IN THE COURT OF APPEAL OF NEW ZEALAND

CA503/2016
[2017] NZCA 365

BETWEEN	TRENDS PUBLISHING INTERNATIONAL LIMITED Appellant
AND	ADVICEWISE PEOPLE LIMITED First Respondent
	CALLAGHAN INNOVATION Second Respondent
	MEDIAWORKS RADIO LIMITED Third Respondent
	WEBSTAR, A DIVISION OF BLUE STAR GROUP (NEW ZEALAND) LIMITED Fourth Respondent

Hearing:	4 May 2017
Court:	Cooper, Asher and Clifford JJ
Counsel:	G P Curry and H D Enright for Appellant S M Bisley and O C Gascoigne for Respondents
Judgment:	24 August 2017 at 10:30am

JUDGMENT OF THE COURT

A **The application for leave to adduce further evidence is granted.**

B **The appeal is dismissed.**

C **The appellant must pay the respondents one set of costs for a standard appeal on a band A basis and usual disbursements. We certify for two counsel.**

REASONS OF THE COURT

(Given by Asher J)

Table of Contents

Introduction

[1] The appellant, Trends Publishing International Ltd (Trends), appeals against a decision of Heath J making an order that a creditors compromise be set aside.[1] The compromise was supported by the directors of Trends and their associated interests who directly or indirectly at the time of the meeting controlled more than 75 per cent of the creditors' vote by value. The respondents are four creditors who are not associated with the company. They claim that the vote in favour of the compromise was a deliberate and unfair manipulation of the voting processes.

[2] Heath J found that although the legal rights of the creditors might have been the same, the creditors who were associated with the company should have been separated into their own class because their economic interests were distinct. The passing of the compromise without such a separation in his view amounted to unfair prejudice to the non-associated creditors in terms of s 232(3)(c) of the Companies Act 1993 (the Act).

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1 *Advicewise People Ltd v Trends Publishing International Ltd* [2016] NZHC 2119.

[3] Trends argues before us that Heath J erred by applying a broad approach to the classification of creditors based on legal rights and economic interests, when he should have applied a pure legal rights test. It submits that Heath J's approach was commercially impractical and unduly complex. It does not accept his finding of unfair prejudice.

Background

[4] The facts are set out in considerable detail in the High Court judgment and we will provide a short summary.[2]

[5] Trends is part of a wide group of companies that trades internationally. In New Zealand it carries on business as a provider of print and digital media solutions. The co-founder and director of Trends, David Alan Johnson, in an affidavit filed in support of the compromise, explained how as a result of the global financial crisis in 2009 Trends suffered a severe downturn in its United States market. Decisions had to be made, and it decided not to seek a merger or acquisition. There was something of a change of direction which included the company seeking funding.

[6] A grant was obtained from the Ministry of Science and Innovation in 2012. Then, on 2 April 2014, a research and development growth grant was awarded to Trends by Callaghan Innovation (Callaghan). Callaghan is a Crown entity established under the Callaghan Innovation Act 2012 that provides financial grants for scientific and technology-based innovation research. Between April and July 2014 Callaghan advanced $313,536.70 to Trends. A further $69,375.27 was advanced in October 2014.

[7] By late-2014, on the basis of a report it had obtained from Deloitte, Callaghan had formed the view that its advances had been induced by false representations as to Trends' financial position. Callaghan made a complaint to the Serious Fraud Office. In late-2014 the Serious Fraud Office initiated an

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2 At [1]–[40].

investigation into Trends' financial affairs.[3] Mr Johnson deposed that the financial fallout of this announcement put Trends at risk of insolvency.

[8] In April 2015 Callaghan purported to terminate the grant and demanded repayment of the moneys advanced. Mr Johnson deposed that he consulted with a Mr Khov, an experienced insolvency practitioner. Under his guidance, on 12 May 2015, the directors of Trends put forward a proposal to creditors under pt 14 of the Act to compromise the company's debts. The proposal to compromise was put to 62 unsecured creditors, whose debts totalled $4,267,347.41 (the affected creditors). Of that sum, a total of $3,080,361.80 was owed to an associated company, Thecircle.co.nz Ltd (Thecircle). The debt owing to Thecircle was said to represent unpaid rent. Also, Trends' general manager, Ms Louise Messer was owed $120,030, and one of its directors, Mr Paul Taylor, $30,000. The balance of the debts apart from these three appear to have been incurred at arm's length and in the ordinary course of business.

[9] Of the three creditors who had a close association with Trends, Ms Messer had worked for Mr Johnson for over 30 years. Mr Taylor was a director of Trends until his resignation on the day the compromise was adopted. Most importantly, through his various interests, Mr Johnson appears to be the controlling shareholder and sole director of Thecircle. Two months before the compromise was proposed Trends had given Thecircle a personal property securities interest over all its present and after acquired property. However for the proposal it waived a security it held over Trends' undertaking (to the extent of $3,080,361) so that it could vote as an unsecured creditor. These three creditors had a significant association with the company, and the events leading to its financial problems. Like Heath J, we will refer to them as the insider creditors.

[10] The proposal documents attributed Trends' financial difficulties to the revocation of the Callaghan funding grant. It was stated that if the proposal was not accepted, the company was likely to go into liquidation or voluntary administration. If the compromise was adopted the company could continue trading, and an

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[3] We note that the investigation is now concluded and the Serious Fraud Office has announced that it will be taking no further steps against Trends.

unnamed third party would introduce fresh capital into the company. No further details about this fresh capital were given.

[11] A sum of $50,000 was to be made available for the purposes of the compromise. It was called the "initial pool". All "entitled creditors" would get one hundred cents on the dollar for the first $1,000 (which would use up most of the $50,000).[4] Further payments would come from a "subsequent pool" of funds, to be deposited presumably from the cash flow of Trends. The compromise would impose a moratorium on creditors' recovery proceedings, which would include applying for the liquidation of Trends. It would leave all major creditors with a substantial shortfall.

[12] Thecircle, Ms Messer and Mr Taylor chose not to receive payments that were to be made under the compromise. Mr Johnson deposed that he was concerned that if Thecircle were included in the payments, his interests would receive most of the benefit of the compromise. He considered that the exclusion of Thecircle and the other two insider creditors associated with the company from the compromise distribution would demonstrate Trends' good faith to the remaining creditors. Importantly, however, the three insider creditors were listed and would vote on the proposal, giving the insider creditors the necessary majority to successfully vote for approval of the compromise. We say more about the commercial features of this later in the judgment.

[13] The initial proposal was made on 12 May 2015. The proponents were stated to be Mr Johnson and Mr Taylor. There was then correspondence between the proposal managers and Buddle Findlay, solicitors on behalf of Callaghan. Callaghan questioned whether sufficient information had been provided to the creditors to enable them to make a reasoned decision. It made inquiries into the position of the insider creditors who intended to vote. It expressed the view that the compromise was not in the best interests of creditors and should not be approved.

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[4] "Entitled creditors" were defined in the proposal as all 62 unsecured creditors except Thecircle, Ms Messer and Mr Taylor.

[14] The creditors met for the purposes of a vote on 22 May 2015. 48 creditors were present and entitled to vote. Many of the creditors claimed sums of $10,000 or less. Callaghan was a listed creditor as were the other respondents, Advicewise People Ltd, Mediaworks Radio Ltd, and Webstar Ltd. Ultimately 39 creditors, including the insider creditors, voted in favour, representing 81.25 per cent of the total number of affected creditors. In summary:

(a) Among those voting in favour was Thecircle, who represented 72.21 per cent of the total value of affected creditors.

(b) Thecircle's vote, along with votes in favour by other insider creditors, represented 75.73 per cent, so on the basis of these votes, the 75 per cent in value requirement to adopt the compromise was met.[5]

(c) Other votes in favour by non-insider creditors represented 6.82 per cent of the total value.

(d) The respondents voted against the proposal. We will refer to them, like Heath J, as the challenging creditors.

[15] Because the compromise had been adopted in accordance with cl 5 of sch 5 of the Act, s 230(2) meant that it bound all affected creditors with notice of the compromise, regardless of whether the creditor voted against the proposal.

The High Court judgment

[16] Heath J considered that the fundamental issue was whether Trends had manipulated the voting process in order to achieve a successful outcome, and whether the challenging creditors were prejudiced in terms of s 232(3)(c) as a result. After a detailed and careful review of the facts and the relevant law, Heath J determined that in relation to a compromise the courts should take a broad view of circumstances, particularly those relating to the definition of a class of creditors who

[5] Under cl 5(2) of sch 5 of the Companies Act 1993 a resolution at a meeting held for the purposes of s 230 of the Act is adopted if a majority in number representing 75 per cent in value of the creditors votes in favour of it.

might act to unfairly prejudice the dissenting creditor.[6] He considered that a pragmatic business-oriented approach was required to ensure that creditors were classed in such a way that enabled them to meaningfully consult with other members of the class. That would not occur with members of the same class who were affected by competing commercial imperatives.

[17] He rejected the proposition that the differential between classes should be based solely on legal rights, and favoured a more general test that entitled the court to consider both legal rights and economic interests.[7] He concluded in this case that the insider creditors should have been put into a separate class for the purpose of voting on the compromise.[8]

[18] As a result of the failure to allow for that extra class, the challenging creditors were prejudiced.[9] The Judge found the explanation given as to why the insider creditors were to vote alongside the challenging creditors to be implausible.[10] He considered that the only credible explanation for the inclusion of the insider creditors in the vote, despite their non-participation in any compromise distributions, was that Trends had deliberately manipulated the process to achieve their required statutory majorities. He drew a negative inference from the fact that neither Mr Taylor, Ms Messer or Mr Khov gave evidence. He considered that the manipulation of the position by Trends was "precisely the type of abuse at which s 232(3)(c) of the Act is aimed".[11] He did not uphold or did not need to decide the challenging creditors' other grounds of complaint.

[19] He considered that the appropriate relief was to set aside the compromise and to restore the status quo.[12] He set the compromise aside with immediate effect. This meant that all of the Trends creditors would be at liberty to pursue a liquidation if satisfactory settlement arrangements could not be made.

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6 *Advicewise People Ltd v Trends Publishing International Ltd*, above n 1, at [88].
7 At [91].
8 At [94].
9 At [98].
10 At [101].
11 At [102].
12 At [128].

The arguments on appeal

[20] It was submitted for Trends that there was an error in Heath J's basic approach. Mr Curry for Trends argued that the purpose of pt 14 was to provide a constructive and inexpensive alternative to liquidation, and unnecessary involvement of the courts should be avoided. It was submitted that it was inappropriate to consider commercial interests for the purposes of classification. This would prove commercially impractical and unduly complex. A test for classes based purely on legal rights was more appropriate. If different commercial interests were given undue emphasis minority creditors could be placed into separate classes where they could thwart the interests of the great majority. It was emphasised that in the United Kingdom, Australia and Hong Kong the courts have embraced a pure legal rights test.

[21] Trends submitted that the insider creditors had the same rights against the company as all other creditors, and were rightly included in the same class. In any event it was argued that their economic interests were the same as those of other creditors. The only basis for distinguishing the insider creditors was that they waived their entitlement to payment, which was not sufficient to lead to a finding that they could not meaningfully consult. Trends also submitted that a challenge to the construction of classes for the purposes of pt 14 amounted to a material irregularity under s 232(3)(b) rather than unfair prejudice under s 232(3)(c).

[22] The challenging creditors submitted that Heath J's finding that the compromise was not advanced in good faith because of deliberate manipulation was clearly correct. As well as relying on the evidence before the High Court the challenging creditors sought leave to adduce on appeal two affidavits that Trends had filed in support of an unsuccessful application in the High Court to stay the enforcement of the judgment. They argue that this evidence discloses attempts by Trends to reach compromises with individual creditors on terms that are inconsistent with the compromise that Trends seeks to reinstate on appeal. In our view the evidence, alluding as it does to material produced by Trends since the hearing, is fresh and credible, and is sufficiently cogent to be admitted.[13] Thus we granted the

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[13] *Paper Reclaim Ltd v Aotearoa International Ltd* [2007] 2 NZLR 1 (SC).

application at the hearing without particular opposition from Trends. In the end, however, we reach our decision without relying on that material. The challenging creditors also supported the judgment on other grounds, challenging Heath J's determinations that there was no material irregularity arising out of Trends' failure to supply adequate information, or in not determining that Callaghan should have been in a separate class.

[23] We turn now to consider these arguments, and the nature of classes in a creditors compromise.

A new regime

[24] Until the Act came into force, a company that wished to compromise its debts with creditors, in circumstances where not all creditors would necessarily agree with its proposal, had to formulate a scheme of arrangement and obtain the court's sanction to it. This was done under s 205 of the Companies Act 1955. The s 205 procedure as it then was had been widely used throughout the Commonwealth and followed the equivalent provisions in the United Kingdom.[14] The court had to be involved in two stages:

(a) First, the proponent of a scheme would prepare a proposal and apply to the court for procedural orders. The court was empowered to call a meeting of creditors or class of creditors to vote on the proposal.

(b) Second, if 75 per cent in value of creditors voting at a meeting or meetings agreed to the proposal, the proponent would apply to the court to sanction the scheme. If the court approved the scheme, it would bind all creditors.

[25] In the leading case of *Re C M Banks Ltd* it was stated that the court, when exercising its discretion at the sanction stage, would consider whether the scheme had been fairly put before the class or classes of creditors to enable them to make a

[14] Statutory provisions enabling binding compromises to be made between a company and its creditors have existed in the United Kingdom since ss 136 and 137 of the Companies Act 1862 (UK).

reasoned judgment, to ensure that the statutory majority acted bona fide and did not coerce the minority, and that the compromise was objectively reasonable.[15] Under s 205 a court would consider whether an intelligent and honest business person, being a member of the class concerned and acting in respect of that interest, might reasonably approve of the scheme.[16]

[26] The Law Commission reviewed the Companies Act 1955 in 1989.[17] In relation to compromises with creditors it observed:[18]

> In the course of consultation with insolvency practitioners about possible changes to the statutory law on corporate insolvency and liquidations it became clear that compromises with creditors under section 205 of the 1955 Act are rarely attempted. The present procedure is perceived as slow, complex and expensive with an unnecessary degree of involvement by the Court. As a compromise should be a constructive alternative to liquidation of a company, the present state of affairs is most unsatisfactory. Part 13 of the draft Act is designed to provide a more useful procedure which features a greater provision of information by those proposing a compromise but limits the role of the Court to one of review on specified grounds.

[27] It attached a draft Bill which is largely reflected in the present pt 14. It was observed about the new Bill:[19]

> As mentioned in the immediately preceding paragraphs, the role of the Court is quite different from that under section 205 of the 1955 Act. The fate of the compromise should rest with the voting creditors unless the information supplied or procedures followed are irregular. The "unfairly prejudicial" limb (section 200(2)(c)) provides a residual power which will be available to prevent abuse of the new procedure.

[28] The Companies Bill 1990 (50-1) was introduced to Parliament in September 1990. It was based on the Law Commission draft.[20] There was no equivalent of the present pt 15, but the explanatory note to pt 13 (now pt 14) stated that it was "designed to provide a more useful procedure for effecting compromises with creditors".[21] It was also designed to limit the role of the court to one of review on specified grounds.

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15 *Re C M Banks Ltd* [1944] NZLR 248 (SC).
16 At 252.
17 Law Commission *Company Law: Reform and Restatement* (NZLC R9, 1989).
18 At 148.
19 At 149.
20 Revised as at May 1990 to correct minor proofreading issues.
21 Companies Bill 1990 (50-1) (explanatory note) at ix.

[29] The effect of the new pt 14 was to take the procedure to reach a compromise out of the High Court's direct control, and put it into the hands of those who might propose a compromise under s 228(1) and creditors. The court was not taken out of the process entirely. Under the new regime it has a supervisory jurisdiction if there is an application by a defined interested party.

[30] Section 228 sets out who may propose a compromise and s 229 sets out notice requirements. Section 230 provides for the effect of a compromise that is passed by the requisite vote. Schedule 5 of the Act contains a detailed prescription of various procedural matters relating to meetings of creditors. It makes provision for the giving of notice of the meeting. Clause 5(2) of sch 5 provides that a resolution is adopted if a majority in number representing 75 per cent in value of the creditors or class of creditors, voting in person or by proxy vote or by postal vote, vote in favour of the resolution.

[31] The powers of the court are set out at s 232:

> **232 Powers of court**
>
> (1) On the application of the proponent or the company, the court may—
>
> (a) give directions in relation to a procedural requirement imposed by this Part, or waive or vary any such requirement, if satisfied that it would be just to do so; or
>
> (b) order that, during a period specified in the order, beginning not earlier than the date on which notice was given of the proposed compromise and ending not later than 10 working days after the date on which notice was given of the result of the voting on it,—
>
> (i) proceedings in relation to a debt owing by the company be stayed; or
>
> (ii) a creditor refrain from taking any other measure to enforce payment of a debt owing by the company.
>
> (2) Nothing in subsection (1)(b) affects the right of a secured creditor during that period to take possession of, realise, or otherwise deal with, property of the company over which that creditor has a charge.
>
> (3) If the court is satisfied, on the application of a creditor of a company who was entitled to vote on a compromise that—

> *(a) insufficient notice of the meeting or of the matter required to be notified under section 229 was given to that creditor; or*
>
> *(b) there was some other material irregularity in obtaining approval of the compromise; or*
>
> *(c) in the case of a creditor who voted against the compromise, the compromise is unfairly prejudicial to that creditor, or to the class of creditors to which that creditor belongs,—*
>
> *the court may order that the creditor is not bound by the compromise or make such other order as it thinks fit.*
>
> …
>
> (Emphasis added.)

[32] It is significant for the purposes of the issues we must determine that the relevant sections continue to refer to classes of creditors. In particular, s 230(3) requires that each class of creditor must approve a compromise by the requisite majority before it becomes operative. A properly constituted class still has the ability to defeat the compromise by voting against it, at least insofar as that class is affected. This demonstrates that under pt 14 it is still important that classes are defined correctly.

[33] There is no definition of a class of creditor, or anything to indicate that the approach to classes of creditors adopted in past decisions in relation to s 205 should not still apply. However, it is clear that there must still be a division of creditors into classes to ensure that creditors compromises do not become instruments of injustice.

[34] There is a potential for unfairness in a compromise if the requisite majority of creditors is able to outvote a minority that has different circumstances or interests. The minority could find their legitimate interests and expectations seriously prejudiced by the compromise. However, there is also a great potential for unfairness if classes are too readily created, given the requirement that each class approve the compromise. It would be unfortunate if there was too great a power of minority groups to advance their own ends and defeat reasonable compromises.

[35] There is a material difference between the old s 205 process and the new pt 14 process. Under s 205(1), if any question arose under the section as to whether

or not any members or creditors of a company constituted a class of members or a class of creditors, it was to be "determined by the Court as in the circumstances it thinks proper". There was therefore a specific legal procedure provided for in relation to the determination of who should be in a separate class. This is removed in the new version.

[36] However, pt 14 contains new express requirements which can be seen as operating to prevent injustice. The major focus of submissions before us and before Heath J was on s 232(3). To summarise the effect of that new section, on the application of a creditor of a company who was entitled to vote on a compromise, the court may, if there has been an insufficiency of notice, some material irregularity, or if the compromise is unfairly prejudicial, order that the creditor is not bound by the company compromise or make "such other order as it thinks fit".

[37] These provisions can be seen as a development of the principles set out in *Re C M Banks Ltd* adapted to a new streamlined procedure run by commercial proponents rather than the court.[22]

[38] If classes have been incorrectly defined in the compromise, the court may intervene either on the basis of a material irregularity (s 232(3)(b)) or because the compromise is unfairly prejudicial to the objecting creditor (s 232(3)(c)). The court does not necessarily have to analyse the correct definition of classes exclusively in terms of either ground, as both grounds may apply if there is an incorrect division of classes. In *Public Trust v Silverfern Vineyards Ltd* Muir J chose to consider a classification argument under the "material irregularity" head.[23] In this case Heath J chose the "unfair prejudice" head. In this case, where there are allegations of unfair manipulation, like Heath J we consider it appropriate to look at the issues through the unfair prejudice lens. This is consistent with the comment of the Law Commission that the "unfairly prejudicial" limb provides a residual power which will be available to prevent abuse of the new procedure.[24] However, we see no need to be prescriptive on this point. Depending on the circumstances, the classification of classes can be considered under either head.

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22 *Re C M Banks Ltd*, above n 15.
23 *Public Trust v Silverfern Vineyards Ltd* [2015] NZHC 3078.
24 Law Commission, above n 17, at 149. The relevant paragraph is quoted in full at [27] above.

[39] Given that classes are still referred to in pt 14, it is necessary for us to consider the case law as it relates to how classes are to be determined in the context of a creditors compromise.

Case law on how classes are to be determined

[40] There is a considerable body of law arising out of the old s 205 procedure or its equivalent in other common law jurisdictions on how a class of creditors is to be determined in the context of a creditors compromise. It was traversed in detail by Heath J. We see it as not having the pivotal relevance it formerly had, given that the new pt 14 regime now has the "unfairly prejudicial" provision. It is nevertheless still relevant given that importance is still placed on classes in the new regime. A wrong classification can be unfairly prejudicial.

[41] The leading case on classes was *Sovereign Life Assurance Co v Dodd*.[25] In a frequently cited passage Bowen LJ said, with reference to what constitutes a class in a creditors compromise:[26]

> The word "class" is vague, and to find out what is meant by it we must look at the scope of the section, which is a section enabling the court to order a meeting of a class of creditors to be called. It seems plain that we must give such meaning to the term "class" as will prevent the section being so worked as to result in confiscation and injustice, and that it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.

[42] In the same judgment Lord Esher MR observed:[27]

> [Policyholders whose claims had matured] must be divided into different classes [from policyholders whose claims had not matured] ... because the creditors composing the different classes have different interests; and, therefore, if we find a different state of facts existing among different creditors which may differently affect their minds and their judgment, they must be divided into different classes.

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25 *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573 (CA).
26 At 583.
27 At 580.

[43] In *Re Hellenic & General Trust Ltd* Templeman J referred to these two passages and in the context of the case before him said:[28]

> Vendors consulting together with a view to their common interest in an offer made by a purchaser would look askance at the presence among them of a wholly owned subsidiary of the purchaser.

[44] In relation to directors of the company holding one type of share and whether they could be independent and unbiased in relation to the interests of the whole class of ordinary shareholders, Templeman J observed:[29]

> This seems to me to be unreal. Hambros are purchasers making an offer. When the vendors meet to discuss and vote whether or not to accept the offer, it is incongruous that the loudest voice in theory and the most significant vote in practice should come from the wholly owned subsidiary of the purchaser.

[45] Despite these statements referring to classes in terms of different interests likely to lead to different positions on a proposal, in Australia and in some other jurisdictions it has been emphasised that classes of creditors should be differentiated if they had different "legal rights" rather than "interests".[30] In *UDL Argos Engineering and Heavy Industries Ltd v Li Oi Lin*, Lord Millett NPJ delivering the principal judgment of the Hong Kong Court of Final Appeal adopted a legal rights approach.[31] His comments were relied on by Trends, and we set them out in full:

> [26] Why, it may be asked, should persons with divergent interests be allowed to vote as members of the same class ... The first is the impracticality in many cases of constituting classes based on similarity of interest as distinct from similarity of rights ... A second is that the risk of empowering the majority to oppress the minority ... is not the only danger. It must be balanced against the opposite risk of enabling a small minority to thwart the wishes of the majority. Fragmenting creditors into different classes gives each class the power to veto the Scheme and would deprive a beneficent procedure of much of its value. The former danger is averted by requiring those whose rights are so dissimilar that they cannot consult together with a view to their common interest to have their own separate meetings; the latter by requiring those whose rights are sufficiently similar that they can properly consult together to do so. The third reason is that this is mandated by the rationale which underlies the calling of separate meetings. A company can be regarded as entering into separate but linked arrangements with groups whose members have different rights or who are

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28 *Re Hellenic & General Trust Ltd* [1976] 1 WLR 123 (Ch) at 126.

29 At 126.

30 See for instance in England: *Re Hawk Insurance Company Ltd* [2001] 2 BCLC 480 (CA).

31 *UDL Argos Engineering and Heavy Industries Ltd v Li Oi Lin* [2001] HKCFA 19, [2001] 3 HKLRD 634 at [17].

> to receive different treatment. It cannot sensibly be regarded as entering into a separate arrangement with every person or group of persons with his or their own private motives or extraneous interests to consider.

[46] There is a body of Australian case law which also adopts the legal rights test.[32] In *Re Jax Marine Pty Ltd* the central issue was whether certain subsidiaries should have been permitted to vote with other unsecured creditors.[33] Street J held that the subsidiaries need not have been separated into a different class, and the fact that they had a special interest did not bar them from voting with the other creditors.[34] However, he noted that, if and when the Court was asked to approve the scheme, the court could exercise its discretion not to do so, on the basis that the subsidiary companies were wholly controlled by the company and their votes represented the wishes of the company and not those of other creditors.[35]

[47] There have been a number of New Zealand decisions in which the issue of whether creditors belong to a particular class has been considered.

[48] In *Re Stewart & Sullivan Farms Ltd* Barker J took the view that the court would "err on giving a liberal meaning to the word 'class' of creditor or shareholder".[36] His remarks did not differentiate between "rights" and "interests". His non-prescriptive approach was followed in *Re National Dairy Association of New Zealand Ltd*[37] and in *New Zealand Municipalities Co-operative Insurance Co Ltd v Dunedin City Council*.[38] In the latter case McGechan J said, after referring to the comment of Lord Bowen in *Sovereign Life Assurance Co*:[39]

> I follow [the approach taken by Bowen LJ], restated as a converse, ie that there is not one class where persons have rights so dissimilar as to make it impossible for them to consult together with a view to their common interest. Borderline cases can produce difficulties.

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32 *Re Chevron (Sydney) Ltd* [1963] VR 249 (SC); *Re Jax Marine Pty Ltd* [1967] 1 NSWR 145 (SC) at 148; and *Re Landmark Corporation Ltd* [1968] 1 NSWR 759 (SC) at 766.
33 *Re Jax Marine Pty Ltd*, above n 32.
34 At 148.
35 At 148.
36 *Re Stewart & Sullivan Farms Ltd* [1981] 1 NZLR 712 (HC) at 719.
37 *Re National Dairy Association of New Zealand Ltd* [1987] 2 NZLR 607 (HC) at 619.
38 *New Zealand Municipalities Co-operative Insurance Co Ltd v Dunedin City Council* (1989) 3 NZCLC 65,044 (HC) at 65,052.
39 At 65,052.

[49] He quoted the comment of Barker J that the courts would err on giving a liberal meaning to the word "class", and he adopted the same approach. He observed in relation to s 205:[40]

> It is proper for the Court to ensure so far as practicable that all interests have a genuine opportunity to participate, and that small classes are not drowned in the flood. Where there is some doubt whether a separate class exists, as opposed merely to dissentients, the benefit of that doubt should work in favour of recognition of the separate class.

[50] There is a helpful article by Michael Josling where these cases and a number of others are analysed in considerable detail.[41] Mr Josling argues for a "more flexible test" to determine whether different classes of creditors should consider a pt 14 proposal.[42] He observed:[43]

> In terms of a general test, the last part of Bowen LJ's seminal statement (with some modification) is a useful starting point; that is, where the effect of a scheme on persons is so dissimilar as to make it impossible for them to consult with a view to their common interest. Another way of putting it would be to say that class voting is appropriate when the interests of the creditors are so opposed that their response to the scheme is predetermined. It is suggested that in terms of a test for classes, nothing more specific is required, or useful. It is noted that this suggested test reflects, to an extent, the attitude taken in New Zealand case law (although a precise test has never been articulated.)

Our view

[51] We agree with Heath J, who referred to Mr Josling's article with approval, that the less prescriptive, more flexible, approach adopted in the New Zealand cases is preferable, particularly now under pt 14. A proponent will be bound to differentiate between classes if not to do so will be unfairly prejudicial to a creditor or group of creditors. That obligation is explicit in s 232(3)(c). It would be inconsistent with the broad discretion of the court under s 232(3)(c), where it may intervene if a compromise is unfairly prejudicial to a person or group, to have a rigid rule limiting separate classes on the basis only of different legal rights. It is undesirable for any precise formula to be articulated in relation to what constitutes a class. A court will not intervene when the divisions are robust and fair.

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40 At 65,052.

41 Michael Josling "An analysis of the rights test in determining classes of creditors" (2010) 18 Insolv LJ 110.

42 At 110.

43 At 135.

[52] We note also that a similar view was taken by Winkelmann J in *Bank of Tokyo-Mitsubishi UFJ Ltd v Solid Energy New Zealand Ltd* where she observed:[44]

> A creditor's prospects of repayment may be substantially adversely affected without any alteration to its legal rights. For these reasons the definition of "affected" must encompass adverse affects to both legal rights and economic interests.

[53] We agree that both legal rights and potentially competing economic interests and priorities should be taken into account in evaluating the need for separate classes. The concerns about such an approach causing a fragmentation of the vote and unworkable minorities will be met if proponents of compromises genuinely put forward a compromise in the interests of the creditors and the company. They must be careful to understand the need to avoid unfairness to a distinct group and be aware of the examples provided in the case law. We see no reason not to apply the broad language of s 232(3)(c) in this way. While we recognise that a precise test turning on legal rights could make it easier to advise on and plan for creditors compromises, and help avoid a plethora of possible classes, the cases demonstrate the danger of such a dogmatic rights-based approach. Plainly an insider creditor who is likely to have a stake in the company not going into liquidation will be in a conflict position with third party trade creditors, even if it has the same rights. This was the point that led to Templeman J rejecting the lack of class division in *Re Hellenic & General Trust Ltd*.[45]

[54] In a case such as the present, while an insider creditor of a company notionally has the same legal rights as a third party creditor, it is unjust and impractical that they should be in the same voting class. As we will set out, this case demonstrates how an insider creditor, while enjoying the same legal rights as a third party creditor, can be in a serious conflict of interest situation if it pursues its own interests in keeping the company out of liquidation.

[55] Therefore both legal rights and economic interests must be considered in order to discern whether a separate class is warranted. It will be left to the good sense of the proponents of a compromise and, if they do not show good sense, the

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[44] *Bank of Tokyo-Mitsubishi UFJ Ltd v Solid Energy New Zealand Ltd* [2013] NZHC 3458 at [139].

[45] *Re Hellenic & General Trust Ltd*, above n 28, at 126–127.

courts, to decide when a difference in legal rights or economic interests between creditors is of sufficient gravity to warrant the creation of a class. Persons who have irreconcilably different commercial goals should not be required to vote together.

Should the insider creditors have been in a separate class?

[56] It is easy to see why the challenging creditors in this compromise opposed it. There are a number of unusual features about the debt to Thecircle. Thecircle obtained security from Trends only two months prior to the liquidation. Then it abandoned most of that security so it could vote in favour of the compromise. This was in spite of it being clear that Thecircle would not participate in any dividends under the compromise. Both companies appear to be controlled by Mr Johnson. He is a proponent of the compromise. This abandonment of Thecircles' security is difficult to explain in terms of a usual commercial response, which is to always seek and retain security.[46]

[57] One obvious consequence was that the insider creditors achieved a position where they could dominate the voting of the creditors compromise. It is difficult to see any motivation Thecircle could have to abandon the significant commercial advantage of security for voting power, unless it did not want Trends to go into liquidation. This may well have been because a liquidation could have seriously adverse consequences for the directors or shareholders in the company if the directors have been guilty of any wrongdoing.

[58] In this regard there is an affidavit from an accountant, Grant Graham, who makes a number of observations about Trends. Mr Graham is a very experienced accountant, and has acted as a liquidator or receiver in over 800 insolvencies. Mr Graham gave evidence in the High Court and was cross-examined.

[59] He pointed out in his affidavit that if the insider creditors had not been allowed to vote, the compromise would not have been approved and Trends could have been liquidated. A liquidator would have been able to investigate the affairs of the company and the actions of the directors in detail. In his view there was a

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[46] See generally *Antons Trawling Ltd v Dawson & Associates Ltd* [2017] NZCA 237.

prospect that such an investigation could lead to greater recoveries for the creditors than they would receive under the compromise. He observed that there are dangers to ordinary creditors in compromise situations in that insider creditors can overwhelm the pool of creditors and decide the destiny of the company.

[60] He noted that a good deal of the balances shown in the general ledger of the company were liabilities which were payable on demand. He considered that those balances had been classified as equity to prop up the balance sheet. There were many inter-company loans between Trends and other associated companies. But in the end they had negative equity and limited assets. He had doubts about the value of the intellectual property assets shown in the accounts and he expected that secured creditors would face a shortfall.

[61] In his view there were therefore areas of investigation which could lead to recoveries for creditors including claims based on:

(a) reckless trading;

(b) directors' duty of care;

(c) directors' duty to act in good faith and in the best interest of the company;

(d) investigation into related party transactions;

(e) keeping of books and records; and

(f) actions against third parties.

[62] He noted that in its later stages of trading Trends may not have been solvent, although this issue would have required a detailed analysis of a liquidator. He noted the existence of possible voidable transactions and the possible claw back of moneys to increase the pool of liquidation funds. He analysed the books and records of the company and found that there were "red flags" that records had not been kept in accordance with the company's obligations.

[63] The upshot of these largely uncontested observations by Mr Graham is that insider creditors are likely to have had a totally different goal in voting for a compromise than the other creditors. The insiders would want no liquidation and resulting investigation and action; the arm's length creditors who were owed sums significantly in excess of $1,000 the opposite. The insider creditors should therefore have been put in a separate class from the true third party creditors who include the challenging creditors, even if they all have the same notional rights as creditors. If this had been done the challenging creditors, the genuine third party creditors, would have at least had the option to have kept themselves apart from the compromise.

[64] We do not think a decision along these lines will make it too easy for small minorities to dictate what happens in compromises. As Winkelmann J pointed out in *Bank of Tokyo-Mitsubishi UFJ Ltd v Solid Energy New Zealand Ltd*, a company is free to select the creditors and debts it wishes to compromise. It is possible to compromise with particular sections of creditors.[47]

[65] We take the view therefore that there was an error made in setting up the compromise in that there was a failure to provide for a separate class for the insider creditors. There is a real prospect that the third party creditors will obtain better recoveries if Trends' affairs are investigated by a liquidator, rather than there being a compromise on the basis proposed.

[66] What should follow from this? There is a difference in the nature of the court's power under s 232(3) and that which arose under the old s 205 procedure. Under s 205 the court's power was not subject to any words of limitation or guidance as to whether the scheme should be sanctioned or not (although there was a body of case law which provided guidance). If the court was not satisfied it would refuse to sanction. In contrast, in s 232(3) the three bases for the court intervening are set out. Under that section the court must be "satisfied, on the application of a creditor" on one of them before the court can make an order. The court's analysis of the classes of creditors must take place in this new context.

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[47] *Bank of Tokyo-Mitsubishi UFJ Ltd v Solid Energy New Zealand Ltd*, above n 44, at [151].

[67] In this case we see the analysis of the appropriate classes as an aspect of the consideration in s 232(3)(c) of whether the compromise is unfairly prejudicial to a creditor. We consider the insider creditors should have been a separate class. We will return later to the consequences of this.

Failure to give adequate information

[68] The challenging creditors gave notice of their intention to support the judgment on other grounds and argued that Heath J should have found that Trends' provision of insufficient and inaccurate information was a material irregularity. Given that the correspondence demonstrated an ability for individual creditors to seek additional information, Heath J found that there was no "causal nexus" between the absence of information of the type sought and the way in which the voting was undertaken.[48]

[69] As Heath J observed, a generic rather than a prescriptive approach to the provision of information is required.[49] The statutory assumption appears to be that a proponent will make a full disclosure of all material that will be sufficient to enable a third party creditor to make an accurate and considered decision on whether to agree.

[70] Section 229(2) of the Act requires the proponent of a compromise to give to each known creditor notice of intention to hold a meeting in accordance with sch 5 of the Act, and a statement containing specified information. Section 229(2)(b)(iv) requires a proponent to give creditors a statement setting out the reasonably foreseeable consequences for creditors of the compromise being approved. Section 229(2)(b)(v) requires a statement setting out the extent of any interest of a director in the proposed compromise. Clause 2(2)(a) of sch 5 requires a notice to state the nature of the business to be transacted at the meeting "in sufficient detail to enable a creditor to form a reasoned judgment in relation to it." In our view, the failure to provide information can be a material irregularity under s 232(3)(b). It could also make a compromise unfairly prejudicial to a creditor under s 232(3)(c).

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48 *Advicewise People Ltd v Trends Publishing International Ltd*, above n 1, at [106].
49 At [62].

[71] The importance of the provision of information was emphasised by the Law Commission in its Report. It referred to what was to become pt 14 being designed to provide a "more useful procedure which features a greater provision of information by those proposing a compromise".[50] The Report read:[51]

> The ability of a 75 percent majority to bind the majority of relevant creditors is retained in section [230] but is subject to notice of the proposal being given to a creditor as well as the grounds for challenge set out in section [232(3)]. *The details of information required in section [229] support the central theme that the compromise must be able to be properly considered by creditors affected*, and opportunity afforded for other views to be made known.

[72] We are unable to agree with Heath J's conclusion that Trends' failure to provide adequate information was immaterial in this case. As we have set out, the provision of all the information necessary for an informed assessment of the proposal is very important in the new regime. The notice of proposed compromise circulated by Trends to creditors did not contain any financial information regarding the compromise. Initially there was no statement of the company's financial position. That seems unfair, as the creditors could not assess the merits of the compromise without knowing the detail of Trends' financial circumstances.

[73] Callaghan sought further information. Two days before the creditors' meeting Mr Khov's company, Waterstone Insolvency, provided to the solicitors for Callaghan a one-page summary of Trends' financial position. It did not show inter-company balance assets that appeared on Trends' financial statements of $24.8 million and investments in subsidiaries of $7.4 million. From the perspective of Trends' creditors who were considering the compromise proposal, these were assets of the company.

[74] In the opinion of Mr Graham the notice did not provide adequate financial information for creditors to form a reasoned judgment on the merits of the compromise proposal. It was also his analysis that the notice of the proposed compromise put forward by the proponents Mr Johnson and Mr Taylor did not provide adequate information for the creditors to form a reasoned judgment on the

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50 Law Commission, above n 17, at 148. The relevant paragraph is quoted in full at [26] above.

51 At 149 (emphasis added).

compromise proposal in accordance with cl 2(2) of sch 5 of the Act. He noted that Callaghan requested further information from Trends on two occasions but did not receive that information. They only received the one-page summary of the financial position of Trends.

[75] Detailed information which enabled Mr Graham to form the views that he did was only provided in discovery of these proceedings. In Mr Graham's view the summary that was provided could be misleading to creditors considering the compromise. We do not think that the fact that further information could have been sought cured this failure to provide enough information. There was not enough for a creditor to form a reasoned judgment.

[76] In our view this was material non-disclosure. It was an irregularity in terms of s 232(3)(b). The fact that no causal nexus between the non-supply of information and the voting of the challenging creditors has been established is not determinative. The challenging creditors, if they were armed with all the information that is now available, may well not have been able to stop the compromise because the insider creditors had the numbers, but that does not neutralise the failure to provide information.

[77] While on its own the non-provision of the information may not have been sufficient to warrant an order setting aside the compromise, the fact that there was this material irregularity is relevant to the court's ultimate discretion once all the factors set out in s 232(3) are considered. We will return to the consequences of this at the end of the judgment.

[78] We do not go as far as Heath J in concluding that the obligation to provide information involves the proponent engaging in good faith with all affected creditors. There are specific requirements for the giving of notice which are relatively precise, and which plainly place upon a proponent an obligation to make full disclosure of all matters within that proponent's knowledge that could be material to the decision-making process of a creditor when faced with a notice. Further, the compromise cannot be unfairly prejudicial. These s 232(3) requirements will generally catch bad faith by a proponent. There is no need to go further and impose

a general "good faith" requirement, with the possibility of imprecision and examination of motive. Those who drafted pt 14 saw no need to do so. We conclude that to superimpose an obligation to act in good faith is unnecessary.

Other possible classes

Minor creditors

[79] It was argued that the minor creditors owed less than $1,000 should have been placed in a different class because, unlike other affected creditors, they were to be paid in full if the compromise was approved. Heath J did not find that there was any causal link between a failure to identify the minor creditors as a separate class and any error in the voting process.[52] We had no detailed argument before us on the position of the minor creditors. Given our other findings, there is no need for us to determine this issue.

Callaghan

[80] It was submitted for the challenging creditors that Callaghan also should have been in a separate class. Although Trends admitted the debt to Callaghan at the time of the compromise, it later disputed that debt and filed a significant counterclaim. The challenging creditors contended that, as a creditor whose debt was disputed, Callaghan had different legal rights to other creditors and should have been in a separate class. In addition, if bound by the compromise Callaghan could lose its right to claim because of the moratorium, but would still face a full counterclaim.

[81] On 30 March 2015, just over a month before the compromise was put to creditors, Trends' solicitors wrote to Callaghan advising that Trends intended to pursue a claim for damages against Callaghan in respect of Callaghan's suspension of its grant and its instigation of the audit process with Deloitte. The letter states that the premature public release of information about the audit and the referral of the matter to the Serious Fraud Office, which Trends claims was based on unsubstantiated claims, have had a substantial effect on Trends' current and future business. As we have set out above at [8], in April 2015 Callaghan purported to

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[52] *Advicewise People Ltd v Trends Publishing International Ltd*, above n 1, at [111].

terminate the grant to Trends and demanded repayment of the moneys already advanced. Despite Trends' original position that it considered the suspension of the grant to be unlawful, Trends appears to accept its obligation to repay the moneys already advanced under the grant by recognising Callaghan as a creditor for the purposes of the compromise. The proposal documents and minutes of the creditors' meeting record that Callaghan was invited to and did participate in voting on the compromise as a compromise creditor.

[82] It was a term of the compromise proposal that all affected creditors would be prevented from bringing claims against Trends for moneys beyond what they would receive under the compromise. Clause 4 of the agreement stated that, if the compromise was adopted, no compromise creditor could initiate or continue any claim against the company. Nor could an affected creditor seek to apply any right of set-off or counterclaim for debts owed by the company under the compromise.

[83] The effect of Callaghan's inclusion in the compromise meant that, once passed, the compromise prevented Callaghan from raising the full extent of its debt as a counterclaim if and when Trends pursued the claims outlined in the letter of 30 March 2015. In our view, it is an improper use of a creditors compromise to include a creditor whose right to payment is disputed, and against whom the proposing company intends to issue proceedings, with the result that the creditor's debt is compromised and their right of counterclaim is extinguished.

[84] If Callaghan was to be included within the compromise, it needed to be put into a separate class. As a creditor whose debt was disputed, and who faced a claim by Trends arising out of the same facts that create the disputed debt, Callaghan was in a fundamentally different position than other creditors. That is so even if one is applying the strict legal rights test urged upon us by Trends. Given that the debt to Callaghan was disputed, Callaghan had different legal rights than those creditors whose right to repayment was uncontroversial.

[85] Of course, if Callaghan had been put into a separate category, it could have had an effective right of veto of the compromise. In that case Callaghan's vote against the proposal would prevent the compromise being passed even if all other

creditors had voted in favour of the compromise. Heath J considered that this state of affairs would likely have been unfairly prejudicial to all other creditors.[53] Yet Trends could just have easily avoided that course of events by not including Callaghan in the proposal in the first place. Part 14 does not oblige a company to compromise with all of its creditors.[54] A company can select the creditors with whom it wishes to compromise.

[86] It is not difficult to see why Trends wanted to include Callaghan in the compromise. Callaghan had clearly indicated its view, following the Deloitte report, that Trends was insolvent. Its requests for further information in the lead-up to the compromise suggest that Callaghan perceived that creditors may have a greater chance of recovery in a liquidation than under the compromise. Unless Callaghan was included in the compromise, Trends would be at risk of liquidation on the application of Callaghan, and the compromise with other creditors would be futile.

[87] The circumstances of Trends' dispute of the debt to Callaghan strongly suggest that the compromise was being used at least in part as a device to defeat Callaghan's substantive claim. Despite having indicated just one month earlier that it considered Callaghan's suspension of the grant to be unlawful, Trends appears to accept the debt to Callaghan for the purposes of the compromise. Then, when Callaghan and the other challenging creditors instituted proceedings challenging the compromise, Trends disputed the debt to Callaghan and filed a $22 million counterclaim.[55] Meanwhile, Trends continues to argue in the present proceedings that the compromise is valid, with the consequence that Callaghan is unable to raise the full extent of its claimed debt in the counterclaim proceeding.

[88] For the above reasons, Callaghan should not have been included in the compromise or, if it was, it should have been placed in a separate class for voting purposes. If the compromise was otherwise sound, we would have ordered that Callaghan not be bound by it under s 232(3).

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53 At [113].

54 We note that s 227 of the Act defines a compromise as including a compromise cancelling all or part of a debt to the company.

55 The counterclaim proceeding was split from the present proceedings in December 2015 and is set down to be heard in November 2017.

Was the compromise unfairly prejudicial to the creditors?

[89] Under s 232(3)(c), if a court is satisfied on the application of a creditor of a company that, in the case of a creditor who voted against the compromise, the compromise is unfairly prejudicial to that creditor, or to the class of creditors to which that creditor belongs, the court may order that the creditor is not bound by the compromise. As Winkelmann J noted in *Bank of Tokyo-Mitsubishi UFJ Ltd*:[56]

> [182] The scheme and purpose of Part 14 makes clear that [the intelligent and honest business person who might reasonably approve of the scheme] test does not apply to s 232(3). The substantive merits of a proposed compromise is an issue for the creditors. As is apparent from the Law Commission Report, the unfairly prejudicial limb was intended to provide a residual power to the Court, to prevent abuse of the procedure. The Court's role does not involve substituting its views of the compromise with that of the required majority of creditors. Nor does it involve the Court in second guessing the wisdom or sense of fairness of creditors in voting by the required majorities in favour of the proposal.

[90] We consider that the compromise was unfairly prejudicial to the challenging creditors. In summary:

(a) The insider creditors should have been separated into a different class for voting purposes, but were not.

(b) The compromise process involving the insider creditors indicates a wish to keep control of the company and avoid liquidation.

(c) The insider creditors and Mr Johnson may have much to lose from a liquidation, and the challenging creditors much to gain.

(d) Some of the actions of the insider creditors indicate commercial manipulation in order to control voting.

(e) Insufficient information was provided, so that creditors could not properly assess the proposal.

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[56] *Bank of Tokyo-Mitsubishi UFJ Ltd v Solid Energy New Zealand Ltd*, above n 44 (footnotes omitted).

(f) Callaghan ought to have been placed into a separate class for voting purposes, but was not, or ought to have been excluded entirely.

Conclusion

[91] The actual compromise offered to the challenging creditors was dismal in terms of return. They might not get much more than the initial $1,000 payment. There was no guarantee or indeed, on an objective assessment, a likelihood of any further payments.

[92] Heath J observed that it could not be confidently said that a better outcome would have been available to creditors if the compromise had not been approved.[57] We agree that a better outcome cannot be predicted. But certainly, on the basis of Mr Graham's affidavit, there is, as we have stated, a reasonable chance of a better outcome if the compromise is set aside. In any event, it is sufficient that there has been inadequate classification of creditors resulting in unfair prejudice, as we have set out.

[93] For these reasons the intervention of the Court under s 232(3) was warranted. Heath J decided to make an order that the compromise of 22 May 2015 be set aside. There is not an express power to set aside in s 232(3) of the Act. However, the power is to make an order that a creditor is not bound by the compromise "or make such other order as it thinks fit". There are no words of limitation, and in a case where there has been a serious irregularity and there is evidence of severe unfair prejudice, an order for setting aside can be appropriate. This is such a case.

[94] There was no contest before us about Heath J's jurisdiction to make an order setting aside the compromise. We consider that Heath J chose the right remedy when he set it aside.

Result

[95] The application for leave to adduce further evidence is granted.

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[57] *Advicewise People Ltd v Trends Publishing International Ltd*, above n 1, at [118].

[96] The appeal is dismissed.

[97] The respondents have been successful. The appellant must pay the respondents one set of costs for a standard appeal on a band A basis and usual disbursements. We certify for two counsel.

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