE guarantee amounted to a variation of the terms of the charge. If this argument was successful the failure to lodge a notice with ASIC rendered the charge void with respect to the YVE guarantee.

At first instance, the Queensland Supreme Court found that the extension of the charge to the guarantee was a variation requiring notice to ASIC. The effect was that the charge could not secure the increased liabilities.

As the Supreme Court result was contrary to market practice the decision had created much uncertainty in financial circles and put an indeterminable number of Australian security transactions into jeopardy.

The Queensland Court of Appeal has now overturned the Supreme Court decision. In a unanimous ruling, the Court of Appeal held that the increase in liabilities secured by the charge did not amount to a variation which would trigger the need for notification, or a new charge requiring registration. The Court of Appeal decided that the requirement to give notice of a variation only arises where the actual terms of the charge document are itself varied or amended. The Court of Appeal's decision is thus consistent with accepted market practice.

Unfortunately, this decision is the subject of an application for leave to appeal to the High Court of Australia and there remains the possibility that the decision of the Supreme Court could be reinstated.

In light of this case, New Zealand clients should take the following actions:

- Review each Australian security that has been granted to them (if any).
- Determine if there has been any variation to the charge similar to the facts above or otherwise, when that variation occurred, and whether any steps have been taken to register a variation of the charge.
- Ensure all security is brought within the ambit of the charge at inception.
- Seek appropriate legal advice before taking new or further security.

Where could the Government guarantee end?

In *Munro v Perpetual Trust Limited* the receivers of Mascot Finance Limited sought directions from the High Court regarding whether interest owing under certain stock certificates issued by Mascot continued to accrue subsequent to the date of receivership.

This issue was decided by the documents governing payment of interest—the stock certificate itself and the trust deed of Mascot. As Mascot was the first company to fall into receivership while being covered by the Government retail deposit guarantee the question was of concern to the Crown.

The receivers sought directions from the Court as it was not clear under the documents in question whether interest would continue on receivership. A particular factual issue was whether Perpetual had provided notice to Mascot under the specific clause of the stock certificate in question calling in all amounts owing. If Perpetual had provided such notice the main question could be easily decided.

The Court found that the notice the trustee provided on the day of the receivership was also sufficient to give notice under the specific clause. On that basis, the documents could be interpreted so that interest would continue subsequent to the appointment of receivers. However, if this notice had not been provided the decision of the court would have been much more difficult.

The key points of the case are that as follows:

- The protection afforded by the retail deposit guarantee scheme is determined by the terms of the guarantee and the terms of deposit being guaranteed.
- Where the terms of the deposit are unclear investors may not have certainty regarding the quantum of investment being guaranteed beyond the principal.
- Receivers of finance companies covered by the guarantee need to carefully review the terms of deposits to understand the extent of their obligations to recover interest.

The footnote to this case is that, as explained earlier in this edition of *Financial Law Update*, The Treasury is in the process of pushing out a revised form of guarantee which allows the Crown to limit its ongoing obligation to pay interest after a finance company failure.

Restraining a mortgagee sale

In *Fern Limited v Financial Trust Limited and Matrix Custodians Limited*, the High Court granted an interim injunction restraining Financial Trust Limited (FTL) and Matrix Custodians Limited (MCL) from taking steps to enforce a mortgage over a property owned by Fern Limited (FL).

FL was required to provide a guarantee for a loan increase from FTL. It was agreed that a residential property owned by FL was to be the security for the guarantee. One of the directors of FL who occupied the residential property for domestic use became concerned about the property being security and negotiated a qualification. This qualification included an option that FL would be able to provide alternative security in substitution for the mortgage over the residential property.

A dispute arose when FL wished to exercise this option by substituting another property. FTL refused to accept FL's proposed substitute property as security for the guarantee and sought to exercise its power of sale in relation to the property.

The case then became a 'contest' between two conflicting pieces of correspondence with each party insisting that its correspondence was the true version of the substitution agreement. There were important differences. In short, FTL's correspondence gave it a general discretion whether to accept substitution in a way that was inconsistent with FL's earlier communication. There were also significant periods of delay between the parties' communications and neither party directly addressed the other's correspondence. As a result there was no clear acceptance of either substitution agreement or indication as to which was intended to have contractual effect.

The Court accepted that under either agreement FTL was likely to be entirely within its rights to reject the proposed substitute security. However, the outcome of the hearing turned on whether FTL, in acting on the basis of its version of the substitution agreement rather than FL's earlier

correspondence, had discharged the guarantee or alternatively breached the guarantee so that FL was entitled to cancel it. The Court considered that there were significant issues warranting a full hearing and granted an interim injunction restraining FTL from proceeding with the mortgagee sale of FL's residential property.

Although substantive issues were not determined in this interim hearing, the decision demonstrates that:

- where there is a variation it is imperative that there is certainty as to what is agreed, especially where there is a variation from standard form documents
- parties should not delay in confirming arrangements where uncertainty exists
- uncertainty creates delay—here the lender is unable to undertake a mortgagee sale and recover amounts outstanding and the guarantor cannot otherwise deal with the property
- reliance on an incorrect contract document as containing the terms of a guarantee may amount to repudiation of the correct contract, giving rise to a right of cancellation.

We will update you further on this case in the event it goes to a full hearing.

Subrogation and a warning to lenders

A recent High Court of Australia decision affirms the principles of subrogation but in so doing provides a warning to lenders.

The facts of *Bofinger v Kingsway Group Limited* are relatively common. A property development company, B & B Holdings Pty Limited (B&B), entered into three separate financing arrangements with three different lenders. Each loan was secured by a mortgage in favour of the particular lender over the land being developed by B&B, along with personal guarantees from Mr and Mrs Bofinger, which were secured by a mortgage over property

owned by the Bofingers in their personal capacity.

B&B defaulted in its obligations and, with the consent of the second and third mortgagee, the Bofingers sold their property in part reduction of the amount due the first lender. The first lender then exercised its power of sale against some of the mortgaged land owned by B&B to make up the shortfall. Having satisfied the amount owing the first lender, the first lender then paid the surplus to the second lender in satisfaction of the amount due that lender.

The Bofingers brought proceedings claiming that the first lender should have returned the surplus monies to them and, through the equitable principle of subrogation, claimed to be entitled to surplus funds and the first lender's security over the remaining property owned by B&B in priority to the second lender.

The High Court of Australia held that the Bofingers were entitled to the benefit of the security held by the first lender over the remaining land owned by B&B and were the beneficiaries of a constructive trust, of which the first lender was the trustee, in respect of the surplus proceeds. The Court found that by transferring the surplus funds to the second lender, the first lender was knowingly in breach of its duties as a trustee.

The second lender had sought to argue that the terms of the no-compete clause in its guarantee prevented the Bofingers from exercising rights of subrogation against the first lender. While the Court accepted that this could be done, it held that it had not been achieved in the present circumstances.

The 'no competition' clause was standard. Under the terms of the second lender's guarantee, the Bofingers agreed not to 'make a claim or enforce any right against any Obligated Person (which included B&B) or against the estate or any of the property or any of them' while the second lender was owed money. In interpreting the clause, the Court held that this clause only applied to claims made by the Bofingers under the second lender's

guarantee and did not apply to any security held by the first lender.

The Court's decision is not controversial from a legal perspective, rather, its importance lies in the current practice and the lessons which can be drawn from it for both lawyers and lenders.

First, both lawyers and lenders should revisit the non-compete clauses, along with the boilerplate provisions more generally, in guarantees. While amending current guarantees is not practical, future guarantees should be drafted with this decision in mind.

Secondly, mortgagees exercising the power of sale should be aware of just what their obligations are in respect of the distribution of sale proceeds. Moreover, they should be cognisant that they are acting as constructive trustees while holding surplus funds. Notably, there was no priority arrangements entered into by the various lenders. The Bofinger situation could be avoided if priority arrangements had been entered into which provided for a cascading of payments, with the guarantors and borrower as the final recipients.

Thirdly, the Court noted the second and third mortgagees should have imposed additional obligations when they released their mortgages over the guarantors' property. While hindsight is 20/20, it is a good reminder for lenders to think broadly when dealing with their securities, particularly when the prospect of full recovery is not high.

Start a conversation...

If you would like further information in relation to the above cases, please contact [Nigel Seibold](mailto:Nigel.Seibold@kensingtonswan.com) on 09 375 1132 or [Mark Brown](mailto:Mark.Brown@kensingtonswan.com) on 09 918 6518, or contact the team at financiallawupdate@kensingtonswan.com

Start a conversation with us...

Your team of specialists at Kensington Swan are on top of the issues and can provide you with practical advice on operating in today's dynamic business environment.

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