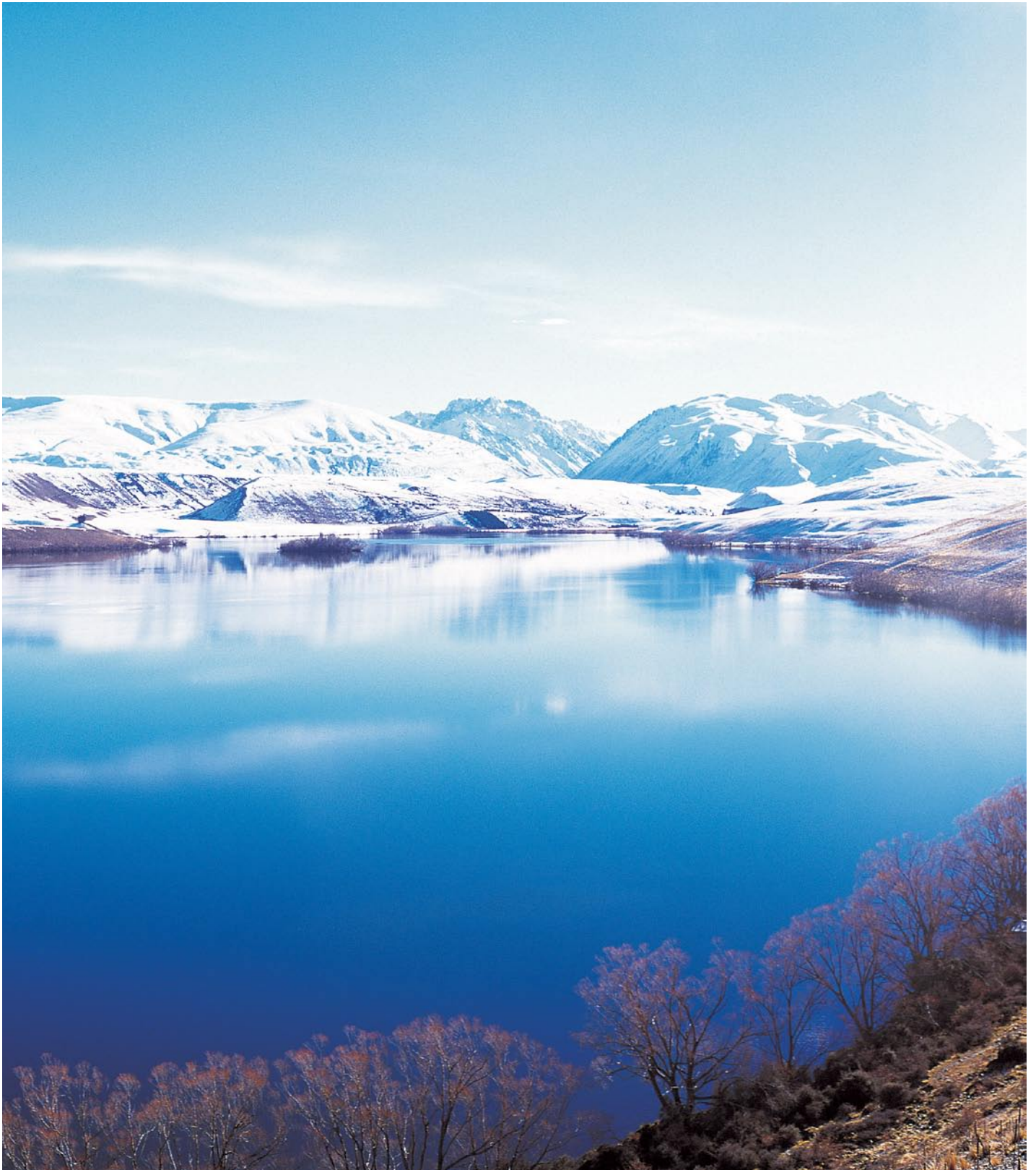


Financial Services Quarterly

WINTER 2005

Bell Gully





Welcome to the Winter 2005 issue of *Financial Services Quarterly*, a review of current legal issues in the financial sector.

Each quarter, we summarise recent issues and preview upcoming developments under these headings:

In the courts
In the journals
Legislation/In Parliament
Recent developments
Bell Gully news
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Disclaimer: this publication is necessarily brief and general in nature. You should seek professional advice before taking any action in relation to the matters dealt with in this publication.

In the courts

Lending to a Maori incorporation

The Court of Appeal has found that a mortgage granted by a Maori incorporation over land at Matauri Bay in Northland was not authorised by the incorporation's objects. However, the question of whether the lender was entitled to assume that the incorporation had taken proper steps to authorise the mortgage remains to be decided.

Sale by receiver extinguishes subordinate security

An appeal is pending following a High Court case that determined that, where a receiver sells personal property of a borrower, the sale automatically releases any security interest in those assets held by subordinate security holders.

Strict obligations for purchasers settling real estate transactions

The Supreme Court has agreed with a vendor under an agreement for sale and purchase that payment by the purchaser of a deposit by personal cheque is insufficient to give certainty of actual receipt of funds, and the vendor was entitled to cancel the agreement. In another recent case, a purchaser was denied specific performance after faxing confirmation of the deposit of settlement funds seven minutes late.

Undue influence over guarantors – new requirements for lenders in New Zealand?

The Court of Appeal has discussed the likely requirements for a defence of undue influence in lending cases in New Zealand.

Clear legal principles for derivative actions by shareholders or directors

In this case, the High Court stated that there is no dispute as to the legal principles applying to applications by a shareholder or director for leave to bring derivative action on behalf of a company under section 165 of the Companies Act 1993.

Goods leasing: no recovery of future rental payments following default

The High Court has indicated that a termination provision in a lease agreement that allows a lessor to recover on default the balance of the rental owing for the whole term, as well as the amounts already due and unpaid, may be viewed as a penalty and therefore be unenforceable.

Set-off arrangements subject to claw-back on liquidation

The Court of Appeal determined that set-off arrangements entered into by a company shortly before liquidation involved a "payment of money" that could be set aside by the liquidator as a transaction having preferential effect under the Companies Act 1993.

Conditional agreement to mortgage not caveatable

In a recent case, the High Court has confirmed the importance of expressing an agreement to mortgage as a present interest in the relevant property.

Discharge of mortgage does not release debtor from obligation to pay

The High Court has held that a discharge of mortgage given by a guarantor, which mistakenly acknowledged receipt of all moneys intended to be secured by that mortgage, only released the relevant property and did not, according to its terms, release the principal debtor or the mortgagor from the repayment obligations owed to the bank.

Pooling of related companies' assets on liquidation allowed in limited circumstances

Despite the doctrine of separate legal personality, the "corporate veil" can be lifted and the assets of a company pooled with the assets of a related company in liquidation if there is some conduct that disentitles the companies from relying on the doctrine.

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The Court of Appeal was required in this appeal¹ to consider the powers of a Maori incorporation to borrow money and to mortgage its land.

The case involved the well-publicised circumstances of the Matauri X Incorporation, which borrowed over \$3 million to invest in a water bottling business but subsequently found itself unable to make the repayments. Security for the loan was a mortgage over the incorporation's land at Matauri Bay, a beauty spot in Northland. Matauri X argued before the Court of Appeal that the loan was beyond its powers and void.

The Court found that the loan and security arrangements were unauthorised. Section 358A of the Te Ture Whenua Maori Act 1993 (the **1993 Act**) preserves the objects of an existing incorporation over and above those provisions of the 1993 Act that would otherwise have permitted the incorporation to carry on any business or enter into any transaction with full capacity. Matauri X was incorporated in 1967 with objects that did not extend to entering into loan and security arrangements for this type of business scheme, and it had not subsequently resolved to dispense with those objects.

However, the Court also concluded that Bridgecorp may possibly have an answer to the finding that the loan was unauthorised on the basis of the "indoor management" rule set out at section 271 of the 1993 Act. Section 271 provides that "a Maori incorporation shall be bound by every act of its committee of management, and no person dealing with the incorporation shall be concerned to inquire in relation to any such act whether the committee is authorised or restricted by any resolution of the shareholders, or as to the terms and conditions of any such resolution". The section goes on to say that "no person lending money to a Maori incorporation shall be concerned to inquire as to the necessity for the loan or as to the application of the proceeds of it". However, this question was referred back to the High Court for further consideration.

The Supreme Court² has subsequently granted Bridgecorp leave to appeal this decision as to Matauri X's powers to enter into the loan and security arrangements. As the Court of Appeal has pointed out, Matauri X may have enjoyed a victory in one battle, but it may yet lose the war.

¹ *The Proprietors Of Matauri X Incorporation v Bridgecorp Finance Limited* (CA8/04, 26 October 2004)

² *Bridgecorp Finance Limited v The Proprietors of Matauri X Incorporated* (SC28/2005, 2 June 2005)



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In the courts

Sale by receiver extinguishes subordinate security

An appeal is pending following a High Court case that determined that, where a receiver sells personal property of a borrower, the sale automatically releases any security interest in those assets held by subordinate security holders.

This important decision was recently highlighted in our FSQ Bulletin of 8 June. A Bill is currently before Parliament that will rectify this effect of the Receiverships Act 1993. However, until the new legislation is passed, a holder of a subordinate security interest over personal property must be very careful to protect its position in any receivership situation.

In this case¹, the debtor company had granted general security interests in favour of a bank and a supplier. Those rights were subject to a deed of subordination and priority, which provided that the bank would have priority up to \$2.5 million.

The bank enforced its security by appointing a receiver. The receiver sold the assets of the company for a sum substantially in excess of the bank's priority amount.

The issue for determination by the Court was whether the balance of sale funds realised by the receiver was held for the benefit of the second security holder or held for all creditors. The Court considered the provisions of section 30A of the Receiverships Act 1993. This section was added after the Personal Property Securities Act 1999 had been passed. The Court favoured a literal interpretation of the provision and held that the sale extinguished the supplier's security. This meant that the supplier was relegated to the position of an unsecured creditor in respect of the proceeds of assets sold by the receiver.

This anomaly is being rectified by amendments to the Receiverships Act 1993 made in the Statutes Amendment Bill (No.5) 2005. The Bill has received its first reading but the date upon which it will become effective is currently unknown.

This decision highlights that, until the amending legislation is passed, holders of second ranking security interests cannot rely on their security if a receiver sells the debtor's assets first. However, this case does not apply to registered mortgages over land, only personal property securities.

The decision is subject to an appeal, which is to be heard on 19 September.

¹ *Re Building Depot Ltd (in receivership and liquidation)* (CIV2005-404-1347, High Court Auckland, 19 May 2005)



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Strict obligations for purchasers settling real estate transactions

The Supreme Court has agreed with a vendor under an agreement for sale and purchase that payment by the purchaser of a deposit by personal cheque is insufficient to give certainty of actual receipt of funds, and the vendor was entitled to cancel the agreement. In another recent case concerning due payment under an agreement for sale and purchase, a purchaser was denied specific performance after faxing confirmation of the deposit of settlement funds seven minutes late.

Case 1: personal cheque does not satisfy obligation to pay deposit

The facts of the case before the Supreme Court¹ involved two agreements for the sale and purchase of parcels of rural land in North Otago, which both provided for a deposit of 10% of the purchase price. The agreements were in the form of the standard ADLS Agreement for Sale and Purchase of Real Estate, the conditions of which (a) require the purchaser to pay the deposit immediately on execution of the agreement and (b) allow the vendor to cancel if the deposit is not paid within three working days of notice of a default in payment. The agreements were signed and a number of months passed without payment of the deposits. The vendor's solicitors gave notice in accordance with the agreements of an intention to cancel the agreements, and the deposits were consequently paid by way of personal cheque from the purchaser shortly before the expiry of the notice period. However, the vendor's solicitors advised that the personal cheque was not legal tender and did not comply with the agreements and gave notice of cancellation.

The Supreme Court dismissed the purchaser's appeal. It found that a person entitled to payment of a deposit is entitled to "the certainty of actual receipt", and that payment must be made by legal tender (bank notes), bank cheque or other cleared funds. A vendor who takes a personal cheque without specifically objecting to it must be taken to have dispensed with that requirement, but otherwise a vendor is entitled to refuse to accept a personal cheque as due payment (and the vendor had no obligation to advise the purchaser in advance that a personal cheque would be unacceptable). The Supreme Court's decision emphasises the importance of certainty and security to the vendor's position.

Case 2: fax settlements and electronic funds transfers

In the second case², the purchaser entered into agreements to purchase ten apartment units in Papakura. The vendor's solicitors subsequently wrote to the purchaser's solicitors specifying that settlement would occur on receipt of the deposit of the settlement amount by bank cheque into their trust account, and that confirmation of this was to be given by fax. The purchaser in fact deposited the settlement amount by electronic funds transfer no less than six minutes before the 5pm expiry time for the settlement notices. The purchaser's solicitors, in attempting to confirm the deposit of the settlement amount, found the vendor's solicitors' fax line to be engaged and did not manage to send confirmation successfully until 5.07pm. The vendor purported to cancel the agreements on the basis of non-tender of settlement, and the purchaser sought specific performance.

The High Court focused on the contractual obligations of the parties (over and above evidence about common conveyancing practices) and found that the standard ADLS Agreement for Sale and Purchase of Real Estate contemplates face-to-face settlement. In this case, however, the parties had subsequently agreed to remote settlement by fax. The Court therefore concluded that the vendor was not entitled to cancel on the basis that face-to-face settlement was required. However, the Court also found that remote settlement is not complete until the fact of payment has been confirmed to the vendor, if the requirement for confirmation has been agreed between the parties. Unfortunately for the purchaser, it was not enough just to dial the fax number – in order for the confirmation to have been "sent", the purchaser needed to show that transmission to the vendor's solicitors' fax number actually occurred. Since successful transmission had occurred seven minutes late, the purchaser was denied specific performance.

The High Court also discussed whether the electronic funds transfer was good performance of the purchaser's payment obligations. Although it was not required to make a decision on the point, it suggested that the time has come for electronic funds transfers to be seen as equivalent to payments in cleared funds by cash or bank cheque. However, this would not have assisted the purchaser in the particular circumstances in question since deposit by bank cheque had been specifically stipulated.

¹ *Otago Station Estates Ltd v Parker* (SC CIV 6/2004, 19 April 2005)

² *Rick Dees Limited v Larsen* (CIV-2004-404-1357, High Court Auckland, 29 April 2005)



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In the courts

Undue influence over guarantors – new requirements for lenders in New Zealand?

The Court of Appeal has discussed the likely requirements for a defence of undue influence in lending cases in New Zealand.

This is an important case, potentially imposing greater obligations on banks and other creditors to ensure that a guarantor in a non-commercial relationship with a borrower has not been subject to undue influence. Creditors should review their current procedures to ensure that they are protected from the possibility of a guarantor avoiding liability on this basis.

Facts

The Court of Appeal¹ heard arguments on behalf of Mr Hogan, a director and former shareholder of his son's company, that a guarantee from Mr Hogan in support of funding for the company from Commercial Factors was given subject to undue influence.

3 step test for undue influence

In its judgment, the Court stated that a guarantor's liability will only be avoided on the basis of undue influence if the following test is satisfied:

1. the guarantor was subject to undue influence (e.g. the exploitation of a relationship of trust and confidence);
2. the circumstances as known to the creditor were such as to put the creditor on inquiry as to the risk of undue influence; and
3. the creditor did not act in such a way as to insulate itself from the consequences of such undue influence.

New Zealand approach

In considering the circumstances in which a creditor would be on inquiry as to undue influence and what steps such a creditor should then take (the second and third points above), the Court of Appeal explicitly suggested that a creditor seeking a guarantee should allow for the possibility that the principles set out in the English case of *Etridge*² would be applied in New Zealand banking cases (although the Court was unwilling to express a definitive view on the point).

The Court of Appeal made no mention of a previous New Zealand High Court decision³ that did not adopt the *Etridge* rules for determining what steps a bank must take to discharge its duty in relation to the risk of undue influence (although that case did apply the *Etridge* test for establishing when a bank is put on inquiry). The safest approach for New Zealand banks is now to assume that the *Etridge* principles apply in full.

Etridge principles

In *Etridge*, the House of Lords held that banks should regulate their affairs on the basis that they are put on inquiry in every case where the relationship between the guarantor and the borrower is non-commercial, and must always take reasonable steps to bring home to the individual guarantor the risks that he or she is running by standing as guarantor.

Those reasonable steps are:

1. checking directly with the guarantor the name of his or her solicitor, and communicating directly with the guarantor that the creditor requires (for its own protection) written confirmation from that solicitor that the guarantee and its implications have been fully explained to the guarantor;

2. providing the guarantor's solicitor with the financial information needed for that purpose;
3. if the bank believes that the guarantor has been misled by the borrower and is not entering the transaction of his or her own free will, informing the guarantor's solicitor of the facts giving rise to that suspicion; and
4. obtaining written confirmation of the above from the guarantor's solicitor.

These principles go further than current New Zealand banking practice, by requiring creditors to make direct contact with potential guarantors. Previously, it has been sufficient for creditors to insist that a guarantor be given independent legal advice and to obtain a solicitor's certificate that the implications of the guarantee have been explained to and understood by the guarantor.

Result

The Court of Appeal found in this case there was no evidence of any person exercising undue influence over Mr Hogan (rather, he appeared to have been the driving force behind the funding transaction), nor any factors that put Commercial Factors on inquiry as to the risk of undue influence. The Court was satisfied that the transaction was a commercial one from Mr Hogan's point of view. However, it also noted that Commercial Factors did little to ensure that the guarantors were not subject to undue influence, although it wrote to the company strongly recommending independent legal advice for the guarantors.

¹ *Hogan v Commercial Factors Limited* (CA225/03, 10 November 2004)

² *Royal Bank of Scotland plc v Etridge (No.2)* [2002] 2 AC 773

³ *Lee v Damesh Holdings* (CA77/03, 30 September 2003)



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In the courts

Clear legal principles for derivative actions by shareholders or directors

In this case, the High Court stated that there is no dispute as to the legal principles applying to applications by a shareholder or director for leave to bring derivative action on behalf of a company under section 165 of the Companies Act 1993.

Tweedie and Newcombe, the directors and shareholders of Packsys, fell out. Tweedie sought leave of the Court¹ to sue Newcombe in Packsys's name and at its expense because Newcombe had set up a Packsys business in Australia without proper authorisation or consent. The Court observed that the falling out of the parties was not helped by Tweedie twice covertly gaining entry to Packsys's premises and removing material, including cloning the hard drive on its computers, in search of evidence to support his assertions.

Section 165 of the Companies Act 1993 allows a shareholder or director of a company to take action on behalf of and in the name of the company in any situation where the company has a right to proceed that it is not exercising. The shareholder or director must first obtain the leave of the Court.

The High Court in this case made it clear that the test for the granting of leave is whether a prudent business person would be likely to commit the company to litigation, should the decision lie with that person, after considering the factors listed in section 165(2).

Section 165(2) requires consideration of:

1. the likelihood of success;
2. the likely costs in relation to the likely relief;
3. any action already taken by the company to obtain relief; and
4. the interests of the company in proceedings being commenced.

The Court observed that the threshold for granting leave under section 165 is not high, and noted an earlier case² in which it was said that applications such as these are not an interim trial on the merits, but require consideration of the amount at stake, the apparent strength of the case, the likely costs and the prospect of satisfaction of any judgment.

In this case, Tweedie was granted leave, although Williams J advised both parties to resolve their differences without litigation: *"They should bear in mind that the evidence to date suggests the amount in issue in the case may well turn out to be of no great moment and that, at the end of the litigation unless something else occurs, they will still both be shareholders and directors of Packsys. Derivative actions are not an appropriate vehicle for leveraging increased share offers by third parties or directing share sales"*.

¹ *Tweedie and others v Packsys Limited and Newcombe* (CIV 2005-404-1038, High Court Auckland, 2 June 2005)

² *Vrij v Boyle* (CP31/94, High Court Auckland, 24 July 1995)



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In the courts

Goods leasing: recovery of future rental payments following default

The High Court has indicated that a termination provision in a lease agreement that allows a lessor to recover on default the balance of the rental owing for the whole term, as well as the amounts already due and unpaid, may be viewed as a penalty and therefore be unenforceable.

In our experience, this type of provision is reasonably common and therefore the High Court's judgment may have important consequences for lessors. However, the decision was made in an application for summary judgment and further arguments will be heard at a full defended hearing.

The High Court heard an application for summary judgment¹ from a lessor, Steelbro, for amounts due under two commercial trailer lease agreements of 60 months each.

The lessee, Marshall, only made payments under the two leases for periods of five months and two months respectively. The trailers were repossessed, and Steelbro subsequently leased one trailer to another lessee and sold the other.

The amounts that Steelbro sought to recover from Marshall by way of summary judgement included (in accordance with the termination provisions of each lease agreement) the due and unpaid amounts under both leases, the balance of the rental payments for the whole 60 month term under both leases, and penalty interest on all amounts.

The Court granted summary judgment for the amounts outstanding as at the termination date of the leases together with penalty interest on those amounts, but refused summary judgment on the balance of the rental payments or penalty interest on those payments.

Associate Judge Abbott agreed with Marshall's counsel that there were substantial benefits to Steelbro in receiving a lump sum for future rentals as distinct to receipt of that money over the remaining term of the agreements. He noted that *"in my view the requirement for immediate payment of all future rental without allowing any discount for acceleration or payment (by as much as four-and-a-half years) means that the plaintiff would recover significantly more as a result of the defendant's default than it would have had the lease run its course. On that basis alone I find that [the termination provision] is penal in nature and unenforceable"*.

The Court acknowledged that a lessor is entitled to recover non-penal liquidated damages following default and, in that respect, a lessor may rely on the "worst case scenario" to calculate a genuine pre-estimate of damages. However, Associate Judge Abbott expressed serious doubt as to whether the relevant termination provisions in this case were a genuine pre-estimate given the context (in other words, whether Steelbro's trading position and the state of the market for such trailers at the time was such that it was a real and reasonable likelihood that Steelbro could not re-sell or re-let the trailers in the event of a breach).

¹ *Steelbro New Zealand Limited v Marshall and others* (CIV 2004-404-3233, High Court Auckland, 22 June 2005)

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In the courts

Set-off arrangements subject to claw-back on liquidation

The Court of Appeal determined that a set-off arrangement entered into by a company shortly before liquidation involved a “payment of money” that could be set aside by the liquidator as a transaction having preferential effect under the Companies Act 1993.

This is a curious decision and one that should concern all those whose businesses rely on the enforceability of contractual set-off (such as banks and derivatives counterparties). An application for leave to appeal to the Supreme Court has been made.

Trans Otway Limited and Newman Carrying Limited agreed that the companies would set off the debts that each owed to the other. These debts included \$95,000 owed by Newman Carrying to Trans Otway for freight services and the same amount owed by Trans Otway to Newman Carrying by way of an agreement for the purchase of Newman Carrying’s client list. Newman Carrying went into liquidation shortly after the set-off agreement was entered into, and the liquidators sought to recover \$95,000 from Trans Otway.

Under section 292 of the Companies Act 1993, a liquidator may set aside a “payment of money” as a transaction having preferential effect if it:

1. was made at a time when the company was unable to pay its debts and within two years of the liquidation;
2. enabled another person to receive more towards satisfaction of a debt than the person would otherwise have received or be likely to have received in the liquidation; and
3. was not made in the ordinary course of business.

The issue for the Court of Appeal in this case¹ was whether the set-off arrangements involved a “payment of money” for the purpose of section 292(1)(e). The Court found that there is no requirement in this respect for the physical passing of a cash or cheque, and payment may be effected by way of set-off.

The Court stated that it was not required to determine whether the set-off arrangement enabled Trans Otway to receive more towards satisfaction of the debt owed by Newman Carrying than Trans Otway would have received in the liquidation. However, the Court nonetheless went on to say that *“Newman’s “payment” of its \$95,000 debt to Trans Otway clearly enabled Trans Otway to receive more towards satisfaction of that debt than Trans Otway would otherwise have received or be likely to have received in the liquidation. That is self-evident. The debt was paid in full. Clearly, if the debt had not been paid, Trans Otway would now be proving in the liquidation and would receive in respect of that debt a very much lower figure”*.

Consequently, the amount owed by Newman Carrying that had been set off by Trans Otway could potentially be clawed back by the liquidators.

This decision appears to conflict with well-established authority that a creditor will not be regarded as having been “preferred” if it is merely put in the same position that it would have been in had the mandatory liquidation set-off rule applied. That rule is set out in section 310 of the Companies Act 1993 and would have applied to set off the debts of Trans Otway and Newman Carrying for the purposes of any claim by Trans Otway in the liquidation.

Also, there seems to have been a good argument for saying that the set-off agreement was a “bilateral netting agreement” for the purposes of section 310A of the Companies Act 1993. If that were the case, only the “netted balance” (zero in this case) would have been claimable by the liquidators from Trans Otway. However, the argument seems not to have been considered by the Court of Appeal.

¹ *Trans Otway Limited v Shepard and Dunphy* (CA98/04, 13 June 2005)

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In the courts

Conditional agreement to mortgage not caveatable

In a recent case, the High Court has confirmed the importance of expressing an agreement to mortgage as a present interest in the relevant property.

Kuek owed Liang a debt and a document was signed by Kuek, which Liang alleged was an agreement to mortgage. In the document, Kuek promised as follows: *"Now I failed to provide the goods or return the money...I am willing to put a house property of mine in pledge to guarantee the payment of the debt mentioned above"*.

An agreement to mortgage creates a caveatable interest, and Liang registered a caveat over Kuek's property after receiving legal advice.

On an application by Liang that the caveat should not lapse¹, the High Court found on the facts that the document did not constitute an agreement to mortgage. Kuek's promise was read to be a statement by Kuek that he owns a house, and therefore has capacity to meet the debt, and, if required, will provide security for the debt. The Court emphasised that the terms of an agreement to mortgage must be expressly stated so as to avoid the agreement amounting to a promise of future action.

The High Court also confirmed that, in order for an agreement to mortgage to create a caveatable interest, both the equitable mortgagee and the equitable mortgagor must be parties to and sign the agreement.

¹ *Liang v Kuek* (CIV 2005-404-001930, High Court Auckland, 22 June 2005)



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In the courts

Discharge of mortgage does not release debtor from obligation to pay

The High Court has held that a discharge of mortgage given by a guarantor, which mistakenly acknowledged receipt of all moneys intended to be secured by that mortgage, only released the relevant property and did not, according to its terms, release the principal debtor or the mortgagor from the repayment obligations owed to the bank.

This case is a useful reminder of the need to ensure that any discharge of mortgage expressly does not release any other securities or obligations.

Back in the 1980s, a bank made a series of loans to Taylor. The loans were supported by a guarantee and mortgage from Taylor's mother. By the late 1980s, Taylor was having difficulty meeting his repayment obligations and the parties eventually entered into a deed of settlement in 1991. That deed acknowledged a debt of \$250,000 and agreed that \$100,000 would be paid off by Taylor immediately and the remaining \$150,000 would be payable on the death of Mrs Taylor from the proceeds of the sale of her home. Mrs Taylor died in 1999. However, the bank mistakenly discharged the mortgage over her property without first requiring payment of the \$150,000. The bank also advised the executors (one of whom was Taylor) that no money was owed under the mortgage. The estate was distributed before the bank discovered its mistake. The High Court heard proceedings brought by the bank seeking recovery of the money from Taylor.

The Court did not accept Taylor's argument that the discharge of the mortgage released Taylor from his obligations as debtor. The wording of the deed of settlement clearly made Taylor a principal debtor in respect of all liabilities and obligations to the bank. Although the bank's discharge of the mortgage acknowledged receipt of all moneys intended to be secured by the mortgage, it was equally clearly given *"without releasing or discharging the Mortgagor/s or any other person or persons...under the within obligations or any collateral instrument or otherwise"*.

The High Court also rejected Taylor's estoppel defence. In the Court's view, Taylor knew of the bank's error and the fact that \$150,000 remained owing under the deed of settlement, but withheld that information from the estate's solicitors: Hansen J stated that *"no representation can be relied on as an estoppel where it is induced by the concealment of a material fact on the part of the person who wishes to use the representation as an estoppel"*. In addition, the Court found that Taylor had suffered no detriment as a result of the bank discharging the mortgage and advising that no further money was owed.

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In the courts

Pooling of related companies' assets on liquidation allowed in limited circumstances

Despite the doctrine of separate legal personality, the "corporate veil" can be lifted and the assets of a company pooled with the assets of a related company in liquidation if there is some conduct that disentitles the companies from relying on the doctrine.

A pooling order is a way for a Court to look through the barriers between related companies where it just and equitable to the creditors of a company in liquidation. Pooling orders are uncommon in New Zealand, but have the potential to affect the rights of a creditor in the event of the insolvency of a related company.

The liquidator of Tasman Pacific Regional Airlines (**TPRA**) applied for a pooling order¹ under sections 271 and 272 of the Companies Act 1993 in respect of TPRA and its holding company Tasman Pacific Airlines, trading as Qantas New Zealand (**Qantas NZ**). Qantas NZ collapsed in 2001.

The question for the High Court was how sections 271 and 272, under which a related company can be ordered to pay claims in the liquidation of another company, can be reconciled with section 15 of the Companies Act 1993, which establishes that each company is a legal entity in its own right with separate legal personality. Justice Baragwanath considered that the Court should uphold the doctrine of separate legal personality unless there is some conduct which disentitles the companies from relying on it.

Qantas NZ and TPRA operated as separate companies. However, TPRA provided servicing, maintenance and crew to Qantas NZ and relied on it for over 99% of its income. The Court also found that Qantas NZ directed TPRA to transfer \$650,000 to it (at a time when Qantas NZ was insolvent, according to TPRA's liquidator) and the transfer was later treated as a nil debt between the companies.

The High Court was required to consider, under section 272:

1. the extent to which Qantas NZ took part in the management of TPRA;
2. the conduct of Qantas NZ towards the creditors of TPRA;
3. the extent to which the circumstances that gave rise to the liquidation of TPRA were attributable to the actions of Qantas NZ; and
4. such other matters as it thought fit.

Justice Baragwanath concluded that a pooling order should be granted because:

1. although TPRA operated as a separate and autonomous entity, it was dependent on Qantas NZ and the insolvency of Qantas NZ made TPRA insolvent;
2. Qantas NZ removed funding that would have allowed TPRA to survive, which put TPRA's creditors at risk;
3. Qantas NZ provided TPRA with a bad debt which contributed to TPRA's insolvency; and
4. TPRA's directors (who were also directors of Qantas NZ) breached their duties by allowing TPRA to grant credit to an insolvent holding company, and this blurred the separate identities of the companies.

The effect of the pooling order was to allow unsecured creditors of TPRA partial recovery. As Justice Baragwanath said: *"such an order, which would reduce the parent's return by only half a cent in the dollar but bring the regional creditors to equality, should be made to remove an injustice caused by [Qantas NZ]'s wrongful abstraction of [TPRA]'s funds"*.

¹ *Mountfort v Tasman Pacific Airlines of NZ Limited* (CIV 2004-404-1843, High Court Auckland, 12 July 2005)

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In the journals

The PPSA and the common law

This article explores areas in which Canadian cases have relied on common law principles to supplement or interpret the relevant personal property securities legislation, and considers the relevance of those decisions in New Zealand.

Security over book debts in England

A recent test case in the English courts has considered the requirements for a bank taking security over book debts. Two articles on the case consider, firstly, the question of whether separate security can be taken over book debts and their proceeds and, secondly, the consequences of the House of Lords decision that the charge given over book debts and their proceeds was a floating charge.

Negligence liability for pure economic loss

This article discusses an English case in which a bank was found to owe a duty of care to a creditor that had obtained freezing orders over the accounts of two of the bank's customers.

Contractual duress and the Supreme Court

The elements of the defence of contractual duress in New Zealand have recently received attention from the Court of Appeal, but in refusing leave to appeal the Supreme Court has left some confusion as to the correct principles applying in this area.

Finance and factoring

This special feature examines the business of factoring and discounting debts in New Zealand.

Impending securities and money-laundering reform in New Zealand

In two recent initiatives, the Government has signalled impending law reform that will impact on the finance and securities sector.

Banks count the cost of money laundering

KPMG has reported on banks' increased spending on anti-money laundering systems.

CCCFA might affect residential sale and purchase

This article considers that a residential sale and purchase agreement may be a "consumer credit contract" for the purposes of the Credit Contracts and Consumer Finance Act 2003 in some circumstances.

Simms revisited

The legal principles applying in Australia where a bank pays a cancelled cheque and subsequently seeks to recover the payment from the payee are analysed.

Age discrimination and bank lending

Would a New Zealand bank have a defence to an age discrimination claim by a borrower?

The reckless launderer

This article explores the offence of "reckless laundering" under the Crimes Act 1961, and the risks involved in any transaction where a large sum of cash changes hands.

In the journals

The PPSA and the common law

Anthony Duggan, *New Zealand Business Law Quarterly*, May 2005

This article explores areas in which Canadian cases have relied on common law principles to supplement or interpret the relevant personal property securities legislation, and considers the relevance of those decisions in New Zealand.

The article focuses on the implications, in three areas, of the Personal Property Securities Act 1999 (the **PPSA**) being supplemented or interpreted by reference to the common law. The author discusses how the Canadian courts have resorted to common law principles in those areas, and considers the relevance of those decisions in New Zealand. The conclusion of the article is that familiarity with the PPSA requires an understanding of common law principles as well as the statute itself.

Contract formation

The author discusses Canadian cases in which the courts were required to consider whether or not an enforceable security agreement existed, and concludes that the cases establish that:

1. a security agreement does not necessarily have to be in writing, so long as the secured party can prove the agreement; but
2. as a general rule, a security interest will be unenforceable against third parties in the absence of writing (although it is sufficient if the writing evidences the agreement rather than contains all the terms).

Subrogation

The doctrine of subrogation is considered in light of a Canadian case in which a second mortgagee (which paid off the first mortgage but which had not registered a financing statement in respect of its security interest) was entitled to exercise the rights of the first mortgagee (which had a perfected security interest in the mortgagor's property).

Tracing

The author discusses the Canadian courts' approach to allowing a right to trace proceeds, and notes that a secured party's statutory right may go further than equitable tracing principles. The author considers in particular a Canadian case in which a secured party's interest in a herd of cattle was found to follow the proceeds of the sale of the herd through the debtor's overdraft account and into a new herd of cattle purchased using that overdraft.



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In the journals

Security over book debts in England

"More on book debts", P G Turner, *The Australian Law Journal*, April 2005

"Thinner", *The Economist*, 9 July 2005

A recent test case in the English courts has considered the requirements for a bank taking security over book debts. Two articles on the case consider, firstly, the question of whether separate security can be taken over book debts and their proceeds and, secondly, the consequences of the House of Lords' decision that the charge given over book debts and their proceeds was a floating charge.

In the first article, the author discusses the Court of Appeal decision¹, in which the Court said that it is not possible for a bank to take separate security over a borrower's book debts and their proceeds. The Court found that a debenture imposing restrictions on the use of the proceeds of book debts also created a fixed charge over book debts themselves. Mr Turner describes other cases and commentary that support the opposite idea that book debts and their proceeds are in fact legally divisible.

The second article summarises the broader implications of the eventual House of Lords decision, which allowed the appeal and reversed a long-standing 1979 judgment² that a charge is a fixed charge if the lender and the borrower so agree. The House of Lords in this case found that the borrower had given the bank a floating charge over its debts and proceeds and not a fixed one. Whether a charge is truly fixed or floating, said the House of Lords, depends on how much control the borrower has over the charged assets and not on how it is described by the parties. The author points out that this decision will have considerable significance for floating charge-holders, who may now be able to recover more in a liquidation than under the previous law. Banks and other creditors in the UK will need to consider more closely how to secure repayment from trade borrowers.

In New Zealand, however, the Personal Property Securities Act 1999 has effectively removed the distinction between fixed and floating charges. A security interest in after-acquired property is treated in the same way as a security interest in existing property, and will attach in accordance with the Act without reliance on any subsequent crystallising event.

¹ *Re Spectrum Plus Ltd (In liq)* [2004] Ch 337

² *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142

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In the journals

Negligence liability for pure economic loss

Paul Mitchell and Charles Mitchell, *Law Quarterly Review*, April 2005

This article discusses an English case in which a bank was found to owe a duty of care to a creditor that had obtained freezing orders over the accounts of two of the bank's customers.

In this article, a case¹ is analysed in which the English Court of Appeal found that a bank owed a duty of care to a creditor that had obtained freezing orders over money held by two debtors in accounts at the bank. The case (and the article) explores the various approaches to determining negligence that have been laid down by the courts in cases of economic loss, and will be of interest to banks in considering the extent of their duties to non-customers.

1 *Customs and Excise Commissioners v Barclays Bank Plc* [2004] EWCA Civ 1555



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In the journals

Contractual duress and the Supreme Court

Rick Bigwood, *The New Zealand Law Journal*, May 2005

The elements of the defence of contractual duress in New Zealand have recently received attention from the Court of Appeal, but in refusing leave to appeal the Supreme Court has left some confusion as to the correct principles applying in this area.

The traditional approach to contractual duress, originally set out by the House of Lords¹ and subsequently adopted in New Zealand², is a two-pronged test requiring:

1. pressure amounting to compulsion of the will; and
2. the illegitimacy of the pressure exerted.

However, the New Zealand Court of Appeal has recently suggested that the matter today is a little more complex. In fact, according to the Court, there now exist seven elements of contractual duress, as follows:

1. a threat or pressure;
2. the threat or pressure is improper;
3. the victim's will has been overborne by the improper pressure so that his free will and judgment have been displaced;
4. the threat or pressure actually induces the victim's manifestation of assent;
5. the threat or pressure was sufficiently grave to justify the assent from the victim in the sense that it left the victim with no reasonable alternative;
6. duress rendered the resulting agreement voidable at the insistence of the victim; and
7. the victim may be precluded from avoiding the agreement by affirmation.

The author is of the view that this latest judgment creates unnecessary confusion in what was a relatively settled area of law. Nevertheless, he concedes that, at least for the moment, this most recent Court of Appeal case may well represent the primary authority on contractual duress in New Zealand. However, leave to appeal to the Supreme Court was refused on the basis that "*the law of New Zealand on the subject of duress is sufficiently clear and settled*", referring in particular to a Privy Council decision that followed the two-pronged test mentioned above, and so some uncertainty remains as to the Supreme Court's perception of the law in this area.

¹ *Universe Tankships Inc of Monrovia v International Transport Workers Federation* [1983] 1 AC 366

² *Shivas v Bank of New Zealand* (CP1/89, High Court Timaru, 14 November 1989)

³ *Pharmacy Care Systems Ltd v Attorney-General* (CA 198/03, 16 August 2004)



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In the journals

Finance and factoring

Anthony Davies, *The Independent*, 11 May 2005

This special feature examines the business of factoring and discounting debts in New Zealand.

The feature includes a number of articles explaining the nature of factoring and invoice discounting, and the current status of the New Zealand market.

Full-service factoring is where the factor buys all or part of the client's debtors' ledger and then assumes responsibility for collecting the debts. Invoice discounting, also known as confidential or non-disclosed factoring, is where the discounter buys the debts but the client retains control of the ledger and the relationship with the debtors.

While factoring and discounting are still relatively small industries in New Zealand, the articles include comments from a number of businesses and financiers pointing to the growth of the practice. The special feature also includes an article exploring current trends in trade finance products and trade credit insurance.



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In the journals

Impending securities and money-laundering reform in New Zealand

David Craig (partner, Bell Gully), *Butterworths Journal of International Banking and Financial Law*, May 2005

In two recent initiatives, the Government has signalled impending law reform that will impact on the finance and securities sector.

Securities Legislation Bill

This Bill amends the provisions of the Securities Markets Act 1988 relating to insider trading, including imposing criminal liability, and the insider conduct prohibitions purport to extend to cover trading in futures contracts.

The Bill also introduces three market manipulation offences: making misleading statements, causing misleading appearance of trading, and generally engaging in misleading conduct.

The Investment Advisers (Disclosure) Act 1996 will be replaced under this Bill with a new regime that requires investment advisers and investment brokers to give their clients a disclosure statement before giving them advice.

Money laundering

In February 2005, the Government announced new laws to counter money laundering. The legislation to be introduced will include a registration regime for those providing money transfer or currency change services and will require financial institutions to implement internal anti-money laundering systems.

The Government is also considering a regime that would require directors and senior managers of certain non-bank financial institutions to be evaluated to ensure that they meet the "fit and proper persons" criteria.



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In the journals

Banks count the cost of money laundering

Chartered Accountants Journal of New Zealand, June 2005

KPMG has reported on banks' increased spending on anti-money laundering systems.

KPMG's report addressed the issues of the impact of the recent rapid strengthening of laws and regulations to combat money laundering, and how banks are coping with their increased responsibilities as the gatekeepers of the financial system.

Of the 209 banks interviewed in 41 countries about their spending over the past three years, 83% said they have increased spending on anti-money laundering, on average by 61%. The trend is set to continue, with most banks expecting their spending to increase by over 40% over the next three years, demonstrating that much remains to be done to enhance anti-money laundering systems and controls.



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In the journals

CCCFA might affect residential sale and purchase

Property Law Section, *NZLS Lawtalk*, 4 July 2005

This article considers that a residential sale and purchase agreement may be a "consumer credit contract" for the purposes of the Credit Contracts and Consumer Finance Act 2003 in some circumstances.

The primary provisions of the CCCFA apply to "consumer credit contracts".

It is important to note that a contract for the sale and purchase of property will not be a "consumer credit contract" if:

- the purchaser is not a natural person;
- the property is bought for a business or investment purpose;
- the contract does not provide for interest or credit fees to be payable by the purchaser, or for security to be taken by the vendor;
- the vendor does not make a practice of providing credit or entering into credit contracts, and the parties have not been introduced through a paid adviser or broker; or
- the total price is payable within two months of the date of the contract.

It is not possible to contract out of the CCCFA if a contract for the sale and purchase of property otherwise meets the definition of a "consumer credit contract".

This article points out that, where the vendor agrees to defer settlement, thereby making credit available to the purchaser, the Credit Contracts and Consumer Finance Act 2003 (the **CCCFA**) may apply. The article describes possible indicators of a deferred obligation to pay as follows: the purchase price being described as deferred; the agreement providing for interest to be payable on the purchase price prior to settlement; the purchase price being higher than if the settlement date were earlier; and possession being given prior to settlement.

However, an exemption is available under section 15(1)(a) of the CCCFA where payment of the purchase price is made within two months of the date of the agreement. The article suggests a clause that could be added to a residential sale and purchase agreement where the purchase price is payable after more than two months, which is intended to confirm that there is no deferment of payment and that the CCCFA does not apply.



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In the journals

Simms revisited

Dr Alan Tyree, *Journal of Banking and Finance Law and Practice*, June 2005

The legal principles applying in Australia where a bank pays a cancelled cheque and subsequently seeks to recover the payment from the payee are analysed.

Where a customer instructs a bank to stop payment on a cheque, the customer's countermand does not cancel the debt owed by the customer. In the English case of *Simms*¹, in which a bank paid a countermanded cheque and then sought to recover the money from the payee as a payment made under mistake of fact, the following principles were also not disputed: *"a bank which pays a cheque drawn or purported to be drawn by its customer without mandate...unless the customer is able to and does ratify the payment, the bank cannot debit the customer's account, nor will its payment be effective to discharge the obligation (if any) of the customer on the cheque, because the bank had no authority to discharge such obligation"*.

In this article, it is argued that the *Simms* analysis (that the debt is not discharged because the cheque is paid without authority) does not represent the law in Australia. The author analyses the Australian legal situation and concludes that the debt is discharged by payment of the debt since the money is paid by the paying bank itself, for which it does not need authority from the customer. The bank does, however, need the customer's authority to debit the amount from his or her account.

Furthermore, recovery of money paid under a mistake of fact is based on a concept of unjust enrichment, but the payee of a countermanded cheque has not been unjustly enriched if he or she is in fact owed the money. The fact that the bank's customer may be enriched if the bank cannot debit his or her account is of no concern to the payee.

Finally, the author argues that the payee should be able to resist on the grounds of a change of position: *"it is hard to imagine a more prejudicial position than to go from being paid to being the holder of a discharged cheque"*.

The provisions of the Australian Cheques Act 1986 (Cth) and other legal principles discussed in this article have similar equivalents in New Zealand.

¹ *Barclays Bank Ltd v W J Simms Son and Cooke (Southern) Ltd* [1979] 3 All ER 522



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In the journals

Age discrimination and bank lending

Andrew Shann, *New Zealand Law Journal*, June 2005

Would a New Zealand bank have a defence to an age discrimination claim by a borrower?

Section 21 of the Human Rights Act 1993 prohibits discrimination based on age. There are some exceptions in the Act (for instance, in situations where the Human Rights Tribunal declares there to be a genuine justification for treating somebody differently), but there are no specific exceptions for age in relation to the provision of credit and it is unclear whether the exceptions cover this situation.

The author points out that there is an exception in the Australian Age Discrimination Act 2004, which strengthens the chance of there being a genuine justification as a defence in New Zealand, but this defence has not been tested in New Zealand in the context of the provision of credit.



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In the journals

The reckless launderer

David Johnstone, *New Zealand Law Journal*, June 2005

This article explores the offence of “reckless laundering” under the Crimes Act 1961, and the risks involved in any transaction where a large sum of cash changes hands.

In late 2003, an amendment to the Crimes Act 1961 came into force, creating a new section 243, which made it an offence to be a “reckless launderer” of money.

The author suggests that, wherever a transaction involves an unusually large sum of cash, there is a risk that it was derived from serious offending. If that is the case, everyone who deals with large sums of cash is in jeopardy of prosecution as a reckless launderer if the cash turns out to be derived from a serious offence.

The author goes on to suggest that, although it would not be a defence in itself, the potentially reckless launderer should report the transaction to the appropriate law enforcement agency, which could be the basis for a defence of good faith (which is an available defence under section 244). Alternatively, the potentially reckless launderer should not participate in the transaction at all.



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Legislation/In Parliament

New limited partnership regime

The Government has announced that a Bill to give effect to a new limited partnership regime will be introduced next year to encourage venture capital investment in New Zealand.

Review of non-bank finance sector and changes to credit union rules

The Government has also announced a review of how a number of non-bank financial products and providers are regulated. In the same announcement, the Minister of Commerce announced proposed changes to the legislation governing friendly societies and credit unions.

Greater protection for sensitive and heritage sites

The Overseas Investment Act passed by Parliament in June is intended to tighten the screening and monitoring regime for overseas persons seeking to purchase properties in New Zealand that have special cultural or environmental value.

Securities Legislation Bill update

The Commerce Committee recently presented its Select Committee report on the Securities Legislation Bill back to Parliament, recommending that it be passed subject to certain amendments.

Legislation/In Parliament

New limited partnership regime

The Government has announced that a Bill to give effect to a new limited partnership regime will be introduced next year to encourage venture capital investment in New Zealand.

A limited partnership has separate legal personality and comprises general and limited partners. A general partner is personally liable for the debts of the partnership, but a limited partner is liable only to the extent of his or her investment and only has management involvement in limited circumstances (not dissimilar to a company shareholder). New Zealand limited partnerships will be given flow-through tax status under the new legislation, so that each partner is taxed at his or her personal tax rate rather than a tax being levied on the partnership.

The new regime is expected to align New Zealand's regulatory framework with international standards, with the intention of providing overseas venture capital investors with greater clarity and certainty. The current New Zealand concept of special partnerships is believed to be a barrier to investors who are not familiar with that terminology.



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Legislation/In Parliament

Review of non-bank finance sector and changes to credit union rules

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The next year or so will be an important period for finance companies and non-bank financial institutions in terms of understanding, and having the opportunity to make submissions on, the direction of the Government's thinking. Bell Gully has established a team to focus on these developments (see article on Bell Gully's Finance Companies Focus Group in the Bell Gully news section) and will be able to provide advice on what the changes mean for your business in practice.

The Government's review of non-bank financial products and providers will cover superannuation, insurance, managed fund products, and securities offerings, and the regulation of non-bank providers generally. Policy decisions on the review are expected in late 2006 with any changes to be effective in 2008.

The Minister of Commerce has also announced that changes to the legislation governing friendly societies and credit unions is expected later in 2005 in order to remove certain current restrictions. For instance, under the proposed changes, credit unions will be able to extend new services to their members. Other areas for change will be considered in the review of non-bank financial products and providers mentioned above.

The Minister said that *"Credit unions and friendly societies play an important role in providing financial services to New Zealanders who do not have access to mainstream banking providers. The proposed changes, and those to be developed through the review, should give these institutions greater flexibility to grow and bolster their value to consumers and the wider market."*



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Legislation/In Parliament

Greater protection for sensitive and heritage sites

The Overseas Investment Act passed by Parliament in June is intended to tighten the screening and monitoring regime for overseas persons seeking to purchase properties in New Zealand that have special cultural or environmental value.

These changes are expected to take effect later in the year (the current proposed date is 1 September). They will concern any overseas person considering investment in New Zealand after that date.

The new Act will replace the Overseas Investment Act 1973 and the Overseas Investment Regulations 1995, prescribing the criteria for overseas investment in New Zealand assets.

The specific changes that will be introduced by the Overseas Investment Act 2005 are as follows:

1. Overseas applicants wishing to purchase land assets will have to provide (as conditions to consent) management plans detailing how they will manage any historic, heritage, conservation or public access factors relevant to the property as well as any economic development planned.
2. The onus of compliance will be on the overseas investor, who must report regularly on compliance.
3. The Crown will have a right of first refusal over any foreshore, seabed, riverbed or lakebed where this would otherwise be sold into foreign ownership.
4. The threshold for screening non-land business assets where the proposed acquisition entails a 25% or more shareholding will be raised from \$50 million to \$100 million. This reflects the rarity with which business applications not involving land are rejected (the last time being 1984).
5. Purchases involving land with an unimproved value of more than \$10 million will no longer require consent where the land is not screened for other reasons. This is expected to affect only purchases within the main centre CBDs, since rural land sales over 5 hectares will continue to require consent.
6. Land adjoining some non-sensitive reserves, for example drainage and hospital reserves, will be removed from the scope of the regime.

Additionally, the Overseas Investment Commission will be disestablished and its regulatory functions performed by a dedicated unit within Land Information New Zealand (the Overseas Investment Office).



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Legislation/In Parliament

Securities Legislation Bill update

The Commerce Committee recently presented its Select Committee report on the Securities Legislation Bill back to Parliament, recommending that it be passed subject to certain amendments.

The Securities Legislation Bill is designed to ensure confidence in New Zealand's capital markets by increasing the effectiveness of securities, securities trading and takeover laws.

The Bill is intended to:

1. simplify the current substantial security holders' disclosure regime;
2. introduce comprehensive prohibitions against practices involving the creation of a false impression of securities trading activity, price movement, or market information;
3. strengthen the law relating to insider trading;
4. improve the quality of advisor and broker disclosure and business practices across the advisory industry; and
5. overhaul the penalties and remedies available under securities and takeovers law to deter illegal behaviour and encourage compliance.

The Bill amends the Securities Act 1978, the Securities Markets Act 1988, the Takeovers Act 1993, and the Fair Trading Act 1986.

The Commerce Committee has now examined the Bill and reported back to Parliament.

More information about the changes to be introduced by the Securities Legislation Bill is available in publications listed on the Corporate and Securities page on the Bell Gully website.



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Recent developments

Financial intermediaries: consultation on options for change

The Task Force on the Regulation of Financial Intermediaries, which is considering the regulation of financial intermediaries such as brokers and other financial advisers in New Zealand, has consulted on various options to improve quality standards in the industry.

Report on compliance by registered banks with the Securities Act 1978

In its most recent newsletter, the Securities Commission says it has found that most banks are aware of their statutory obligations to ensure that customers receive investment statements before applying for term deposits and other investment products.

Internet banking and the Code of Banking Practice

The Code of Banking Practice is due for review this year. The Banking Ombudsman has said that this is an opportunity to develop some more specific standards to deal with the problems that are starting to arise with internet (and phone) banking.

Shortcomings revealed in Securities Commission review of 2004 financial reports

The Securities Commission has completed the first stage of its financial reporting surveillance programme by reviewing a selection of audited full-year reports, and it found shortcomings in 40% of those reports.

Website information must not be misleading

The Commerce Commission has succeeded in a criminal prosecution under the Fair Trading Act 1986 in relation to a website promotion that made inaccurate representations about the availability and prices of various items.

Securities Commission takes action against property developers

The Securities Commission is clamping down on property developers and their advisers who do not properly consider securities law issues when offering and allotting securities to raise funds for developments.

Publication of CCCFA guide

The Commerce Commission has published an 80-page general guide for the credit industry on the Credit Contracts and Consumer Finance Act 2003.

Immediate disclosure of changes to large public shareholdings required

The Securities Commission has announced that it may take action against people with substantial shareholdings in listed companies who fail to disclose, or do not make timely disclosure of, changes to their interests.

Recent developments

Financial intermediaries: consultation on options for change

The Task Force on the Regulation of Financial Intermediaries, which is considering the regulation of financial intermediaries such as brokers and other financial advisers in New Zealand, has consulted on various options to improve quality standards in the industry.

The scope of the reforms to be introduced following the Task Force's recommendations will be of interest to any financial institution in New Zealand that uses sales advisers or other intermediaries. Bell Gully is monitoring the implications of the changes [link to "Launch of BG's Finance Companies Focus Group" page] and providing advice on what the reforms mean for your business in practice.

Background

The Task Force was appointed by the Government in November 2004 to consider and report on the regulation of financial intermediaries. Its task is to suggest options for reform that will enhance the quality of financial information and advice being provided to the public and assist New Zealanders to make the most of their savings.

In May, the Task Force published a consultation paper setting out the issues that it identified from its first round of consultation and looking at options to address them. The period for submissions on the consultation paper closed in June and the Task Force will now report back to the Government on its conclusions. The Task Force has published a summary of the responses it received to its consultation paper.

Areas of proposed reform

The Task Force made proposals for reform in three key areas.

1. Enhanced consumer information

The Task Force's consultation paper proposed to improve consumer education initiatives and enhance the disclosure obligations for financial intermediaries. The aim of the reform is to enable consumers to make better decisions about an intermediary or financial product and to make comparisons. The Task Force also believes that it would encourage greater competition. The Task Force's summary of responses says that respondents generally agreed that the education proposal would be effective to address at least some issues, and that many agreed that accurate, clear and concise disclosure is required.

2. Enhanced redress, enforcement and sanctions

In its consultation paper, the Task Force proposed that consumer confidence in the industry would be promoted by effective and comprehensive dispute resolution procedures plus effective enforcement mechanisms and sanctions, including the ability to remove negligent or unethical participants from the industry. Respondents to the paper have agreed with the need for enhanced redress, and many support building on the existing Ombudsman schemes.

3. Enhanced standards

The Task Force identified an issue with a lack of mandatory minimum industry-wide standards, meaning that the industry suffers from a variance in the quality of services and difficulty for consumers in understanding and distinguishing between quality standards. Most respondents to the consultation paper supported the idea of enhanced baseline standards, especially in relation to ethics and competency. Many also supported business conduct standards, although there was less support for standards of remuneration or restrictions on ownership structures.

Mechanisms to implement the proposed reforms

The Task Force also identified various implementation options.

1. **General legal standards**

The proposal of industry-specific legislation with mandatory disclosure, redress, ethical and conduct standards has received considerable support from respondents to the consultation paper, possibly in combination with other options.

2. **Registration (in addition to general legal standards)**

A registration regime would require intermediaries to register their details with a governing body. Respondents showed a mixed level of support for this, with some considering that it would do little to achieve the desired objectives, while others considered that it would assist with recognition of and enforcement against intermediaries.

3. **Restriction of occupational designations (in addition to general legal standards and possibly registration)**

The Task Force proposed as an option a restriction on the ability to use certain titles, for example "financial adviser", subject to adherence with certain requirements. This received little public support, particularly when restrictions were tied to remuneration.

4. **Licensing**

Under this proposal, only licensed people or organisations would be able to offer financial intermediary services. The person or organisation would have to meet minimum standards for entry and there would be ongoing competency and conduct requirements. This idea also received considerable support, although some respondents considered that it would be too costly when balanced against the benefits.

Other proposals put forward by respondents to the Task Force's consultation paper included co-regulation between the Government and industry self-regulation, and enhanced trans-Tasman regulation (including application of the Trans-Tasman Mutual Recognition Agreement).

For more information, see www.med.govt.nz.



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Recent developments

Report on compliance by registered banks with the Securities Act 1978

In its most recent newsletter, the Securities Commission says it has found that most banks are aware of their statutory obligations to ensure that customers receive investment statements before applying for term deposits and other investment products.

The Securities Commission's latest quarterly newsletter¹ comments on a report published by the Commission in March, which dealt with compliance by registered banks with the requirement of the Securities Act 1978 to provide investment statements.

The Commission began its report after finding that some banks were advertising term investment products in such a way that investors could subscribe for the products without first receiving an investment statement. Banks are required to make sure that investors receive investment statements before subscribing for debt securities such as term deposits and other types of investment accounts.

The Commission found that most banks were aware of the legislative requirements, and had adequate processes to ensure compliance. However, some banks noted areas where their compliance systems could be improved, and one bank did not have an investment statement for its term investment products.

¹ 1 March 2005 (www.sec-com.govt.nz)

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Internet banking and the Code of Banking Practice

The Code of Banking Practice is due for review this year. The Banking Ombudsman has said that this is an opportunity to develop some more specific standards to deal with the problems that are starting to arise with internet (and phone) banking.

The Banking Ombudsman, Liz Brown, has called for changes to the Code of Banking Practice in order to focus more on internet and telephone banking. Concerns were raised earlier this year about online banking security after it was revealed that spyware could be used to find out customers' passwords. Ms Brown has asked for more clarity about who is responsible for protecting bank accounts against electronic fraud.

In her most recent newsletter¹, she sets out two case studies that illustrate the problems. Ms Brown comments that *"while it is reasonable for customers to expect banks to provide protection against unauthorised access to internet banking facilities to much the same degree as they provide protection against unauthorised access to more traditional facilities, it is not always possible to apply the same rules or to reason by analogy"*.

In the first case, the customer chose an existing internet access password for internet banking. The password was discovered by someone else, who used it to carry out internet banking transactions without the customer's authority. Banks are required to warn customers about certain prohibited passwords, and are permitted to refuse reimbursement of unauthorised transactions that result from the use of those prohibited passwords. However, passwords used for access to other internet services are not prohibited as internet banking passwords in the current Code of Banking Practice. In this case, the bank was potentially liable for the unauthorised transactions.

The second case deals with a fraudulent scam, under which Mr Z was persuaded to accept a payment by way of credit into his bank account from Mr and Mrs K and to withdraw the funds (less a commission) and send it to an overseas organisation by way of international money order. Mr and Mrs K had been tricked into disclosing their internet banking password and the credit to Mr Z from their account was subsequently reversed. Mr Z was unable to cancel the money order and he was left with an overdraft that he could not repay. There was no lapse of security on the part of either Mr Z's bank or the Ks' bank. In the end, the Banking Ombudsman did not resolve the question of whether Mr and Mrs K's bank was entitled to reverse the credit to Mr Z's account. She considered that, if the credit was reinstated, Mr and Mrs K would likely have obtained a freezing order over Mr Z's account and the issue of ownership of the money would have been left to be resolved between the Ks and Mr Z, and Mr Z decided to accept his bank's offer to allow him to repay the overdraft by affordable instalments. As Ms Brown points out, the case is indicative of the complexity of problems that can arise in this area. It also highlights potential areas of liability and/or litigation for banks if their customers are not fully aware of the risks of fraud or their obligations in respect of internet banking security.

Submissions on the current review of the current Code of Banking Practice close at the end of September.

¹ No. 18 May 2005 (www.bankombudsman.org.nz)

Need more information?

For more information on any of the cases, articles and features in *Financial Services Quarterly*, please email katie.johnson@bellgully.com or call on 64 9 916 8393.

Recent developments

Shortcomings revealed in Securities Commission review of 2004 financial reports

The Securities Commission has completed the first stage of its financial reporting surveillance programme by reviewing a selection of audited full-year reports, and it found shortcomings in 40% of those reports.

The purpose of the surveillance programme is to encourage New Zealand issuers to improve the quality of their financial reporting, so that investors can have confidence in the credibility of the financial information provided to them and the integrity of New Zealand's securities markets. Following this review, the Securities Commission has said that *"a number of issuers need to do more to raise the standard of their financial reporting"*. The review also identified incompleteness and inaccuracy in prospectuses, substantial security holder information, and continuous disclosure notices. The Commission expects to publish a report on the review.

For more information, see www.sec-com.govt.nz.



Need more information?

For more information on any of the cases, articles and features in *Financial Services Quarterly*, please email katie.johnson@bellgully.com or call on 64 9 916 8393.

Recent developments

Website information must not be misleading

The Commerce Commission has succeeded in a criminal prosecution under the Fair Trading Act 1986 in relation to a website promotion that made inaccurate representations about the availability and prices of various items.

This is an important reminder to make sure that all product and pricing information (including rates and fees) listed on a website is kept complete, accurate and up-to-date at all times.

A Waitakere-based restaurant pleaded guilty to breaching the Fair Trading Act 1986, after the Commerce Commission discovered that the restaurant's website promoted meals that were not available, or that were not available at the listed price.

Paula Rebstock, chair of the Commerce Commission, has specifically stated that it is not enough for a business to contend that its website is outdated because of lack of time. The Commission has emphasised the growth of internet-based advertising and the potential reach of misleading information posted on a website: *"The misleading impression generated by website representations is very important because it is a gateway to encouraging customers".*

For more information, see www.comcom.govt.nz.



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For more information on any of the cases, articles and features in *Financial Services Quarterly*, please email katiel.johnson@bellgully.com or call on 64 9 916 8393.

Recent developments

Securities Commission takes action against property developers

The Securities Commission is clamping down on property developers and their advisers who do not properly consider securities law issues when offering and allotting securities to raise funds for developments.

The Commission recently required enforceable undertakings from three companies that offered units in developments (together with rights to join income pooling schemes) without complying with the Securities Act 1978 requirements relating to participatory securities. The undertakings require the developers to re-offer the interests and, if subscribers decide not to take up the re-offer, the companies must allow investors to withdraw from the income pooling schemes.

Although not directly relevant to financial institutions, this type of action could have serious consequences for first mortgage lenders who rely on subordinate financing schemes of this type.

For more information, see www.sec-com.govt.nz.



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Recent developments

Publication of CCCFA guide

The Commerce Commission has published an 80-page general guide for the credit industry on the Credit Contracts and Consumer Finance Act 2003.

The Credit Contracts and Consumer Finance Act 2003 (the **CCCFA**) came into effect on 1 April 2005, repealing the Credit Contracts Act 1981 and the Hire Purchase Act 1971 and establishing a new regime for the regulation of credit contracts, consumer leases and buy-back transactions of land.

This publication, produced by the Commerce Commission (which enforces the CCCFA), is intended as a plain English guide to the new legislation for those businesses that want to better understand the CCCFA and what it requires. To a great extent, it simply sets out the provisions of the legislation in “layman’s terms”, and the Commission explicitly recognises that its interpretation of the CCCFA remains to evolve alongside legal developments including court decisions and enforcement experiences.

However, the guide does provide a useful indication of the Commerce Commission’s perspective on a few points of interest:

1. **Default interest**

The Commission is of the view that charging default interest on the entire unpaid balance of the loan rather than the amount in default may amount to an unenforceable penalty, depending on the circumstances. Charging default interest on the entire unpaid balance is not expressly prohibited under the CCCFA.

2. **Interest-free credit**

If credit is described as “interest-free” or “free credit”, the credit amount should be the same as the cash price of the goods.

3. **Fees and charges**

The Commission makes a few points about fees:

- (a) fees payable by the debtor to a third party in connection with the contract (but that are not specified as a term of the contract) and that provide the creditor with an indirect benefit are not, in the Commission’s view, credit fees (except for insurance premiums payable to an insurer specified by the creditor);
- (b) establishment fees must only reflect costs directly attributable to processing, considering or documenting a consumer credit contract – fees calculated as a percentage of the credit are inherently unlikely to reflect actual costs; and
- (c) if a creditor charges the debtor any amount in anticipation of a fee from a third party, but the actual fee charged by the third party turns out to be less than expected, the creditor must refund the difference to the debtor – the CCCFA does not allow a creditor to pass on to the debtor more than any fee that the creditor pays to a third party.

4. **Payments**

Under the CCCFA, a consumer credit contract may specify a schedule of payments and state that any payment will be credited in accordance with that schedule (regardless of when it is received). In this guide, the Commission advises that in order to avoid any misunderstanding creditors should let debtors know, when a payment is made outside the terms of the schedule, that the payment will still be credited according to the schedule.

5. **Early repayments**

The CCCFA sets out a non-compulsory formula for calculating a creditor’s loss from early repayment. The formula has proved difficult for some creditors to apply to their businesses, but the Commission states that:

- (a) a creditor should not charge more than the amount calculated under that formula unless the procedure for calculating the creditor's loss is clearly set out in the initial disclosure statement and the result can be justified; and
 - (b) it is not appropriate for a creditor to take into account the length of time it may take to re-lend the amount prepaid.
6. **Initial disclosure**
The publication provides more detail as to what key information is required to be disclosed to the debtor. For example, the Commission states that, if applicable, the debtor should be given information about how often continuing disclosure statements will be provided, and a statement that the creditor agrees to accept communications from the debtor electronically.
7. **Fair Trading Act 1986**
The Commission notes that breaches of the CCCFA may also constitute breaches of the Fair Trading Act 1986. For instance, a creditor that fails to disclose information required by the CCCFA (or that makes false or inaccurate disclosure) will have failed to comply with its obligations under both Acts. The Commerce Commission also enforces the Fair Trading Act 1986.
8. **Compliance programmes**
This publication sets out some of the elements that the Commission would expect to see in a creditor's compliance programme.

For more information, see www.comcom.govt.nz.



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Recent developments

Immediate disclosure of changes to large public shareholdings required

The Securities Commission has announced that it may take action against people with substantial shareholdings in listed companies who fail to disclose, or do not make timely disclosure of, changes to their interests.

The disclosure rules of the Securities Markets Act 1988 apply to people with interests in 5% or more of the voting shares in a listed company, and require immediate disclosure to both the company and NZX of any increase or decrease of more than 1%. The disclosure must be made as soon as the person knows or ought to know of the change.

The Commission has emphasised that disclosure must be immediate. In the recent high profile example of the Cushing family and Wakefield Hospital, the Cushings (who already held more than 5% of the shares in Wakefield Hospital) increased their relevant interest by 1% during the course of the afternoon of Friday 6 May through the acquisition by their company H&G Limited of Wakefield Hospital shares. The Cushings' existing holdings were not held through H&G Limited. The eventual acquisition of 5% of the shares by H&G Limited was completed at 10.31am on Monday 9 May and announced to the market at 11.30am on the same day. However, substantial security holder notices in respect of the Cushings were not filed until after the market closed that day. The Securities Commission said that this delay was not acceptable.

For more information, see www.sec-com.govt.nz.



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Bell Gully news

Bell Gully Focus Group

Financial institutions in New Zealand are facing a new environment of tougher regulatory scrutiny and legislative reform. In response to this, Bell Gully is forming a specialist Finance Companies Focus Group. The purpose of the Focus Group is to provide targeted, timely support to banks and finance companies and to help you to plan for any developments which will affect your business.

Bell Gully appoints new Chief Executive

Bell Gully has appointed Stephen Macliver as the firm's new Chief Executive, following an international search. Stephen, who this year was appointed Chairman of the International Bar Association's Law Firm Management Committee, has 20 years' management experience in the UK, European, Asian and Australian legal markets.

Bell Gully Focus Group on finance companies

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From time to time, we recognise that some areas of the law require in-depth analysis beyond the scope of FSQ. For this reason, we intend to put together focus groups within Bell Gully to advise on specific legal developments.

In this edition, we have commented on a number of developments affecting financial service providers and it is likely that the next few years will see significant changes to the regulatory landscape. Bell Gully believes it is important that financial institutions (including non-bank finance companies) are fully briefed on all developments in order to make timely changes to documents or systems, whether for the purpose of legal compliance or to ensure that they continue to give sufficient protection.

Current areas of development include:

1. The Government has recently announced a wide-ranging review of how non-bank financial products and providers are regulated.
2. The Credit Contracts and Consumer Finance Act 2003 has introduced new, but as yet untested, standards for consumer credit arrangements.
3. The Financial Intermediaries Task Force has reported to the Government on various options to improve the quality standards for financial intermediaries such as brokers and financial advisers. At a minimum, industry-specific legislation to regulate dealings with financial intermediaries is likely to be introduced.
4. The Securities Commission has announced that finance companies need to be doing more to raise the standard of their financial reporting.
5. Cabinet has approved legislative changes to ensure that New Zealand is fully compliant with international standards for anti-money laundering and anti-terrorist financing, including in areas such as customer due diligence and record retention. The recent London bombings will not have alleviated the OECD's concern about potential loopholes in the New Zealand system. Although this may seem a slightly obtuse area of law, some of the proposed procedures will directly impact on the way in which financiers do business on a day-to-day basis.
6. The Privacy Commissioner has introduced the Credit Reporting Privacy Code, under which financial institutions will need to agree new arrangements with credit reporters.
7. The Securities Legislation Bill will introduce changes to securities and securities trading laws.
8. New legislation is imminent that will substantially change the insolvency regime applying to companies (and necessitate changes to financial institutions' documentation and default-related processes).

Our Finance Companies Focus Group is intended to provide targeted, timely advice in relation to all areas of reform. We aim to promote a practical understanding of the relevant compliance requirements and to support businesses with the implementation of those requirements.

If you would like further information about our Finance Companies Focus Group, or if you have any queries about the developments mentioned above, we would welcome hearing from you. To be added to the mailing list for this Focus Group, please email Rachel McDermott at rachel.mcdermott@bellgully.com.



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Stephen, who this year was appointed Chairman of the International Bar Association's Law Firm Management Committee, has 20 years' management experience in the UK, European, Asian and Australian legal markets.

"To remain the best law firm in New Zealand it is valuable to understand and adopt international best practice," said Bell Gully chairman David Simcock. "Stephen brings a wealth of legal industry knowledge, experience and technical expertise to the firm and a commitment to grow our reputation further, both locally and internationally."

Stephen began his career as a solicitor in Australia, going on to be the co-founder of leading London-based legal consultancy The David Andrews partnership in 1987. In 1996, he was appointed Managing Partner of Minter Ellison in Perth and three years later Executive Managing Partner of the firm based in its Melbourne office. In 2003, he established his own Melbourne-based consultancy to the international legal profession.

"Bell Gully has developed a reputation as being the acknowledged leading law firm in New Zealand," said Mr Macliver. "I am particularly excited to be offered the opportunity to play a role in the further development of the firm's market leading position, with a focus on clearly positioning Bell Gully as the firm of first choice for clients in New Zealand, and to help build its profile and reputation internationally."

Stephen will join the firm in August and replaces Maggie Callicrate who is returning to her native United States.

"Maggie has made a huge contribution to the firm during her three year tenure," said David. "Following a well earned sabbatical she'll no doubt take her career to new heights in the US."



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Useful Web links

New Zealand government

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

New Zealand financial agencies and organisations

- The Companies Office [www.companies.govt.nz]
- Export Credit Office [www.treasury.govt.nz/exportcreditoffice]
- 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

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

Australian government sites

- 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.gov.au]
- Australian Stock Exchange [www.asx.com.au]

International sites

- Bank for International Settlements [www.bis.org]
- Global Banking Law Database [www.gbld.org]
- International Monetary Fund [www.imf.org]
- International Swaps and Derivatives Association [www.isda.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]

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