

In this issue

Be careful what you say in negotiations

Statements made in discussions can lead to binding obligations regardless of written agreements.

Are your guarantees enforceable?

The latest New Zealand case clarifies the steps required to ensure guarantees are enforceable.

Consumer credit law reform

How will it impact on lenders?

Is it goodbye to GAAP?

What does the move to international financial reporting standards mean for borrowers and lenders?

Welcome to the first issue of *Financial Services Quarterly*, a new review of current legal issues in the financial sector from Bell Gully.

Each quarter, we will summarise recent issues and preview upcoming developments.

- * In the courts
- * In the journals
- * Legislation/In Parliament
- * Recent developments
- * Bell Gully news
- * Useful Web links

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The latest New Zealand case on guarantees and undue influence clarifies the steps required to ensure guarantees are enforceable.

GST payable on mortgagee sales

The Court of Appeal has confirmed that GST is payable in respect of a mortgagee sale.

Are high default interest rates oppressive?

Taking into account the borrower's experience, the High Court decided that 35% is not oppressive.

When is compensation payable to mortgagors following a mortgagee sale?

Two recent cases consider how to "take reasonable care to obtain the best possible price" at a mortgagee sale.

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In the courts

Be careful what you say in negotiations

Statements made during negotiations can result in binding obligations regardless of written agreements to the contrary.

A lender made oral representations to a borrower regarding the ability to redenominate a loan and was held liable for misrepresentation causing the borrower to suffer economic loss.

A couple borrowed money from a lender, who they claimed made oral representations to them that the currency of the loan could be redenominated upon request.

The loan agreement simply provided that the lender “may” convert the currency of the loan. When the lender failed to redenominate the loan currency, the borrowers sued the lender for misrepresentation causing economic loss and won in the High Court.

The Court of Appeal dismissed the lender’s appeal, agreeing with the High Court’s decision that the lender had, in oral discussion, misrepresented to the borrowers its ability to redenominate the currency, and this misrepresentation induced the borrower to commit to an offshore loan in Swiss francs which caused the borrower substantial loss.

This case is an important reminder for lenders (and borrowers) that the Courts will override the terms of written contracts where there is an express agreement to the contrary between the parties. It is critical that all parties take care during the documentation process as statements made during negotiations may result in binding obligations.

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In the courts

Are your guarantees enforceable?

The latest New Zealand case on guarantees and undue influence clarifies the steps required to ensure that guarantees are enforceable.

This case¹ is important in the context of guarantees in New Zealand. Although only a High Court decision, which means that it may be appealed, this is a significant case for lenders as it pulls back the high-water mark established in the 2001 House of Lords case of *Etridge*².

The *Etridge* decision requires a bank to meet directly with the guarantor to explain the need for independent advice, and to provide the solicitor giving the independent advice with the financial information necessary to explain the transaction properly.

Background

In a classic scenario, an elderly woman agreed to mortgage her house and gave a guarantee in respect of the obligations of her son. Despite finding that the son placed undue influence on his mother, the guarantee was held to be binding.

The Court decided that the lender discharged its duty to the guarantor because it had insisted that she seek independent legal advice.

This approach effectively approves the usual approach taken by lenders in New Zealand and the Court stated that it would not be proper for it to "take on itself a radical change to the law involving important policy considerations capable of having widespread implications within the commercial sphere".

In this case, the borrowers defaulted, and the lender sought to enforce its security. The widow sought a declaration that the mortgage and her obligations under an associated loan contract were both void by reason of undue influence on the part of her son.

The widow's son had taken her to see a lawyer who advised her against signing the documents on the basis that it was not in her best interests. She signed the documents nonetheless.

The widow's solicitor had signed a certificate, confirming that he had provided her with independent legal advice, which was provided to the lender.

Considerations

The Court considered:

- whether undue influence was established;
- the implications of independent legal advice;
- whether the lender was put on inquiry; and
- if so, whether the lender took appropriate steps to discharge its duty.

Undue influence was established because:

- there was a relationship of trust and confidence between the widow and her son;
- the widow was extremely vulnerable to her son's influence;
- her son never explained the deal to her or consulted her as to the steps that needed to be taken; and
- it was a high-risk transaction that should have been explained to the widow, and the son took unfair advantage of his mother.

The independent legal advice from the widow's solicitor was not adequate in terms of the requirements set out in *Etridge* because:

- the solicitor she met was not known to her;
- the consultation was hurried;
- her son was present for a large part of the interview and his domination over his mother was likely to overshadow any advice given by her solicitor; and
- the effect of the consultation was undermined by the absence of information about the "deal".

Decision

The Court in this case found that the lender must have been put on inquiry because:

- no distinction should be drawn between this mother/son situation and a husband/wife situation;
- the transaction was not for the benefit of the widow - she was providing security to support an advance to her son;
- in transactions of this nature, there is a real possibility of undue influence by a borrower, especially when the person providing the security is his mother who is a widow of mature years; and
- this was a non-commercial relationship because the bond was emotional, not commercial.

However, the Court found that the lender took appropriate steps to discharge its duty because:

- it insisted on independent legal advice for the widow, relied on the statement that her solicitor had advised the guarantor, and regarded this as clear evidence that she had been acquainted with the risks associated with the transaction; and
- it was entitled to rely on the certificate of independent advice.

¹*Alma Daphne Lee v Damesh Holdings Limited* (High Court) (Unreported 14 April 2003)

²*Royal Bank of Scotland v Etridge* ([2001] 2 All ER (Comm) 1061)

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In the courts

GST payable on mortgagee sales

The Court of Appeal¹ has confirmed that GST is payable in respect of a mortgagee sale and is to be paid to Inland Revenue in priority over any secured creditors – the GST is effectively a cost of sale.

This reverses the High Court decision² which held that secured creditors enjoyed priority over the Inland Revenue.

We understand that the Court of Appeal decision is to be appealed to the Privy Council.

1. *CIR v Edgewater Motel Ltd* (2002) 20 NZTC 17, 984

2. *Edgewater Motel Ltd v CIR* (2002) 30 NZTC 17, 713

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In the courts

Are high default interest rates oppressive?

Whether interest rates are oppressive or not will be judged on the borrower's experience and knowledge of the terms and implications of the loan.

In this case¹, a loan was made to a company and guaranteed by a director of the company. When the loan was not repaid, the lender entered into a further loan agreement with the company and the director in order to repay the first loan.

The borrower and the guarantor defaulted and the proceeds of the sale of properties taken as security were insufficient to repay the loan.

The lender sought summary judgement against the guarantor. In response to the guarantor's argument that a default interest rate of 35% was oppressive, the Court observed that the guarantor had been in the commercial property market for about 20 years and had signed both agreements at this specified default rate. He therefore entered into both agreements with full knowledge of their terms and implications and was bound by the agreement.

The key issue for lenders is the experience of the borrower. It is likely that the opposite conclusion would be reached for an inexperienced and poorly advised borrower.

1. *Basecorp Finance Limited v Blackwell & Easson* (Master Lang – HC Auckland, CP 405/02, 24/03/03, 6 pp)

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In the courts

When is compensation payable to mortgagors following a mortgagee sale?

New Zealand and Australian laws require mortgagees to take all reasonable care to obtain the best price reasonably obtainable when exercising their power of sale.

A mortgagor may be entitled to a remedy where this requirement is not complied with, but no rights are conferred on third parties. What counts as reasonable depends on the circumstances of the case.

Two recent cases have considered this issue.

*GE Capital Australia v Davis*¹

In this case, the NSW Supreme Court made observations about section 420A of the Corporations Act 2001 in Australia, a provision similar to section 103A of the Property Law Act 1952 in New Zealand.

The section requires a mortgagee to take all reasonable care to obtain the best price reasonably obtainable when exercising its power of sale, but it is unclear whether this gives rise to a statutory cause of action in damages and, if so, to whom.

The Court stated that the remedy for the mortgagor is to be credited compensation when account is taken of the mortgage debt. The Court also noted it does not give a right to recover damages or any other remedy to guarantors or third parties, as they do not have an interest in the property.

This latter observation is similar to the approach taken by the New Zealand Court of Appeal², where it was held that there is no right of action conferred on a guarantor against the mortgagee under section 103A of the Property Law Act.

*Basecorp Finance Limited v Blackwell*³

In this case, a loan was made to a company and guaranteed by a director of that company. The loan was not repaid so the lender served a notice on the company and the guarantor, in accordance with section 92 of the Property Law Act, to exercise its power of sale.

The sale proceeds of sale of the property were insufficient to repay the loan and the lender sought summary judgment against the guarantor for the shortfall.

In granting summary judgment in favour of the lender, the Court noted that it had obtained advice from a reputable firm of real estate agents about how best to sell the property and what a reasonable price would be. It was therefore not unreasonable or in breach of a duty for the lender to accept the sale price.

¹*GE Capital Australia v Davis* (2003) 77 ALJ 100

²*Bryers v Harts Contributory Mortgages Nominee Co Ltd* [2002] 3 NZLR 343

³*Basecorp Finance Limited v Blackwell*³ (Master Lang – HC Auckland, CP 405/02, 24/03/03, 6pp)

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In the journals

Is it goodbye to GAAP as we know it?

What will a move to international financial reporting standards mean for borrowers and lenders?

The ISDA 2002 Master Agreement

Major changes summarised.

Recent developments in English law

Notes from an article on cases covering interest rates, sub-participation agreements, liability of co-sureties and demand guarantees.

Struggling corporates attacked by distressed debt investors (or vulture funds)

The decisions in two recent English cases are as expected, but the mere fact of the litigation should serve as a warning to both lenders and borrowers.

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In the journals

Is it goodbye to GAAP as we know it?

INnews, InFINZ, Issue 1 2003

With the support of the Financial Reporting Standards Board, the Accounting Standards Review Board has recommended that New Zealand should move to full adoption of international financial reporting standards (IFRS).

The timetable for implementation requires full compliance by 2007, with voluntary compliance from 2005.

The adoption of IFRS will significantly affect the way in which accounts are prepared, particularly in relation to the treatment of deferred tax and financial instruments - including derivatives, business combinations and pensions.

For borrowers and lenders, it will be critical that long-term financial arrangements entered into now cater adequately for the change. For example, financial ratios based on existing GAAP may not be appropriate following the changes to accounting standards.

Bell Gully is recommending the inclusion of specific provisions to deal with this change in all agreements that will survive beyond the transition period.

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In the journals

The ISDA 2002 Master Agreement

Schuyler Henderson, *Butterworths Journal of International Banking and Financial Law*, March 2003

Major changes in the 2002 ISDA Master Agreement reflect increased attention to credit issues, concerns over liability of counterparties stemming from litigation in the mid-1990s, the major crises in South East Asia and Russia in 1997 and 1998, the expansion of the derivatives market, and general experience with the 1992 Master Agreement.

No agency, non-reliance and representations

Each party now represents that it is acting as principal and not as agent. An 'entire agreement' clause provides that each party acknowledges it has not relied on representations from the other in entering into the agreement.

This is intended to remove reliance as one of the principal claims for misrepresentation. However, the acknowledgement is made when executing the agreement and is not repeated on each trade date.

Events of Default

The 'Default under Specified Transaction' provision has been revised and the definition of 'Specified Transaction' has been expanded.

A wider range of derivative transactions has been incorporated (including various forms of credit derivatives, total return transactions and weather index transactions) and transactions that have traditionally not been regarded as derivatives have been added (including repos, buy/sell back transactions and securities lending transactions). In addition, the grace periods for certain Events of Default have been reduced.

Credit Event Upon Merger

Several major changes have been made to the structure of Termination Events. Certain triggering events have been expanded and defined as 'Designated Events'.

Some of the changes include expanding a transfer of substantially all of a party's assets to include a transfer of 'any substantial part of its assets' and creating new triggering events such as a change in capital structure by means of issuing debt, convertible securities or preferred stock.

Illegality and force majeure

The definition of 'Illegality' is modified and a new concept of force majeure is added. The application of Illegality is not dependent on any form of event but is based on performance of payments, deliveries or other material provisions becoming unlawful under any applicable law. The new Force Majeure Event occurs only after giving effect to applicable disruption provisions that are relevant to a given transaction.

Close-out Amount

A new Close-out Amount definition removes Market Quotation and Loss measures and replaces them with a combination of the two, known as 'Replacement Value'. The Determining Party must use "commercially reasonable procedures" when making its determination to produce a commercially reasonable result.

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In the journals

Recent developments in English law

Andrew McKnight, Parts 1 and 2, *Journal of International Banking Law & Regulation*, Vol 18, Issues 3 and 4.

This article highlights developments in English law during 2002. Many of the cases included are applicable to the New Zealand market and we have noted below some banking law cases dealing with interest rates, sub-participation agreements, liability of co-sureties and demand guarantees.

What constraints should be placed on a lender's discretion to set or change interest rates?

In the English Court of Appeal decision of *Paragon Finance v Staunton*¹, the constraints which may be imposed on a lender where the loan agreement allows it to set and change interest rates at its discretion and where no parameters for the exercise of the discretion have been set were considered.

The Court found that the lender's discretion:

- must not be exercised dishonestly, for an improper purpose, capriciously or arbitrarily;
- must be exercised taking into account only matters related to the transaction; and
- must not be exercised in a way that no reasonable lender would act in similar circumstances.

If this situation was to arise in New Zealand, the Credit Contracts Act, which permits the court to reopen a credit contract if it considers that a party has exercised a right or power under the contract in an oppressive manner, would apply.

Sub-participation arrangements – no proprietary rights

Typically, sub-participation arrangements involve a lending bank (the grantor) "selling" part of its participation under a loan to another bank (the grantee).

The grantee makes a payment to the grantor equivalent to the relevant part of the outstanding amount of the loan and assumes the risk of failure by the borrower for that amount, as well as receiving the reward of future performance by the borrower in relation to that amount (effectively the receipt of interest payments).

Importantly, this arrangement is usually entered into without the agreement of the borrower, which retains its relationship with the original lender.

The Privy Council decision of *Lloyds TSB Bank plc v Clark (Liquidator of Socimer International Bank Ltd)* and *Chase Manhattan Bank Luxembourg SA*² found that:

- under a sub-participation arrangement, the grantee will receive no proprietary rights in the facility and will have no claim against the borrower; and
- in this case, the grantee was held to be in the same position as an ordinary unsecured creditor in the grantor's insolvency.

Contribution between co-sureties – what if the parties' interests are not equal?

The English High Court, in *Hampton v Minns*³, has upheld the rule that co-sureties share the burden of their guarantees equally, so that if one of them pays more than his or her fair share he or she can recover from the other co-surety to restore the equal balance between them.

This was held to be so in this case, where the two guarantors were shareholders in the borrower, even though one of them held a significantly higher proportion of the borrower's share capital than the other.

Letters of credit

Two recent cases have confirmed the effectiveness of letters of credit in the absence of fraud by the beneficiary.

In *Montrod v Grundkötter Fleischvertriebs GmbH & Standard Chartered Bank*⁴, the English Court of Appeal has held that an issuing or confirming bank must pay under a letter of credit governed by the UCP 500 in circumstances where the documents presented by the beneficiary under the letter of credit were on their face conforming and presented by the beneficiary in good faith.

In this case, the Court based its decision on the principle of the autonomy of the letter of credit and refused to extend the exception for fraud to a situation where, at the time of presentation of the documents, the beneficiary was unaware of the falsity of the documents.

In *Sirius International Insurance Co Ltd v FAI General Insurance Ltd*⁵, the Court noted that a general principle of letters of credit is that they are separate from the underlying transaction between the applicant for the issue of the letter of credit and the beneficiary of the letter of credit.

Except in cases of fraud, the beneficiary has the right to draw under a letter of credit if the specified requirements within it have been met.

This means that a dispute between the applicant and the beneficiary concerning the underlying agreement between them will be irrelevant in determining the obligations of the issuing or confirming bank under the letter of credit.

Demand guarantees - liability difficult to deny unless demand is fraudulent

In *Standard Chartered Bank London v Canara Bank*⁶, when a demand was made under a demand guarantee issued by a bank, the bank failed in its attempt to avoid liability on the following three grounds:

- the bank's argument that the transaction was a sham and that it had only intended to guarantee a genuine transaction failed on the facts;
- the guarantor's obligations were independent of the validity of the underlying transaction; and
- the guarantor's obligations were to pay if the conditions for payment laid down in the guarantee had been met.

It was accepted that the bank would not be liable where the demand is made fraudulently (which was not established by the facts of this case).

¹*Paragon Finance plc v Staunton* [2002] 1 W.L.R 685

²*Lloyds TSB Bank plc v Clark (Liquidator of Socimer International Bank Ltd) and Chase Manhattan Bank Luxembourg S.A* [2002] UKPC 27; [2002] All ER (Comm) 992

³ *Hampton v Minns* [2002] 1 W.L.R 685

⁴*Montrod Limited v Grundkotter Fleischvertreibe GmbH & Standard Chartered Bank* [2002] 1 All ER (Comm) 257

⁵*Sirus International Insurance Co Ltd v FAI General Insurance Ltd* [2002] EWHC 1611

⁶*Standard Chartered Bank London v Canara Bank* May 22, 2002, Moore-Bick J

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In the journals

Struggling corporates attacked by distressed debt investors (or vulture funds)

Corporate Finance, February 2003

Legal Brief, Issue 218

The decisions in two recent English cases make struggling corporates a less appetising prospect to distressed debt investors (or vulture funds).

Both cases contained interesting decisions on key clauses in loan and bond agreements that are used routinely in the New Zealand market.

*Redwood Master Fund v Toronto Dominion Bank & Others*¹

In this case, the minority lenders argued that the presence of discrimination against the minority was of itself a sufficient condition to justify the Court's intervention.

This decision suggests that challenges to decisions of majority lenders in syndicated loan transactions are possible. However, discrimination (and not merely a difference of opinion) is probably a necessary condition to a successful challenge.

The facility agreement provided that, subject to a number of exceptions:

"...any term of the finance documents may be amended or waived only with the consent of the majority lenders and [the borrower] and any such amendment or waiver will be binding on all parties."

The majority lenders agreed to waive a provision at the request of the borrower. As a result, some, but not all, of the lenders were required to make new advances which were applied in repaying some existing lenders. The minority lenders claimed that the majority decision had discriminated against the lenders who, under the terms of the waiver letter, had to make a new advance.

The Court rejected the claim, stating that if it succeeded, almost any decision by majority lenders could be viewed as favouring one class over another and therefore the minority could paralyse the powers of the majority at the point in the transaction when the facility agreement intended the majority lenders to be able to act.

*Colt Telecom and the Insolvency Act 1986*²

In this case, an agreement contained the following "no action" clause:

"Subject to clause 25.2 (Exceptions) any term of the Finance Documents may be amended or waived only with the consent of the Majority Lenders and [the borrower] and any such amendment or waiver will be binding on all parties."

Rejecting an application by a minority bondholder to put the company into liquidation, the judge commented, "Businesses from all over the world have been using New York Bond issues on a vast scale ... so a change in the interpretation by the New York Courts would seriously undermine the basis on which people thought the bonds had been issued."

Although the decisions seem to be statements of the obvious, the fact that they were litigated at all should serve as a warning of the extent to which distressed debt investors are prepared to go to achieve their aims.

¹*Redwood Master Fund v Toronto Dominion Bank & Others* [2002] EWHC 2703

²*Colt Telecom and the Insolvency Act 1986* [2002] EWHC 2815

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Legislation/In Parliament

Consumer credit law reform

How will it affect lenders?

Goods and Services Tax

GST treatment of financial services to change

Business law reform

What is it trying to achieve?

Insolvency law reform

A summary

Construction Contracts Act 2002

How does it affect development funding?

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Legislation/In Parliament

Consumer credit law reform – how will it affect lenders?

The Consumer Credit Bill tidies up the current regulatory framework protecting consumers against unfair lending practices. It applies to credit contracts for personal and domestic purposes. The Bill changes disclosure requirements for lenders and sets up an enforcement regime for breaches. Significantly, it removes the current \$250,000 "safe harbour" non-disclosure threshold.

Background

In 1999, the Ministry of Consumer affairs undertook a review of consumer credit policy and legislation and concluded that the efficiency of existing consumer credit law is hindered by:

- unnecessary compliance costs for lenders and business borrowers;
- unfairness to consumers;
- difficulties in enforcing the law;
- complexity; and
- fragmentation across a number of statutes.

Objectives

The Bill aims to simplify the law and to protect the interests of consumers under credit contracts (including leases) by providing for:

- disclosure of adequate information to consumers;
- clear rules about interest charges, fees and payments; and
- prevention of oppressive conduct by creditors.

Legislation to be repealed

When the Bill becomes law, it will repeal the Credit Contracts Act 1981 and the Hire Purchase Act 1971, statutes that were conceived and drafted in the 1970s. In the last 20 years, there have been marked technological and economic changes, particularly computerisation and financial deregulation, which render many of the provisions in the existing legislation outdated in light of modern credit products.

Features

The Bill:

- applies to credit contracts entered into for personal, domestic or household purposes;
- imposes new rules for the charging of interest and fees (including where a loan is repaid early);
- does not apply to business loans;
- imposes new disclosure rules;
- specifies a clear regime of damages payable by lenders for breaches of the statutory requirements; and
- provides power for the Commerce Commission to enforce its provisions.

Implications for lenders

The Bill will affect any institution or person that lends money or leases goods to consumers. It will require lenders to review their documentation and lending procedures. In particular, the new legislation will affect:

- *Disclosure requirements*

The Bill preserves most of the requirements for disclosure under the Credit Contracts Act 1981, but lenders will now have to make continuing disclosures (except where the interest rate is fixed for the life of the loan)

- *Interest*

A lender will only be allowed to charge a default interest rate if the borrower has actually breached the contract.

- *Fees*

Fees chargeable by lenders must not be "unreasonable".

- *Prepayment*

Unless a contract explicitly prohibits prepayment, it will be allowed. Lenders can charge fees related to prepayment, as long as they are not "unreasonable".

- *Enforcement*

The Bill establishes a public enforcement regime, and provides increased powers to the Courts to impose a range of simple remedies. The Commerce Commission will have independent powers to investigate lenders' activities and to prosecute breaches.

- *Oppressive conduct*

The Bill preserves the Credit Contracts Act provisions for the reopening of oppressive credit contracts. These provisions have been updated, but are substantively the same and will continue to apply to business and consumer credit contracts.

Compliance costs

In the short term, there will be costs involved in complying with the new regulatory framework. These will generally relate to the revision of documentation and staff training.

The costs will impact on creditors mainly during the transitional phase from the old regime. However, in the long term, compliance costs are not expected to increase, and should decrease for commercial credit contracts of less than \$250,000 (as the Bill removes the current requirement for disclosure if the total amount of credit outstanding between a borrower and lender is less than \$250,000).

Lenders will no longer have to make disclosure to commercial borrowers, irrespective of the amount of the loan. This will in turn lower the compliance costs for banks and other financial institutions. Also, calculations such as the finance rate will no longer be required.

The Consumer Credit Bill has had its first reading and is currently before the Select Committee. Submissions were due on 3 April 2003 and have been reported on in the Select Committee News of 8 May 2003. The Bill's next reading is scheduled for 17 August 2003.

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Legislation/In Parliament

GST treatment of financial services to change

The Government is continuing to progress significant changes to the GST treatment of financial services.

The changes were outlined in two discussion documents released over the last 18 months. A draft bill has just been introduced, and will likely take effect from mid-2004. There are two primary changes suggested.

The first is to allow financial services providers to zero-rate business-to-business financial supplies. Zero rating would apply where the recipient makes at least 75% taxable supplies, by turnover.

This change would allow the financial service supplier to recover GST on costs to the extent they are incurred for the purposes of making business-to-business financial supplies. For example, GST on direct costs associated with a loan to a commercial client are likely to be recoverable by the lender, reducing the cost of providing the credit by 1/9.

The second change introduces a 'reverse charge' which will impose GST on services imported into New Zealand. The 'reverse charge' will be payable by the recipient rather than the supplier and will apply where the recipient would not be able to fully recover any GST that would be chargeable had the services been supplied in New Zealand.

So, where previously services supplied by an overseas entity did not attract a GST component, these changes mean that they will in certain circumstances.

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Legislation/In Parliament

Business law reform – what is it trying to achieve?

The Business Law Reform Bill has had its first reading in Parliament.

The Bill is intended to amend a number of statutes, including:

- the Companies Act 1993;
- the Financial Reporting Act 1993;
- the Securities Act 1978; and
- the Personal Property Securities Act 1999;

with the aim of ensuring the law affecting the operation of business is clear, efficient and effective.

In particular, the legislation, when enacted, will:

- ensure consistency between different statutory requirements;
- remove unnecessary compliance costs; and
- clarify and update certain statutory provisions.

Proposed changes to the Companies Act that may be of specific interest to lenders include:

Solvency test for financial assistance

Amendments to the application of the solvency test in the context of financial assistance to:

- exclude from the definition of "assets" loans given under both section 76 (special or 5 per cent threshold financial assistance) and section 107(1)(e) (financial assistance approved by unanimous consent of entitled persons); and
- include in the definition of "liabilities" those incurred in connection with financial assistance given under both section 76 and section 107(1)(e).

Major transactions - contingent liabilities

Introduction of guidelines for determining the value of contingent liabilities for the purposes of the definition of "major transaction".

Offer to the public

One of the proposed changes to the Securities Act that may be of particular interest to lenders relates to how a determination is made on whether an offer of securities is made to the public.

i Need more information?

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Legislation/In Parliament

Insolvency law reform – a summary

The Ministry of Economic Development began a major review of New Zealand's insolvency law in May 1999.

The objectives of the review are to:

- provide a predictable and simple regime for financial failure;
- distribute the proceeds to creditors in accordance with their relative pre-insolvency entitlements, unless the public interest requires otherwise;
- maximise returns to creditors;
- enable individuals in bankruptcy to participate fully in the economic life of the community again; and
- provide international co-operation in relation to cross-border insolvency.

The Minister of Commerce has stated that New Zealand's insolvency regime will not be completely overhauled but will instead be enhanced to bring it into line with best practice models that have been developed since the last review of New Zealand's insolvency regime over 40 years ago.

Given that New Zealand's insolvency regime is not fundamentally flawed, the key changes following the Government's review are:

Business rehabilitation

The most significant change that has been announced is to the area of business rehabilitation. After considerable debate, the Government has decided to adopt Australia's voluntary administration regime, with the expectation that this will help preserve the economic value of insolvent companies as going concerns in an improved manner over the current regime.

Another intended outcome of this decision is the facilitation of simpler and less costly trans-Tasman administrations. The Ministry of Economic Development has flagged that the Australian voluntary administration will require adjustment to fit with the New Zealand company law framework.

Phoenix companies

Another focus of the proposals are "phoenix companies", where a business is sold as a going concern to another company or to its directors and/or managers, soon after failure.

The Government has decided that there will be an increase in the available penalties to courts when directors deliberately abuse phoenix company arrangements. This will be achieved by providing for criminal penalties when directors have acted in bad faith to defeat creditors' legitimate interests.

Restrictions will also be implemented to prevent re-use of a company name by any director of the company after it has gone into liquidation.

Cross-border insolvencies

The Government has decided to adopt the UNCITRAL Model Law on cross-border insolvency. The Model Law provides for judicial collaboration between countries, rights of access for foreign insolvency administrators and recognition of foreign insolvency proceedings by participating countries.

No asset bankruptcy procedures

A decision was made to address whether current insolvency law deals adequately with low-income debtors with no assets. During the review of this area, it was concluded that bankruptcy of these individuals is largely outside of their control.

The Government has decided to adopt a “no assets procedure” as an alternative to bankruptcy for low-income debtors with few or no realisable assets. This procedure will allow such debtors to be released from the procedure after one year, rather than the three-year period currently in place for bankrupts.

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Legislation/In Parliament

Construction Contracts Act 2002 – development funding

The Construction Contracts Act 2002 came into force on 1 April 2003 and has a number of important implications for financiers and borrowers. It affects commercial construction contracts (and, to a limited extent, construction contracts for residential – i.e. owner-occupied – developments).

The Act provides for certain statutory rights and obligations intended to supplement any construction contract entered into after 1 April, and specifically:

- facilitates cash flow through the industry by regulating payments and providing remedies for unpaid contractors; and
- establishes a supposedly quick and inexpensive adjudication process to help resolve disputes arising from construction contracts.

Implications for lenders and borrowers

“Pay when paid” and “pay if paid” clauses are now unenforceable. These clauses have been used by head contractors to make sure that subcontractors will not get paid for their work until the head contractor has been paid. Lenders will need to take this into account when financing head contractors and sub contractors as cashflows may be affected significantly.

The payment and adjudication processes prescribed in the Act introduce risks for the borrower and its lender.

A borrower, as the principal under the construction contract, may have to pay a greater sum than the costs of the works. This will arise where the contractor has made a payment claim and the borrower has not responded within the specified timeframe under the Act and in default has to pay the full amount claimed.

If the borrower does respond in time but disputes part of the claim, the dispute can be referred to adjudication under the Act and there is the risk of the adjudicator determining an amount beyond what the borrower can pay. This will then become an issue for the financier.

An example of the dramatic results that can arise from an adjudicator’s decision has been demonstrated in an English case, where an adjudicator overlooked a provision entitling the owner to retain moneys and awarded the contractor £207,741, rather than the £141,254 to which the owner would have been entitled had the retentions been taken into account.

The adjudicator’s award was binding and so the amount was required to be paid across to the owner to the contractor. The contractor went into liquidation, and so the amount was not recoverable, even though the adjudicator’s mistake was subsequently rectified in a separate court decision.

In a similar scenario, principals and financiers are likely to seek an amount and coverage of any contractor's bond to extend to cover payments due by a contractor to a principal.

Payment processes and rights of suspension now available to a contractor under the Act could cause delays to the project. These could cause problems where there are sunset clauses or other time constraints in other project documents such as on-sale contracts or leases.

Charging orders

A remedy now available to contractors under the Act, pursuant to adjudication, is a charging order. A charging order is a remedy to enforce a judgment debt, and once registered, it is a charge over the land but ranks behind prior registered charges, according to normal priority rules.

The lodging of a charging order would usually constitute a breach of a borrower's covenants under standard loan documentation. Financiers should ensure that their loan documents provide that the lodging of a charging order against the title to the land constitutes an event of default.

Bell Gully has prepared a guide to the Act – available from www.bellgully.com - and has also prepared "Act-compliant" revisions to the most commonly used New Zealand conditions of construction contracts.

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Recent developments

Changes to stamp duty legislation in New South Wales

Recent changes to NSW stamp duty legislation may affect the structuring of Australian and trans-Tasman funding facilities.

Electronic transactions

How will disclosure by email work under the Credit Contracts Act?

NZBA standard form priority documents available online

Member banks of the NZ Bankers' Association have agreed a number of standard form PPSA compliant priority documents.

Personal Property Securities Register

Access to client training guides and search tips.

Disclosure obligations for directors and officers

Should directors' and officers' shareholdings be more transparent?

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Recent developments

Changes to stamp duty legislation in New South Wales

We have recently been advised of changes to the New South Wales stamp duty legislation, which may affect the way in which Australian and trans-Tasman funding facilities are structured in the future.

In particular, what have been accepted as valid techniques for minimising the amount of stamp duty payable on securities may no longer be effective.

Although the scope of the changes is still being worked through by Australian lawyers, any transaction entered into after 24 June 2003 (including advances made after that date under existing facilities) may be affected.

We will provide more detailed information in the next issue of *Financial Services Quarterly*, but please contact either Alan McDougall (alan.mcdougall@bellgully.com), Murray King (murray.king@bellgully.com) or Rachel Gowing (Rachel.gowing@bellgully.com) if you need advice in the interim.

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Recent developments

Electronic Transactions Act regulations – discussion paper

Practically, how will disclosure by email under the Credit Contracts Act work?

The Minister for Information Technology has released a discussion paper proposing regulations to help achieve the Electronic Transactions Act's objective of giving electronic transactions the same status as paper-based ones.

A number of changes are proposed, including suggested changes to the ways disclosure may be made under the Credit Contracts Act (CCA), including:

- Recipients of disclosure notices should be given a choice between receiving notices by post or electronically, but must have expressly consented to electronic notification.
- Under the Electronic Transactions Act, borrowers are treated as having received information sent electronically when it comes to their attention. Currently, because lenders can't be sure that disclosure notices have come to borrowers' attention within a specified time, it is too risky to send them electronically.
- A 'postal rule', where electronic notices will be treated as having been received four working days after being sent.

You can read the discussion paper online at:
www.med.govt.nz/irdev/elcom/transactions/index.html.

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Recent developments

NZBA standard form priority documents available online

Member banks of the New Zealand Bankers' Association have agreed a number of standard form deeds of priority, and some less formal letters, for use where the secured property:

- is personal property only;
- is property governed by the PPSA (i.e. personal property) and property not governed by the PPSA (e.g. land, large ships, etc.) with one secured amount;
- is property governed by the PPSA and property not governed by the PPSA with a secured amount for each type of property; and
- is land.

These documents are available on the [NZBA website](http://www.nzba.org.nz/prioritydocs.htm) – www.nzba.org.nz/prioritydocs.htm.

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Recent developments

Personal Property Securities Register

The Ministry of Economic Development has reported that registration activity in the PPSR has been consistent with projections, but that searching activity has exceeded expectations to the extent that it expects to be able to announce fee reductions before the end of 2003.

The following statistics have been recorded:

- 100,191 prior security interests were presented in the April "pre-load period" for registration at midnight on 1 May 2002;
- during the transitional period (1 May to 31 October 2002) 931,761 security interests were registered, of which 249,828 were new registrations;
- there was a last-minute rush for re-registration, with 30% of prior security interests (201,162) registered in the final month;
- the following month, the millionth financing statement was registered;
- in the first six months, 474,254 searches were conducted; and
- the millionth search was conducted in April 2003.

PPSR training guides

The Ministry of Economic Development has published a very helpful guide to assist users of the Personal Property Securities Register, taking the reader through all aspects of the register step by step, including setting up secured party groups and registering financing statements. The *PPSR Client Training Guide* is free and a revised version is available online at the PPSR website at www.ppsr.govt.nz.

Search tips

"Did you know" quick tips for PPSR users to improve searching are available via the Ministry of Economic Development's publication *Business Update* – source through www.med.govt.nz.

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Recent developments

Disclosure obligations for directors and officers

Should directors' and officers' shareholdings in listed companies be more transparent?

The Ministry of Economic Development has released a discussion paper considering potential regulations to ensure that information about directors' and officers' shareholdings in listed companies is up to date and transparent.

The Minister of Commerce, Hon Lianne Dalziel, expects regulations to be in place by October 2003. Submissions were due by 30 May 2003.

More information is available online at www.med.govt.nz.

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Bell Gully news

Free seminars and workshops

Specially designed for in-house counsel.

Applications open for CLANZ-Bell Gully Scholarship

Write your way to \$5,000

Rubicon judgment

New Zealand court orders share forfeiture in equity swap case

Regulator Report online

Off the shelf

Other recent newsletters and articles from Bell Gully

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Bell Gully news

Free seminars and workshops from Bell Gully and CLANZ

Bell Gully and CLANZ are running a series of free seminars and workshops throughout 2003, specially designed for in-house counsel.

The seminar series, entitled *Building a Successful In-house Legal Team*, is designed for those counsel that are building, developing or leading an in-house legal service and will be an opportunity to share best practice and debate solutions to common problems within the profession.

During the workshop series *Dealing with Day-to-Day Issues*, Bell Gully staff will update in-house counsel on the latest developments in areas of law and provide common-sense solutions and procedures.

The first seminar, on *Modelling the in-house legal function*, was held on 1 July in Wellington and 2 July in Auckland.

Leading HR consultant John Robertson of John Robertson & Associates facilitated the session with speakers Mike Lennard, Director of Litigation at the Inland Revenue Department, and Phil Griffiths of Griffiths Consulting Limited. Presentations from this seminar are available online at www.bellgully.com.

Future seminars will examine *Delivering quality legal services* in September and *Building an effective in-house legal compliance programme* in November.

The first workshop on *Dealing with workplace stress legislation* was held in Wellington in June. The next workshop will help you *Avoid IT contract nightmares* – it will be held on 29 July in Wellington and on 30 July in Auckland. For more information and booking details, please check our website at www.bellgully.com.

Future workshops will tackle *Handling a Commerce Commission investigation* in September, and *Applying the principles of the Treaty of Waitangi* in November.

The seminars and workshops are free to all CLANZ members. CLANZ membership is free to all New Zealand lawyers employed by a corporate, government department or other organisation, not in private practice. Learn more about CLANZ at www.clanz.org.

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Bell Gully news

Applications open for CLANZ-Bell Gully Scholarship for in-house counsel

A total of \$6,000 in prizes is available to the winners of this year's Corporate Lawyers' Association of New Zealand (CLANZ)-Bell Gully Scholarship, open to in-house lawyers.

The Scholarship winner will receive a \$5,000 scholarship package, designed to advance their professional career.

The Scholarship is open to all CLANZ members (in-house counsel employed by New Zealand companies, government departments and other organisations, not in private practice).

The Scholarship will be awarded for the best paper on the topic "Tips, Tools and Techniques for Developing an In-house Compliance Programme". Two \$500 cash prizes are available for runners-up.

"The Scholarship helps in-house lawyers develop their skills and careers, and provides an opportunity to share experiences and insights with their professional colleagues," said Ron Pol, President of CLANZ.

"This is the second year that Bell Gully has sponsored the Scholarship, and we consider it an important part of our wider support for CLANZ and the in-house profession," said David Flacks, Bell Gully Partner.

Application forms are available [online at www.bellgully.com](http://www.bellgully.com), and entries close on Thursday, 31 July 2003.

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Bell Gully news

New Zealand court orders share forfeiture in equity swap case

In March, the New Zealand High Court ordered the forfeiture of 12 million shares in Rubicon Limited owned by Perry Corporation.

Bell Gully partner David Craig has prepared an article, outlining the facts of the case, the judgment, and the consequences of the decision for equity swap counterparties. The article is available in PDF format from www.bellgully.com.

This case has now been appealed. We are awaiting the decision and will update you in the next issue.

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Bell Gully news

Regulator Report online

Bell Gully's Regulator Report is now available online.

Regulator Report summarises the most recent decisions and developments at New Zealand and Australian exchanges, securities commissions and competition regulators.

It is issued regularly and includes links to media statements, discussion documents, rule and listing changes, exemption notices and policy statements.

Regulator Report is available online at www.bellgully.com and is also available by email to your desktop – email ben.lyon@bellgully.com to subscribe.

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Bell Gully news

Off the shelf: news and publications from Bell Gully

All available at www.bellgully.com/publications/index.html

Takeovers Guide

June 2003

Foreshore and seabed litigation

June 2003

Doing Business in New Zealand

May 2003

Investing in New Zealand Real Estate

May 2003

Please forgive me - I didn't know what I was saying

The Independent, 28 May 2003

New Zealand Budget Report

May 2003

Vicarious liability - When it is the employer's problem

The Independent, 14 May 2003

Termination of employment: employers' and employees' rights and obligations

May 2003

Bonus payments and sex discrimination

The Independent, 30 April 2003

Recent international developments in telecommunications regulation (PDF)

April 2003

How many bodies does it take to build a transport system?

April 2003

Sick and tired - and stressed as well

The Independent, 16 April 2003

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Useful Web links

New Zealand Government

New Zealand Government [www.govt.nz]
NZ Government E-Commerce Information [www.ecommerce.govt.nz]
Office of the Clerk of the House of Representatives
[www.clerk.parliament.govt.nz]
Parliamentary Counsel Office [www.pco.parliament.govt.nz]
Ministry of Economic Development [www.med.govt.nz]
Ministry of Foreign Affairs and Trade [www.mfat.govt.nz]
NZ Treasury [www.treasury.govt.nz]

New Zealand financial agencies and organisations

The Companies Office [www.comcom.govt.nz]
Export Credit Office [www.treasury.govt.nz/exportcreditoffice]
Inland Revenue Department [www.ird.govt.nz]
NZ Law Commission [www.lawcom.govt.nz]
Office of the Banking Ombudsman [www.bankombudsman.org.nz]
Office of Insurance and Savings Ombudsman [www.iombudsman.org.nz]
Office of the Privacy Commissioner [www.privacy.org.nz]
Personal Property Securities Register [www.ppsr.govt.nz]
Reserve Bank of New Zealand [www.rbnz.govt.nz]
Securities Commission [www.sec-com.govt.nz]
Takeovers Panel [www.takeovers.govt.nz]

New Zealand commercial sites

Institute of Chartered Accountants [www.icanz.co.nz]
NZ Business Roundtable [www.nzbr.org.nz]
NZ Institute of Economic Research [www.nzier.org.nz]
NZ Bankers' Association [www.nzba.org.nz]
NZ Stock Exchange [www.nzse.co.nz]
CLANZ [www.clanz.org]

Australian Government

Banking Ombudsman [www.abio.org.au]
National Office for the Information Economy [www.ogo.gov.au]

Australian commercial sites

Australian Financial Markets Association [www.afma.com.au]
Australian Securities and Investment Commission [www.asic.com.au]
Australian Stock Exchange [www.asx.com.au]

International sites

Global Banking Law Database [www.gbld.org]
International Swaps and Derivatives Association [www.isda.org]
International Monetary Fund [www.imf.org]
NASDAQ [www.nasdaq.com]
New York Stock Exchange [www.nyse.com]
United States Securities and Exchange Commission [www.sec.gov]
World Bank [www.worldbank.org]
Bank for International Settlements [www.bis.org]

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