

Financial Law Update

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Banking and finance

Non-bank deposit takers: credit ratings

The Reserve Bank has released a consultation paper proposing the type of credit ratings to be set for non-bank deposit takers under the recent amendments to the Reserve Bank of New Zealand Act 1989.

Under new legislation passed in 2008 the Reserve Bank of New Zealand Act 1989 was amended to address the numerous recent failures of non-bank deposit takers. One of the most significant changes introduced is the requirement for all non-bank deposit takers to obtain credit ratings. The Act was amended on the basis that the form of the new requirement for credit ratings would be introduced by regulation.

The Reserve Bank has considered the credit rating options available for non-bank deposit takers and proposes to recommend to the Minister of Finance that the regulations specify local currency, long term, issuer ratings.

The credit rating options considered by the Reserve Bank are as follows:

- long or short term ratings
- issuer or issue ratings
- local or foreign currency ratings
- global or national rating scales.

In specifying a preference for local currency, long term, issuer ratings the Reserve Bank made the following comments:

- Long term ratings provide the best capture of risk and overall creditworthiness of a deposit taker.
- Ratings of issuers, rather than of individual debt issues, are preferred on the basis that issuer ratings:
 - can be widely applied to all deposit takers and are relatively easy to understand
 - are derived from an evaluation of the overall position of a deposit taker, rather than the security position of an individual debt issue; and
 - do not relate to a particular type of debt and therefore do not require an understanding of how the debt would rank upon insolvency (as would be required to understand the rating of a particular debt issue).
- A local currency rating is preferred over a foreign currency rating as a deposit taker is, by definition, a person who offers debt securities to the public in New Zealand.

- It is proposed that the rating scale to be used is the familiar 'triple-A' global scales used by Fitch, Moody's, and Standard and Poor's.

Although anticipated by the amendments to the Act, the Reserve Bank does not propose that ratings be required for a deposit taker's entire borrowing group. This position has been adopted on the basis that rating agencies, when establishing an issuer's rating, generally take into account its relationship with its guaranteeing subsidiaries and related parties.

In setting out its preferred approach the Reserve Bank has stated that flexibility should be maintained to enable deposit takers to use credit ratings other than those prescribed in the regulations, according to their business needs. However, it is proposed those ratings should be used in addition to a local currency, long term, issuer rating, which would be prescribed by the regulations.

The introduction of credit ratings for non-bank deposit takers has been welcomed by most parties in the finance industry. Mum and dad investors will benefit from the increased quality of information available when making investment decisions. Trustee companies will also benefit from the new rating requirements

Want to know more?

If you would like any further information in relation to the credit rating obligation please contact **Nick Lodder** on (09) 375 1194 or email the team at financiallawupdate@kensingtonswan.com.

as the information about the financial position of issuers derived during the rating process will assist them in fulfilling their monitoring role.

However, the success of the introduction of credit ratings hinges on public education. Currently, there appears to be limited public understanding of how credit ratings operate. A public awareness campaign will need to be launched in conjunction with the introduction of the regulations to ensure the benefits inherent in credit ratings are understood and correctly utilised by investors.

Nevertheless, credit ratings are a long step in the right direction. Many investors are still in shock over the 4-star rating awarded to Bridgecorp by Australian ratings firm Property Investment Research. The statement in their report that Bridgecorp had 'the highest rating that had been awarded to any New Zealand finance company reviewed by PIR is a good example of why greater rigour over the process for awarding credit ratings should form an integral part in future regulation of the New Zealand finance industry.

The requirement for non-bank deposit takers to maintain a credit rating comes into effect on 1 March 2010.

Recent court decisions

As always the Courts have been busy considering banking and finance related matters. We outline below three recent decisions of interest.

Subordination

In Westpac New Zealand Limited v Auckland Finance Limited Westpac and Auckland Finance entered into financing arrangements with three joint venture companies that involved the execution of three deeds of priority.

Auckland Finance, the second-ranking secured creditor, received a sum of \$1.2m from a guarantor of the loan it had provided to the borrowers. In a summary judgment application, Westpac sought a declaration that the funds held by Auckland Finance were held on trust for Westpac on the basis that Auckland Finance was acting in breach of a specific obligation to that effect under the deed of priority.

Auckland Finance contended that it was not bound to account to Westpac for the funds as the deed, which related to the principal debt, did not make reference to the guarantee and, accordingly, any payment by the guarantee was therefore outside of the subordination arrangements. On that basis, Auckland Finance argued that it was under no duty to account to Westpac for the funds it received from a guarantor making a voluntary payment.

The terms of the deed of priority were relatively standard, as follows:

7. Subordination of Debt

Subject to clause 4, the Second Securityholder's (Auckland Finance) Secured Money shall be subordinate and subject in right of payment, to the extent and in the manner hereinafter set forth, to the prior payment in full of the First Securityholder's (Westpac) Secured Money.

7.1 No Repayment of Subordinated Debt

The Mortgagor shall not (without the prior written consent of the First Securityholder) pay any part of the Second Securityholder's Secured Money to the Second Securityholder unless and until payment in full of the whole of the First Securityholder's Secured Money has been made.

7.3 Payments Held on Trust

Any payment made to the Second Securityholder, whether voluntarily or in any other circumstances, by or on account of the Mortgagor (including by way of credit or otherwise howsoever) in breach of the foregoing provisions will be held by the Second Securityholder in trust for and to the order of the First Securityholder.

In its review of the deeds of priority, the Court noted that the post contract conduct by the parties could be used as an interpretative tool in the event of uncertainty. In the absence of any such conduct, the Court was bound to rely upon the words of the particular document unless such reliance would result in an interpretation that would impugn commercial common-sense.

The Court noted that the deeds of priority were prepared carefully by a bank and, on that basis, it could be assumed that a particular meaning was intended by each clause, phrase, and word. Accordingly, the Court found that the exclusion of a particular clause, phrase, or word was seen as a deliberate act.

The Court concluded that clause 7 of the deeds of priority was drafted specifically to exclude the very contingency which had arisen in this case, as a result it was held that the guarantor (who

was not a party to the deeds) was permitted to reduce the indebtedness of the mortgagor with Auckland Finance, without Westpac having rights to those funds.

In the current economic climate it is becoming increasingly difficult to roll-over existing loan facilities due to the lack of liquidity in the market. As a result, the number of borrower defaults is on the rise. In the event of a default, secured parties will rely on the strength of their security documentation. Lenders need to consider not only the arrangements they have in place with a borrower, but also the impact of third party actions, such as a payment from a guarantor. This case is a timely reminder for lenders to re-examine their security arrangements.

Fraudulent representation

A recent decision of the New South Wales District Court provides growing evidence that lenders are looking more closely at the representations made by borrowers and are prepared to take action when those representations are subsequently proven to be false.

In *Commonwealth Bank of Australia v Hilellis* a vendor sold a property to two purchasers for AUD\$550,000. The purchasers funded the purchase with a loan from CBA. CBA's loan was granted subject to certain conditions, including proof of income and a copy of the sale and purchase agreement. On the basis of the information provided, CBA agreed to lend \$440,000 secured by a first ranking mortgage.

The sale and purchase agreement stated the purchase price as \$550,000 and recorded that a deposit of \$55,000 had been paid to an agent. However, while a deposit cheque had been provided, it was given, not to the agent, but to the vendors directly who were instructed not to deposit the cheque and to return it to the purchasers. The bank account on which the cheque had been drawn was closed. In addition, the confirmation of income supplied to CBA by the purchasers was later found to have been falsified.

The sale of the unit was settled with the purchasers paying the loan proceeds of \$440,000 to the vendor. No attempt was made by the vendor to either recover, or record the shortfall in the purchase price.

After the purchasers defaulted CBA exercised its power of sale resulting in a loss of \$121,000. CBA sought to recover the shortfall from the vendor, purchasers, and the individual who witnessed the signatures of the purchasers on the mortgage and loan documentation.

CBA alleged that the vendor and the purchasers had engaged in misleading and deceptive conduct in trade under the Trade Practices Act 1974 (Cth) and the Fair Trading Act 1987 (NSW), the equivalent to New Zealand's Fair Trading Act 1986, while the witness was guilty of accessorial liability under the same legislation.

CBA took an action alleging that, in providing the loan to the purchasers, it had relied upon three representations made by the parties:

- The sale was on arms length terms.
- The sale price in the sale agreement reflected the market value of the property.
- The purchasers were paying \$550,000 to purchase the property.

By the time of the trial, the purchasers had absconded and recovery was not sought from them.

In considering the factual background, the Court concluded the following:

- The sale price on the sale agreement implies that the listed price is the market price: 'especially in the context of a bank financed purchase'.
- The unambiguous reference on the front page of the sale agreement that a deposit had been paid was a representation; as was the claim that the deposit would be held by an agent.

- The purchasers had no intention of paying \$550,000 for the property.

The Court held that, in respect of the first two points, the representations were, or were likely to be, misleading or deceptive and were made with the intention of inducing CBA to provide the loan to the purchasers. Notably, the Court found that the representations had been made by both the vendors and purchasers.

Having found that the representations were false or misleading, the Court rejected the vendors' assertion that any representations that they had made were solely in their capacity as vendors and concluded that, because the property was an investment property, they were representations made in trade or commerce.

The witness was a mortgage broker first approached by the purchasers to arrange finance. Unable to assist, the witness introduced the purchasers to CBA.

In attributing liability to the witness, the Court found that when he witnessed the mortgage and loan documents, the witness had knowledge of the scam which made him an accessory to the fraud committed by the parties.

The Court found in favour of CBA ordering the witness and the vendor to pay CBA the entire shortfall of \$121,000.

PPSA: security interests under terms of trade

In Jones v Auto Imports Wholesale Limited, Jones registered a security interest on the PPSR against Auto Imports. Auto Imports subsequently gave written demand pursuant

to section 162 of the PPSA requiring Jones to discharge the registration on the basis that no security agreement existed between the parties. Jones made an application to the Court for an order that the registration be maintained.

Section 167 of the PPSA requires the Court to be satisfied on the application by a secured party that one of the grounds of making a demand under section 162 exists. The central question for the Court was whether the terms of trade between the parties contained a retention of title clause sufficient to support the security interest.

Jones argued that a retention of title clause existed between the parties based on an internet platform and also a course of dealings through e-mail and telephone conversations.

The court held that Jones had failed to establish that a retention of title clause existed. The arrangements between the parties were held to be informal (i.e. telephone and email contacts) and the evidence of the arrangements was too uncertain to satisfy the Court. On that basis the Court declined to make the order maintaining the registration.

This case is a clear lesson that it is the responsibility of suppliers to ensure that formal terms of trade exist with each and every customer. These usually take the form of written terms of trade handed over to the customer at the start of a business relationship or printed on the back of the supplier's invoice. Alternatively, if the transaction is conducted on the internet, the internet platform needs to alert the debtor to the supplier's terms of trade before the transaction is finalised.

Want to know more?

If you would like any further information about any of the above cases, or any consequences they may have for your business, please contact [Nick Lodder](mailto:Nick.Lodder@kingslawn.com.au) on (09) 375 1194, [Mark Brown](mailto:Mark.Brown@kingslawn.com.au) on (09) 918 6518 or email the team at financiallawupdate@kingslawn.com.au.

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If you would like further information call your usual Kensington Swan adviser or contact the team at financiallawupdate@kensingtonswan.com.

Auckland

Nigel Seebold*Partner*

DDI: +64 9 375 1132

FAX: +64 9 309 4276

nigel.seebold@kensingtonswan.com**Peter Missingham***Partner*

DDI: +64 9 375 1141

FAX: +64 9 309 4276

peter.missingham@kensingtonswan.com**Maria George***Senior Associate*

DDI: +64 9 914 7290

FAX: +64 9 309 4276

maria.george@kensingtonswan.com**Nick Lodder***Senior Associate*

DDI: +64 9 375 1194

FAX: +64 9 309 4276

nick.lodder@kensingtonswan.com

Wellington

Simon Mark*Partner*

DDI: +64 4 498 0891

FAX: +64 4 472 2291

simon.mark@kensingtonswan.com**David Ireland***Partner*

DDI: +64 4 498 0840

FAX: +64 4 472 2291

david.ireland@kensingtonswan.com**Gerald Fitzgerald***Partner*

DDI: +64 4 498 0835

FAX: +64 4 472 2291

gerald.fitzgerald@kensingtonswan.com**Catriona Grover***Partner*

DDI: +64 4 498 0816

FAX: +64 4 472 2291

catriona.grover@kensingtonswan.com**Tony Lines***Partner*

DDI: +64 4 498 0805

FAX: +64 4 472 2291

tony.lines@kensingtonswan.com**Nick Summerfield***Senior Associate*

DDI: +64 4 498 0876

FAX: +64 4 472 2291

nick.summerfield@kensingtonswan.com

AUCKLAND



Nigel Seebold



Peter Missingham



Maria George



Nick Lodder

WELLINGTON



Simon Mark



David Ireland



Gerald Fitzgerald



Catriona Grover



Tony Lines



Nick Summerfield

AUCKLAND: 09 379 4196 | WELLINGTON: 04 472 7877 | WWW.KENSINGTONSWAN.COM**KensingtonSwan**
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