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2015 EDITION 16

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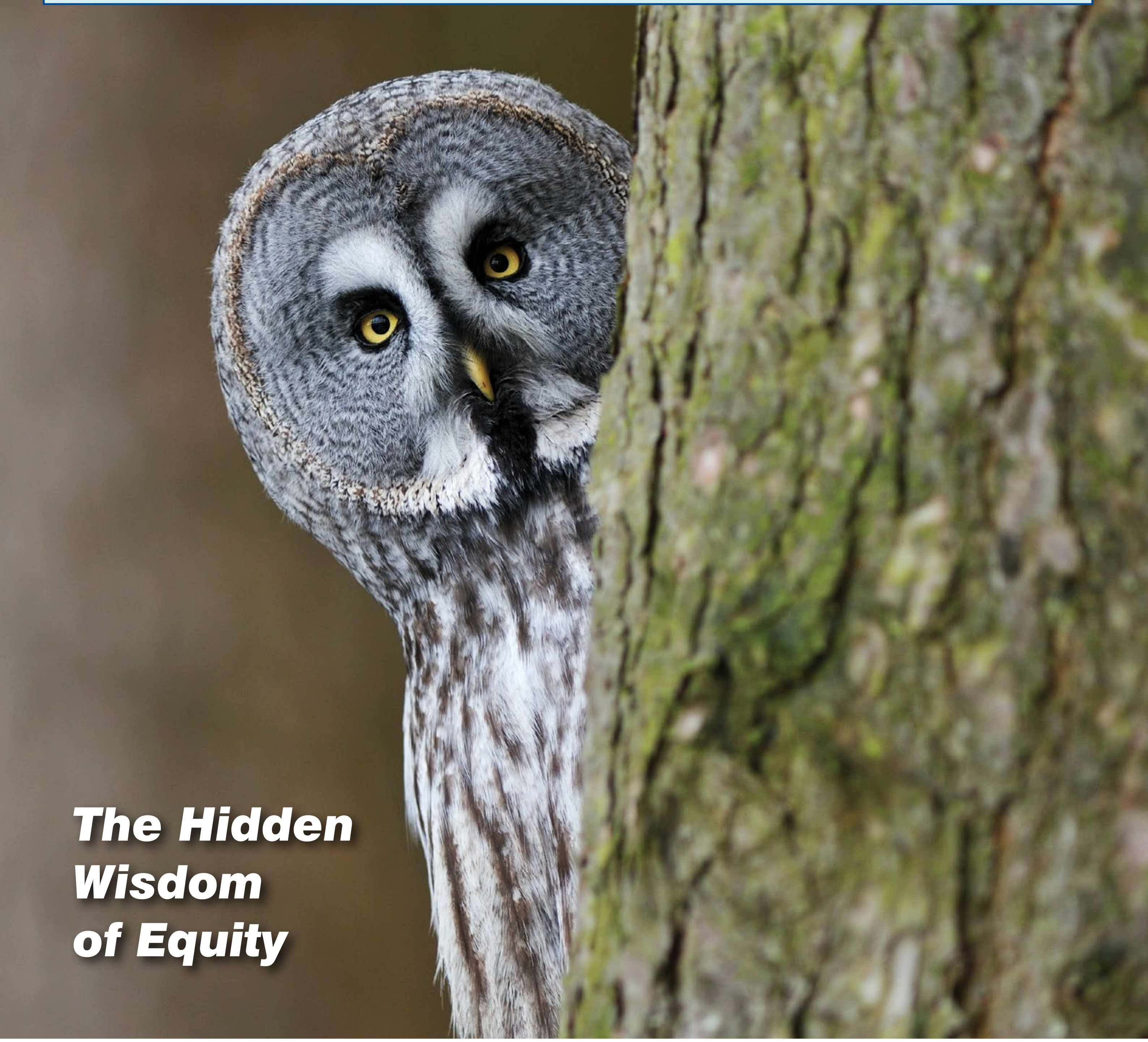

The Hidden Wisdom of Equity

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So. Voidables. What do we know?

Although the final judgement has yet to be written the courts have given some clear guidelines on how they are going to treat voidable transactions.

There have been more twists in the drama of insolvent transactions than in two years of Shortland Street and for those who have an interest we have produced a booklet; *The Logic of the Voidable Transaction Regime.*

It is on our website and it traces the history of insolvent transactions to their origins in the Fraudulent Conveyances Act of 1571. To understand the current it can help to understand the past.

However, what we have bequeathed to us can be broken into two parts; what is a voidable transaction and when can a creditor be forced to pay it back.

What is an Insolvent Transaction?

The best case, which withstood the Court of Appeal, is Levin and Timberworld. The court went back to the start of the specified period, two years before the date of liquidation, to define the start of the trading relationship. It took the level of indebtedness between the creditor and the liquidated company, $77,095. It then took the date at which trading between the entities ended. This could be the date of liquidation but in the Timberworld case it was about a year prior.

The court took the closing balance at that point; $47,605. All of the transactions were taken into account, including late payment penalties, interest and other incidental costs. The difference between the opening and closing balances was $29,490 and this was an insolvent transaction.

Once the trading relationship had ended, however, the court ignored the incidental costs, such as interest calculations, and declared all payments as being void. In the Timberworld case there was a further $44,250 in payments.

The total amount voidable was therefore $29,490 plus $44,250.

This is an important caveat to this analysis and that is that the debtor company must be insolvent when the payments were made. If it can be shown that the company did not become insolvent until later than the start of the specified period then the court will probably (this has yet to be determined) treat the time that the company became insolvent as the start of the trading relationship. In this context, insolvent is being unable to pay due debts.

What are the defences?

Once an amount has been found to be voidable the creditor isn't bound to repay it. There is a three part defence and the creditor must pass all three tests.

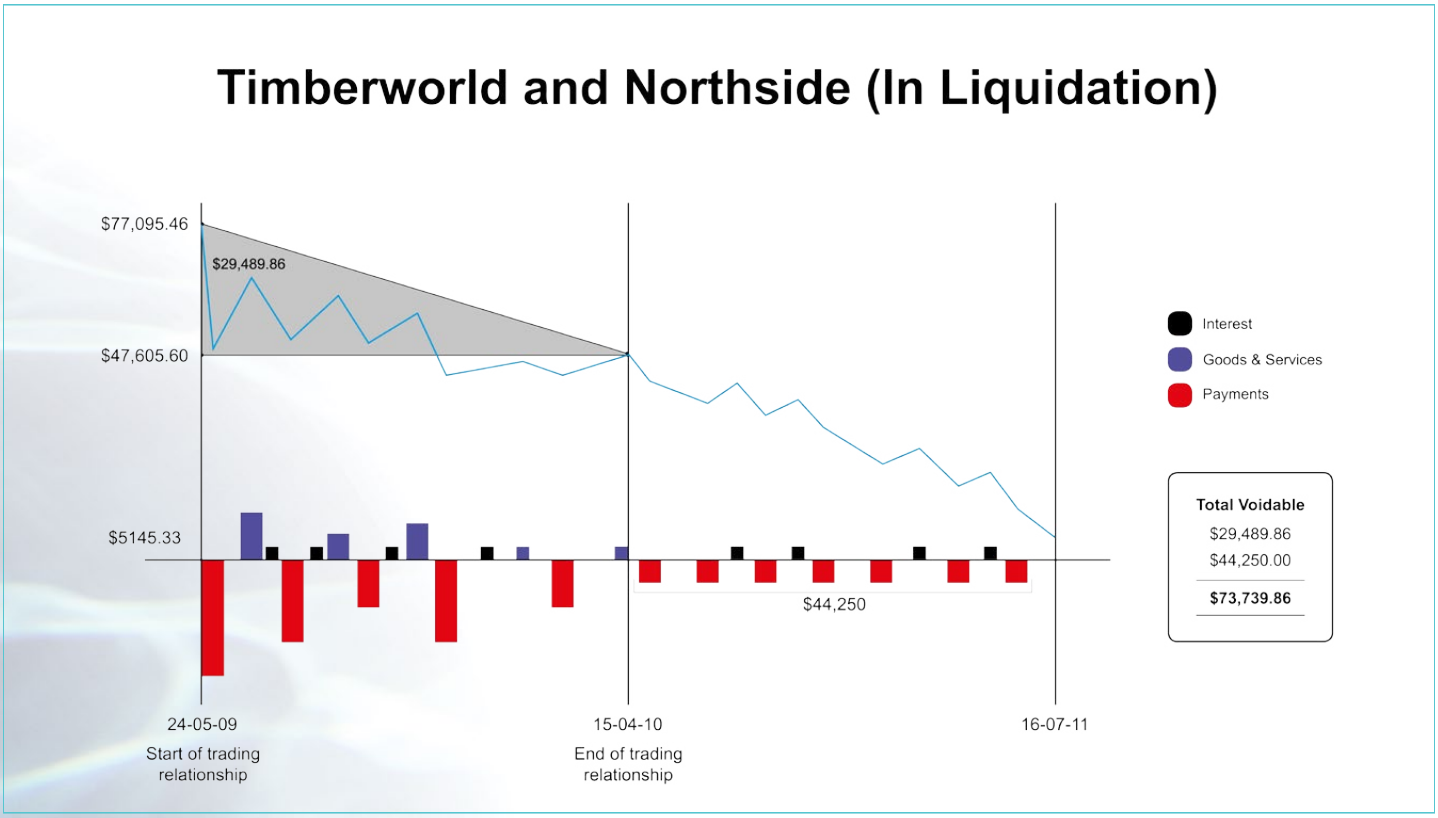
Test one:
Did the creditor act in good faith?
An unrelated creditor acting without knowledge of the debtors' insolvency and without applying unreasonable pressure for payment will pass this test.

Test Two:
Was the creditor aware of the insolvency of the debtor?
A very fact specific test and it extends not only to what the creditor actually knew but what a reasonable person in the creditor's position should have known.

Test Three (A):
Did the creditor provide value?
If the creditor provided goods or services to the value of the money received, regardless of when this was provided, then the creditor will pass this test.

However, if they fail Part A; there is…

Test Three (B):
Did the creditor alter their position?
If the creditor incurred an expense they would not otherwise have done or if they waived some security or other means of collection, they will probably pass this test.



CREDITOR MUST SHOW THAT

THEY ACTED IN GOOD FAITH; AND

DIDN'T SUSPECT INSOLVENCY; AND

A

GAVE VALUE

OR

B

ALTERED THEIR POSITION

STATUTORY DEFENCE TO VOIDABLE TRANSACTION

Our Mascot Prudence; inspecting the Volcanos in Hawaii.

The Official Assignee's Long Laundry Cycle

Bankruptcy is viewed as the end of a person's commercial life with a clean slate issued to them after a three year sojourn.

However, there are some debts that stick to a person even after they have been through the Official Assignee's 36 month laundry cycle.

Only debts that are provable can be discharged and in the Insolvency Act court fines or reparation orders are not provable; which oddly has the effect that if the debtor has assets these cannot be used to pay his court fines or meet reparations obligations.

So, court fines and repatriation orders that have resulted from a criminal conviction remain in place. From a public policy perspective this makes perfect sense; a fine is a substitute for prison and inmates can't get an early release by declaring bankruptcy.

Parking fines, therefore, are forever.

Debts that were the result of fraud are also specifically excluded although the commentary and case law on this point is thin. However, those who have debts owed to them by the bankrupt that originated by fraud do have the advantage of being able to both claim in the bankruptcy and are able to enforce their debts after the bankrupt's discharge.

This also applies to debts that have been incurred as a result of a fraudulent breach of trust. This would appear to be a relatively limited area of liability covering trustees who get confused between what is the trust's assets and what is their own.

Also excluded are child support payments and any maintenance obligations that have been made under the Family Proceedings Act; so dead-beats dads have nowhere to hide.

Oddly Parliament has allowed student loans to be included as a provable debt and declared discharged once a bankruptcy is done.

In exceptional circumstances the court can order a discharge but hold the discharged bankrupt liable for a specific debt but this appears to be a rarely used provision.

Oops. The FMA did it again

David Ross must have been a compelling individual. The pictures of him sitting in the dock, looking a little forlorn and not unlike a defrocked Westfield Santa, do not do him justice. He talked his way into over a hundred million dollars based on nothing other than a $10 moustache and an Access Database.

He was a good operator, if not a good person. By the time the FMA registered him as a Financial Advisor he was two decades into his Ponzi scheme and investors believed they were sitting on over 400m of assets. The liquidators, PwC, reported that there was less than ten million of realisable assets at the time of their appointment.

Which brings into question, how did the FMA overlook the missing 400m? The FMA have been quiet on this. There has been no mea-culpa and as we shall see if they did anything to improve their processes it wasn't very effective.

However, in their defence, Ross was a Chartered Accountant. He was respected. There were no indications that he was as bent as a corkscrew. Also, the registration regime was new, there were a lot of people seeking admission and it is always possible that the process was being overseen by a couple of admin staff appointed to meet a diversity quota rather than merit.

That was in 2011. To misquote Britney Spears; Oops. The FMA did it again.

Arena Capital, trading as BlackfortFX, was a small business operating in Christchurch and it sought registration with the FMA as a registered financial advisor. The director, a chap called Jimmie McNicholl, had no real experience in this area but he dressed nicely so the FMA registered him.

Well. This raised the eyebrows of the Companies Office because they had information that a more colourful chap by the names of Lance Thompson, Jack Ryan and sometimes Lance Ryan, who had a reputation as sour as unsweetened Mongolian yak-milk, was involved in Arena Capital.

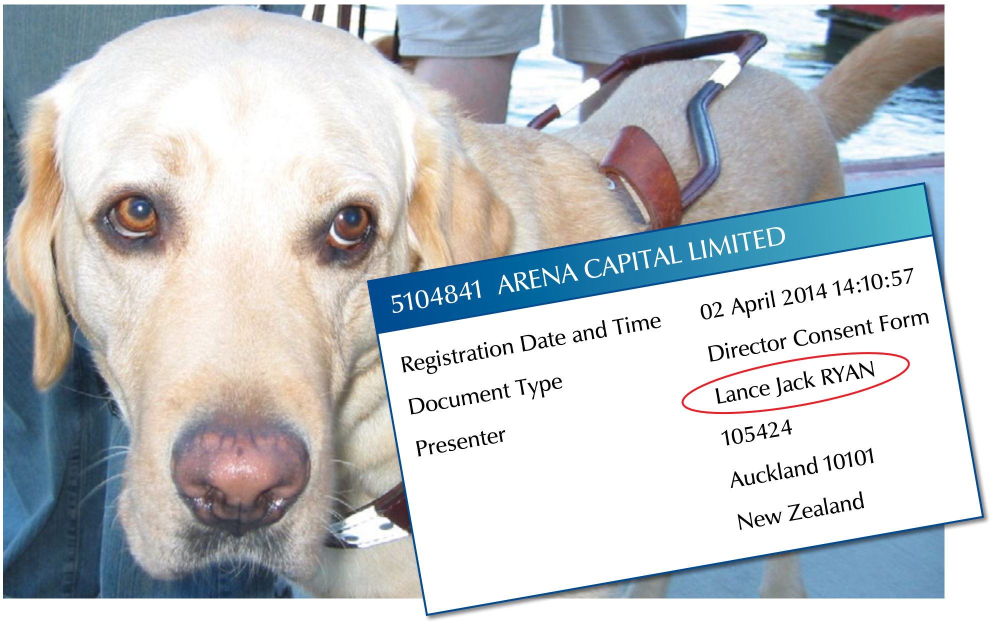
Mr Thompson/Ryan was bankrupted in 2014. He has been convicted of identity theft and the Companies Office tipped the FMA off. Christchurch journalist Martyn Van Buren reported in The Press the FMA's statement;

> *"In late 2014 Blackfort's registration was referred to us by the Companies Office who had concerns that Lance Ryan was involved with the business. We raised these concerns with the sole director Jimmie McNicholl and he provided a firm assurance that Lance Ryan would not be involved with BlackfortFX. On this basis the FMA did not have any grounds to object to the registration."*

The FMA's defence appears to be little better than *Jimmie said it was all good*. And to be fair, what else could they do? They are a government department after all, with a paltry $30m budget. Their 160 staff are probably frowned at for working more than the contracted 37.5 hours a week and are not allowed to drink coffee given the obvious risks of boiling water in the work place. They clearly do not have time to investigate every little allegation that a bankrupt ex-con is seeking a front-man to run some dodgy enterprise.

It wasn't as if there was a piece of evidence sitting in plain view that was so obvious even a cataract afflicted guide-dog could see it.

Oh. Turns out there was.



Registrations are covered by the Financial Services Providers (Registration and Dispute Resolution) Act 2008. Section 15 B of the Act provides the FMA with broad powers to reject an application and Parliament went further;

> *15 B*
> *If the FMA decides to consider the application the FMA must, after taking into account section 15A, consider whether preventing the applicant from being registered… is necessary or desirable.*

> *15 A*
> *The purpose of 15B is to prevent a person (A) from being registered as a financial service provider if such a registration has, will have, or is likely to have the effect of;*
>
> - *Creating or causing the creation of a false or misleading appearance with respect to the extent to which A provides or will provider financial services…*
> - *Otherwise damaging the integrity or reputation of New Zealand's financial markets*

This is a pretty wide paint brush parliament has given the FMA. If the guy's eyes are too close together the FMA can refuse him entry. Here we have one government department giving the FMA a warning that there is something to be investigated here and the FMA, it seems, did little more than send an email.

Let's re-cap. A bankrupt convicted identity thief was updating the Companies office for Arena Capital, a company seeking registration as a Registered Financial Advisor. The Companies Office tipped off the FMA. The FMA still registered Arena Capital.

The existence of a body like the FMA creates a public impression that someone has an eye on the financial markets and is keeping the likes of Jack Ryan away from the roulette wheel of capital markets. To be fair they probably couldn't even if they tried but the fact is they **are** registering people like David Ross and Jack Ryan. In all likelihood there are other conmen out there running scams today that are registered financial advisors.

Equity

Monarchs are tricky beings. England has had some great ones. Henry V smashed the French at Agincourt, Edward the First hammered the Scots; (great, clearly, is a relative term). Sadly, there have been some shockers, none worse perhaps than Henry the VI who spent most of his half century on the throne time either in prayer or catatonic.

Kings, however, were the apex of the state. They were justice and their will was not constrained by the laws of the land. Petitions to the King, therefore, could overturn a decision by a court. This was not appreciated by the judges presiding over England's evolving common law.

Two streams of English law therefore emerged. The common law, bolstered over time with statutes, with judges presiding, and the Kings (and intermittently Queens) over-riding prerogative to dispense justice as they saw fit, sometimes overturning the common law.

This royal discretion became formalised by Edward the First, when he wasn't flattening haggis, around 1280 when he instructed that appeals to him over legal issues be referred to his Lord Chancellor.

This duty of the Lord Chancellor evolved further into the Chancery Court. This court was not constrained by precedent but rather justice, or the more elusive concept of equity. Because this court drew its authority from the Monarch it held supremacy over the common law courts.

This didn't sit well with the common law judges, nor with Parliament. However, the Chancellery Courts remained popular with petitioners and as a last refuge for those who had what they perceived injustice from the common law.

The initial popularity of the Chancery Court was its speed and efficiency as it was unencumbered with the weight of processes, procedures and precedents that burdened the common law courts. Over the centuries, however, the Chancery Courts developed their own built-in-delays and some cases could take decades to work through.

The common law courts were by nature backwards looking. They could impose a penalty or damages once a wrong had been committed. By contrast the Chancery Court could issue injunctions and order specific performance to prevent a wrong occurring.

The common law courts were also local affairs and were not immune from being influenced by whoever held sway in the region. The Chancery Court was in London and perceived to be free of parochial taint.

Usually the two streams of justice kept out of each other's way but the issue of primacy was formally resolved in the Earl of Oxford's case in 1615; discussed overleaf. The Courts of Chancery, being the King's justice, prevailed.

In 1875 the Court of Chancery was abolished and its remedies were vested into the common law courts. In New Zealand the High Courts, then called Supreme Courts, were established in 1841 with the power to exercise both the jurisdiction of the Chancery Court and common law courts in Britain.

Equity, best defined as a plea to the Sovereign's absolute discretion, remains a live force in New Zealand and it's preserved in the Judicature Act 1908. There two key sections.

First; Section 99; which speaks for itself

> **In cases of conflict rules of equity to prevail**
>
> *Generally in all matters in which there is any conflict or variance between the rules of equity and the rules of the common law with reference to the same matter the rules of equity shall prevail.*

Equity trumps the common law; the doctrine defined in the Oxford Case, prevails. Then we have Section 94B

> **Payments made under mistake of law or fact not always recoverable**
>
> *Relief …. in equity …shall be denied wholly or in part if the person from whom relief is sought received the payment in good faith and has so altered his position in reliance on the validity of the payment that in the opinion of the court, having regard to all possible implications in respect of other persons, it is inequitable to grant relief, or to grant relief in full, as the case may be.*

To those familiar with the defences to voidable transaction in both the Companies Act and the Property Law Act will recognise some similarities and these are explored in the article on the back page.

Over time the two streams, common law and Equity, have become merged and in many cases indistinguishable; to such an extent proponents of fusion maintain that the two streams now run into the same river and the historical distinctions between them are of no more than historical interest.

The Earl of Oxford

The issue of the competing jurisdictions became the unintentional focus of the Earl of Oxford's case in 1615. The case has a complex history but it starts with the financial deprivations of a religious order; the Priory of Holy Trinity in London that forfeited seven acres land to the Crown in lieu of unpaid debts in 1532 under the reign of Henry the VIII.

This wasn't a nice piece of land. It lies roughly between Aldgate and Bishopsgate. Part of it was used as a tip and the rest wasn't much better. Today the area is a little nicer and the famous landmark known as the Gherkin sits just to the south of the seven acres in question. Of more interest, however, is a street named Bevis Marks, a name that appears to have been in use since at least 1407, which sits on the southern border of this piece of otherwise uninteresting piece real estate.

We will come back to Bevis Marks.

At this time a portly lawyer known as Lord Audley was enjoying the favour of King Henry. He was at the time Lord Chancellor and these seven acres came into his possession. Lord Audley died in 1544 and, perhaps in an attempt to preserve his soul that had been severely tarnished given the amount of blood on his manicured fingers, he bequeathed much of his ill-gotten wealth to worthy causes. The seven acres was gifted to Magdalene College in Cambridge.

Lord Audley

They were not to prove competent custodians, leasing out the land for a mere £20 per annum.

By 1558 Elizabeth the First was on the throne and in 1571 Parliament passed a law preventing colleges from disposing of their properties by the means of long-term leases; part of the historically important Statute 13 of Elizabeth the First; more commonly known as the Fraudulent Conveyances Act. Why parliament did this isn't apparent to this Author, but they did.

Magdalene College began regretting the poor lease deals it had entered into and engaged a morally questionable Genoese businessman by the name of Benedict Spinola for assistance.

Mr Spinola was a wily trader and knew an opportunity when he saw it. Spinola proposed that the college grant him a form of title known as a *fee farm*, where the College would be the nominal owner but Spinola would hold the right to the land in perpetuity. In return Spinola would pay the College an increased rental of £40.

However, the Fraudulent Conveyances Act specifically forbade such arrangements so Spinola had a brilliant idea. The land was gifted by the College to the Crown and the Crown then granted the land to Spinola who in turn would agree to pay the College the £40 but the college retained rights over the rental income; including the right to re-enter the property if rental income wasn't paid.

This was a shockingly bad deal for the College but that is exactly what happened. The College gifted the land to the Crown who granted it to Spinola who proceeded to buy or break the existing leases, investing in upgrading the land and getting better paying tenants. By 1571 the land was sold to the Earl of Oxford for £2,500.

Henry the VIII awarded the 7 acres in question to Lord Audley in gratitude for Audley's assistance in the demise of Anne Boleyn.

The Earl of Oxford was himself a colourful character. He inherited the Earldom of Oxford as a child and was kept as a ward of Elizabeth where he emerged as one of her favourites until he got one of the Queens' maids pregnant. Some contemporary historians claim Oxford to the true author of Shakespeare but this isn't widely accepted.

In any event, Oxford died in 1604, by which time the College was feeling aggrieved and not all of the rent was forthcoming. The College had the right to re-enter the land if the lease payments fell due and they did so, prompting the whole mess to fall before the courts.

The case was incredibly complex but let's shake it down to a seven act play.

Act one 1608;
The plaintiff was the Earl. He petitioned the Court of Wards (because the new earl was a minor) for an order of ejectment against the college.

Act Two 1615;
The matter works its way through to the common law King's Bench where judgement is in favour of the College. The Act of 1571 made the disposition of lands of the type conducted by the College illegal and of no effect. As a result, the grant by the Queen to Spinola was also void. The land belonged to the College.

Act Three 1615;
The Earl, still a minor, appealed to the Courts of Chancery. They claimed that Spinola, the Earl of Oxford and their tenants had spent over £10,500 on the land. To hand the land back to the College was an injustice. The Chancery Court put several matters back to the defendants, the Master and Bursar of the College.

Act Four 1615;
The Master and the Bursar demurred; claiming that the issue was one for common law and that Chancery had no jurisdiction. They went to prison for their refusal to answer the court's questions. The two jail birds brought a writ of Habeas Corpus to the King's Bench.

Act Five 1615;
The Chancery Court relented and had the men released but heard the case in the absence of the College's evidence.

Act Six 1615;
The Chancery Court found for the young Earl. It would be against conscious to disposes those who, in good faith, purchased property. The College was the author of its own misfortune and could not profit from its own failings. The common law decision was overturned.

Act Seven 1616;
Two courts, two different results? This issue is referred to King James the First. James responded unequivocally; "Where equity and law conflict, equity shall prevail"

This was a battle of jurisdictions. Lord Coke, representing the Common Law and Lord Ellesmere upholding the right of his court of Chancery differed in their perception on the fundamental nature of the English constitution and the role of laws and that of the king.

Coke believed parliament and common law should be pre-eminent. Ellesmere took a more conservative stance. King James was called upon to arbitrate and found in favour, unsurprisingly, of Chancery and by extension his own royal prerogative.

Who is Bevis Marks?

One of the more enduring mysteries of the David Ross fraud is the mythical broker Bevis Marks.

In the accounts of Ross Asset Management Bevis Marks was listed as a broker that held much missing four hundred million dollars. Alas, there was no Bevis Marks. No such person exists. But Bevis Marks exists. It is a street in London. It has been since medieval times and it sits on the southern boundary of the seven acres of land at the centre of the Earl of Oxford's famous equity case.

Only David Ross can answer this mystery and perhaps even he doesn't know why he choose that name but if ever the universe was sending a signal this is a pretty strong one.

Lord Coke; Defender of Common Law
It is a great grievance that the parliament shall say, be it enacted that all such Leases shall be void, and the Chancellor, be it decreed that it shall be good; for it was done in Magdalen College Case… it touches every man in his inheritance.

Lord Ellesmere; Defender of Chancery
Mens Actions are so diverse and infinite, that it is impossible to make any general Law which may aptly meet with every particular Act ... The Office of the Chancellor is to correct Men's Consciences for Frauds, Breach of Trusts, Wrongs and Oppressions … and to soften and mollify the Extremity of the Law.

King James the First
We do will and command that our Chancellor … shall not hereafter desist to give unto our … such relief in equity (notwithstanding any proceedings at the common law against them) as shall stand with the merit and justice of their cause and with the former ancient and continued practice and presidency of our Chancery.

Equity and the Ross Asset Management Scheme

Hamish McIntosh invested $500k with Ross Asset Management in 2007. He withdrew his initial investment plus $454k in profits in late 2011.

As is well known, Ross Asset Management was a poinzi scheme, and the $454k wasn't real profit but rather money paid in by fresh victims.

The liquidators, PwC, went to court to recover the full $954k. They argued that under both the Property Law Act and the Companies Act that McIntosh should be forced to repay the money.

The Court found McIntosh had a defence under both Acts. He had acted in good faith, had no knowledge his payment resulted in prejudice, nor knowledge of insolvency, and he had provided valuable consideration, being the initial $500k investment.

He was allowed to keep the $500k but was required to repay the $454k because he failed the third test under both acts; He didn't acquire the false profits for valuable consideration and nor did he give value.

Critically, the court also found that McIntosh did not alter his position. Had there been a successful claim in equity, McIntosh wouldn't have had a defence. Yes; he acted in good faith, but he would have failed the second limb of the equity defence; he did not alter his position.

The court clearly felt there was an equity argument, in the judgement at paragraph 22;

> *Further, because funds which were to be held on trust were misapplied, the liquidators may not be the only persons with claims to funds paid out by RAM to investors. Other investors may have their own remedies, in equity, in respect of the funds, at least to the extent that they can be followed or traced.*

The concept of equity is dealt with in this newsletter and Waterstone's interest in this matter is purely academic but this paragraph accords with our view on this case.

Those who have lost money in the RAM case may have a claim against those who got their money out. It might be that, as the judge implies, only those who received their money rather than the money coming back into a general pool to be distributed on a pari-passu basis.

Possession and the Law

To those familiar with the claw-back provisions in the Companies Act and in the Property Law Act the defences to a claim in equity will be familiar. In both these two acts recovery of voidable transactions can be defeated. A summary of the defences are;

In order to obtain protection of the Companies Act and the Property Law Act a person must tick all three boxes. Two out of three isn't enough. However, in equity, the burden is lower. You must only have acted in good faith and altered your position.

Property Law Act s 349	Companies Act s 296	Equity
Acted in good faith **And** Without knowledge that someone else was prejudiced by the transaction **And** Acquired property for valuable consideration	Acted in good faith **And** Had no knowledge of insolvency of debtor **And** Gave value ***or*** altered position	Acted in good faith **And** Altered Position

Acting in good faith is usually a given. However, altering your position isn't. What constitutes an altered position hasn't been well defined by the courts but;

1) Paying down an existing debt with the money isn't altering your position

2) Making a purchase you would not have otherwise made probably is

3) Abandoning another course of action to get paid, such as a security, definitely is

In past cases the court has ruled that if you used the money to pay a debt that existed at the time you were paid then your position has not altered. However, if you were paid the money and made a decision to spend it on something that you would not have otherwise have done then you have altered your position.

If you took a holiday every year then an annual holiday isn't going to count as an altered position. However, if you never take holidays but did so after you were paid then the court may consider that your position was altered.

It is common for a creditor to have multiple courses of action in the event of a non-payment. If such a course of action was abandoned when payment was made this too will be considered an alteration of position. An obvious example will be releasing a mortgage over property or forgiving a personal guarantee in consideration of payment.

The Liquidator's Little Friend

Things are tough for liquidators these days. Voidable transactions are gone and the economy is bubbling along like a freshly popped bottle of cheap champagne. So we have to look a little harder for our daily bread.

It is in this spirit of desperation that we dusted off the case law around Section 161 of the Companies Act, blowing off the cobwebs and detritus that has settled onto this long overlooked piece of legislation.

Section 161 deals with payments to directors. Company directors may not receive a salary, dividends, or take a loan from the company without first obtaining a board resolution that authorises any remuneration or the provision of any benefits to the director.

Not only must there be a board resolution but directors who vote for this remuneration must sign a certificate stating that the benefit is fair to the company and the grounds upon which they base that opinion.

Now. There might be the occasional small business or even medium business that complies with this requirement but the vast majority of firms don't. This is helpful for those of us in the insolvency industry because the case law is pretty consistent; that a failure to comply with this requirement will make a director who receives the benefits liable for money or benefit that they received, even if the company was solvent at the time.

In our experience most directors will, when asked, simply manufacture the documents after the event and fortunately for them the courts will happily accept obvious forgeries unless the liquidators can prove beyond all doubt that the documents are bogus.