IN THE HIGH COURT OF NEW ZEALAND
CHRISTCHURCH REGISTRY

CIV-2008-409-001140
[2012] NZHC 1105

BETWEEN	STEPHEN DESMOND EATON, SEDDON JAMES MARSHALL Plaintiffs
AND	LDC FINANCE LIMITED (IN RECEIVERSHIP) First Defendant
AND	PERPETUAL TRUST LIMITED Third and Counterclaim Defendant
AND	ANDREW JOHN HARDING, MURRAY SCHOFIELD Second Counterclaim Defendants

Hearing: 20, 21, 22, 23, 29 February and 1, 2, 5, 6, 8, 29 and 30 March 2012
(Heard at Wellington and Auckland)

Appearances: J B M Smith, P R W Chisnall and J D Haig for Plaintiffs and Second Counterclaim Defendants
D J Goddard QC, P J Woods and N K Caldwell for First Defendant

Judgment: 23 May 2012

JUDGMENT OF FOGARTY J

This judgment was delivered by Justice Fogarty on
23 May 2012 at 11.30 a.m., pursuant to
r 11.5 of the High Court Rules

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Table of Contents

Introduction ....[1]

A Narrative of primary facts ....[5]
F & I's business ....[5]
LDC's business, with a prospectus ....[13]
Dealings between F & I and LDC ....[17]
F & I in receivership ....[19]
The use of the deposits ....[23]

B Do the plaintiffs have a proprietary interest in the $8 million held by LDC? ....[42]
(i) Was F & I in breach of offering securities to the public? ....[85]
(ii) Does s 3(2) exclude some deposits from the breach? ....[93]
(iii) What is the character of the statutory trust, given that the deposits were used in trading? ....[97]
(a) The plain language of s 36A ....[105]
(b) Section 36A read in the light of its purpose ....[115]
(c) Section 36A read in the context of involving the law of trusts ....[117]
Conclusion that there is a trust for a class ....[118]
(iv) Whether the sums being pursued by the plaintiffs are the property of this trust? ....[122]
Conclusion that the receivables of F & I are trust property ....[136]

C Are Perpetual and/or LDC bona fide purchasers for value without notice of the breach of trust? ....[137]
Does Perpetual have the defence of being a bona fide purchase for value? ....[141]
Did LDC have notice on 4 September 2006? ....[160]
The test for notice ....[162]
The Sinclair test ....[167]
The Macmillan test ....[182]
Was LDC on actual notice as at 4 September 2006? ....[193]
Constructive notice of LDC as at 4 September 2006 ....[221]
Actual notice of LDC in 2007 ....[234]
Constructive notice of LDC ....[258]
Was Perpetual on notice in 2006 and 2007? ....[262]

Subsidiary issues ....[276]
Re-assignment of the Three Stores and The Tavern loans ....[276]
Counterclaim by LDC against Messrs Harding and Scholfieldfor breach of warranties ....[285]
Counterclaim by LDC against Messrs Harding and Scholfield and Perpetual seeking a declaration of priority of Perpetual's security interest ....[301]
Recovery of costs of the receivership of F & I ....[304]

Judgment ....[305]

Introduction

[1] The plaintiffs seek relief in equity. This is a representative action. The plaintiffs are representatives of the remaining unpaid depositors of an insolvent money lending partnership which traded as "Finance & Investments" ("F & I"). They are pursuing a sum of about $8 million held by another failed finance company, LDC Finance Ltd ("LDC"). That sum is the cash equivalent of assets realised by the receivers derived from assets of F & I which were either assigned to LDC or over which LDC took a charge in two transactions, one in May 2006 and the other in March 2007.

[2] These proceedings allege that the plaintiffs, as unpaid depositors, have a proprietary interest in that sum being held by LDC. LDC disputes that. Second, LDC argues that even if the plaintiffs have a proprietary interest, LDC has the defence of bona fide purchaser for value without notice. This is a knowing receipt claim. The pleadings also allege a knowing assistance claim, against other parties, which may be the subject of a separate trial. The names of these two parties have been removed from the intituling. There is no issue estoppel in respect of them.

[3] These are the two principal contentions between the parties and are at the heart of the dispute. There are a number of other issues which can be approached as sub issues in the context of these two contentions or side issues.

[4] The parties did not agree on the ordering of issues for analysis. This judgment follows the following organisation:

A Sets out a narrative of the uncontested primary facts of the case.

B Examines whether the plaintiffs have a proprietary interest in the $8 million held by LDC.

C Examines whether LDC (and its trustee, Perpetual) have the defence of being bona fide purchasers for value of the F & I receivables, without notice.

D Subsidiary Issues.

A Narrative of primary facts

F & I's business

[5] F & I's partners were Mr A J Harding and Mr M Scholfield. In the 1960s both men were car salesmen and were involved in separate car sales businesses. By the early 1970s they had joined forces and each owned 50 per cent of Andrew Harding Car Sales. Mr Harding had been running a very small finance operation with his car sales business and when they became partners in the car sales they also became partners in that business which they then called "Finance and Investments".

[6] Of necessity, Mr Harding brought some capital to that business, but it was small, and not proved. The F & I business got its start in financing from a deposit of $20,000 (a substantial sum in 1973) from Mr Dick Shuttleworth and a deposit of $60,000 from Mr Lloyd Cole, the owner then of LDC Investments Ltd ("LDCI"). This was by a deposit from LDCI to F & I. It is not clear whether the whole of the $60,000 was taken at once. The scale of the new business was such that F & I did not want to have idle money sitting in the bank. On the probabilities, F & I took the advances from Mr Cole in small amounts. F & I had a separate ledger for the Cole/LDC deposits and ran it under a different business name, Nelson Vehicle Advances. This business was subsequently sold to Finance and Discounts Ltd in 1986.

[7] F & I's businesses operated like a bank. It had only two operating bank accounts, a cheque account and a call account. The main account was the cheque account. All depositors' funds were deposited in the cheque account as were interest paid on loans and repayments of loans. Funds were drawn from the same cheque account to meet the business expenses, rent and wages etc, pay profits to the partners, and make loans to lenders, and to repay deposits.

[8] Surplus funds in the cheque account were placed in the call account in order to be placed on term deposit and to earn some interest. Little use was made of overdraft facilities.

[9] In the absence of a prospectus F & I were able to operate without any trustee oversight as to the adequacy of shareholder funds and the ability to repay depositors. F & I were trading on a basis of taking most deposits on call. Some depositors were on six months at an interest rate a percentage above the call rate. The call rate was always higher than that offered by the trading banks. Like banks, F & I was borrowing short and lending long. So it was always vulnerable to a run on its deposits if its depositors lost confidence.

[10] In 1978 the Securities Act 1978 ("the Securities Act") was enacted. The prohibition against allotting securities offered to the public without a prospectus came into effect when s 37 of the Securities Act came into force on 1 September 1983. Prior to that time there was no obligation on F & I to trade under a prospectus.

[11] The purpose of the Securities Act is to ensure that before the public subscribe for securities they have access to reliable financial information enabling them to make an informed judgment as to whether to invest or not. The content of this information is scrutinised and its continuing validity supervised by both trustee and by a government agency, then the Securities Commission. These various obligations tend to be summarised by saying that the business has to operate within the terms of its prospectus. Any would be investor is provided with an investment statement and informed that there is a registered prospectus. Typically a registered prospectus will set limits on the liabilities that the business can assume, broken down into classes, relative to the businesses shareholder funds.[1] The content is fixed by regulations made under the Act.[2] If these limits are broken the trustee intervenes and the business can no longer trade normally, and indeed, it can only trade according to directions of the trustee, while in breach of the prospectus.[3] As we will see, this predicament happened twice to LDC. It needed more capital before it could register

[1] See Securities Regulations 2009, Schedule 2, r 14(1)(c)(ii).
[2] See Securities Act 1978, s 39; Securities Regulations 1983, Part 1; Securities Regulations 2009, Part 1.
[3] See Securities Act 1978, s 49; Securities Regulations 2009, Schedules 2 and 15.

a new prospectus. It accessed more capital on two occasions, both from F & I, one each in 2006 and 2007.

[12] F & I did not, however, change its manner of business to comply with the Act. Messrs Harding and Scholfield received, they said, legal advice that they did not need a prospectus because they were not advertising or otherwise actively soliciting deposits. They also believed that because they were trading as a partnership rather than limited liability company, that meant the Act did not apply.

LDC's business, with a prospectus

[13] The business of LDC was started by Mr and Mrs Cole, as LDCI. In 1990 a significant borrower of LDCI was unable to repay its debt. One of the partners of Carran Miller, a Nelson firm of chartered accountants, was a guarantor of this debt. This led to LDCI being acquired in 1999 by the partners of Carran Miller. As it happened, prior to this acquisition, Messrs Harding and Scholfield had been intending to acquire the business and had in that context been appointed directors of LDCI for a few months. In the end they did not participate in the sale. They retired as directors.

[14] In early 2004, the New Zealand Institute of Chartered Accountants, in the course of a regular review of Carren Miller Ltd, questioned the directors of LDCI as to whether or not LDCI was compliant with Securities Act in respect of offerings to the public. As a result of that review the directors informed the Securities Commission of the current operations of the company. The Commission ruled that LDC was not compliant due to subscriptions being received from the public as a result of application forms and deposit slips being made available at the counter. Following this ruling by the Commission, LDC was incorporated on 5 February 2004. It purchased the business of LDCI. On 18 June it entered into a debt securities trust deed with Perpetual Trust Ltd. LDCI and the directors of LDCI, Mr Miller and Mr Elliott, entered into an enforceable undertaking to the depositors with LDCI. This undertaking is dated 3 September, but records:

> 8. As at the date of this undertaking LDC Investments has confirmed that –

> (a) LDC Investments has informed persons who currently hold securities allotted in possible breach of the Securities Act of their rights in terms of section 37 of the Securities Act; and
>
> (b) LDC Investments has offered each such person the opportunity to either have their original subscription refunded together with interest (if applicable) or offered, via LDC Finance, to invest their original subscription together with interest (if applicable), in new securities on the basis of the investment statement of LDC Finance.

[15] By this mechanism Carren Miller Ltd were able to transit from LDCI operating in breach of the Securities Act to LDC, as a compliant business. But as part of that process they had to offer to refund all the deposits made to LDCI.

[16] In December 2004, Eagle Finance Ltd, a company formed by Mr John Jannetto, and with a prospectus, was acquired by LDC. The firms merged in 2004 and Mr Jannetto was appointed director of LDC and became managing director of LDC.

Dealings between F & I and LDC

[17] In September 2006, F & I purchased preference shares in LDC for the sum of $1.5 million. This was financed by a loan from LDC to F & I of the same amount. In the same transaction, LDC agreed to provide working capital to F & I of $500,000, a sum which later increased to in excess of $700,000 plus interest. The indebtedness of F & I to LDC was secured by a security interest under the Personal Property Securities Act 1999 ("PPSA").

[18] In March of 2007, there was a further transaction between the two companies. F & I purchased 25 per cent of the ordinary shares of LDC and in consideration assigned the benefit of four major loans to LDC, who thereby acquired an equitable interest in those loans.

F & I in receivership

[19] F & I and LDC both suffered a run by depositors in 2008 at the same time. They both went into receivership, LDC appointing the receivers of F & I. The

receivers were partners of PricewaterhouseCoopers (PwC). The firm already had experience with both businesses.

[20] At the time of the receivership of F & I, its liabilities consisted of unsecured investor claims (depositors) amounting to $15,935,943; an advance of $2.896 million from LDC; and a bank overdraft of $192,008.

[21] As to assets, at the date of receivership F & I had 706 loans outstanding with a total face value of $13.3 million. However, those loans along with the other assets were subject to LDC's secured interest granted in 2006 and the equitable assignment of four major loans granted in 2007. During the F & I receivership, LDC enforced its secured interest charge over F & I's assets, and the assignment of the F & I loans, and collected the sum of $7,792,197.36. This sum is being held on an interest bearing deposit pending the outcome of this litigation; it is now about $8 million.

[22] In addition, F & I had a little cash in the bank, some fixed assets of low value including general office equipment, furniture and computer assets, a property in Kaikoura, and its 25 per cent shareholding in LDC. (The latter was not really an asset as LDC was also in receivership and it was unlikely there would be funds available to F & I.) The balance sheet insolvency of F & I is unknown and not relevant in this case. What is relevant is that there are now no outstanding creditors of F & I except for the remaining unpaid depositors, LDC and the bank.

The use of the deposits

[23] As already noted, F & I operated like a bank. The Court had the benefit of two excellent briefs of evidence from two expert forensic accountants, Messrs M P Stiassny for the plaintiffs, and Mr P J Munro for the defendants. In every material particular the two experts agreed. The common context of both of their instructions were to examine LDC's proposition that the assets held by LDC cannot be traced back to the depositors with F & I.

[24] Mr Stiassny's instructions were stated by him as follows:

> I understand … that it has been suggested by LDC that relative entitlement to the proceeds should be determined (at least in part) by tracing the proceeds back to the contributors of the funds comprising the advance being repaid by each instalment of the proceeds.
>
> In that context we have been asked to:
>
> (a) carry out a tracing analysis of a sample loan or loans;
>
> (b) provide our view as to the availability and efficacy of tracing through F & I's bank account to determine the composition of specific loan receivables at issue, and also to determine what would be required to trace individual depositor's funds through into specific finance receivables;
>
> (c) analyse F & I's financial information to determine the sources and uses of its funds overall;
>
> (d) trace the use of LDC payments to F & I; and
>
> (e) analyse F & I's current bank account and call bank accounts to identify instances when they were overdrawn.

[25] Mr Munro stated his instructions as follows:

> The four areas that I have been requested to investigate are:
>
> (a) whether or not funds deposited into F & I's bank account were able to be traced to any loan advance;
>
> (b) whether F & I's cash position went into overdraft;
>
> (c) whether I was able to identify the funding source of certain receivable assets (otherwise known as "the Assigned Loans") received by LDC from F & I as part of a recapitalisation transaction prior to the respective receivership appointments; and
>
> (d) whether I was able to identify the use by F & I of funds deposited by a number of depositors.

[26] Transactions with depositors' funds were recorded as transactions between the depositor and F & I and transactions with borrowers were recorded as transactions between F & I and the borrower. No record was maintained as to how a receipt from a borrower was applied either:

(a) among depositors who were due repayments at the times the funds were available; or

(b) to further loan advances; or

(c) to F & I's own purposes.

[27] F & I's accounts were collected by way of electronic record. It was common ground that the computerised records were accurate.

[28] Because all F & I's business was transacted through the current bank account, all money borrowed by the partnership and contributed back into the business by the partners, repayments of loans and two payments of $500,000 each, were mixed in the current bank account.

[29] The partners of F & I do not assert any claim to the funds recoverable from F & I receivables. Since the receiverships, the F & I partners have contributed their personal assets to the common pool for the benefit of depositors.

[30] Mr Stiassny considers that the above facts are relevant to the characterisation of the competition for the funds in this case between LDC and the unpaid depositors of F & I. He says:

> This is not a case involving competition among F & I depositors themselves (as I am aware arises in the context of receiverships where several creditors may claim a special interest in funds or property). No individual depositor is attempting to claim his or her money back from F & I in whole or in part. Instead the depositors into F & I are all claiming together as one group against LDC as the entity who received and holds the funds at issue.

[31] It was, therefore, Mr Stiassny's position:

> I consider there should be no need to analyse individual depositors' deposits because of the depositors' agreement to share in proportions. The depositors' funds should in my opinion be able to be aggregated and treated as one.

[32] Notwithstanding that qualification, Mr Stiassny then examined whether there were any tracing exercises attributing LDC's receivables, making up the $8 million to any one depositor was possible. His answer is no. Mr Munro agrees.

[33] In addition to the constant mixing of all funds through one bank account, LDC contends that there is a difficulty for the plaintiffs in the composition of the $8 million. Mr Stiassny explains it this way:

> There is real difficulty in ascertaining what of F & I's loan receivables were realised by PWC to comprise the total $7,792,197.36 taken (in payment of what PWC had calculated F & I owed to LDC). I understand the relevant cashflows are a combination of funds taken from the F & I bank account, and funds received by LDC or others direct into their own bank account. For example, the The Tavern (F1009) and Three Stores Limited (C1245) are individual loans as specified in F & I's ledgers. But we have been informed that The Tavern and Three Stores loans were in fact not realised by PWC. Those loans were transferred back to F & I for collection and PWC simply took the balance of those loans outstanding from F & I's current bank account. So while the collections may be attributed to these nominated loans, the actual funds as appropriated were from other sources. In addition we are not aware of what receivables comprised the balance of funds taken as given in the references 'F & I (12727)' and 'F & I (12728') and 'F & I current account (GL6123)'.

[34] Mr Stiassny addressed past overdrafts:

> I note that F & I's current bank account was overdrawn on a number of occasions. Even after offsetting credit funds available in the call (interest bearing) bank account, the net balance was negative on 32 occasions in the period we have reviewed. I understand an overdrawn account can present issues as to tracing however, I consider in this instance it would be reasonable to aggregate the loans ledgers with the bank accounts such that the total of those assets would be treated as the value of the tracing facilities. I form this opinion on the basis that neither the bank, nor the partnership, is claiming the funds at issue. The sole point of such a tracing exercise would be to establish the interests of the Depositors and LDC such that, in my view, the interests of other parties might be put to one side.

[35] Mr Stiassny did not think it was practical at this time to trace the funds at issue to the standard of "the legally acceptable principles", which he did not define. He said if indeed it were possible:

> … the volume of transactions would render such an exercise inordinately expensive and the results would necessarily simply reflect the rules adopted such that the outcome would be of limited relevance when the F & I depositors have already agreed to put aside the competition between their claims in order to share pro rata.

[36] However, as instructed, his team endeavoured to do that analysis and concluded it was futile.

[37] Mr Munro's brief responded to Mr Stiassny as well as setting out his views. Mr Munro presented a useful summary of his findings which I set out in its entirety. With one exception, 6.5, his summary records the consensus between the two experts:

> 6.1 All depositor funds were deposited into the F & I Cheque account and intermingled with other types of funds. As the funds were mixed and there is no one irrefutable tracing method that can be used, the deposits cannot be traced to any one particular loan advance (or to a group of loan advances);
>
> 6.2 F & I's Cheque account was overdrawn on 182 working days between 2 October 2001 and 6 September 2007. I agree with Mr Stiassny that the total cash balance was overdrawn at least 32 times, which includes the 6 working days prior to receivership;
>
> 6.3 Due to the sheer volume of transactions through the Cheque account and intermingling of funds, direct tracing or matching of investor deposits with loan advances is not clear. Investor deposits are not available to be traced to individual loan advance transactions, specifically they cannot be traced to the Assigned Loans;
>
> 6.4 Due to the volume of transactions and the fact there is no defined method to determine the order of priority of the tracing of funds (it could be argued numerous different ways of how the deposits were applied by F & I, with no one argument better than another) tracing is not able to be completed on the use of the depositors' funds;
>
> 6.5 My views align with the evidence presented by Mr Stiassny in terms of the intermingling of funds limiting the specific traceability. However, there are a few points of analysis that Mr Stiassny puts forward that I believe are legal argument to be decided by the Court, namely:
>
> > (a) The aggregation of depositors' claims as one (which he suggests may eliminate the need for tracing);
> >
> > (b) The aggregation of the bank account overdrafts with the loan ledger (which he suggests is relevant to the issue of whether the overdraft position affects the ability to trace).
>
> 6.6 Mr Stiassny also proposes evidence around possible tracing rules (i.e. FIFO [first in first out] on a whole day basis) but acknowledges that there are different approaches that could be applied and which would result in a different outcome. I concur with this position and note that differing approaches would give different outcomes.

[38] There is complete agreement between the experts on propositions 6.1 – 6.4 and 6.6. As to 6.5, Mr Stiassny states his view. It is essentially a legal viewpoint and one upon which Mr Munro properly did not join. I received Mr Stiassny's views

in this regard as part of the totality of his evidence, but do not rely on the prescriptive legal elements of his opinion. Later in this judgment I will come back to the significance of the fact of aggregation of claims by the unpaid depositors.

[39] The bulk of the briefs of Mr Stiassny and Mr Munro were demonstrating the conclusions that they reached, by way of specific examples of futile analyses. I am not going to burden the length of this judgment by going to the examples.

[40] Significantly, both accountants have a similar view as to the character of various rules of tracing such as FIFO which can be drawn from different cases. Mr Munro put it this way:

> 7.14 There are numerous methods that can be applied to attempt to trace any particular funds intermingled with other deposits in an account. Each method has its own rules to abide by, to remain consistent in the treatment of the funds. From an accounting perspective, I agree with Mr Stiassny's statement that "*there is no demonstrative history of support for them [rules for tracing] and I accept that another analyst could come out with another set of equally supportable, but similarly equally challengeable rules that would produce a different result*."

[41] Mr Munro goes on to make these practical points:

> 7.15 Any principle that was to order transactions that happen within a day would be unworkable (Mr Stiassny concedes this). Not only would this be due to the impracticability of working out the timing of when the transactions actually occurred during the day, but in reality, due to New Zealand's banking system, all transactions are processed overnight at the same time, meaning no order can be ascertained. The only exception is if a transaction is processed as a same day payment.
>
> 7.16 Mr Stiassny chose to analyse the transactions applying the FIFO principle on a whole day basis. At first this approach seems reasonable; however this principle will not provide a realistic picture of the situation where the funds have been deposited, for a particular purpose, to be withdrawn the same day.
>
> 7.17 For example, it could be reasonable to believe that F & I management transferred funds from the Call account to cover loan advances that were to be paid out of the Cheque account on the same day.
>
> 7.18 This is relevant to the example given in Mr Stiassny's brief of evidence of the analysis of the sources of the $650,000 advance to Three Stores Limited, as there was a $630,000 transfer from the Call

> account to the Cheque account (on the same day as the $650,000 was advanced) which, under the analysis of Mr Stiassny's brief, was not accounted for as a potential source of funds for the advance.
>
> 7.19 Also, another quandary for an analyst is to how to order the transactions in the following day. Are they to be sorted large to small or vice versa, alphabetically by product or depositor, or by some other way? All scenarios would produce a different result.

B Do the plaintiffs have a proprietary interest in the $8 million held by LDC?

[42] The pervasive argument for LDC is that inasmuch as an F & I depositor is the beneficiary of a trust, that depositor has lost any right to the funds held by LDC because of the inability to trace. Indeed, from the time that the funds were used by F & I for lending or any other purpose, a proprietary interest on those deposits was lost and the individual plaintiffs' depositors were confined to a personal claim against the trustees of the trust. Mr Goddard QC put it this way in his mini-opening: "[The case law on tracing into a mixed fund] *only apply if LDC was paid out of a mixed fund that included the depositors' money*."

[43] Mr Goddard QC acknowledged that the Court was likely to find there was some trading by F & I in breach of the Act, so that there had to be a trust of some sort. Later in this judgment I will be examining the nature of that trust. It drives off the application of s 36A of the Securities Act. Section 36A provides:

> **Subscriptions must be held in trust**
>
> An issuer must ensure that subscriptions for securities offered to the public are held in trust for the subscribers until the securities are allotted or until the subscriptions are repaid to the subscribers under this Act. (Emphasis added)

[44] Before going into the question of the extent to whether or not F & I was offering securities to the public and so triggering s 36A, it is appropriate to set out the cornerstone argument of LDC.

[45] The argument by the defendants against tracing centres upon a different description of the trust. The defendants argued that the trust established by s 36A is a separate trust for each individual subscriber, who can assert an individual claim to

the funds he or she paid to the issuer only if those funds are identifiable. Mr Goddard submitted:

> In circumstances where there is no statutory provision for pooling of investor funds in a single trust, but rather separate trusts for each subscriber whose funds are received, there is no collective beneficial claim to assets shared by the body of investors as a whole. Each has an equitable right to his or his own funds, and can sue to protect that right separately from – and potentially in competition with – the other investors.
>
> …
>
> In a case where the claim is proprietary, that means that the represented group can make out ownership rights in respect of particular assets only by showing that one or more members of the group hold those rights. The essential starting point remains the funds paid over to F & I by members of the group, and a process of tracing of those funds into the assets that the plaintiff group claims as now representing their funds.

[46] "Ownership rights" or, more commonly, "a proprietary interest" should not be confused with the common law of property. A proprietary interest to an equity lawyer is simply a claim which equity will recognise of a beneficial interest in property.[4]

[47] Mr Goddard argued:

> … it is important to bear in mind that the inquiry begins while the assets are in F & I's hands, and that if at any stage it ceases to be possible to follow a plaintiff depositor's funds into identifiable assets in the hands of F & I, that plaintiff depositor has no proprietary claim to any assets of F & I, or to the assets subsequently disposed of by F & I. …
>
> Thus for example if a depositor's money was paid into the F & I account while it was overdrawn, the depositor has lost the ability to trace because there is no longer an identifiable asset in which that claimant can assert a beneficial interest: *Re Registered Securities Ltd* [1991] 1 NZLR 545 at 554.

[48] The material facts, however, of *Re Registered Securities Ltd* are important. When these are taken into account, the case distinguishes itself.

[49] Registered Securities Ltd ("RSL") was a wholly owned subsidiary of the New Zealand Mortgagee Guarantee Company ("NZMG"). RSL carried on business as a contributory mortgagee company. It solicited and received funds from the

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[4] *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd* [2011] EWCA Civ 247 at [89].

public and purported to advance such funds on contributory mortgages of land for specific investors.

[50] The provision of "contributory mortgages of land for specific investors" is quite contrary to the way in which F & I traded. Depositors with F & I were given no promise at all that their funds would be allocated to specific loans. On the contrary, F & I operated as a bank. By contrast, the persons who deposited with RSL, on the other hand, did so on the understanding that their deposits would be identifiably placed with contributory mortgages.

[51] RSL often lent to unsound borrowers on poor security. At the time of the appointment of provincial liquidators there were 8,500 persons who had made in all some 15,000 payments to RSL for investment in mortgages. RSL then held 206 mortgages; 125 were first mortgages securing $59.76 million and 78 second mortgages securing $38.04 million. Parts of the principal of some mortgages and the whole of one large mortgage had not been expressly allocated to investors. As well, there were 788 separate investments totalling $4.28 million which had been not allocated to any mortgage.

[52] Somers J, who wrote the judgment for the Court of Appeal, said:[5]

> … the primary question is, and has been, whether mortgages purporting to have been allocated by RSL in whole or in part to specific investors are to be dealt with by the liquidators on the footing that those investors are the beneficial proprietors of such mortgages or interests therein or whether the proceeds of the mortgages should be distributed pro rata among all the investors presently unpaid or some class or classes of them and, if so, which.

[53] Pausing here, the issue in *Re Registered Securities* was one of allocation of receivables amongst the investors. That is a different issue from this case. In this case, all the unpaid depositors have agreed to become a class and have joined together pursuing the litigation. None of these unpaid depositors are asserting any specific interest in any asset.

[5] *Re Registered Securities Ltd* [1991] 1 NZLR 545 at 547.

[54] In *Re Registered Securities* in the High Court, Barker J held that investors to whom mortgages were allocated by RSL, as evidenced by certificates issued by it, had a proprietary interest to the extent certified.[6]

[55] RSL was described in its own literature as being a custodian of its investors' funds. It did not purport to be trading as a finance company. It was promising specific investments. Clause 20 of its brochure included this proposition:

> On receipt, funds are lodged in one of two RSL Trust Accounts – the First Mortgage Trust Account or the Second Mortgage Trust Account. They are then lodged in one or more specific mortgages, and they can be traced as individual investments from the time they are received until they are repaid to the investor on maturity.

[56] These differences in material facts are important for identifying the obligations of the fiduciary (trustee). Obligations of the fiduciary are always specific to each trust. Where express trusts are created, the trustees' obligations are defined by the terms of the trust. Where trusts are imputed, the fiduciaries' obligations are defined by the Courts' recognition of the fiduciary obligation arising in the particular context, by the application of the principle that a person in control of another's assets cannot use them unconscionably.

[57] Given the way that RSL was operating, it was inevitable that those investors with RSL whose investments were allocated into specific identifiable mortgages were in a different class from those investors whose funds were not so allocated. There are two different classes of beneficiaries.

[58] Where, in a trust, individual investors or groups of individual investors fall into different classes, then different rules can apply. Equity selects rules which achieve justice. It is important to keep in mind that in RSL the Court was dealing with a trust comprising of funds obtained by promising investors that their funds would not be mixed except by way of contribution into a specific mortgage. Thereby the express terms of the RSL trust were to keep apart the separate investment of each beneficiary.

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[6] *Re Registered Securities Ltd (in liquidation); National Bank (NZ) Ltd v Tuck* (1990) 5 NZCLC 66,248 at 66,263.

[59] There are many authorities which recognise that equity selects the appropriate method of doing justice to beneficiaries depending on the context. In *Re Registered Securities*, the Court of Appeal applied the rule in *Clayton's Case*.[7] This is the rule that where a trustee mixes the funds of more than one beneficiary and there is a subsequent shortage as between beneficiaries, the money that the beneficiary first paid in is the first drawn out (FIFO). This is one of the "legally acceptable rules" that the two experts endeavoured to apply to the facts of this case, and found futile.

[60] Somers J pointed out:[8]

> The automatic application of the rule in *Clayton's Case* as between beneficiaries will not in our view withstand scrutiny. In the first place, the rule is founded on presumed intention. It is in truth a fiction and cannot be allowed to work an injustice.

[61] It is difficult to overstate the importance of that observation of Somers J, which is consistent with dicta in many United Kingdom cases.[9] Inasmuch as *Clayton's Case* and other like rules are founded on a presumed intention, they cannot be applied to a trust which is expressly founded on a different intention, or to a constructive trust which imposes fiduciary obligations on the holder of a mixed fund, incompatible with such rules. The correct approach in equity is to select such rules consistent with the particular trust being enforced, and which rules will achieve equity as between the beneficiaries.

[62] As the two expert accountants, Messrs Stiassny and Munro repeatedly emphasised in their evidence that all such rules, e.g. FIFO and LIFO, are essentially arbitrary. They are applied to achieve the goal of doing equity, but only where that is appropriate to the application of a particular trust obligation. It follows that to do equity the context and consequential nature of the fiduciary obligations enforced should dominate the selection of the mechanism used to ascertain the beneficiaries' rightful claims on any assets.

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[7] *Clayton's Case* (1816) 1 Mer. 572.
[8] *Re Registered Securities*, above n 5 at 553.
[9] See for example *Barlow Clowes International Ltd (in liq) v Vaughan* [1992] 4 All ER 22 at 39 per Woolf LJ.

[63] It is useful to read in support of the experts' views, *Underhill and Hayton's* comment on *Clayton's Case*:[10]

> Where the assets of two trusts have been mixed (other than in a current banking account) any losses or gains in the value of the mixed fund are shared rateably according to the values of the mixed assets of each trust. Where mixing occurs in a current banking account the rule in *Clayton's Case* has traditionally been applied to attribute the first drawings out to the first payments in unless this produces an inequitable result. However, the courts are now so quick to find that application of the rule in *Clayton's Case* would be inequitable that it is effectively a dead letter. (Emphasis added)

[64] On the particular facts of *Re Registered Securities,* one can understand why those investors who were specifically allocated mortgages were in a superior position to the other investors. But it is quite wrong to elevate the decision in *Re Registered Securities* as to some general proposition that a beneficiary loses the ability to trace because there is no longer an identifiable asset into which that claimant can assert a beneficial interest because the depositors funds had been mixed with other funds.

[65] Before I leave *Re Registered Securities,* I would note that on my reading of it, Somers J would agree. Here is another comment, carefully qualified, by Somers J at the bottom of page 553:

> It must follow in our view that where a trustee mixes the funds of different beneficiaries a withdrawal which is expressly or by implication intended to be to the account of one particular beneficiary must be so treated. In such a case there is no apparent equity in that beneficiary entitling him to impose part of the loss on the other. (Emphasis added)

[66] In this case, however, there was no differentiation by the proprietors of F & I, who were the trustees, as to one particular beneficiary over another except in repaying them when they sought to withdraw their funds. But, of course, those beneficiaries who were repaid are no longer able to make claims against the assets of the trust.

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[10] D Hayton (ed) *Underhill and Hayton's Law Relating to Trusts and Trustees* (18th ed, LexisNexis, London, 2010) at [90.1].

[67] Essentially, LDC's arguments against the availability of the remedy of tracing in this case presupposes that one depositor is in conflict with another. This is simply contrary to the facts.

[68] Counsel for LDC and Perpetual, seek to deploy the rule in *Clayton's Case* against the plaintiff beneficiaries so as to completely destroy their claim against LDC. The application or not of *Clayton's Case* is better decided in an argument between beneficiaries. No such dispute exists here. It is agreed that the $8 million fund reflects the realisable value of the assets of F & I acquired by LDC in the 2006 and 2007 transactions.

[69] As already noted, LDC submitted that the case law on tracing into a mixed fund applies only if LDC was paid out of a mixed fund *that included the plaintiffs' depositors' money*.

[70] LDC counsel were not able to cite any case where beneficiaries' money had been mixed with other beneficiaries' money so that as a consequence the beneficiaries only had a personal claim against the trustee and could not follow to the mixed fund.

[71] Secondly, it is a basic principle of trust law that funds invested in breach of trust do not lose the character of being the property held by the fiduciary for the beneficiaries. The fact that it is an unlawful investment or that there were some costs incurred along the way does not mean that the resultant asset is no longer a trust asset. If it is a trust asset it is subject to a claim by the beneficiaries. *Underhill and Hayton* formulates the law as this:[11]

> If a trustee or other fiduciary has, in breach of trust or other fiduciary obligation, converted trust or fiduciary property into some other form, <u>the property into which it has been so converted becomes subject to the trust or other fiduciary obligation</u>. If *all* the beneficiaries or principal and all principals are of full age and capacity, then they can collectively elect to adopt the transaction, and take the property as it then stands; but failing such election, the property must be reconverted if it is not an authorised investment. In that case any gain accrues for the benefit of the beneficiaries or principal and any loss falls on the trustee or other fiduciary. (Emphasis added)

[11] Ibid.

[72] If all the beneficiaries' entitlements are mixed into one fund which contains no other funds in respect of which there are claims by other persons, then equity has no difficulty in allowing the beneficiaries to wind up the trust and make a direct claim to those assets, as is noted by *Underhill and Hayton* above. This remedy is available even though no individual beneficiary can identify his or her deposit in the mixed fund. Where funds are mixed particularly with the wrongdoer trustee's assets, then there are various methods deployed by equity all designed to give the beneficiary a remedy. Mixing is not fatal.

[73] As well as arguing that the fund is mixed because all the depositors' money has been mixed together, LDC argued that there was some capital injected into the business and the business went into overdraft from time to time. As to overdraft, Mr Goddard argued that all depositors' money that was used to reduce overdrafts is immediately lost leaving those depositors only with a personal remedy against the trustees. Similarly, he argued that where depositors' money is used to pay the rent, or other costs, or take profits, the deposits are lost.

[74] For the purposes of the analysis, at this stage I want to focus on the proposition that over a period of time the depositors' funds were mixed with capital introduced by the principals to the business, and we know that at least two lots of $500,000 was introduced by each partner.

[75] So far as other contributions to the fund are concerned, the position is clear. *Re Hallett's Estate*[12] provides that where money held on trust is mixed with the trustee's personal money, the whole of the resulting fund is treated as trust property and can, following a successful tracing exercise be claimed by the trust beneficiaries. The trustees are presumed to act honestly where personal funds and trust funds are mixed and when there is a shortfall the trustee is presumed to intend to deplete their own funds first.

[76] There is no difficulty with beneficiaries who form a class claiming as a class against a mixed fund. The most recent, and much quoted case in this regard, is

[12] *Re Hallett's Estate* (1879) 13 Ch. Div. 696.

Foskett v McKeown.[13] In this decision, Mr Murphy took out a life insurance policy on his own life and later declared the policy and its proceeds to be held on trust for his children. He paid the first two premiums out of his own funds. He paid at least the fourth and fifth premiums by takings funds that were held on express trust for the purchasers of land in a development site in Portugal. There was a dispute between the children and the beneficiaries of the express trust over a share of the proceeds of the policy, after Mr Murphy committed suicide. This is a case which divided the Court of Appeal and the House of Lords. The majority in the House of Lords held that both the children and the purchasers could trace to the proceeds of the policy rateably according to their respective contributions to the premiums paid.[14]

[77] Lord Millett described the case as:[15]

> … a textbook example of tracing through mixed substitutions. At the beginning of the story the purchasers were beneficially entitled under express trust to a sum standing in the name of Mr Murphy in a bank account. From there the money moved into and out of various bank accounts where in breach of trust it was inextricably mixed by Mr Murphy with his own money. After each transaction was completed the purchasers' money formed an indistinguishable part of the balance standing to Mr Murphy's credit in his bank account. The amount of that balance represented a debt due from the bank to Mr Murphy, that is to say a chose in action. At the penultimate stage the purchasers' money was represented by an indistinguishable part of a different chose in action, viz the debt prospectively and contingently due from an insurance company to its policyholders, being the trustees of a settlement made by Mr Murphy for the benefit of his children. At the present and final stage it forms an indistinguishable part of the balance standing to the creditor respondent trustees in their bank account.

[78] And:

> A beneficiary of a trust is entitled to a continuing beneficial interest not merely in the trust property but in its traceable proceeds also …[16]
>
> In principle it should not matter (and it has never previously been suggested that it does) whether the trustee mixes the trust money with his own and buys the new asset with the mixed fund … [17]
>
> … it is impossible to distinguish between the case where mixing precedes the investment and the case where it arises on and in consequence of the investment.[18]

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[13] *Foskett v McKeown* [2001] 1 AC 102 (HL).
[14] Ibid at 109 per Lord Browne-Wilkinson.
[15] Ibid 126-127.
[16] Ibid at 127.
[17] Ibid at 130.

[79] Lord Millett went on to say that in *Re Hallett's Estate* Jessel MR acknowledged that where an asset was acquired exclusively with trust money, the beneficiary could either assert equitable ownership of the asset or enforce a lien or charge over it to recover the trust money. But the Master of the Rolls appeared to suggest that in the case of mixed substitution the beneficiary is confined to a lien. Any authority that this dictum might otherwise have is weakened by the fact that Jessel MR gave no reason for the existence of any such rule, and none is readily apparent. Lord Millett cited an abundance of authority critical of the rule, including the great Learned Hand J who, in *Primeau v Granfield,*[19] expressed himself in forthright terms:

> On principle there can be no excuse for such a rule.

[80] Lord Millett, having quoted these authorities, went on to say:[20]

> Accordingly, I would state the basic rule as follows. Where a trustee wrongfully uses trust money to provide part of the cost of acquiring an asset, the beneficiary is entitled *at his option* either to claim a proportionate share of the asset or to enforce a lien upon it to secure his personal claim against the trustee for the amount of the misapplied money. It does not matter whether the trustee mixed the trust money with his own in a single fund before using it to acquire the asset, or made separate payments (whether simultaneously or sequentially) out of the differently owned funds to acquire a single asset.

Lord Millett further said:[21]

> Innocent contributors, however, must be treated equally inter se. Where the beneficiary's claim is in competition with the claims of other innocent contributors, there is no basis upon which any of the claims can be subordinated to any of the others. Where the fund is deficient, the beneficiary is not entitled to enforce a lien for his contributions; all must share rateably in the fund.
>
> The primary rule in regard to a mixed fund, therefore, is that gains and losses are borne by the contributors rateably.

[81] This is exactly what the contributors seek to do in this case. They are the remaining class of unpaid depositors. They are not seeking to recoup any repayments made to earlier depositors. They are simply seeking, as a class, to

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[18] Ibid at 131.
[19] *Primeau v Granfield* (1911) 184 F 480 at 482.
[20] *Foskett v McKeown*, above n 13 at 131.
[21] Ibid at 132.

pursue assets of F & I which on the evidence were substantially acquired by misuse of depositors' money generally with some historic contribution of small amounts of equity. The trustees who might in theory have made a claim for contributions to equity were the sum being pursued not deficient, are not pursuing this claim. The bank overdrafts have been repaid. Accordingly, it is irrelevant to the tracing exercise that historically the funds of the depositors were mixed with bank credit and some modest equity introduced into the business by the partners.

[82] This analysis still leaves unanswered LDC's argument that this class of unpaid depositors cannot claim these proceeds of $8 million because they cannot prove that their contributions contributed to the acquisition of the asset now held by LDC. I answer that submission in the course of examining just exactly what was the trust created by s 36A of the Securities Act.

[83] For the foregoing reasons, I think it is an error of law and a distraction to proceed on the basis that because each depositor in F & I was separate, then if there is a trust, no matter what the trust is, the right to trace disappears when the deposits were used by F & I to trade in breach of s 36A, if that section is breached.

[84] The next part of the analysis as to whether or not the depositors have a proprietary claim begins by addressing four sub issues:

(i) Was F & I in breach of offering securities to the public, in order to trigger the application of s 36A?

(ii) If F & I was in breach, do some of the unpaid depositors fall into the exceptions in s 3(2) of the definition of "offers to the public"?

(iii) What is the character of the s 36A statutory trust, or a consequential trust, given that the deposits were used in trading?

(iv) Whether the sums being pursued by the plaintiffs are the property of this trust?

(i) Was F & I in breach of offering securities to the public?

[85] F & I at all material times traded without a prospectus. It could only do this without breaching the Securities Act if it was not offering securities to the public.[22]

[86] By the conclusion of the evidence there was little further contest between counsel as to whether or not F & I was offering securities to the public. Section 3 of the Securities Act provides:

> **3 Construction of references to offering securities to the public**
>
> (1) Any reference in this Act to an offer of securities to the public shall be construed as including—
>
> (a) A reference to offering the securities to any section of the public, however selected; and
>
> (b) A reference to offering the securities to individual members of the public selected at random; and
>
> (c) A reference to offering the securities to a person if the person became known to the offeror as a result of any advertisement made by or on behalf of the offeror and that was intended or likely to result in the public seeking further information or advice about any investment opportunity or services,—
>
> whether or not any such offer is calculated to result in the securities becoming available for subscription by persons other than those receiving the offer.
>
> (2) None of the following offers shall constitute an offer of securities to the public:
>
> (a) An offer of securities made to any or all of the following persons only:
>
> (i) Relatives or close business associates of the issuer or of a director of the issue:

[22] Securities Act 1978, s 37(1) provides: No allotment of a security offered to the public for subscription shall be made unless at the time of the subscription for the security there was a registered prospectus relating to the security.

(ii) Persons whose principal business is the investment of money or who, in the course of and for the purposes of their business, habitually invest money:

(iia) persons who are each required to pay a minimum subscription price of at least $500,000 for the securities before the allotment of those securities:

(iib) persons who have each previously paid a minimum subscription price of at least $500,000 for securities (the initial securities) in a single transaction before the allotment of the initial securities, provided that—

(A) the offer of the securities is made by the issuer of the initial securities; and

(B) the offer of the securities is made within 18 months of the date of the first allotment of the initial securities:

(iii) Any other person who in all the circumstances can properly be regarded as having been selected otherwise than as a member of the public:

(b) An invitation to a person to enter into a bona fide underwriting or sub-underwriting agreement with respect to an offer of securities:

(c) Repealed.

[87] There is no doubt that F & I's mode of trading fell within s 3(1)(b). F & I operated from a "high street" storefront in Nelson. It had a large sign naming the business, "Finance and Investments". There was ample evidence that persons learning of F & I's business from word of mouth, not being "relatives" or "close business associates" of the principals of the business, would walk in and make inquiries. Their deposits would be taken. They would receive in return a note recording the amount of the deposit, the interest promised and the term. Most deposits were on call. F & I operated as a bank.

[88] There were some depositors, as one would expect, who could be described as "relatives" of the principals, and no doubt some who could be described as "close business associates".[23] LDC did not seriously dispute, however, that a significant number of the public responded to an offer of securities within the terms of s 3(1)(b).

[23] See Securities Act 1978, s 3(2)(a)(i).

[89] F & I did not advertise. It placed a small notice for a few years in a local yachting club annual report. There is no significant evidence that these few advertisements triggered s 3(1)(c).

[90] There was no evidence of any separate offers (distinct from the general trading of F & I as a store front lender) which would fall within s 3(2)(a). No doubt some members of the families and close business associates did deposit with F & I because they knew the principals and trusted them, but that is quite a different matter from whether or not the principals sought out any particular relatives or close business associates to solicit their deposits. There is no evidence they did.

[91] F & I deliberately traded without advertising and relied upon its general reputation in town and maintaining and staffing a high street business premises taking deposits from whoever walked in or posted in deposits. Accordingly, there is no doubt that F & I was trading in breach of the Securities Act.

[92] It is of no surprise to the Court that Mr M G Noone, a partner of PwC, came to that conclusion on the very day he visited Nelson in January 2007 to meet with the principals of LDC, Mr David Miller and Mr Jannetto, and Mr Andrew Harding of F & I. Mr Noone not only told Mr Harding that F & I were not compliant with the Securities Act, but that he and Mr Scholfield could go to prison. Of course he was mistaken on the later point, but the fact he said it reveals he was quite confident, on the first day, that F & I was trading in breach of the Act.

(ii) Does s 3(2) exclude some deposits from the breach?

[93] LDC argued that those depositors who might be classed as “relatives” and “close business associates” did not fall within offers to the public. In that regard, LDC seeks an inquiry as to who in the present class of plaintiffs should be excluded from any relief, because they are “relatives” or “close business associates” within s 3(2)(a).

[94] The plaintiffs, however, do not make that argument. They are united. Furthermore, they rely on the opening phrase in s 3(2)(a):

> An offer of securities made to any or all of the following persons **<u>only</u>** (Emphasis added)

[95] There is no advantage to LDC in arguing the potential class of beneficiaries is a smaller class than the plaintiffs. This is because there is a gross deficit between the fund being pursued of $8 million and the face value of the 706 outstanding loans. As earlier noted, that face value at the date of receivership was $13.3 million. It will have a much higher value now with added interest. In broad terms, if the depositors succeed in these proceedings they are unlikely to secure more than 50 cents in the dollar. There was some evidence that some members of the partners' families made significant deposits. But there is no suggestion that they were of any significance measured against the total book of deposits unpaid on receivership. Even if they were excluded, as LDC argues they should be, it would be of no consequence to LDC as the total face value of remaining depositors would easily consume the $8 million.

[96] I conclude that F & I was always trading in breach of the Securities Act, and there is no live dispute in these proceedings of interest to LDC as to the membership of the class of plaintiffs.

(iii) What is the character of the statutory trust, given that the deposits were used in trading?

[97] F & I traded in breach of s 37 of the Securities Act from the time that section came into force and down to the date of its receivership. That means at various times either s 37(5) as originally enacted, or s 36A applies. As originally enacted, s 37(5) provided:

> (5) Where subscriptions for securities are received by or on behalf of an issuer, but, by virtue of this section, the securities may not be allotted, or for any reason the securities are not allotted, the issuer shall ensure that—
>
> (a) At all times while held by it, the subscriptions are kept in a trust account on behalf of the subscribers; and
>
> (b) The subscriptions, together with such interest (if any) as has been earned thereon, are repaid to the subscribers as soon as reasonably practicable.

[98] There was no issue as to how this section was intended to apply. It is presuming a compliance with the law.

[99] F & I have never complied with s 36A nor its predecessor s 37(5). Whatever might have been the law under s 37(5) and before it, there is no doubt that from 15 April 2004 when s 36A came into effect and replaced s 37(5)(a), F & I have been in breach of s 36A.

[100] Section 36A provides:

> **36A Subscriptions must be held in trust**
>
> An issuer must ensure that subscriptions for securities offered to the public are held in trust for the subscribers until the securities are allotted or until the subscriptions are repaid to the subscribers under this Act.

[101] Questions then arise as to whether (a) the statutory trust survives the breach and, if so, what are its characteristics; or (b) whether there is another trust to be recognised by equity.

[102] There were two competing arguments in this Court. Mr Goddard, for the defendant, argued that s 36A applies in respect of each subscriber in a unitary fashion. He argued that the receipt and use of deposits was in breach of trust. However, the deposit was almost immediately lost in the mix of funds being expended and loaned out, so the remedy of the depositors is against Messrs Harding and Scholfield personally. It goes no further.

[103] The alternative argument is that the plaintiff depositors are a class. They own the assets of the trading partnership (which was trading in breach of trust) and can now trace those assets collected by LDC from F & I's receivables.

[104] In my view, there are three sets of reasons, all of which drive to the same conclusion, namely: that as a consequence of the breach of s 36A, Messrs Harding and Scholfield held the receivables of the partnership in trust for the unpaid depositors at any one time. This crystallised upon receivership into the class of unpaid depositors. These depositors are the beneficiaries of the trust. They are

beneficiaries according to their contribution; that is, in the traditional language of equity, *pari passu*. I deal with each set of reasons in turn.

(a) The plain language of s 36A

[105] Section 36A uses the phrase "*are held in trust for the subscribers until the securities are allotted or until the subscriptions are repaid to the subscribers under this Act*".

[106] The term "*subscribers*" is anticipatory. For at the time the trust arises they are not subscribing to script, because there is no script to be allotted. Script can only be allotted after a prospectus is in place,[24] which can only occur where a trust deed has been executed between the issuer and a trustee.[25] Yet the plain language of s 36A requires the trust to be in place until steps are taken to enable valid allotment of securities. The trust exists prior to valid allotment of securities. It is a trust for the depositors.

[107] Second, the language "in trust for the subscribers" is plural. It does not say in trust for each subscriber.

[108] There is no difficulty in equity with the concept of a trust for a class of beneficiaries. Trusts for classes of beneficiaries are common place. In family trusts it is common place for there to be trusts for children or grandchildren or a member of the family.

[109] An instance of a class trust in the financial world is the case of *Brazzill & Others v Willoughby & Others.*[26] KSF, a subsidiary of an Icelandic Bank, carried on business in the United Kingdom as a deposit taker pursuant to an authorisation issued by the Financial Securities Authority (the FSA). The depositors included members of the general public, institutions, local authorities and others. Some depositors were protected under the Financial Services Compensation Scheme but others were not. In October 2008, KSF's parent company collapsed causing KSF's

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[24] See Securities Act 1978, s 37(1).
[25] See Securities Act 1978, s 33(2).
[26] *Brazzill & Ors v Willoughby & Ors* [2010] EWCA Civ 561.

liquidity position to deteriorate as a result of a loss of public confidence. The FSA required KSF to open a trust account with the Bank of England and to pay into that account an amount equal to "deposits" received from "customers" on or after 2 October 2008. KSF paid some $147 million into this account. However, KSF had received a further $141 million in deposits from financial institutions and customers but had not paid corresponding amounts into the account. There was a doubt as to who were the beneficiaries of the trust. It was held that the supervisory notice served by the FSA created a trust for a class of beneficiaries comprising all KSF's account holders in respect of whose deposits payments should have been made into the account in accordance with the notice whether or not money was so transferred.

[110] To the extent that its first issue is comparable, the recent decision of the Supreme Court of the United Kingdom in *In the matter of Lehman Brothers International (Europe) (In Administration)*[27] supports this reasoning. This case arose from the insolvency in administration of the Lehman Brothers group of companies. Lehman Brothers International (Europe) ("LBIE") was regulated by the Financial Services Authority ("FSAUK"). The FSAUK issued the Client Assets Sourcebook (CASS 7) for the safeguarding and distribution of client money. Regulation 7.4.16G of CASS 7 provides, amongst other things, that:

> Under the alternative approach, *client money* is received into and paid out of a *firm's* own bank accounts … A *firm* that adopts the alternative approach will segregate *client money* into a *client bank account* on a daily basis, after having performed a reconcilation of records and accounts of the entitlement of each *client* for whom the *firm* holds *client money* with the records and accounts of the *client money* the *firm* holds in *client bank account* and *client transactions accounts* to determine what *client money* requirement was at the close of the previous *business day*.

[111] CASS 7 (7.7.2R) further provides that:

> A *firm* receives and holds *client money* as trustee (or in Scotland as agent) …

[112] The Supreme Court unanimously held that the statutory trust under CASS 7 arrises on receipt of clients' money. In reasoning to this conclusion, Lord Hope said:

> 47. … The modern approach of the court to construing commercial or regulatory documents is to prefer a purposive to a literal approach.

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[27] *In the matter of Lehman Brothers International (Europe) (In Administration)* [2012] UKSC 6.

> …
>
> 62. On the first issue Briggs J and the Court of Appeal were in agreement that the statutory trust arises on receipt of the money; and this court, I understand, unanimously agrees that they were right. …

[113] Lord Hope then went on to summarise Briggs J in these terms:

> 63. …
>
> (1) Where money is received from a client, or from a third party on behalf of a client, it would be unnatural, and contrary to the primary purpose of client protection, for the money to cease to be the client's property on receipt, ….
>
> (2) … Under the alternative approach an immediate trust of identifiable client money does provide protection, though mixed funds are subject to a variety of risks.

[114] Subsequent issues were decided in accordance with the regulations, not on any general principles of trust law.

(b) Section 36A read in the light of its purpose

[115] The Securities Act 1978, like all statutes, has to be interpreted in the light of its purpose. The context of the Act is that it is addressing the allotment of securities to subscribers (i.e. depositors). Securities legislation addresses businesses taking subscriptions from numerous persons. Where a number of depositors are placing money with a lender, it would be extremely unusual for the lender to be required by law to open a separate bank account for each depositor. Of course the lender, as normal business practice, would give an individual receipt to the depositor, but the deposit, albeit a cheque, internet deposit or cash, would be accepted by the issuer's bank and credited to the issuer/lender's bank account. Immediately the individual deposits are be irretrievably mixed.

[116] It matters not whether the lender has one, two or any number of accounts. We can be sure, however, that the natural context for construing s 36A is that there will be pooling of deposits. Yet, on a strict construction of Mr Goddard's argument, the trust character of the funds is lost on pooling, leaving the depositors only with a personal claim against the trustees. That argument destroys the benefit of the trust

upon the receipt of the funds. For equitable relief confined to a personal remedy against the trustees only duplicates the available common law remedy in contract. Section 36A has the purpose of protecting the deposit by reserving a proprietary claim by the depositor as a beneficiary. To achieve its purpose, s 36A has to be applied as a trust for a class, with proprietary claims which survive the mixing of deposits.

(c) Section 36A read in the context of involving the law of trusts

[117] When Parliament used the term "trust", without defining it, it clearly intended that the Judges applying the Securities Act apply the law of trusts. A trust is a relationship where a person holds property on behalf of others. You cannot have a trust without there being property being held on behalf of others. If a person holds property but does not hold it on behalf of others there cannot be a trust. There has to be certainty of property and certainty of object (that is, beneficiaries).

Conclusion that there is a trust for a class

[118] These contextual considerations reinforce the plain language of s 36A. It can be read confidently in the plural.

[119] Section 36A is creating a trust for a class of subscribers/depositors. The property held on their behalf are their subscriptions/deposits. The maxim equality is equity applies so the deposits when banked into a pool will be held *pari passu*; that is, in proportion to each other both as to amount and time of deposit. The time of deposit is relevant to dividing the accrual of interest being paid by the bank who has taken the deposit.

[120] Those deposits are the subject of the trust. They are the property of the trust. They are held on behalf of the depositors. Any other interpretation would defeat s 36A.

[121] It matters not that there may be some other funds deposited in the same bank account. For equity has appropriate rules for allocating property between mixed

classes of claimant. Take a simple example. A person has in his bank account a credit of $100,000 and then takes another $100,000 by way of deposit in breach of s 36A. That person now becomes a trustee of 50 per cent of the account, to hold it on behalf of the depositor. It matters not that it is impossible to separate the original credit of $100,000 from the deposit of $100,000. It is sufficient that there is certainty as to the extent of the claim that can be made by the beneficiaries on the fund. There can be because there is no doubt as to the obligation of the owners of the lender under s 36A to hold those deposits on trust for the depositors.

(iv) Whether the sums being pursued by the plaintiffs are the property of this trust?

[122] The F & I trustees have been constantly in breach of trust since 1 September 1983, when the Securities Act came into force. Funds by depositors have never been held simply for the depositors. They have been used to add value to the deposits by carrying on the business of money lending. They have been expended either by way of loans to borrowers or, to meet the ongoing costs of making loans, being used to fund both fixed and variable costs e.g., rent (fixed) and postage (variable). They have been used to repay other depositors. Profits have been withdrawn against book records of profits on loans made and interest due. Those withdrawals are likely to have been funded at least in part from deposits. As Lord Millet put it in *Foskett v McKeown*:[28]

> The claimant claims the new asset because it was aquired in whole or in part with the original asset. What he traces, therefore, is not the physical asset itself, but the value inherent in it.

[123] It is a feature of this case that the business had a credit deposit with its trading bank from cash flow for almost the entire time of its more than 30 year history. It very rarely went into overdraft. It did not depend on overdraft facilities. There was only one injection of capital of $500,000 each by the two shareholders. In an analysis done by Mr Stiassney over the period from 1 April 2002 to the receivership in 2007, all but $3 million of $139 million moving through the accounts came from deposits or receivables of loans.

[28] *Foskett v McKeown*, above n 13 at 128.

[124] Applying Article 90.1 of *Underhill and Hayton*, it is plain that during the business, in breach of trust, the deposits have been substantially, and progressively, converted into receivables. These receiveables are the substitute for the deposits. They were deliberately obtained, by loans, in order that interest could and was obtained, from the funds deposited, at a higher rate than the interest promised to the depositors, so that the trustees could and did make a profit. Equity requires the trustees to account for the profits and for the capital earning the profits. As both are the property of the beneficiaries.

[125] An alternative equitable approach, with the same consequence, is to reason that given that it was a successful business until its collapse in 2006-2008, the expenditure on fixed and variable costs and the drawing of profits from the firm are, in equity, deemed to be drawn from the margin between the liabilities to repay the deposits with promised interest as a cost, and the receivables of repayment of the loans together with interest as an asset.[29]

[126] Either way, the trustees, Messrs Scholfield and Harding, have in breach of trust converted the deposits into another form of wealth, the receivables. But those receivables, so converted, become subject to the same trust and are so property of the trust held for the benefit of all the beneficiaries who have not been repaid their deposits.

[127] Those beneficiaries who were repaid naturally fall out of the trust class of beneficiaries. This is so, because you can only be a beneficiary of the trust if you are capable of making some claim on the trustee. Or, to put it another way, you can only be a beneficiary of a trust if the trustee has a fiduciary obligation to you. If you have been paid out and have no further claim there is neither a claim nor an obligation. You simply fall out of the class of unpaid beneficiaries.

[128] The wrongdoer trustees had no claim at any time on the receivables of F & I and the balance in the bank accounts against the claims of the beneficiary depositors. For all the profits from trading, even in excess of the interest entitlements at common

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[29] See above at [70].

law, belonged to the depositors. Trustees must account for all profits earned in breach of trust.[30]

[129] This position existed at least from 2 May 2006. On that day the trustee partners learned that F & I's $7 million of advances to Halifax Finance Ltd were likely irrecoverable. Halifax borrowed from LDC and from F & I. It did not have the ability to repay its loans and was subject to a first charge in favour of LDC ahead of F & I. Indeed, F & I needed, it thought at the time, about $500,000 as a loan from LDC to maintain its liquidity. In fact, as it turned out, it needed more than that. As at 2 May 2006, F & I no longer had a positive margin between its liabilities to its depositors and its book of receivables, written down to reflect realistic recoveries. Messrs Harding and Scholfield could only hope that with liquidity funding from LDC, F & I would be able to meet its liabilities as they fell due, trade on, and, over time, absorb the loss in Halifax. As wrongdoer trustees Messrs Harding and Scholfield had no claim at all on the receivables from the loans, which on any view were almost entirely funded from deposits, let alone any claim on the deposits. The position in equity of the partners was that they were trustees holding the deposits and receivables for the depositors, unpaid, so that the deposits and receivables were the property subject to the trust.

[130] The position would be otherwise if the trustees had both traded in breach of trust and successfully augmented the working capital of the business with more equity and overall made significant profits. In such a situation there would be a claim capable of being made by the trustee in breach of trust against the assets of the finance business being a mixed fund of depositors' property and trustees' property. An instance of such a case is *Re Tilley's Wills Trusts; Burgin v Croad and Another.*[31] Here, a widow trustee accumulated trust capital but thoroughly confused those moneys with her own private funds. She invested well, however. There was no loss. Ungoed-Thomas J in Chancery held that if a trustee mixes trust assets with his own in such a way that they cannot be sufficiently distinguished and treated separately to the extent that he fails to distinguish them, the onus being on him, they

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[30] See for example *Boardman v Phipps* [1967] 2 AC 46 (HL).

[31] *Re Tilley's Will Trusts; Burgin v Croad and Another* [1967] 1 Ch. 1179.

belong to the trust.[32] Here that principle was needed in order to resolve essentially the allocation of the profits.

[131] This case is otherwise. There is a deficit. It it is not necessary to apply the wrongdoer principle in the way it was done in *Re Tilley's Wills Trust*. The trustees in this case do not. Rather, they gave evidence in support of the claim by the beneficiaries. Nor could they have come to equity and sought some portion of the fund. For the fund is only a fraction, in round terms about half, of the unpaid depositors' funds. Equity would treat the first losses in the write-down of receivables by F & I as being booked against any contributions to working capital by F & I, limited as they were. On the facts of this case such contributions were well and truly only a fraction of the total losses suffered by F & I.

[132] Accordingly, the proper, and I think inevitable, conclusion is that as between the beneficiary depositors and the trustee partners of F & I as at 2 May 2006, and probably for some time unknown before, all cash credits in the bank accounts and receivables were held by the trustees as the property of the trust for the unpaid depositors, as a class, at any point in time.

[133] The beneficiaries, had they known that, could have unanimously called for a winding up of the trust and taken legal title to those assets.

[134] Ungoed-Thomas J in *Re Tilley's Will Trusts* cited *Snell's Principles of Equity*[33] with approval at 1189:

> Where the trustee mixes trust money with his own, the equities are clearly unequal. Accordingly, the beneficiaries are entitled to a first charge on the mixed fund, or on any land, securities or other assets purchased with it. Thus if the trustee purchases shares with part of the mixed fund, leaving enough of it to repay the trust moneys, and then dissipates the balance, the beneficiaries' charge binds the shares; for although under the rule in *In re Hallett's Estate* the trustee is presumed to have bought the shares out of his own money, the charge attached to the entire fund, and could be discharged only by restoring the trust moneys. Where the property purchased has increased in value, the charge will be not merely for the amount of the trust moneys but for a proportionate part of the increased value. Thus if the trustee purchases land with £500 of his own money and £1,000 of trust

[32] Ibid at 1180.
[33] *Snell's Principles of Equity* (26th ed, Sweet & Maxwell, London, 1966) at 315.

> moneys, and the land doubles in value, he would be profiting from his breach of trust if he were entitled to all except £1,000; the beneficiaries are accordingly entitled to a charge on the land for £2,000.

[135] Because this is not a mixed fund, the position is even simpler. All the receivables are the property of the trust, and if they remained under the control of the trustees, could have been claimed by the unpaid depositors as a class.

Conclusion that the receivables of F & I are trust property

[136] In this case the plaintiff beneficiaries have clearly elected to seek to pursue the receivables of the F & I partnership as trust property. I find that they are trust property. Further, I find that the depositors as a class are entitled to that trust property. All being adult beneficiaries, they are entitled to agree to the division of that property once it is recovered. If they cannot agree, they can obtain directions from the Court in equity. The Court would start with the presumptions that the fund would be allocated *pari passu*.

C Are Perpetual and/or LDC bona fide purchasers for value without notice of the breach of trust?

[137] The plaintiffs bring their claim against LDC on the basis that LDC was in knowing receipt of trust funds. LDC defends on the basis that it is a bona fide purchaser for value without notice of F & I's trust obligations.

[138] Furthermore, LDC has interpleaded to join its trustee, Perpetual. LDC contends that Perpetual's security interest over LDC's assets, acquired in 2004, means that Perpetual stands ahead of the plaintiffs, as Perpetual is itself a bona fide purchaser for value of LDC's assets without notice, in 2004. This is by reason of the deed with LDC, whereby Perpetual acquired present and future assets of LDC.

[139] LDC's defence of being a bona fide purchaser for value without notice is both as at the September 2006 transaction and as at the March 2007 transaction.

[140] I propose to deal with these defences in chronological order starting with the acquisition of its interests by Perpetual in 2004, dealing with the agreements entered into by LDC and F & I in September 2006, and moving on to the 2007 transaction.

Does Perpetual have the defence of being a bona fide purchase for value?

[141] In 2004 LDC entered into a Debt Securities Trust Deed ("the Deed") with Perpetual. The purpose of the Deed was to enable LDC to issue debt securities complying with s 37 of the Securities Act. After providing for prior ranking stock, the Deed provided for:

> Unsecured Deposits (hereinafter called "Deposits") constituted and secured by a Trust Deed dated …………… between the Company [LDC] and Perpetual Trust Ltd (as Trustee for the Depositors) ("the Trust Deed") which Deposits are issued with the benefit and subject to the provisions of the Trust Deed and the Conditions annexed to this Deposit Certificate.

[142] The first condition was:

> 1. The holder of the Deposits is entitled pari passu and rateably with the holders of all other Deposits constituted by the Trust Deed to the benefit of, and is subject to, the provisions of the Trust Deed (including the conditions).[34]

[143] It is a continuing security. When the deposit moneys become payable the Deed obliges LDC to pay them to Perpetual, including interest on the debt securities.[35] However, notwithstanding that until required by Perpetual, LDC pays the principle and interest directly to the security holders.[36]

[144] Under the Deed, LDC grants to Perpetual a security interest in all of the company's personal property and its other property. Clause 6.1, headed "Security Interest", provides:

> As continuing security for the payment of the Secured Moneys compliance with the secured obligations, the company and each of the charging subsidiaries grants to the trustee a security interest in all of the charged assets.

[34] Debt Securities Trust Deed, Schedule Part 2, Deposit Certificate, Condition 1.
[35] Clause 2.5(a) and (b) of the Debt Securities Trust Deed.
[36] Clause 2.5(c) of the Debt Securities Trust Deed.

[145] "Charged assets" means all of LDC's personal property and its other property. Other property includes all of LDC's and its subsidiaries' present and future interests in land or any other property other than personal property. Personal property includes "all of its present personal property and after-acquired personal property …".

[146] Accordingly, LDC argued that by the 2004 Deed, Perpetual acquired a security interest or charge or legal interest over all the present and future assets, personal property, real property and any other property of LDC.

[147] LDC then argued that this was for consideration because Perpetual gave valuable consideration. Counsel submitted that valuable consideration was an agreement by Perpetual to provide trustee services. Recital (B) to the Deed says:

> The Trustee has agreed for the consideration expressed to act as Trustee for the benefit of Securityholders upon the terms and conditions of this Deed.

Clause 9.1 deals with trustee's remuneration. The relevant extracts are:

> 9.1 Trustee's Remuneration
>
> (a) The Company shall pay to the Trustee by way of remuneration such sums as shall from time to time be agreed between the Company and the Trustee.
>
> (b) In respect of any matter in relation to this Deed and its services as Trustee pursuant to this Deed, the Company will pay to the Trustee on demand all costs, charges and expenses (including travelling expenses), reasonably incurred by and on behalf of the Trustee.

[148] LDC argued that the agreement by Perpetual to provide services was adequate consideration because it is sufficient for the purposes of the doctrine of bona fide purchaser for value that the consideration be more than nominal. Mr Goddard cited the text *Meagher Gummow and Lehane* (4th ed) para [8-250],[37] in turn citing *Park v Dunn* [1916] NZLR 761.

[149] Meagher et al were setting out a general proposition. The facts for *Park v Dunn* have no application to this case. There the defendant Dunn was applying for

[37] R Meagher, O Heydon and W Leeming *Meagher Gummow and Lehane's Equity Doctrines and Remedies* (4th ed, LexisNexis, Australia, 2002) at [8-250].

land transfer title to a parcel of land. Prior to the grant of title, he signed a document under seal acknowledging that his sister was entitled to a share of the land and he agreed to transfer the share to her conditional upon her paying a proportion of the land tax and the expenses of perfecting title. Cooper J held that all the requisites for an effective declaration of trust were present in the document thus signed. Alternatively, if that was not the case then his sister had provided some consideration, when taking into account the relationship of brother and sister was so inadequate as to justify the Court in refusing specific performance.

[150] Counsel in this case were unable to provide the Court with any precedent for a defence by a trustee as being a bona fide purchaser for value because the trustee was to be remunerated. Trust deeds regularly provide for trustees to be remunerated. This is because the default position in equity is that the trustee is not entitled to make any profit in discharging his duties as trustee. As it is put in *Snell's Equity*:[38]

> (d) *Fiduciary remuneration*
>
> (i) GENERAL RULE
>
> Another application of the general fiduciary conflict principle is the rule that trustees and executors are generally entitled to no allowance for their care and trouble …[39]

[151] To suggest that a trustee has given consideration for the acquisition of the legal interest in assets being transferred by agreeing only to do so if remunerated, is a concept totally foreign to the application of a bona fide purchaser for value defence. It was nothing to do with the policy reasons for the defence which provide protection for purchasers in market transactions.

[152] In oral argument, Mr Goddard developed an alternative basis for consideration. He argued that although not party to the deed, the trust deed between LDC and Perpetual should be regarded as two legs of a triangle, the third leg being the security holders for whose benefit the deed is enacted. The consideration was provided by the security holders when purchasing securities. That consideration becomes the consideration provided by Perpetual.

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[38] J McGhee QC (ed) *Snell's Equity* (32nd ed, Sweet & Maxwell, London 2010) at 195.

[39] Citing *Robinson v Pett* (1734) 3 P.Wms. 249 (24 E.R. at 1049).

[153] He offered no authorities in support of this argument. It suffers from an immediate problem that under the terms of the Deed there are no securities issued until after the deed is complete. The provision of securities is enabled by the Deed and happens later. Yet under the terms of the Deed the secured interests over the assets of LDC have been transferred to Perpetual prior to any securities being issued.

[154] I reject any proposition that this deed should be taken as a bona fide purchase of assets for value for the purposes of applying the equitable defence. It would be an unconscionable misuse of the defence.

[155] As to absence of notice on Perpetual's part, LDC also argued that because the trust deed is a continuously charging instrument which takes effect as from 2004, the time for examining whether or not Perpetual had any notice is in 2004. In 2004 there were no dealings between LDC and F & I so no issue of notice could possibly arise.

[156] Mr Goddard acknowledged that the alternative view is that as assets were transferred by F & I to LDC (to be swept as PPSA security interest held by Perpetual), a test could be whether or not Perpetual had notice at that time. He argued that four decisions of the Supreme Court of Canada pointed against that conclusion.[40] These are decisions which reiterate the continuous charging function of such deeds. However, in none of these cases were the Judges having to consider whether the transferee was on notice of a breach of trust at the time of the after acquired charges.

[157] As I have found that Perpetual as trustee is not a bona fide purchaser for value, it is not strictly necessary for me to decide whether it was on notice on 4 September 2006 or in March of 2007. I will, however, examine those issues chronologically after I have examined whether LDC was materially on notice on those two occasions. It is sufficient to end this discussion of Perpetual's position by saying that I favour the view that where there is a continuously charging instrument intended to transfer assets as yet unknown at dates in the future, equity will intervene

[40] *Royal Bank of Canada v Sparrow Electric* [1997] 1 SCR 411; *Bank of Montreal v Innovation Credit Union* [2010] 3 SCR 3; *Royal Bank of Canada v Radius Credit Union* [2010] 3 SCR 38; *I Trade Finance Inc v Bank of Montreal* [2011] 2 SCR 360.

to prevent the transferee taking advantage of a breach of trust when on notice at the time of transfer.

[158] I note that in the case of single transactions, such as the paradigm of a market transaction for sale and purchase of an item of property, the test is of a bona fide purchaser for value without notice at the time of the transaction. Subsequent knowledge of breach of trust does not vitiate that transaction.[41] That law is quite settled. It has an obvious purpose of facilitating the private market for the sale and purchase of assets by reinforcing certainty of title acquired by a purchaser for value without notice. I note a similar outcome is reached by the common law which will not declare a contract a sham unless both the party and the counterparty are agreed at the time of its making that it is a sham.[42]

[159] The reason why equity will intervene in acquisitions under a continuously charging clause, some time after the execution of the instrument, is simply that it would be unconscionable for a party to take advantage of a continuously charging clause entered into some years before to take title to and enjoy an asset, which that party was on notice that the asset is subject to prior equity, i.e. a claim by someone else. Unconscionability is the touchstone of the remedy of a constructive trust preventing a person taking an asset which belongs to someone else.

Did LDC have notice on 4 September 2006?

[160] On 4 September 2006, LDC advanced a loan of $1.5 million to F & I. At the same time F & I subscribed to preference shares in LDC for the consideration of $1.5 million. At the end of the transaction F & I was the holder of 1.5 million $1 preference shares in LDC and in debt to LDC for $1.5 million together with interest accruing. In addition, LDC agreed to provide a finance facility to F & I of $500,000 for working capital. To secure the inebtedness, F & I granted a charge to LDC over its assets including all its receivables.

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[41] *Blackwood v London Chartered Bank of Australia* (1874) L.R. 5 P.C. 92 (PC) at 111, cited in *Macmillan Inc v Bishopsgate Trust (No.3)* [1995] 1 WLR 978 at 1002.
[42] *Snook v London and West Riding Investment Ltd* [1967] 2 QB 786 at 802 per Diplock LJ, citing *Yorkshire Railway Wagon Co. v MacIvre* (1882) 21 Ch.D. 309 and *Stoneleigh Finance Ltd v Phillips* [1965] 1 All ER 513 (CA).

[161] Notwithstanding the circular character of the transaction, there is no dispute between counsel that LDC was a bona fide purchaser for value of a charge over F & I's asssets. The question is, did LDC acquire that charge on notice of F & I's trust obligations?

The test for notice

[162] There was no agreement between counsel as to the criteria for judging whether or not LDC was on notice.

[163] Counsel for LDC formulated the test of actual notice as being whether LDC had:

> Actual knowledge that F & I was in breach of the Securities Act, that would give rise to proprietary claims on the part of F & I depositors. LDC directors knew that deposits would have to be repaid, but the evidence that they did not know about the possibility of proprietary claims was not contradicted.

[164] On constructive notice, it was argued, LDC had to have some constructive notice of some kind of proprietary claim. So, in the context of constructive notice they had to have notice of facts which had come to their notice and into which a reasonable man ought to have inquired, and which inquiry would have led to an appreciation of the presence of a proprietary claim to F & I's assets by the depositors in F & I.

[165] The plaintiffs argued that the law is correctly stated in *Meagher* both as to actual knowledge[43] and constructive notice.[44] These two paragraphs relevantly provide:

> **Actual notice**
>
> It is essential that the holder of the legal estate have no notice of the prior equity at the time when he furnished consideration; if at that point of time he had notice, he will take subject to the prior equity. If his absence of notice continues until the time when he acquires the legal estate, his title is perfect, even though he might unwillingly have acquired title from a trustee selling [in] breach of trust.

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[43] *Meagher Gummow and Lehane*, above n 37 at [8-255].
[44] Ibid at [8-270].

> **Constructive notice**
>
> A person is deemed to have constructive notice of all matters:
>
> (a) Of which he would have received notice if he had made the investigations usually made in similar transactions; and
>
> (b) Of which he would have received notice had he investigated a relevant fact which has come to his notice and into which a reasonable man ought to have inquired. It follows that all cases in which a person is said to have constructive notice of a fact or thing are cases in which he has failed to inquire, either sufficiently or at all.

[166] The plaintiffs also rely on the much cited formulation by Lord Browne-Wilkinson in *Barclays Bank Plc v O'Brien*:[45]

> The doctrine of notice lies at the heart of equity. Given that there are two innocent parties, each enjoying rights, the earlier right prevails against the later right if the acquirer of the later right knows of the earlier right (actual notice) or would have discovered it had he taken proper steps (constructive notice). In particular, if the party asserting that he takes free of the earlier rights of another knows of certain facts which put him on inquiry as to the possible existence of the rights of that other and he fails to make such inquiry or take such steps as are reasonable to verify whether such earlier right does or does not exist, he will have constructive notice of the earlier right and take subject to it.

The Sinclair test

[167] The LDC argument that there has to be the actual or constructive notice of the presence of a proprietary claim to F & I's assets is founded on the recent decision of *Sinclair Investments v Versailles Trade Finance Ltd.*[46] *Sinclair Investments* and other traders were victim of a fraud. The following summary of facts is taken from the judgment of the Trial Judge, Rimer J, which states:[47]

> 1. This [was] a claim by Sinclair Investments Holdings SA ("Sinclair") for recovery of a proprietary nature in consequence of alleged breaches of fiduciary duty and dishonest assistance in a breach of trust. It [was] made in the aftermath of a fraudulent conspiracy carried on by Carlton Cushnie and Frederick Clough during the 1990s. Their fraud was one whereby so-called "traders", including Sinclair, were induced to advance money to an offshore company

[45] *Barclays Bank Plc v O'Brien* [1994] 1 AC 180 at 195-196.

[46] *Sinclair Investments v Versailles Trade Finance Ltd* [2011] EWCA Civ 347 at [93] – [108], [109], [115], [144] – [148].

[47] *Sinclair Investments Holdings S.A. v Versailles Trade Finance Ltd* [2007] EWHC 915 (Ch) at [1] – [6] and [60].

called Trading Partners Limited ("TPL") by false representations that the money would be used by TPL for trading transactions of a particular type. Sinclair was induced to advance £2.35m to TPL.

2. In fact the money advanced by the traders was not used by TPL for such transactions. It was instead used in a "cross-firing" operation involving transfers between bank accounts held by TPL, Versailles Trade Finance Limited ("VTFL", the first defendant) and other companies in the control of Messrs Cushnie and Clough with the object and effect of falsely inflating VTFL's turnover, profit and assets. VTFL was a subsidiary of Versailles Group Plc ("VGP"), a listed company. The further effect of the fraud was falsely to inflate the value of VGP's shares and so enable Mr Cushnie to procure his company Marrlist Limited ("Marrlist") to sell shares it held in VGP at that inflated price: Marrlist sold approximately 5% of its VGP shares on 9 November 1999 for just under £29m.

3. Marrlist also held (through Strathforn Limited, a subsidiary) a valuable house, which Mr Cushnie occupied, at 19 Upper Phillimore Gardens, London W8 ("the Kensington property"). Strathforn had purchased it on 17 August 1999 with the help of a loan from the Royal Bank of Scotland Plc on the security of a charge of the property. The charge was paid off by 28 January 2000 with (in round figures) (i) £9.6m of the proceeds of sale of the VGP shares that Marrlist had sold in November 1999 and (ii) £384,000 provided by Mr Cushnie from an unknown source.

4. The sham basis of VTFL's trading activities and on which VGP attained its status as a listed company could not continue undiscovered indefinitely. The collapse came on 20 January 2000 when three creditor banks appointed joint administrative receivers in respect of VTFL and VGP. The joint receivers (Anthony Loams, who is the second defendant, and Neville Khan) later entered into a series of settlement agreements with Mr Cushnie and Marrlist, as a result of which the Kensington property was sold on 5 December 2001. Out of the proceeds, and pursuant to the agreements, some £5.2m was paid to the receivers, which they still hold. Robert Birchall, the third defendant, replaced Mr Khan as a receiver on 30 September 2002. The receivers are partners in Pricewaterhouse Coopers ("PwC").

5. By this claim Sinclair [sought] a declaration that the defendants [held] those proceeds of the Kensington property upon a constructive trust for beneficiaries that include itself; and that Sinclair, as such a beneficiary, is entitled to an account of the sums due to it under the trust and to payment. The claim is exclusively *property* based: Sinclair's case is that those proceeds represent property in which it had had a proportionate beneficial interest. It relies on the assertions that: (i) the Kensington property was (or is to be regarded as having been) purchased with profits improperly made by Mr Cushnie (namely, the realised value of the VGP shares) in breach of a fiduciary duty he personally owed to Sinclair with regard to the application by TPL of the advances that it had made to TPL; alternatively (ii) that it was (or is to be regarded as having been) purchased with profits whose making had been achieved by Mr

> Cushnie's unconscionable and dishonest conduct in inducing Sinclair to pay its advances to TPL and then dishonestly assisting in TPL's breach of trust towards Sinclair by procuring the use of the money for an unauthorised purpose which had the effect of artificially inflating the profits of VTFL and, in turn, the price of the VGP shares.
>
> 6. The defendants [resisted] Sinclair's claim as unfounded. They [said] that, on the facts, Mr Cushnie owed no personal fiduciary duty to Sinclair with regard to the application of the money it paid to TPL and so the first basis of the claim must fail. As to the second, they [admitted] that, on the facts, TPL was a trustee of the money paid to it by Sinclair, that it breached that trust and that Mr Cushnie dishonestly assisted in that breach. But they [said] that a claim for dishonest assistance is one that entitles the claimant to no more than monetary compensation for breach of trust. It does not entitle him to a proprietary remedy in respect of the fruits of such assistance, which is what is sought. Sinclair has already, in other proceedings, obtained a money judgment against Mr Cushnie for his fraud and has entered into a compromise with him in respect of its claim against him for compensation for dishonest assistance in TPL's breach of trust. The defendants [said] that Sinclair is not entitled to further, proprietary, relief in consequence of his wrongs.
>
> …
>
> 60. [There was] an additional defence raised by the defendants: namely, assuming all else in favour of Sinclair, the receivers received the £5.2m as good faith purchasers for value without notice of any claim such as Sinclair … brought or of any trust such as Sinclair asserts. If they are wrong on all else, but right on that, it affords a complete defence. Sinclair does not dispute that the defendants gave value for the £5.2m, nor does it question the receivers' good faith in negotiating the settlements. But it [asserted] that they had sufficient notice of its claim to deprive the defendants of this defence.

[168] Rimer J rejected the plaintiff's claim to a proprietary interest in the equity of the Kensington property. As a result, he did not need to spend any time on the question of whether or not the receivers were on notice. It is sufficient to set out the brief dismissal of the without notice defence as follows:

> 136. The only matter which requires further consideration is the "good faith purchaser without notice" defence, which I will deal with briefly. For that purpose I must presumably assume that, contrary to my decision, Sinclair was a beneficiary of a constructive trust under one or other of its alternative arguments. I consider the relevant question to be whether, by the time of the first settlement agreement in February 2001, the defendants had actual or constructive notice of that trust; and I regard the relevant notice, if any, as that of the receivers. I have approached this issue bearing in mind the approach of the Court of Appeal to the like question that arose in *Carl Zeiss Stiftung v Herbert Smith & Co and Another (No 2)* [1969] 2 Ch 276.

> 137. In my judgment the receivers had no notice of any trust in favour of Sinclair. They did not know, and could not have known, of the existence of any trust arising under the first limb of Sinclair's case, because it is accepted that they had no sort of notice of Mr Cushnie's assurances to Mr Hill, which are of the essence of that case. As for Sinclair's alternative case, the question is conceptually more difficult and I do not propose to wrestle with it: it would require me to consider whether they had actual or constructive notice of a trust arising on undisputed facts, being a trust which (in my view) is unrecognised by the law. I add that if, contrary to my view, the question is whether the receivers had actual or constructive notice of a trust *claim* being brought by Sinclair, I find they did not. Sinclair did not, prior to the February 2001 agreement, indicate to the receivers that it proposed to bring any such claim.

[169] Sinclair appealed and the appeal was dismissed.[48] I address only the notice issue. The Master of the Rolls, Lord Neuberger, delivered the judgment of the Court of Appeal. At [94] he formulated the issue as follows:

> 94. The question is whether TPL's attempt to follow certain payments to the banks from those proceeds of sale can be defeated by the banks on the ground that they were *bona fide* purchasers for value without notice. There is no suggestion that the banks did not act *bona fide* (save to the extent that that question overlaps with the question of notice). There is no dispute that they were "purchasers" for value, in the sense that the money they received was used in partial discharge of Mr Cushnie's secured liabilities to them. Accordingly, the sole issue is whether the banks had notice of the proprietary claim at the time they received the relevant payment. As to that it is common ground that the burden of proof is on the banks: see *In re Nisbet and Potts' Contract* [1906] 1 Ch 386.

[170] Lord Neuberger cited the dicta of Lord Browne-Wilkinson in *Barclays Bank plc v O'Brien*[49] (set out above) and of Millett J, as he then was, in *Macmillan Inc v Bishopsgate Trust Plc and Others (No.3)*:[50]

> … [The plaintiff] attempted to establish constructive notice on the part of each of the defendants by a meticulous and detailed examination of every document, letter, record or minute to see whether it threw any light on the true ownership of the [relevant] shares which a careful reader — with instant recall of the whole of the contents of his files— ought to have detected. That is not the proper approach. Account officers are not detectives. Unless and until they are alerted to the possibility of wrongdoing, they proceed, and are entitled to proceed, on the assumption that they are dealing with honest men. In order to establish constructive notice it is necessary to prove that the facts known to the defendant made it imperative for him to seek an explanation, because in the absence of an explanation it was obvious that the transaction was probably improper.

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[48] *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd* [2011] EWCA Civ 347.
[49] *Barclays Bank plc v O'Brien* [1994] 1 AC 180, 195-196.
[50] *Macmillan Inc v Bishopsgate Trust Plc and Others (No.3)* [1995] 1 WLR 978 at 1014.

[171] Lord Neuberger went on:

> 100. In the present case, as at the three dates identified in para 95 above, TPL's case is that the banks ought to have appreciated that the transfers of money effected on, or as at, those dates was "probably improper" on the ground that the money was beneficially owned by TPL, or at least that the banks ought to have made inquiries before accepting the money. It is accepted by both TPL and the defendants that the issue is to be determined by asking what the banks actually knew, and what further inquiries, if any, a reasonable person, with the knowledge and experience of the banks, would have made, and, in the light of that, whether it was, or should have been, obvious to the banks that the transaction was probably improper.
>
> 101. The information available to the banks, through the administrative receivers, as to what had really been going on in the Versailles Group started to come through from December 1999. The incremental increase in the available information then built up over the next three years, as a result of forensic accounting investigations, meetings and discussions, especially with representatives of those who had been defrauded, such as Mr Akers on behalf of TPL, and legal, accounting and financial reports and advice. The ultimate, and difficult, task for the Judge was to decide at what point the level of information was such that the banks had notice of TPL's proprietary claim. At some point, an item of factual information, a (possibly informal) notification of a claim, or a piece of advice, when taken together with the facts, notifications and advice already available would have changed the banks' position from not having notice to having such notice. That point had to be decided, of course, on the basis of the evidence available to the Judge, and his assessment of what a reasonable and honest person in the position of the banks, with all their experience and available sources of advice, should have known, done, and appreciated, as well as what they actually knew, did, and appreciated.

[172] Lord Neuberger went onto the question of whether it is right to impute the legal consequences of known facts, and it is relevant to quote his citation of *Carl Zeiss Stiftung v Herbert Smith & Co (No 2)*[51] and his comments which refer back to paragraphs [98] – [100], just quoted.

> 105. That conclusion seems to be consistent with the principles referred to in paras 98 and 99 above, although the cases referred to there were concerned with facts and factual inferences rather than legal consequences. The conclusion also appears consistent with what was said in *Carl Zeiss Stiftung v Herbert Smith & Co (No 2)* [1969] 2 Ch 276, 290 where Danckwerts LJ said this:
>
> > "In my view, knowledge of a claim being made against the solicitor's client by the other party is not sufficient to amount to notice of a trust or notice of misapplication of the moneys. In the present case, which involves unsolved questions of fact, and difficult questions of German and English law, I have no doubt that

[51] *Carl Zeiss Stiftung v Herbert Smith & Co (No 2)* [1969] 2 Ch 276.

> knowledge of the plaintiffs' claim is not notice of the trusts alleged by the plaintiffs."

> Sachs LJ took the same view and, at p 297, described "the duty to inquire" as "vary[ing] according to the facts", and that, in that case, when it came to the law, the defendants were "under no duty … in such a complex matter either to make inquiries or to attempt to assess the result".
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> 106. It is true that, like the *Belmont Finance Corpn* case [1980] 1 All ER 393, the *Carl Zeiss* case [1969] 2 Ch 276 was not a notice case. It is also true that different standards may be appropriate for assessing what constitutes knowledge or notice in knowing receipt, constructive trust, and notice cases: see per Megarry V-C in *In re Montagu's Settlement Trusts* [1987] Ch 264 and *Bank of Credit and Commerce International (Overseas) Ltd v Akindele* [2001] Ch 437. However, all such cases ultimately involve the question whether a recipient of money to which another person has a proprietary claim can properly retain the money, in the face of a claim by the other person, given what the recipient knew or ought to have appreciated at the time he received the money.
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> 107. Even if different standards are appropriate to those different equitable claims (as to which I express no view), it would be surprising if a wholly different approach was taken when assessing whether the recipient of the money should be assumed to appreciate the legal consequences of the facts he knows or ought to know. It seems to me that the question whether one attributes to the recipient of the money knowledge of the legal consequences of the facts that he knows should be determined by reference to the same standard as is applicable to the facts. Thus, in the present case, the proper approach to the issue should be as laid down in the passages cited in paras 98-100 above.
>
> 108. Accordingly, I agree with the judge that it is not right automatically to impute to the banks knowledge of the legal consequences of the facts which they knew or ought to have known. I also agree with him that the reasoning in the *Carl Zeiss* case [1969] 2 Ch 276 supports the proposition that notice of a claim is not the same as notice of a right. In every case one has to identify the facts known to the person alleged to have notice, and then consider the question by reference to the guidance given in the passages quoted in paras 98 and 99 above, whose effect is, I believe, accurately summarised in para 100 above.

[173] Having thus formulated the test, the Court of appeal came to the same view as the trial Judge.

[174] This is not the standard and traditional formulation of the test. LDC relied on the proposition that they had to be on notice of "a proprietary interest". That is also not the normal formulation of the test of notice, which, as we have seen, is notice that there is a claim on the assets.

[175] It is always important to read judicial dicta in the context of the material facts and the issue which the Judges have to decide. This is particularly important in equity cases. Counsel for the plaintiffs submitted that the facts in *Sinclair* were far removed from the case before me. I agree. It needs to be kept in mind that both the trial Judge and the Court of Appeal rejected the ability to trace. That is not surprising given the facts of that case. The sale by the receivers of the Kensington property was far removed from that transaction by which Sinclair invested money to TPL. The identification of any obligation owed by the fraudster, Mr Cushnie, depended upon knowledge that Mr Cushnie was a fraud.

[176] It took time for the receivers to twig to that. They did not even know of the cross-firing operation until some time into the receivership. They did not know of the relationship between Mr Cushnie and Sinclair in any detail at all. By a settlement the receivers acquired charges over the Kensington property on 26 February 2001 and sold it on 5 December of the same year. The receivers had reached a settlement with Mr Cushnie in 2000, settling claims by VGP and VTFL against him for repayment of dividends paid on a false basis that VGP had distributable profits enabling dividends to be repaid and a claim by VTFL for breach of his duties as a director. "Neither dishonesty nor a proprietary claim was alleged in the settlement agreement."[52]

[177] By contrast with *Sinclair,* here Mr Noone of PwC, a year before the receivership, on his first visit to F & I, as an adviser to LDC, immediately recognised that it was trading in breach of the Securities Act. He told Messrs Harding and Scholfield that they could go to prison. Mr Noone was accompanied to that meeting by Mr Malcolm Hollis, who later became the receiver of both F & I or LDC**.** No one suggested that Messrs Noone and Hollis did not know of the need for F & I to be operating with a prospectus. That is the very reason why Mr Noone made his remarks to Messrs Harding and Scholfield.

[178] The reason why the test was formulated in *Sinclair* as to whether or not the receivers were on "notice of a proprietary claim", was that seems to have been the jargon which was used in the conversations and communications with the receivers

[52] *Sinclair v Versailles,* above n 46 at [18].

at the time. Mr Akers, one of the liquidators of TPL, advised the creditors of that company that PwC (Mr Lomas) had put him (Mr Akers) on notice of "their [VTFL and VGP] proprietary claim over the $400,000 recovered from NatWest Hammersmith."[53]

[179] A proprietary claim is nothing more than a shorthand summary of the following proposition by Millett LJ in *Paragon Finance*, as cited at [43] by the Court of Appeal in *Sinclair*:[54]

> A constructive trust arises by operation of law whenever the circumstances are such that it would be unconscionable for the owner of the property … to assert his own beneficial interest in the property and deny the beneficial interest of another. In these classes of case … the constructive trustee is really a trustee … in these cases the plaintiff does not impugn the transaction by which the defendant obtained control of the property. He alleges that the circumstances in which the defendant retained control make it unconscionable for him thereafter to assert a beneficial interest in the property.

Millett LJ went on to distinguish that kind of case from where equity gives relief against fraud. Millett LJ further said:[55]

> Such a person [a fraudster] is not in fact a trustee at all, even though he may be liable to account as if he were. He never assumes the position of a trustee, and if he receives the trust property at all it is adversely to the plaintiff by an unlawful transaction which is impugned by the plaintiff.

[180] *Sinclair* is essentially a fraudster case. It is distinguishable in material respects from the issues I have to decide in this case for the foregoing reasons, which I now endeavour to summarise:

(a) In the case of F & I, the question of whether or not the partners of F & I were trustees of the depositors' assets by reason of s 36A was a much simpler question than the questions of either relief against a fraudster and/or constructive trust (rejected) which arose in a much more complicated chain of events in *Sinclair*.

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[53] *Sinclair Investments Holdings S.A. v Versailles Trade Finance Limited* above n 47 at [68] – [69] per Rimer J.
[54] *Paragon Finance plc v B D Thakerar & Co* [1999] 1 All ER 400 at 409.
[55] Ibid.

(b) The formulation of the test in *Sinclair* using notice of proprietary relief was influenced by the way in which the issue had been discussed between the liquidator of EPL and the receivers, ironically in another trust issue in a claim embedded in the VPG/EPL litigation.

(c) On the facts, in *Sinclair,* at the time the receivers sold the Kensington property, they simply did not have enough information to be on notice of the very complex chain of reasoning, that was yet to be developed, to assert a proprietary claim over the proceeds of sale of the Kensington property.

(d) There was no issue in *Sinclair* as to whether the receivers were sufficiently on notice as no continuing trust was found. There was no need to apply any test of whether it was obvious or not. The case against the receivers was so slight that the trial Judge dismissed it in two paragraphs.

[181] Accordingly, I do not use *Sinclair* as a reliable guide to formulating the test for notice in this case. *Sinclair's* material facts are simply too far removed from the context of this case.

The Macmillan test

[182] Counsel for LDC in their submissions emphasised the dictum of Millett J (as he was then) in *Macmillan*:[56]

> In order to establish constructive notice it is necessary to prove that the facts known to the defendant made it imperative for him to seek an explanation, because in the absence of an explanation it was obvious that the transaction was probably improper. (Emphasis added)

[183] *Macmillan* concerned the newspaper magnate, Mr Robert Maxwell, who died at sea in 1991. He was the head of a large and complex web of private companies and trusts through which he and his family controlled media interests known as Maxwell Communications and the Mirror Group. Macmillan was a Delaware

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[56] *Macmillan Inc v Bishopsgate Investment Trust Plc* [1995] 1 WLR 978 at 1014.

Corporation and a wholly owned indirect subsidiary of Maxwell Communications. The action was brought in order to recover shares in an operating subsidiary, Berlitz, from various parties into whose hands they had come and who still retained them. During the last month of Mr Maxwell's life, the shares of Maxwell Communication in Mirror Group had been falling in value and Mr Maxwell had been providing ever increasing collateral in order to avoid breaches of the Group's banking conveyance. It was a claim in restitution and was dismissed. In the course of his judgment, Millett J had to apply the English law on notice. He cited with approval the passage from Lord Browne-Wilkinson already referred to in this judgment from *Barclays Bank*.[57] That is an orthodox statement of the doctrine of notice. There is nothing in that passage which suggests that what is notice has to be "obvious that the transaction was probably improper".

[184] The above phrase appears at page 1014 under the heading "Epilogue", which was a discourse about the course which the proceedings had taken. It was after the Judge had made his decision. The Epilogue was written as a complaint by Millett J against the way the case was conducted. "The pleadings filled nearly 1,000 pages. They obscured the issues."[58] I think it is fair to say that this Epilogue was written with some "heat". The Judge complained about the way in which it was sought to show that the defendants had notice. The passage Mr Goddard relies upon falls out of these remarks:[59]

> Worse still, Macmillan attempted to establish constructive notice on the part of each of the defendants by a meticulous and detailed examination of every document, letter, record or minute to see whether it threw any light on the true ownership of the Berlitz shares which a careful reader - with instant recall of the whole of the contents of his files - ought to have detected. That is not the proper approach. Account officers are not detectives. Unless and until they are alerted to the possibility of wrongdoing, they proceed, and are entitled to proceed, on the assumption that they are dealing with honest men. In order to establish constructive notice it is necessary to prove that the facts known to the defendant made it imperative for him to seek an explanation, because in the absence of an explanation it was obvious that the transaction was probably improper. In this regard it is necessary to bear in mind what Bowen L.J. said in *Sanders Bros. v. Maclean & Co.* (1883) 11 Q.B.D. 327, 343:

[57] See above at [166].
[58] *Macmillan v Bishopsgate*, above n 56 at 1013.
[59] Ibid at 1014-1015.

> "But the practice of merchants, it is never superfluous to remark, is not based on the supposition of possible frauds. The object of mercantile usages is to prevent the risk of insolvency, not of fraud; and any one who attempts to follow and understand the law merchant will soon find himself lost if he begins by assuming that merchants conduct their business on the basis of attempting to insure themselves against fraudulent dealing. The contrary is the case. Credit, not distrust, is the basis of commercial dealings . . ."

> As Steyn J. pointed out in *Barclays Bank Plc. v. Quincecare Ltd.* [1992] 4 All E.R. 363, 377:

> "The relationship between merchants is very different from the relationship between a banker and a customer. But, it is right to say, that trust, not distrust, is also the basis of a bank's dealings with its customers. And full weight must be given to this consideration before one is entitled, in a given case, to conclude that the banker had reasonable grounds for thinking that the order was part of a fraudulent scheme . . ."

> Further duplication was due to the insistence of each of the defendants on calling its own expert evidence, and much unnecessary elaboration of legal argument was due to their insistence on taking every point, however remote. Even in a case of this magnitude, some judgment is called for, not merely in deciding which points are arguable and which are not, but which need to be argued and which can be discarded as too remote and unlikely to be needed. In this regard, I exempt Swiss Volksbank from criticism.

[185] I think it is quite wrong to pull out of this criticism, in an Epilogue, after judgment, a new test for constructive notice. A test which has no antecedence in the authorities. There is no suggestion at all that Millett J was giving a considered statement of the law. His considered statement of the law was his earlier citation of Lord Browne-Wilkinson’s much-quoted statement in *Barclays Bank*. Of which Millett J said, immediately after quoting this statement:[60]

> In this formulation the doctrine is in my judgment of general application.

More importantly, this case is not one calling for “suppositions of a possible fraud”. Rather, Millett J has categorised the issue in *Macmillan* as a test of notice upon merchants undertaking an apparently regular transaction. That is why he cited *Sanders Bros. v Maclean & Co.*, where transactions are routine, merchants are not likely to be on notice. It is the antithesis when a transaction is extraordinary, as the F & I/LDC transactions were.

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[60] Ibid at 1000.

[186] Before I leave the *Barclays Bank* test, which I regard as "text book", it is appropriate to refer to the diverging dicta in some New Zealand cases, of mixed knowing receipt and dishonest assistance causes of action, which I do not consider binding on me, and which, with respect, I think would be wrong, inasmuch as they might suggest that the test of notice in a knowing receipt case calls for some kind of test of common law dishonesty. These divergent views of New Zealand Judges were discussed by Lord Nicholls in *Royal Brunei Airlines v Tan.*[61] Nourse LJ, in a knowing receipt case, reduced the test of notice to its essence:[62]

> The recipient's state of knowledge must be such as to make it unconscionable for him to retain the benefit of the receipt. A test in that form, though it cannot, any more than any other, avoid difficulties of application, ought to avoid those of definition and allocation to which the previous categorisations have led.

I notice that was the view of Wylie J in *Equiticorp Industries Group Ltd v Hawkins*.[63]

[187] This unconscionability test was recently applied by Courtney J in *Worldtel NZ Ltd v Kim*:[64]

> In determining the type of knowledge required to render a person liable as a constructive trustee as a result of the receipt of funds acquired through fraud (and which they may no longer have control over) it is the effect on that person's conscience that should be the determinative factor. That effect could not safely be found to exist without a court being satisfied that the receiver knew, when in receipt of the funds, that they were impressed with a trust. I therefore proceed on the basis that the test in New Zealand is that articulated by Nourse LJ … namely knowledge that would make it unconscionable for the recipient to retain the benefit of the money received.

[188] The unconscionability test is illuminated by Millet LJ's discussion of fiduciaries in his judgment in *Bristol and West Building Society v Mothew*:[65]

> This leaves those duties which are special to fiduciaries and which attract those remedies which are peculiar to the equitable jurisdiction and are primarily restitutionary or restorative rather than compensatory. A fiduciary is someone who has undertaken to act for or on behalf of another in a

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[61] *Royal Brunei Airlines v Tan* [1995] 2 AC 378 (PC) at 388.
[62] *Bank of Credit and Commerce International (Overseas) Ltd & Anor v Akindele* [2000] 3 WLR 1423 (CA) at 1439.
[63] *Equiticorp Industries Group Ltd v Hawkins* [1991] 3 NZLR 700 at 727.
[64] *Worldtel NZ Ltd v Kim* HC Auckland CIV-2009-404-1158, 30 September 2011 at [38].
[65] *Bristol and West Building Society v Mothew* [1998] Ch 1 at 18.

> particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations. They are the defining characteristics of the fiduciary. As Dr. Finn pointed out in his classic work *Fiduciary Obligations* (1977), p. 2, he is not subject to fiduciary obligations because he is a fiduciary; it is because he is subject to them that he is a fiduciary.
>
> …
>
> The nature of the obligation determines the nature of the breach. The various obligations of a fiduciary merely reflect different aspects of his core duties of loyalty and fidelity. Breach of fiduciary obligation, therefore, connotes disloyalty or infidelity. <u>Mere</u> incompetence is not enough. A servant who loyally does his incompetent best for his master is not unfaithful and is not guilty of a breach of fiduciary duty. (Emphasis added)

[189] A distinction can be drawn here between the phrasing of Millett J saying "Mere incompetence is not enough" and his phrasing in the Epilogue in *Macmillan* talking about what is obvious and what is probably improper. [66]

[190] The typical setting of a constructive trustee claim is that the person sought to be identified as a trustee is not dishonest. If he was dishonest who would bother going via equity? For fraud unravels all. One can use the much simpler path of an action in fraud at common law. To try to marry equitable relief against a fiduciary, with relief in fraud at common law, is a category mistake. When a Court in equity examines whether a person was sufficiently on notice to become a fiduciary, it is not an inquiry into negligence, or improper conduct, or dishonesty. Rather, it is an examination as to whether or not the particular circumstances give rise to a relationship of trust and confidence; an obligation of loyalty to another.

[191] Counsel for LDC argued that the Court should allow for the person who might be on notice to make errors of fact and errors of law and keep in mind how much time the person had to consider the facts. I agree the context is important, including time to analyse information. The question of error of law is different. The

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[66] *Macmillan v Bishopsgate,* above n 56 at 1014.

constructive notice test is prescriptive in part. Where a person on inquiry knows she or he ought to seek legal advice, error of law by the advisee is unlikely to exclude recognition of a fiduciary duty. That said, the test of whether or not a person is sufficiently on notice so as to become a fiduciary is largely a question of fact.

[192] Accordingly, I proceed to examine the question of actual notice of LDC according to the standard test as set out in *Meagher, Gummow and Lehane* above at [165] and as understood by the explanation of Lord Browne-Wilkinson in *Barclays Bank*[67] illuminated by Millett LJ in *Bristol and West Building Society v Mothew*.[68]

Was LDC on actual notice as at 4 September 2006?

[193] F & I executed the General Sales Agreement ("GSA") in favour of LDC on 4 September 2006. That was the date on which LDC obtained a secured interest in the assets of F & I, including an equitable interest in the receivables. It was an equitable interest because the borrowers of F & I were not formally notified of the assignment of the benefit of the loans to LDC. At the time, s 130 of the Property Law Act 1952 required notice of assignment to the borrowers in order to transfer legal title. Nothing turns in this case on the fact that it was an equitable assignment. Rather, the question is whether or not on 4 September LDC had actual notice of a prior equity. The GSA was registered on 6 September.

[194] It is common ground that at that time LDC knew that:

(a) F & I did not have a prospectus;

(b) F & I had a book of approximately $20 million; and

(c) F & I had approximately 400 investors.

[195] It was Mr Harding's evidence that in May 2006 Mr Miller had informed them that he believed F & I were operating in breach of the Securities Act. He had

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[67] *Barclays Bank Plc v O'Brien*, above n 49 at 195-196.
[68] *Bristol and West Building Society v Mothew*, above n 65.

referred to LDCI's own situation in 2004 and how they had been through the process of becoming compliant without losing any of their depositors.

[196] In his evidence, Mr Miller consistently denied that he knew in 2006 that F & I was trading in breach of the Securities Act. Counsel for the plaintiffs argued that there was a credibility issue here. They sought to corroborate Mr Harding's evidence in this trial with his statement in an interview he gave to regulatory authorities after the receivership, but before this litigation. It was also supported by a recollection of Joy Drummond, an employee book-keeper of F & I, who recalled that in the early stages of meetings between F & I and LDC in 2006, Mr Harding told her that Mr Miller had informed her that someone should have been knocking on F & I's door and saying "you need a prospectus". Mr Miller believed F & I was trading illegally because of no prospectus.

[197] On the totality of his evidence, I think Mr Miller was careful to distinguish knowing for sure that F & I were trading in breach of the Securities Act, which he says he did not know, from being on notice as to the terms of trade. He never said he did not have his doubts. I accept the recollections of Mr Harding and Ms Drummond are correct.

[198] Given LDC's predicament from 2005 where it needed an injection of equity to continue to trade, its directors, Messrs Miller and Jannetto, were not immediately concerned as to whether or not F & I was trading in breach of the Securities Act. Rather, they were concerned to persuade F & I to introduce some equity into LDC, particularly Mr Miller.

[199] Mr Miller approached Messrs Harding and Scholfield to pursue the interests of LDC, not F & I. Mr Miller's own experience of the Securities Act was that trading in breach of the Securities Act did not mean that the business had to stop. As discussed in the narrative of facts, in the process of LDCI transferring its business to LDC, he was able to negotiate a transition without the collapse of the LDCI/LDC business.

[200] Mr Miller's immediate concern in 2006 was the ability of LDC to continue to trade without having its trading suspended by its trustee, Perpetual, because of breach of LDC's prospectus. The fact that F & I did not have a prospectus was an advantage. Without knowing for sure whether or not F & I was trading in breach of the Securities Act because it did not have a prospectus, Mr Miller was in a position where he considered he could have LDC enter into an agreement with F & I, anticipating that in the medium term it was quite likely that F & I would need to operate with a registered prospectus. But that future imperative did not prevent the transaction being contemplated in 2006. Therefore, Mr Miller did not need to know for sure whether F & I was trading in breach of the Securities Act. It was against LDC's interest to make an issue of it at the time. It was sufficient to bring the prospect up with Mr Harding as part of the exercise of persuading F & I to join forces with LDC.

[201] Mr Smith, for the plaintiffs, argued that Mr Miller's negotiating strategy was a carrot and stick. He was offering the carrot of funds to assist F & I's liquidity problem and the stick that it might be in breach of the Securities Act. I do not see Mr Miller's strategy in such stark terms. F & I had an immediate concern for liquidity after being told that they were subordinated to LDC and that because of Halifax's non-performing loans there was a substantial impairment in the F & I book. F & I were facing a substantial deficit, about $8 million out of the $20 million book debt. Mr Miller was offering a way out of that calamity which mutually suited the needs of LDC. He was also indicating that in the future they were likely to have to acquire a prospectus either separately or upon merger with LDC.

[202] Such a view of the evidence is consistent with Mr Miller's internal e-mails at the time. On 20 May he made a detailed internal note, not copied to F & I, beginning with these remarks:

> 1. LDC and F & I have the resources to deal with potential loss on Halifax loan.
>
> 2. Arrangements need to provide for F & I solvency.
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> 3. Arrangements need to provide for LDC compliancy requirements.

> 4. Suggestion by F & I that they may accept any loss and wind up business unnecessary and unwise.

[203] He then went on to record and examine various proposals before coming up with the suggestion which eventually formed the basis of the transaction in September 2006. In the course of a first formulation of this proposal where F & I injected capital into LDC's business, and LDC lent Messrs Harding and Scholfield money to introduce into F & I, Mr Miller recorded:

> When F & I capital deficit (if any) is known, I suggest the difference is replaced by additional share capital (or partnership capital). Depending on its circumstances at the time the capital is required, LDC may be prepared to help in this respect either by way of lending, or taking a shareholding themselves if F & I shareholders want that. An alternative Andrew Murray should consider is to approach a limited number of F & I depositors, preferably family or close friends who may welcome the opportunity to take up shares with part of their deposit money. This way A and M will not be going to the 400 or so depositors with a proposition which may be difficult in terms of getting full support and adverse publicity.

[204] He went on to suggest a way forward which was the bones of the transaction entered into in September, and then:

> 9. If F & I want to consider a merger with LDC after the situation has been clarified, then LDC is prepared to consider this option. This could be helpful to F & I if they have difficulty meeting any regulatory requirements such as the Commerce Commission <u>as was the case with LDC two years ago</u>. (Emphasis added)

(It is common ground that the reference to the Commerce Commission was in context to a reference to the Securities Commission.)

[205] Under the heading "Final Comment" he said:

> I genuinely believe these proposals are sound and will secure the position of LDC and F & I in relation to potential losses on realisation of Halifax loans book.
>
> …
>
> I am absolutely certain that F & I should not "throw in the towel" and accept any loss that occurs. That is unnecessary as there is clearly a way forward that is very likely to ensure there is no loss of depositor's funds, no loss of reputations and a satisfactory future ongoing income for all concerned.
>
> There is also the prospect, should F & I want it for any reason, to consider a merger of the two Companies at some time in the future.

[206] That proposal was put orally to Mr Harding by Mr Miller the same day. There was cross-examination and submission as to the meaning of the phrase in paragraph 9 "as was the case with LDC two years ago". Mr Goddard argued that Mr Miller was anticipating regulatory reform of the second tier companies which might place F & I in a similar position that LDC had two years ago.

[207] The phrase "as was the case with LDC two years ago" appears on the face of it to be suggesting that F & I might face the same regulatory requirements from the Securities Commission that LDC faced two years ago. Those regulatory requirements were undertakings and processes required by the Securities Commission because LDCI was taking loans from the public without a prospectus. Second, the phrasing of paragraph 9 does not suggest that at some time in the future LDC and F & I will have a common set of regulatory requirements from the Securities Commission.

[208] Mr Miller said he was alluding to the possibility of future reforms. There is no reference to that in this long memorandum, nor in earlier memoranda. There was some government work being done. But it was not imminent. If the phrase alluded to anticipated future law reform, and so new requirements from the Securities Commission, that reform would likely set new requirements for both F & I and LDC – then again, the choice of words makes no sense, read that way.

[209] I am quite satisfied that the normal and natural meaning of paragraph 9 is what was intended by Mr Miller. He was alluding to the fact that LDC had been in breach of the Securities Act and had had to manage its way through to compliance. He was anticipating this might become F & I's experience at some time in the future.

[210] The first sentence of paragraph 9 is holding out an intention to offer to F & I a readiness by LDC to consider a merger. This was designed to be helpful to F & I as the opening words of the second sentence say.

[211] Those notes do not record LDC offering to consider a merger in the future. However, the notes dated 20 May are consistent with Mr Harding's evidence in chief, which I have noted I accept:

> Although not noted amongst our formal meetings or negotiations, because the main objective was to overcome our financial difficulties (and that was the focus), Mr Miller informed us right from the start (in May 2006) that he believed we were operating in breach of the Securities Act 1978 ("the Act"). And he referred to LDC's situation in 2004. He told us they had got through the process of becoming compliant without losing any of their depositors.

[212] Mr Miller's evidence to the effect that he was not <u>certain</u> that F & I were acting in breach of the Securities Act is consistent both with his own memoranda of 20 May, paragraph 9, and with Mr Harding and Ms Drummond's evidence. It is also consistent, however, with the fact that the <u>question</u> of whether or not F & I was in breach of the Securities Act had been identified by Mr Miller.

[213] The context also recorded in those same notes reinforces the likelihood that the risk of breach of the Securities Act would be identified. As the same note records in paragraph (v) and is partly noted above, Mr Miller knew that F & I had 400 or so depositors at that time. Mr Miller is a professional chartered accountant who had been through compliance with the Securities Act so knew that compliance was required in the case of LDCI because LDCI was trading with the public. Mr Miller, when looking at F & I, was looking at the very predicament that he had found when he and his partners were forced to buy into LDCI.

[214] There is no inconsistent evidence to this analysis. There is a lot of supporting evidence, which I do not want to burden the length of this judgment by setting out. I am quite satisfied that the plaintiffs have proved that Mr Miller had actual notice that F & I might well be trading in breach of the Securities Act by reason of not having a prospectus and that he was on notice from at least 2 May 2006, if not earlier.

[215] Mr Miller also knew the consequences if the Securities Commission took an interest in the trading of F & I. He had experienced having to provide an undertaking to the Securities Commission to offer to all depositors of LDCI their money back. Mr Miller knew that if F & I was trading in breach of the Securities Act the Securities Commission would take steps immediately to protect the depositors' interests, including requiring F & I to give the depositors an opportunity to have their money back, straight away. If so, where was the money going to come from – it had to be from F & I's receivables.

[216] It needs to be kept in mind at all times that Mr Miller's scenario in this regard was that compliance by F & I could be faced at some time in the future, after the immediate transaction being proposed was done with F & I. At this time LDC was trading day by day. So was F & I. Survival was of the essence. In paragraph 9 Mr Miller was addressing a problem for another day. That other day would only come to fruition if the 2006 transaction could be done, so that LDC was able to continue trading and likewise F & I.

[217] It also needs to be kept in mind that the whole scheme was that by joining forces, LDC and F & I would be able to absorb the cost of the bad Halifax loans by making a profit on good loans. Mr Miller had to construct a deal for LDC now, not some time in the future, and it was not of immediate concern how long the deal might last. No deal now meant LDC's future was at an end. As would be F & I's. A deal offered the prospect of long term survival, no more.

[218] Understanding this context enables one to appreciate that when Mr Miller said at the trial that the illegality or not of LDC's trading was not an issue at that time, he meant that it did not matter at that time. Right then, in May 2006, F & I did not need a prospectus. A transaction could be done with F & I without having to bother and persuade a trustee of F & I. If F & I was actually trading in breach of the law, that was a problem for another day.

[219] So as to actual notice, Mr Miller knew:

1. F & I might be offering securities to the public in breach of the Securities Act;

2. That if it was, and if that was identified by the Securities Commission, the Securities Commission would require F & I to offer to return its deposits to its depositors; and

3. Such a requirement would impose an urgent funding problem on F & I.

[220] There is no evidence that Mr Miller had actual knowledge that the risk of F & I trading in breach of the Securities Act raised the risk of the presence of a statutory trust under s 36A.

Constructive notice of LDC as at 4 September 2006

[221] The documentation for the September 2006 transactions was done by or under the supervision of Mr Mark Russell, a securities expert and partner of Buddle Findlay. Mr Russell gave very clear evidence that he was instructed to document the transaction, not to give advice as to the merit of the transaction.

[222] The law as to constructive notice is a prescriptive standard. A person is deemed to have constructive notice of which he would have received notice "had he investigated a relevant fact which has come to his notice and into which a reasonable man ought to have inquired". It follows that "all cases in which a person is said to have constructive notice of a fact or thing are cases in which he has failed to inquire, either sufficient or at all".[69] As Lord Browne-Wilkinson said in *Barclays Bank*:[70]

> … if the party asserting that he takes free of the earlier rights of another knows of certain facts which put him on inquiry as to the possible existence of the rights of that other and he fails to make such inquiry or to take such steps as are reasonable to verify whether such earlier right does or does not exist, he will have constructive notice of the earlier right and take subject to it.

Such an inquiry is beyond the skills of the experienced chartered accountant directors of LDC. They would be expected to instruct one or more legal practitioners with the skills and experience appropriate to the task.

[223] Arguing against constructive notice, Mr Goddard pointed to the fact that when the solicitors of the partners of F & I first made a claim against the receivers of LDC to recover the value of F & I receivables, the claim was based on common law. The tracing remedy had not been identified.

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[69] *Meagher Gummow and Lehane*, above n 37 at [8-270].
[70] *Barclays Bank Plc v O'Brien*, above n 49 at 195-196.

[224] The findings of fact in this judgment show Mr Miller of LDC was on actual notice before the 2006 transaction that F & I might well be trading in breach of the Securities Act and he knew what the consequences of that would be. Similarly, both he, his fellow directors and PwC were even more substantively on notice prior to the March 2007 transactions. There is no suggestion in the statement of claim filed in May 2008 that the legal advisors to F & I had identified the potential of F & I to have been trading in breach of the Securities Act. Once that is identified s 36A of the Act immediately comes into play. The findings in this judgment based on notice step off the actual notice that LDC had at relevant times of the likely breach of the Securities Act by F & I. There is no evidence that the plaintiff's advisors in May 2008 had identified that point. The appropriate course in 2006 was for the directors of LDC to obtain advice from practitioners practising under the Securities Act and if need be, they or those practitioners obtain advice from a second practitioner with experience in the law of trusts.

[225] As this judgment reflects, it is my view that it would be easy for a commercial practitioner experienced in the Securities Act to identify immediately that F & I had been trading with the public. Such a practitioner would know of s 36A, creating a statutory trust and also know of the regulatory consequences of trading in breach of trust. The Securities Act practitioner would know that the immediate response of the Securities Commission would be to require F & I to offer to refund all of its depositors. It would not be possible for F & I to continue to trade.

[226] As this judgment reflects, it is possible for there to be arguments for and against the ability to trace, because of the mixing of funds. But all trust practitioners know that where trust assets are wrongly invested by a trustee, while those wrongly acquired assets still remain legally owned by the trustee they remain the property of the trust. Second, a competent trust practitioner knows that trust obligations are not ended if the trust property is mixed with other assets. Third, the same practitioner knows that there is a remedy of tracing if the trust assets are required by a person who does not have the defence of bona fide purchaser for consideration without value without notice. Finally, the trust practitioner knows that the availability of tracing may be uncertain because of mixing issues impeding the ability to trace assets once they leave the control of a trustee. The question of whether or not

tracing will succeed requires some analysis. A competent trust practitioner will know that if a beneficiary has a claim on property of the trust prior to the property being sold by the trustee to a third party, that beneficiary has an "equity" which is prior to any ownership rights acquired by the third party. The ability to pursue that prior equity may be in doubt but not the existence of the equity, prior to the transaction between the trustee and the third party assigning away the trust property. The fact that the trust practitioner might perceive that tracing might be difficult is not part of the defence of bona fide purchaser for value without notice.

[227] Such advisors do not need to be sure that such a claim will succeed. It is sufficient that they are aware (on notice) that there is a prior equitable claim at the time of the transfer. At that point the purchaser cannot proceed in good faith knowing that the transaction, if it does proceed, will at law, if not in equity, defeat that claim. When Lord Browne-Wilkinson said in *Barclays Bank*[71] that the party asserting he takes free, must take steps "as are reasonable to verify whether such an earlier right does or does not exist", the Judge was not saying the party has to be sure. The test is what an honest and reasonable person would do with the knowledge (actual, imputed, or constructive). It is again, as Nourse LJ emphasises, a question of conscience. If the presence of a prior equity is sufficiently realistic then it will naturally be unconscionable to take an assignment of the property. If the party does, the party holds that property against the right of the other party to pursue its claim in equity over the property.

[228] I mention only to dismiss an argument made more than once by Mr Miller in the course of his answers in cross-examination and briefly mentioned in submissions. This was to the effect that Mr Miller could not understand why LDC was not entitled to rely on warranties made by F & I in the September 2006 documentation to the effect that it was the sole owner of the property being secured in favour of LDC.

[229] For example, in the agreement, F & I, as the debtor, made as its first representation and warranty the following clause 6.1:

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[71] *Barclays Bank Plc v O'Brien*, above n 49 at 195-196.

> **Secured property**: The Debtor represents and warrants that:
>
> (a) **No security interest**: it is, and will at all times be, the sole legal and beneficial owner of all its Secured Property and no Security (nor any agreement to create any Security) exists over or affects any of its Secured Property, except as permitted by this Agreement;
>
> (b) **Compliance requirements**: it is in compliance with:
>
> (i) all laws, regulations, by-laws, directives and consents to which the Secured Property is subject; and
>
> (ii) all obligations binding on it or the Secured Property by law, contract or otherwise.

[230] There are other more detailed warranties reinforcing these general warranties. Among those it is useful to record clause 6.3:

> **Future Secured Property**: Whenever any Secured Property is acquired by the Debtor or comes into existence after the date of this Agreement, the Debtor will be deemed to have given the representations and warranties set out in this clause 6 in respect of that property.

[231] Warranties may have effect in the law of contract, depending upon other documents signed at the same time. But any competent commercial solicitor would know that they cannot be relied upon where a party is on actual or constructive notice that the transaction may be defeating a prior equity. I would not expect Mr Miller to appreciate the distinction between common law rights which can be enforced and equitable obligations which can operate to render ineffectual the common law rights. But distinctions are known to commercial practitioners in this area and the law assumes that such practitioners would know the difference.

[232] I do, however, expect Mr Miller to know that he could have taken advice on whether F & I was in breach of the Securities Act, and the full implications of LDC exchanging assets with F & I. By reason of the exigencies of LDC, it was not in LDC's interests to pursue that line of inquiry; a pursuit which would likely defeat the ability to do the September transaction, as a matter of urgency.

[233] I find that LDC was on constructive notice in September 2006 that the depositors of F & I had a prior claim in equity on the receivables of F & I.

Actual notice of LDC in 2007

[234] After the September transaction, in late 2006 LDC retained PwC to advise on the possibility of the introduction of an equity partner or sale of LDC's business. PwC very quickly came to the view that LDC could not be sold in its present state. PwC considered that further bad debt provisioning was required in respect of the Halifax loan book. This advice from PwC to LDC was also made in the presence of Mr Harding of F & I at a meeting on 25 January 2007.

[235] PwC's advice also included advice that LDC's prospectus was misleading. This was as to capital adequacy. That advice in turn generated the attention of the trustee Perpetual. The PwC advice placed LDC in a position where it could not accept new deposits. LDC was then exposed to remedies by depositors under s 37 of the Securities Act for refund of their deposits. In simple terms, the consequences of this PwC advice is that LDC had to acquire new capital urgently. LDC had very little time to resolve the issues that PwC had raised, and which were now the subject for the attention of Perpetual. The earlier LDC/F & I transaction increasing LDC's capital by $1.5 million had been an insufficient response to its impaired book of receivables.

[236] To fix the problem, LDC had to not only find new capital, but also register a new prospectus with the Companies Office and thereby potentially expose itself to scrutiny from that office (Mr John MacPherson), which in turn could lead to scrutiny from the Securities Commission.

[237] Given the state of LDC, PwC were advising that it was not possible to bring in an outside investor. That left the only source of additional capital being the good loans of F & I. F & I's future was now utterly entwined with LDC's future. Both had to reach an agreement, to have any prospect of survival.

[238] PwC prepared two reports for LDC, one on LDC (PwC/LDC), the other on F & I (PwC/F & I).

[239] The first draft of PwC/LDC on 31 January, in paragraph 2.4, included these passages as to F & I.

> They have some 385 depositors, being family and friends and their wider personal network, from whom they [have] taken funds for investment. They have built the business over the last 30 years so that now they have some 19 million in depositors' funds …
>
> Of the 22 million however, some 6.9 million is owed to F & I by SCM [an LDC subsidiary]. Given that, unless a substantial recovery can be obtained from the Heli-Logging loans, the estimate of the recoverable SCM book is some $6m to $8m, thus the SCM debt to F & I is virtually certain of not being recovered.
>
> In addition, Harding is of the view that a further $0.5m of provision would be required on the F & I book, thus making F & I's net recovery some $14.5 million - compared to public funding of $19 million.

[240] Internal e-mails from LDC directors from that time, January 2007, record LDC directors understanding that it was the view of Maurice Noone of PwC and Mark Russell of Buddle Findlay, that F & I were trading in breach of the Securities Act. This information was first conveyed orally by Maurice Noone to the directors of LDC and to Mr Andrew Harding in Nelson at a meeting on the same day that Mr Noone visited the business premises of F & I for the first time at the end of January 2007. On 1 February 2007, Kevin Elliot, a director of LDC, wrote to his fellow directors, David Miller and John Jannetto, saying:

> We may need to make certain that John Fitchett [F & I's lawyer] understands that F & I are not compliant with Security Regulations because they are operating as a partnership. The possibility of merging F & I into LDC and becoming compliant that way must be an incentive for them.

[241] The next day, on 2 February, John Jannetto sent an e-mail to his fellow directors, Kevin Elliot and David Miller, saying:

> I also told him [Andrew Harding] I believed, based upon what Mark and Maurice have advised, that F & I need a prospectus and that they are at risk of taking money from the public regardless of the advice of Fitchett.

[242] It is common ground that there was an issue from this time common to LDC, F & I and PwC as to whether or not F & I was compliant with the Securities Act.

[243] On 3 March 2007, PwC prepared for LDC a high-level review of F & I (PwC/F & I). In this report, PwC recorded that F & I:

(a) Is currently insolvent, in that investors' deposits exceeded finance assets by approximately $7.3 million.

(b) Is currently operating at a loss, and requires a further $2 million of funds to be injected and on-lent to create a break even position.

(c) Is likely in breach of the Securities Act regarding the taking of moneys without a prospectus.

(d) Through operating via a partnership structure, all personal assets of the partners are at risk.

This business in the short term will face a liquidity crisis, and a high profile local failure will occur. Time is not on the side of F & I. Only if it is highly probably that current proposals will substantially improve the position, in the short term, should they enter into the arrangements.

[244] Similarly, as regards LDC, this PwC/F & I report said LDC:

(a) Requires approximately $4 million in new equity in order to comply with trustee covenants.

(b) Needs to issue a new prospectus as a matter of priority in order to remove the current and potentially misleading prospectus from the market.

(c) In order to be capable of seeking interest from potential purchaser[s], needs to "tidy up" the balance sheet through removal of the Halifax advances and the Heli-Logging advances.

Without the immediate injection of new capital, bringing the company into compliance with the Trust Deed, and the issuance of a new prospectus, the directors [of LDC] need to seriously consider whether they can continue to trade without incurring personal liability.

[245] Perpetual received the PwC/LDC report both in its original form and then in an edited form. In the original form in paragraph 2.4 (above), it named the F & I partnership, the number of depositors, and the size of the book.

[246] The PwC/LDC edited report rewrote 2.4. As provided to Perpetual and onto the Companies Office, it now recorded only the following:

Relationship with Finance Investments

This is an unincorporated partnership between Andrew Harding and Murray Scholfield. Harding and Scholfield have car dealer backgrounds and are both now semi-retired.

As part of the arrangements between Paul Brownie of Halifax, F & I and LDC, we understand that LDC agreed to provide F & I with $1 million in

> funding. This loan is secured over the finance receivables book of F & I, which we understand has no other charges against it.
>
> F & I had an original loan facility from LDC of $2 million, of which $1.5 million was applied to subscribe to new preference shares in LDC, with the remaining $500,000 to provide additional working capital to F & I. This working capital facility has since been temporarily increased to $1 million.

[247] On 22 March 2007, F & I and LDC entered into two agreements. F & I agreed to subscribe for the 4 million LDC shares in exchange for $4 million in receivables, and a deed of assignment of those receivables was also entered into. Perpetual's consent was sought for the issue of the shares to F & I.

[248] The draft prospectus, proffered to Perpetual for approval with this second deal, described the agreement between LDC and F & I as follows:

> This agreement is with a privately-funded Nelson-based finance partnership, for that partnership to subscribe for $4,000,000 worth of ordinary shares in the Company. The consideration for the subscription for these ordinary shares will be an assignment to the Company of certain financing receivables. The company's directors have received professional advice confirming the quality of those receivables and have confirmed that the value of those receivables is no less than the value of the new share capital in the Company.

[249] The trustee, Perpetual, did not receive the PwC/F & I report.

[250] The draft prospectus was submitted to the Companies Office and generated the same day a large number of questions from Mr John MacPherson, including asking if any of the four finance companies to whom LDC lent funds raised money from the public and/or had a prospectus. It also asked for a copy of PwC's report. The edited report was eventually forwarded to the Companies Office.

[251] In April 2007, Perpetual required due diligence on F & I's receivables. In May, Perpetual's solicitor was of the opinion that LDC's prospectus was misleading and Perpetual informed LDC of this in June of 2007. Perpetual continued to have concerns throughout July.

[252] In August, LDC suffered a run on its funds and requested Perpetual to appoint a receiver on 3 September. PwC was appointed receiver of LDC on 4 September and of F & I on 5 September.

[253] I have no doubt that the modifications to the PwC report sent to Perpetual and known to be going to be forwarded on to Mr John MacPherson at the Companies Office were designed with the knowledge of the LDC directors to deflect Perpetual and the Companies Office from identifying the possibility that F & I were trading in breach of the Securities Act.

[254] Were Perpetual and/or the Companies Office to take an interest in this fact, such interest would generate an inquiry which at the very least would withhold approval by Perpetual to the amended prospectus, and so further impede LDC's return to trading.

[255] Already as a result of PwC's first report, LDC was not able to trade because of PwC's view that LDC was trading in breach of its prospectus. Time was of the essence. It is undoubtedly true that the reason for modifying the PwC/LDC report was to disguise the true character of F & I's trading and to ensure that execution and performance of the second agreement between LDC and F & I went ahead, so that LDC could continue trading and not have to close the stores. In that sense an inquiry conducted by either Perpetual or the Companies Office could have been fatal to LDC's business, let alone identification of an actual breach of the Securities Act by F & I. It needs to be kept in mind that the focus of the directors of LDC was on commercial survival. In such a context they had no inclination or reason to inquire into the ramifications of dealings with assets of F & I acquired by F & I in breach of a statutory trust.

[256] There is no evidence that either the directors of LDC, PwC, or Perpetual were on actual notice that the depositors of F & I could have a claim on the receivables of F & I. Due to the commercial exigencies, LDC's directors and PwC did not seek an opinion from Mr Mark Russell of Buddle Findlay, who again documented the second transaction. He was told that F & I were a privately funded finance company. He was not asked to, and he did not, give advice as to the ramifications of dealing with F & I if it was trading in breach of the Securities Act.

[257] However, there is no doubt that he or someone in Buddle Findlay did express the view that F & I was trading in breach of the Securities Act and he knew, and

LDC directors knew, that there was a conflict of advice in this respect between Buddle Findlay and F & I's legal advisor, Mr John Fitchett.

Constructive notice of LDC

[258] Again for the same, but reinforced, reasons, experienced commercial solicitors practising under the Securities Act and knowledge in trust law, at that time in January – April 2007, could have identified relatively easily a prior claim in equity by the depositors over the assets of the F & I partnership, particularly the receivables reflecting loans funded by deposits. The exigencies of immediate survival are the best explanation as to why this inquiry was not undertaken and why Mr Mark Russell was not asked to do more than document the transactions. But those exigencies do not, in my view, excuse LDC's directors from not identifying the problem, by making inquiry.

[259] A distinction needs to be drawn here between receivers and banks conducting transactions which are normal and which are done relatively swiftly without a great deal of analysis. I am alluding again to the point made by Millett J, as he then was, in *Macmillan.*[72] The facts here are different. This was not a routine transaction. It was an extraordinary transaction set in a crisis. It was done in the face of discussion of the fact that F & I was trading in breach of the Securities Act. Its context was one of trying to achieve the commercial survival of LDC which was in a precarious position as a result of PwC having identified that it was trading in breach of its prospectus.

[260] When chartered accountants are engaged in doing unusual transactions, particularly to meet commercial exigencies, the need to examine the probity of the transaction, as to compliance with law and equity, is higher, not lesser. The very commercial exigency prompting the unusual transaction imposes an obligation of conscience to be on guard and to take care that other persons' interests are not defeated. The law would be a nonsense if it were otherwise.

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[72] *Macmillan Inc v Bishopsgate Trust Plc and Ors (No.3)* [1995] 1 WLR 978.

[261] I am quite satisfied that LDC was on constructive notice, because it ought to have inquired and identified, with the assistance of expert advisors, that it was entering into a transaction in May of 2007 to acquire assets over which there was a claim to a prior equity by F & I's depositors. And it was not just any claim, it was a serious claim. The normal regulatory response would be to have stopped the transaction and required the assets of F & I to be liquidated and returned to the depositors. LDC's directors feared that if Mr John MacPherson learned what they knew, he would insist on an inquiry at the very least.

Was Perpetual on notice in 2006 and 2007?

[262] At all material times Perpetual was the trustee of LDC and had been since 2004. Schedule 5 of the Securities Regulations 1983, which were replaced on 1 October 2009 by the Securities Regulations 2009, set out clauses deemed to be contained in trust deeds. Clause 1 provided:

> (1) The trustee shall exercise reasonable diligence to ascertain whether or not any breach of the terms of the deed or of the terms of the offer of the debt securities has occurred and, except where it is satisfied that the breach will not materially prejudice the security (if any) of the debt securities of the interests of the holders thereof, shall do all such things as it is empowered to do to cause any breach of those terms to be remedied.
>
> (2) The trustee shall exercise reasonable diligence to ascertain whether or not the assets of the borrowing group that are or may be available, whether by security or otherwise, are sufficient or likely to be sufficient to discharge the amounts of the debt securities as they become due.

[263] The transaction being way of proposal in 2006 was unusual. The issue of preference shares and its funding was by a circular transaction. The request for approval of that transaction met with a requirement from Perpetual to LDC, addressed to Mr John Miller and Mr K Elliott:

> Hi,
>
> Was the agreement signed on Friday?
>
> Also, to be clear about the requirements before the consent for funding agreement can be processed – as we discussed at our meeting, your request

> for consent should be accompanied by the homework you have completed on the F & I book, and the draft GSA.

[264] Perpetual was asking LDC to do the "homework". For the transaction to be approved by Perpetual, F & I had to have the ability to repay the loan of $1.5 million made to it by LDC so that it could purchase the LDC shares. Otherwise the increase in equity was notional only and left LDC no better off. Mr Miller replied to that e-mail saying that the agreement had been fully executed and "we will now do due diligence on F & I's book before completing the loan and the preference shares purchase agreement. When this was done, LDC will increase ordinary share capital by $1.5 million".

[265] What Mr Miller was asked to do was to be satisfied that F & I had the ability to recover at least $1.5 million from the receivables over which LDC had a charge. This was an easy task, provided that the receivables belonged to F & I.

[266] In this context, it is important to keep in mind that Perpetual had no notice at all, in May 2006, that F & I might be trading in breach of the Securities Act. The Perpetual officers were residing in Christchurch. They were not working in the business district of Nelson.

[267] It was the argument for counsel for the plaintiffs that given the obligations in Schedule 5 of the Securities Regulations where the trustee delegated the duty to exercise reasonable diligence, then the trustee is in no better position than the delegatee by way of the doctrine of imputed notice. The relevant principles are set out by *Bowstead on Agency* as follows:[73]

> 1. The law may impute to a principal knowledge relating to the subject matter of the agency which the agent acquires while acting within the scope of his authority.
>
> 2. Where an agent is authorised to enter into a transaction in which his own knowledge is material, knowledge which he acquired outside the scope of his authority may also be imputed to the principal.
>
> 3. Where the principal has a duty to investigate and make disclosure, he may have imputed to him not only facts which he knows but also

[73] P Watts; F Reynolds; W Bowstead *Bowstead and Reynolds on Agency* (17th ed Sweet & Maxwell, London 2010) at 514.

> material facts of which he might expect to have been told by his agents.

[268] I have already found that LDC had actual notice by May of 2006 that F & I might well be trading in breach of the Securities Act. Second, that LDC knew the regulatory consequences of that over the ability to retain assets in F & I against an obligation to repay deposits. As to that latter fact, that was clearly a matter which the Court will infer Perpetual knew. For Perpertual's business was to act as a trustee pursuant to trust deeds set up in order to comply with s 37 of the Securities Act. The point can be put this way. Would Perpetual have approved the 2006 transaction had it known that it was likely that F & I was trading in breach of the Securities Act and had been trading in breach of the Securities Act since its enactment in 1983? The answer is clearly no. For Perpetual, a specialist trustee, would know, or ought to have known, that that conduct impugned and raised serious question marks as to the true beneficial ownership of F & I's receivables. The facts which LDC knew can be imputed to Perpetual and the consequences of those sections can be inferred as constructive notice of Perpetual. By that combination, Perpetual was on notice in May 2006 of a prior equity over the assets at F & I, which assets were proposed to be charged to LDC.

[269] There is no substantial difference in 2007. It will be recalled that at that time LDC was obtaining an injection of 25 per cent new equity by an issue of shares to F & I, the sale of which was being funded by the acquisition of a significant part of the good book of F & I.

[270] Mr Styant was the officer in charge of supervising this transaction. He is now deceased. He was a victim of the Christchurch earthquake. However, a witness statement was taken from him in anticipation of the litigation. The gist of his statement was that he did examine the worth of F & I's receivables being transferred. There is no doubt that those receivables were valuable. They were from F & I's good book. It also seems clear, however, that he did not avert to the question of F & I trading in breach of the Securities Act.

[271] Mr Styant had started with Perpetual in 2007. He was not a lawyer or an accountant by training. He had considerable experience, however, in dealing in

financial assets. There is no evidence that he had any particular skills or experience in the requirements of the Securities Act. He recalled receiving PwC's report on LDC both in its original form and in the second amended draft. He made notes as to the quality of the receivables. He did not make any notes against paragraph 2.4 of the original report in which was described the way F & I traded, and which information pointed to a breach of the Securities Act.

[272] He reiterated that Perpetual's focus was on receivables and he had no reason to be on inquiry in respect of the status of F & I and that the nature of F & I as set out in paragraph 2.4 did not ring any alarm bells for him. He was aware that F & I did not have a trustee or a prospectus, but that F & I was probably not unique in that position. The fact that it had over 300 depositors established over 30 years was not surprising to him.

[273] As I have already noted, Perpetual held itself out as a competent person to supervise the performance of trust deeds entered into in order to comply with the Securities Act. Perpetual cannot avoid the consequences of notice by relying on the lack of experience of an officer employed to examine the merits of the 2007 transaction. There is no evidence that Mr Styant requested due diligence on the assets. He probably did not need to in that respect of the PwC report. But he ought to have known that it is one thing for borrowers to be able to repay the debts, it is another matter as to whether or not the debts belonged to LDC or were subject to a prior equity in favour of the depositors.

[274] Mr Styant did have a distinct recollection of later seeing the PwC/F & I review and being very disappointed it had not been disclosed earlier. He was very surprised to see PwC's view stated that F & I was insolvent and likely to be in breach of the Securities Act. It was his statement, he said, that these were key matters that would have raised red flags for him if they had been disclosed at the time of the March 2007 agreement. He said he would have known that breaching the Securities Act would mean that the investments of F & I were void or voidable.

[275] I am satisfied on these facts that Perpetual was on imputed notice prior to the 2006 transaction and on imputed and constructive notice prior to the 2007

transaction of the presence of a claim in equity over the assets which proposed to be transferred to LDC.

Subsidiary issues

Re-assignment of the Three Stores and The Tavern loans

[276] LDC challenges part of the quantum of the stake of $8 million. It is the sum of $750,000 approximately before interest which reflect the receivables of two loans due by Three Stores and The Tavern to F & I. In July 2008, the solicitors for the plaintiffs and defendants in the common law pleading were negotiating the terms of setting aside the $8 million stake, pending the outcome of the litigation. It will be recalled at that time the plaintiffs were Messrs Harding and Scholfield and the claim was based on misrepresentations and misleading conduct in trade, that is at common law rather than equity. The proposal was to include in the money to be set aside by the receivers of LDC a sum equivalent to the receivables from Three Stores and The Tavern loans.

[277] On 26 June 2008, Gibson Sheat, acting for LDC, wrote to the solicitors for F & I to inquire what funds were being held by the receivers of F & I and were advised that the receivers held the sum of $7,992,752 net of the receiver's fees. An agreement was negotiated between the two firms of solicitors. It is recorded in a letter from Anthony Harper to Gisbon Sheat of 22 July 2008. It is notable that the agreement is recorded as being between John Fisk and Malcolm Hollis, the F & I receivers, LDC Finance Ltd (in receivership), Mr Eaton and Mr Marshall as trustees of Andrew Harding and Murray Scholfield, and Mr Harding and Mr Scholfield. The agreement provided that LDC would reassign the Three Stores Ltd and The Tavern loans to Messrs Harding and Scholfield and in consideration the F & I receivers would transfer to LDC cash received in the F & I receivership equivalent to the current balances of those two loans. That LDC would be entitled to retain the cash referred to above and would only be required to pay it back if the trustees were successful in setting aside the 2006 and March 2007 agreements. The agreement was also expressed to be without prejudice to the parties' respective positions in respect of the July 2006/March 2007 agreements.

[278] LDC now argues that as the proceedings by Messrs Harding and Scholfield have been discontinued, there cannot be any Court order relating to those proceedings. LDC is entitled to retain the sum and the (current) plaintiffs have waived any right to question or set aside LDC's ability to retain the cash paid to it.

[279] I disagree. There is some doubt as to whether there was any agreement at the time as to the status of Messrs Eaton and Marshall, the current plaintiffs. But there is no doubt that the context was of an agreement made in the face of litigation being brought by the partners of F & I to recover receivables obtained by LDC from assets assigned by F & I to LDC in 2006 and 2007. There is no suggestion in the letter agreeing the terms, which records that Messrs Eaton and Marshall are parties, although described as "trustees of Andrew Harding and Murray Scholfield", that a Court order would be confined to any order arising out of the pleadings as they were in at that time in 2008. The operative clause was:

> LDC, by its receivers will undertake that the proceeds of the assigned loans and funds repaid to LDC by F & I will be held by LDC Finance Ltd (in receivership) and will not be distributed without first giving 21 days notice to Scholfield and Harding and the trustees [Eaton and Marshall] care of their solicitors, Rout Milner and Fitchett [Harding and Scholfield] and Gibson Sheat [Eaton and Marshall] respectively, or in compliance with written agreement of the parties or a Court order.

[280] I consider that that clause was more significant than an earlier clause:

> LDC shall be entitled to retain the cash referred to above and will only be required to pay it back if the trustees are successful in setting aside the July 2006 and March 2007 agreements (as defined in the proceedings commenced by Harding and Scholfield);

[281] The undertaking is more broadly and accurately defined and reflects the parties to this agreement.

[282] The trustees Messrs Eaton and Marshall were parties to the agreement. From a substantive point of view, what happened later was that, as representatives of the beneficiaries of the trust, they took over the proceedings. There can be no suggestion that the responsible receivers of LDC, partners of PwC, ever intended by this agreement to defeat the beneficiaries' rights to the F & I receivables, should they be able to sustain a claim.

[283] This is a highly technical and meritless argument advanced by LDC. It can be answered by applying the common law test of the officious bystander. Had someone at the time anticipated the move by the beneficiaries to take complete control of the proceedings from Messrs Harding and Scholfield and plead in equity rather than common law, the answer would have been "of course the agreement will extend to that". For that is simply another way of challenging the 2006 and 2007 transactions.

[284] I note that this argument is not in fact being advanced by the partners of PwC. It is being advanced by LDC. At the time the contract was entered into, LDC and its receivers were clearly on notice that these two loans were subject to a claim of a prior equity. Contract cannot be used to erase the obligations of conscience of LDC should the depositors prior claim in equity be upheld. That was never the intention of the parties.

Counterclaim by LDC against Messrs Harding and Scholfield for breach of warranties

[285] The counterclaim by LDC against Messrs Harding and Scholfield seeks an order that they jointly and severally pay LDC the amount of any refund of all or any of the recovered funds or an indemnity in respect of any sums which LDC is ordered to pay to the second plaintiffs, including costs on a solicitor/client basis together with interest.

[286] The basis of the counterclaim is contract. It is founded upon breach of various financial representations and warranties that Messrs Harding and Scholfield as the partners of F & I gave in relation to their ability to enter in and perform the 2006 and 2007 transactions. These include warranties that F & I was solvent and was the sole, legal and beneficial owner of the assets.

[287] The loan facility agreement of 4 September 2006 is between LDC Finance Ltd as lendor and M Scholfield and A Harding partnership (trading as Finance and Investments) as borrower. Mr Scholfield and Mr Harding appear as parties of the third part as guarantors. But in the executed agreement that description of them as

parties has been struck out and likewise subsequent references to unlimited guarantees and indemnity from the guarantors has been struck out in clause 5.1(b), and variously wherever else the guarantees appeared such as in clause 7.3 in the subject of security. Section 7 of the agreement provides generally that securities are given as security for all amounts paid under this agreement. Security is defined in this agreement as being the general security agreement.

[288] It is a cornerstone argument of the defendants in these proceedings that the GSA agreement should be read independently of the funding agreement. This is commercial nonsense and inconsistent with the basic principles of the law of contract that where two agreements are signed for the one transaction, each agreement dependent upon the other so that neither one of those agreements would be signed but for the other, the two are to be read as one.

[289] In *Smith v Chadwick,*[74] Jessel M.R. said:

> ... when documents are actually contemporaneous, that is two deeds executed at the same moment, ... or within so short an interval that having regard to the nature of the transaction the Court comes to the conclusion that the series of deeds represents a single transaction between the same parties, it is then that they are treated as one deed; and of course one deed between the same parties may be read to show the meaning of a sentence and may be equally read, although not contained in one deed but in several parchments, if all the parchments together in the view of the Court make up one document for this purpose.

[290] In *Manks v Whitely*[75] (although this was a dissenting judgment, but the majority was reversed by the House of Lords in *White v Delaney*),[76] Fletcher Moulton L.J. said of the rationale behind this principle:

> ... where several deeds form part of one transaction and are contemporaneously executed they have the same effect for all purposes such as are relevant to this case as if they were one deed. Each is executed on the faith of all the others being executed also and is intended to speak only as part of the one transaction, and if one is seeking to make equities apply to the parties they must be equities arising out of the transaction as a whole. It is not open to third parties to treat each one of them as a deed representing a separate and independent transaction for the purpose of claiming rights which would only accrue to them if the transaction represented by the selected deed was operative separately. In other words, the principles of

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[74] *Smith v Chadwick* (1882) 20 Ch.D. 27 at 62.
[75] *Manks v Whitely* [1912] 1 Ch. 735 at 754.
[76] *White v Delaney* [1914] A.C. 132.

> equity deal with the substance of things, which in such a case is the whole transaction, and not with unrealities such as the hypothetical operation of one of the deeds by itself without the others.

This statement of principle in *Manks* was recently applied by the Court of Appeal in *Attorney-General v Forestry Corp of New Zealand Ltd*.[77]

[291] There is no suggestion that Messrs Harding and Scholfield have not realised all the assets of F & I. Indeed, the business was placed into receivership.

[292] In my view, it is plain that the 2006 GSA which implements the 2006 loan facility agreement has to be read as not extending to those personal assets of Messrs Harding and Scholfield, outside of the partnership assets.

[293] The 2007 transaction is not so similarly qualified, so the question is more nuanced. The 22 March 2007 deed of assignment was again expressly between LDC and the "Murray Scholfield and Andrew Harding partnership". There were no provisions for personal guarantees or any additional security taken over any assets of Messrs Scholfield and Harding outside of the assets in the F & I business. Counsel for Messrs Scholfield and Harding submit that the intention of the parties was, however, clear. There was a continuation of the limited liability of Messrs Harding and Scholfield.

[294] The context is beyond dispute. The second agreement was entered into because the first set of agreements in 2006 were insufficient. LDC needed even more equity to survive. It went back to Messrs Harding and Scholfield again. Messrs Harding and Scholfield were persuaded it was in F & I's interest as much as LDC's interest to do the transaction.

[295] The core of the 2007 transaction is the share subscription agreement. The representations and warranties appear in Part 3 of that agreement. They include the warranty that F & I hold sole legal and beneficial ownership of the assigned loans. They include a warranty that Messrs Harding and Scholfield are not aware of any

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[77] *Attorney-General v Forestry Corp of New Zealand Ltd* [2003] 1 NZLR 721 at [46].

circumstances which could be reasonably expected to cause a prudent investor to regard the assigned loan as an unacceptable investment.

[296] There is a very significant weight to the submission for Messrs Harding and Scholfield that there was no suggestion that this time in 2007 they were putting their personal assets, in addition to the assets they had in F & I, on the line. Taking into account the context of the 2006 agreements, the probabilities are that the parties to the subsequent 2007 transaction did not intend to disturb the 2006 bargain limiting LDC to recourse to the assets of the F & I business. It is significant that in the 2007 documents, Messrs Harding and Scholfield are not described separately as parties to the agreement, but as one party called the "Murray Harding and Andrew Scholfield partnership", as they were similarly described in 2006.

[297] If anything, LDC was in a better position to judge the potential impairment or claims against the assigned loans than F & I. LDC and F & I for material purposes had the same common financial predicament, the failure of Halifax. LDC knew in fact more about the failure of Halifax than did F & I. LDC were in receipt of unequivocal advice by March 2007 that F & I was trading in breach of the Securities Act. Whereas on the other hand, Messrs Harding and Scholfield were still taking comfort from the advice that they said they had received from their solicitor that they were trading within the law. Both sides, of course, were aware that there was an issue. It is highly artificial for LDC now to claim a loss for breach of the very risk which had been first identified by LDC and communicated to F & I and in the face of which LDC entered into the transaction.

[298] Messrs Harding and Scholfield plead an equitable estoppel.[78] They argue that it is unconscionable now for LDC to set aside its earlier acceptance of the risk it was taking in dealing with F & I's assets in order to sue Messrs Harding and Scholfield personally once the risk materialised.

[299] I am satisfied that in the context LDC assumed the risk of dealing with F & I, agreeing not to pursue Messrs Harding and Scholfield's assets, and that it is unconscionable to purport to rely on warranties in the 2007 transaction that LDC did

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[78] *Walton Stores v Maher* (1988) 76 ALR 513, 515.

not in fact rely on at the time. The circumstances required LDC to make express any change of position from the position that it adopted less than a year before in the first 2006 transaction. Both at common law by way of construction of this agreement, and by way of estoppel in contract, there is no merit in LDC's arguments in respect of the 2007 transactions. Indeed, to find Messrs Harding and Scholfield personally liable for breach of these warranties in the 2007 transaction would be to substantially rewrite the bargain entered into by the two parties in March 2007. The truth is that the warranties that I have referred to and other similar warranties in the agreement are standard terms generated by the solicitors documenting the transaction and, if read out of context, are inconsistent with the true commercial bargain between LDC on the one hand and the Messrs Harding and Scholfield partnership on the other. I uphold the equitable estoppel argument.

[300] This counterclaim fails on the proposition that Messrs Harding and Scholfield were not liable to LDC for their personal assets beyond the assets that they had put into the business of F & I. This counterclaim is dismissed.

Counterclaim by LDC against Messrs Harding and Scholfield and Perpetual seeking a declaration of priority of Perpetual's security interest

[301] LDC also seek a declaration that Perpetual's security interest created by the Deed of Trust between it and LDC has priority over any amounts which LDC is found liable to pay the second plaintiffs.

[302] The merits of this argument were addressed when considering whether or not Perpetual was a purchaser for value. I have found that Perpetual is not a bona fide purchaser for value.[79] I have also found that Perpetual was on notice.[80]

[303] The application for declaration relies in the pleadings on the proposition that Perpetual purchased this legal interest for value and without notice.[81] This counterclaim is dismissed.

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[79] Above at [157].
[80] Above at [275].
[81] Amended statement of defence to fourth amended statement of claim and amended counterclaim, 16 September 2011, paragraph 128(c), (d).

Recovery of costs of the receivership of F & I

[304] The prayer for relief in the statement of claim seeks the costs of the receivership of F & I to be paid into Court for the benefit of the depositors. Argument in support of this issue was faint in the course of the trial. It has its roots in dissatisfaction by Messrs Harding and Scholfield as to the conduct of the F & I receivers, who were appointed by LDC. The question was not pursued in closing submissions. I am not sure whether the argument has been abandoned. It is a difficult argument to make given that there is no doubt that F & I was insolvent and had to stop trading. Receivership of F & I was inevitable. Out of caution I will not treat the issue as abandoned, but will provide for leave to enable the issue to be pursued.

Judgment

[305] (a) There is an order directing that the sum of $7,792,197.36, together with accrued interest, be paid into Court for the benefit of the depositors.

(b) Leave is reserved to pursue the claim that the costs of the receivership of F & I should be recovered by the plaintiffs.

(c) Leave is reserved to apply for any directions to enforce the trust.

(d) The counterclaim by LDC against Messrs Harding and Scholfield for breach of warranties is dismissed.

(e) The counterclaim by LDC against Messrs Harding and Scholfield and Perpetual for a declaration that Perpetual's security interest has priority over any amounts which LDC is liable to pay the plaintiffs is dismissed.

(f) The plaintiffs are entitled to costs against LDC.

(g) Messrs Harding and Scholfield are entitled to costs against LDC on both counterclaims.

(h) Leave is reserved to Perpetual to apply for costs against LDC.

(i) The quantum of costs is reserved.