IN THE COURT OF APPEAL OF NEW ZEALAND

CA121/2010
[2010] NZCA 353

BETWEEN	STEPHEN JOHN TUBBS AND COLIN ANTHONY LATHAM GOWER Appellants
AND	RUBY 2005 LIMITED Respondent

Hearing: 15 April 2010

Court: Chambers, Arnold and Baragwanath JJ

Counsel: B M Russell and Y Wang for Appellants
D M Lester for Respondent

Judgment: 5 August 2010 at 11am

JUDGMENT OF THE COURT

A The appeal is allowed.

B We make an order of injunction to have effect until further order of the High Court in the terms stated at [43] of the reasons for judgment.

C The case is remitted to the High Court. Any application to vary or revoke the interlocutory injunction in light of changed circumstances must be made to the High Court.

D The respondent must pay the appellants costs for a standard appeal on a band A basis and usual disbursements.

REASONS OF THE COURT

(Given by Baragwanath J)

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[1] The business of Waimate Timber Processing Ltd (Waimate), of which the appellants are receivers, is to cut and sell timber. The receivers were appointed by the ANZ National Bank Ltd (the Bank) under its first ranking general security interest over all of Waimate's assets and undertakings including its timber stock. The security interest was registered under the Personal Properties Securities Act 1999 (PPSA).

[2] French J declined to grant the receivers an injunction to freeze the proceeds of sale by the respondent Ruby 2005 Ltd (Ruby) of timber which it had bought from Waimate and paid for but not removed from Waimate's site and which Waimate had resold to two overseas companies approximately two weeks before the receivers were appointed.[1]

[3] The major issue on their appeal is whether the Bank's security interest extends to such timber, remaining as it did in Waimate's possession but on terms that Waimate was not permitted to sell it save on terms that Waimate immediately replace the timber from Waimate's other stock or account to Ruby for the proceeds of sale. The receivers ~~argue~~:

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1 *Tubbs v Ruby 2005 Ltd* HC Timaru CIV-2009-476-000615, 26 February 2010 [*Tubbs*].

(a) the effect of the terms was such that, although Waimate retained a security interest under s 17 of the PPSA, Waimate's interest was subordinate to that of the Bank as it was unperfected under s 41;

(b) the Bank's interest survived the sale to Ruby, despite the payment by Ruby of the price of the timber, as in terms of s 53 the purchase was not in the ordinary course of business.

[4] A second, alternative, issue is whether Ruby holds the sale proceeds as a constructive trustee on the grounds of its knowing receipt of moneys procured by breach of fiduciary duty on the part of Waimate's directors.

The facts

[5] Waimate was incorporated in April 2001 to mill logs coming on stream from various forests in the Canterbury region. It was funded by substantial shareholder contributions from the local council and funding provided by a subsidiary of the bank. Financial difficulties due primarily to the fluctuating New Zealand dollar imposed heavy pressures. Substantial further funds were advanced to the company by its shareholder directors.

[6] In July 2005 Ruby was incorporated in order to further ease Waimate's financial pressures. Its corporate shareholder was controlled by the directors and shareholders of Waimate. Three of Waimate's four directors are the directors of Ruby.

[7] The Judge found it arguable that Waimate and Ruby entered into the following agreement:[2]

> (a) Ruby would purchase timber from Waimate at market value when Waimate needed to achieve sales.
>
> (b) The timber purchased by Ruby (the Ruby stock) was at all times to remain separate stock and to be treated as belonging to Ruby. The original intention had been to store it off site, but that proved impractical and so the

[2] At [14].

Ruby stock was stored separately in the Waimate yard, separate from the Waimate stock, to wait for a purchaser to be located or found.

(c) The timber sold to Ruby did not form part of Waimate's inventory.

(d) Waimate agreed not to take or use the Ruby stock unless:

(i) It had found a customer to whom the stock could be sold, in which case the stock would either be sold to that customer in the name of Ruby or Waimate would sell in its own name, and account for the sale proceeds from the customer to Ruby.

Or

(ii) Waimate was able to effect a physical swap of timber. This was allowed to occur in the event the Ruby stock contained timber of a particular type wanted by a customer and Waimate had stock on hand of equivalent value which it could use to replenish the Ruby stock (the swap was documented in the company records by way of credit note and simultaneous replacement by invoice).

(e) At all times there was to be stock on site belonging to Ruby which could be uplifted by Ruby.

[8] Between August 2005 and October 2008, sales were made on this basis from Waimate to Ruby. The funds provided by Ruby to Waimate were always for the purchase of specific quantities of timber at full market value and invoiced as such.

[9] Ruby had no staff independent of Waimate which performed the marketing of the Ruby timber.

[10] The Judge found arguable that from December 2007, Waimate's then general manager breached the agreement by taking timber from the Ruby stock and selling it as Waimate stock, despite the fact that Waimate did not have sufficient cash to pay Ruby nor stock to replace the timber taken. The manager prepared invoices purporting to be on Ruby's behalf and showing a sale by Ruby of its timber to Waimate. If effective they would make Ruby an unsecured creditor of Waimate contrary to the agreement between the two companies. By early 2009, most of Ruby's stock had been sold to third parties without payment to Ruby.

[11] The Judge further found that the manager's actions were unauthorised as well as a breach of the contract between Waimate and Ruby, which had never agreed to give credit to Waimate and never authorised the raising of the invoices. The

evidence of the directors of both companies was that as of November 2008, Ruby retained stock to the value of some $288,000 which was being stored on the Waimate site awaiting delivery to Ruby. The last purchase of timber by Ruby was on 20 October 2008. The Judge found that at some point in 2009 Ruby's directors discovered the true situation. As at May 2009 Waimate's current liabilities exceeded its current assets by $2,429,561 and from then on it was insolvent.

[12] While insolvent, by the end of July 2009 Waimate had physically replenished half of the depleted Ruby stock with the remaining half being replenished by early September 2009.

[13] During the last six months of 2009 Waimate was cutting timber only to fill specific orders for export rather than to hold as inventory.

[14] In late September 2009 the Ruby directors were considering uplifting the replenished Ruby stock. They decided that Ruby should instead sell the stock to offshore clients of Waimate who had placed orders with Waimate. That was done in October 2009, with instructions given to the freight forwarding agent to show Ruby rather than Waimate as the shipper of the cargo. The documents created to give effect to the transactions included invoices dated October 2009 showing sale of the timber by Waimate to Ruby. This was said to be done to cancel or balance out the GST effect of the invoices raised by the previous manager, which the directors deposed were unauthorised and had wrongly shown Ruby as selling timber to Waimate. The October 2009 invoices had no GST consequences for Ruby.

[15] On 29 October 2009 the bank appointed the appellants as receivers of Waimate.

[16] The total volume of sawn timber dispatched from the mill during October 2009 was 3,610 cubic metres of which the Ruby component was 1,100 cubic metres. Since 2005 Waimate had dispatched some 100,000 cubic metres of sawn timber for sale equating to approximately 25,000 cubic metres per annum.

[17] Following their appointment the receivers gained access to Waimate's financial records, including those reflecting the October transactions involving Ruby. The records appeared to show Ruby attempting to offset its unsecured debt from its related company Waimate by taking timber in lieu of payment and its directors diverting a sales opportunity belonging to Waimate so as to allow Ruby to cash up the timber.

[18] In November 2009 the receivers notified Ruby that they considered the sale of the timber to Ruby in October 2009 to be outside the ordinary course of Waimate's business, so that the timber and the proceeds of its sale remained subject to the bank's security interest.

[19] At the time the receivers issued that notice they were unaware of the 2005 agreement between Waimate and Ruby and of the directors' evidence that the actions of the general manager were unauthorised.

The decision of the High Court

[20] French J found compelling the evidence establishing the 2005 agreement and as to the lack of authority of the general manager to act inconsistently with it. Since there has been no discovery nor evidence from the general manager we prefer to limit the conclusion to there being an arguable case to that effect. The argument in the High Court was focused on whether it was seriously arguable that:

(a) Ruby was unable to invoke the protection of s 53 of the PPSA;

(b) Waimate's directors breached their fiduciary duty to Waimate and Ruby knowingly assisted that breach.

Section 53

[21] As to the first ground, s 53 states:

> **Buyer or lessee of goods sold ... in ordinary course of business takes goods free of certain security interests**
>
> (1) A buyer of goods sold in the ordinary course of business of the seller... takes the goods free of a security interest that is given by the seller... unless

> the buyer ... knows that the sale ... constitutes a breach of the security agreement under which the security interest was created.
>
> (2) This section prevails over section 3 of the Mercantile Law Act 1908 and section 27 of the Sale of Goods Act 1908 where this section applies and either or both of those sections apply.

[22] French J noted that whether the transaction is the "ordinary course of business" is a question of fact, and set out a number of potentially relevant factors (drawn from *Fairline Boats Ltd v Leger*[3]).

[23] The Judge recorded the receivers' submissions that, because the sale transactions between Waimate and Ruby in 2005–2008 were expressly for the purpose of assisting Waimate's cash flow difficulties, that meant they were not sales in the ordinary course of business but were more in the nature of financing arrangements. They further contended that, at best for Ruby, the unauthorised actions of the manager created a debtor/creditor relationship. Ruby had a claim for the value of the timber which had been misappropriated and the option of either physically uplifting replacement stock itself or claiming payment. It chose the latter and thereby became a creditor. The transaction in 2009 was entered into primarily for the purpose of satisfying a pre-existing debt and was not a sale in the ordinary course of business.

[24] The Judge held that the transactions between Waimate and Ruby in the period between 2005 and 2008 were, for the purposes of s 53, sales in the ordinary course of Waimate's business despite the fact that they were for the express purpose of assisting Waimate's cash flow.

She considered that what happened in 2009 was simply performance of the 2005–2008 sale contracts. At all times Ruby was the legal owner of the timber in its stack. The fact that the timber at issue was not physically the same as Ruby had acquired during 2005–2008 could not alter the position when both the physical exchange of timber and the sales directly to third party purchasers were an integral part of the agreement.

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[3] *Fairline Boats Ltd v Leger* (1980) 1 PPSAC 218 (Ont HC) at [38].

Fiduciary duty

[25] The Judge further held that there was no breach of fiduciary duty by Waimate's directors, known to Ruby, by diverting Waimate's business opportunities to Ruby. She held that there could be no breach of duty owed to either Waimate or its creditors given that the directors were acting in accordance with Waimate's contractual obligations regarding timber belonging to Ruby. She held that there was no serious question to be tried on either course of action and dismissed the receiver's application for an interim injunction.

Discussion

Section 17

[26] In this Court Mr Russell for the receivers submitted that the arrangement between Waimate and Ruby gave rise to a "security interest" in Ruby, as defined by s 17, which, being unregistered, was subordinate to the registered security interest of the bank. Mr Lester for Ruby submitted that Waimate's sales of the timber to Ruby for full value fell outside the PPSA and, by operation of the Sale of Goods Act 1908, conferred on Ruby an unqualified title. What Ruby then did with the timber, including permitting Waimate to arrange for its sale on terms either that the proceeds would be paid to Ruby or that Ruby's pile would be reinstated, could not constitute the grant by Waimate to Ruby of a security interest. Of its nature, a "security interest" relates to security for payment of a debt. But Waimate did not owe money to Ruby. Ruby was the owner of the timber pile, not of a security interest.

[27] Section 17 states:

> **Meaning of "security interest"**
>
> (1) In this Act, unless the context otherwise requires, *the term* ***security interest****—*
>
> > (a) *Means an interest in personal property created or provided for by a transaction that in substance secures payment or performance of an obligation,* without regard to—
> >
> > > (i) The form of the transaction; and
> > >
> > > (ii) The identity of the person who has title to the collateral...

[28] The section directs the Court to have regard to the substance rather than form of the transaction. Essentially, the receivers submit that the 2005–2008 arrangements constituted a loan from Ruby to Waimate, secured by Ruby's taking title to some of Waimate's stock. They argue that Ruby's security in the stock was unperfected under s 41 of the PPSA, and thus subordinate to the bank's perfected interest.

[29] We reject the receivers' contention. We do not consider that the transaction between Waimate and Ruby created a security interest in the sense of an interest governed by the priority rules in the PPSA. Indeed we do not consider that s 17 was engaged. To come within s 17, Ruby's interest in the timber would have had to have been acquired to secure performance of an obligation by Waimate. From what the Judge found was arguably the agreement,[4] Waimate is not shown to have owed any obligation to Ruby. Ruby was reliant on Waimate to find customers for its timber, but could not have compelled Waimate to do anything affecting the timber.

[30] Waimate was permitted to do a number of things with the timber Ruby had purchased, but its obligation to Ruby was only triggered once it exercised one of the following options. If it onsold timber to customers in its own name, it was obliged to account to Ruby or replace the stock with the same value of timber of a different type. If it onsold it in Ruby's name, it was naturally obliged to ensure Ruby received payment. If, on the other hand, Waimate did nothing, it would not owe any obligation which Ruby could enforce.

[31] Since Ruby owned the timber, thereby already holding the highest interest known to the law, there was no need to create a mere security interest to protect Ruby. Ruby's ownership could not be downgraded simply because Ruby was prepared, if paid the market value of any parts of it, or if an equivalent quantity of timber were substituted, to allow access to it for Waimate to make sales to third parties.

[32] It follows that Mr Russell's first argument fails.

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4 At [14] ([7] above).

Section 53

[33] It is convenient to repeat s 53:

> **Buyer or lessee of goods sold ... in ordinary course of business takes goods free of certain security interests**
>
> (1) A buyer of goods sold in the ordinary course of business of the seller... takes the goods free of a security interest that is given by the seller... unless the buyer ... knows that the sale ... constitutes a breach of the security agreement under which the security interest was created.
>
> (2) This section prevails over section 3 of the Mercantile Law Act 1908 and section 27 of the Sale of Goods Act 1908 where this section applies and either or both of those sections apply.

[34] Mr Russell submitted that the sales were made, not in the ordinary course of business of Waimate, but:

(a) to the related company Ruby, which did not have any use of its own for the timber, but was created for the purpose of assisting Waimate's cash flow when it was under financial pressure;

(b) to create a stock-pile or inventory which Waimate would use.

[35] As is clear from the wording of s 53, the section protects a buyer where the sale is in the ordinary course of business, unless the buyer knew that the sale constituted a breach of the relevant security agreement.

(1) 2005–2008 transactions

[36] The "business of the seller", Waimate, was to sell timber. Between 2005 and 2008, Waimate sold Ruby timber, for cash, at full market value. The practical effect of these transactions was that Waimate sold its timber earlier than it would otherwise have done. This was wholly in the interests of Waimate and its creditors; the transactions removed Waimate's inventory from the reach of the Bank's security, but replaced that inventory with cash. The fact these sales were to a related party is here immaterial. There was no suggestion there was otherwise a breach of the security agreement. In these circumstances, the receivers cannot realistically impugn the sales between 2005 and 2008.

[37] The Canadian cases cited by Mr Russell do not assist his argument on this point. In *MacDonald v Canadian Acceptance Corp Ltd*,[5] for example, the relevant sales were by a used car dealer of a number of cars to another dealer to "lessen financial pressure". These sales were held to be outside the ordinary course of business and the buyer accordingly did not take the cars free of the creditor's chattel mortgages. It is highly unlikely that in that case the cars were sold to the fellow dealer at full market value, rather than at wholesale rates. If, as we expect, the sales were sold below market value, we agree with the result. "Market value" would naturally include such usual activities as sales promotions at a reduced price; it is difficult to see how a sale even below such a market value could be in the ordinary course of business.[6] Insofar as the judgment could be read to suggest that the only important consideration was the *purpose* for which the onsale to the dealer was entered into, ie to relieve financial pressure, we respectfully disagree; that is commonly the reason for conventional sales campaigns.

[38] We note for completeness that we agree with the comments of Linden J in *Fairline Boats Ltd v Leger*, also cited by Mr Russell, as to the purpose of the Ontario equivalent of s 53:[7]

> The objective of this section, as I understand it, is to permit commerce to proceed expeditiously without the need for purchasers of goods to check into the titles of sellers in the ordinary course of their business. Purchasers are allowed by our law to rely on sellers using the proceeds of sales to repay any liens on the property sold. In these days inventory is almost invariably financed, and as a result is almost invariably subject to liens of one kind or another. To require searches and other measures *to protect lenders* in every transaction would stultify commercial dealings, and so the Legislature exempts buyers in the ordinary course of business from these onerous provisions, even where they know that a lien is in existence.
>
> (Emphasis added.)

The purpose of s 53 is to limit protection of creditors where a buyer takes goods in a specific way. But in this case there was no need to protect the Bank: the transactions

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5 *MacDonald v Canadian Acceptance Corp Ltd* (1955) 5 DLR 344 (Ont CA).

6 It is unnecessary to discuss the further complication in that case of the creditor's unusual arrangement with the dealer, in which the dealer was permitted to sell cars "retail", with the creditor profiting from a purchase money financing arrangement with the consumer, but not "wholesale", where there could be no such profit. That too was held to take the sale outside the ordinary course of the seller's business.

7 *Fairline Boats Ltd v Leger* [1980] 1 PPSAC 218 (Ont HC) at [8].

did not diminish, and quite possibly enhanced, the value of its security by less liquid stock being converted into cash. (Contrast another case cited by Mr Russel, *Estevan Credit Union Ltd v Dyer*,[8] where there was a specific breach of the security agreement in that the proceeds of the relevant sales went directly to another creditor, rather than into the debtor's general account, which was subject to the creditor's security.)

(2) The 2009 transactions

[39] The 2009 transactions are another matter. We do not yet know what the facts are. We have noted that there has been no discovery and there is no affidavit from the former manager. If at the time the stockpile was depleted the manager acted with Ruby's express or implied approval, Ruby then waived rights against Waimate and its timber. In that event the receivers' submission that Ruby became a mere unsecured creditor is correct. If he acted without Ruby's approval he may be party to a conversion by Waimate of Ruby's property, namely the proceeds of depletion of the stockpile. Receipt of such proceeds would have given Ruby a claim for their amount against Waimate. We do not agree with the Judge ([25] above) that the events of 2009 are to be characterised as mere completion of the 2005–2008 sale contracts. Waimate was passing to Ruby title to timber belonging to Waimate and thus within the Bank's security.

[40] While Ruby had paid cash at full market value in the earlier transactions, this time the "sales" from Waimate to Ruby, which entailed the transfer of Waimate's inventory to Ruby's stockpile (and later to third parties who paid Ruby), were not for cash. They were in satisfaction either of Ruby's existing claim for conversion (if the manager's actions were unknown and unauthorised) or of Waimate's debt to Ruby (if Ruby's directors had known of the manager's actions). Again in contrast to the earlier sales, the 2009 transactions certainly had the effect of undermining the Bank's security. We hold they were arguably not sales and were outside the ordinary course of business, either because:

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8 *Estevan Credit Union Ltd v Dyer* (1997) 146 DLR (4th) 490 (Sask QB).

(a) they were in satisfaction of Waimate's existing debt to Ruby, rather than for cash; or

(b) they were to account to Ruby for Waimate's conversion, via the manager, of Ruby's stock.

[41] Since we accept Mr Russell's submission that there is an arguable case that the 2009 "sales" did not occur "in the ordinary course of business" of Waimate, the appeal must be allowed in respect of those transactions.

[42] It is unnecessary for us to consider the alternative cause of action in breach of fiduciary duty.

Decision

[43] We allow the receivers' appeal and make an order of injunction to have effect until further order of the High Court:

(a) The respondent must pay or receive all proceeds from the on-sale of lumber first sold by Waimate Timber Processing Ltd to the respondent pursuant to invoices 13744 to 13754 inclusive, 13774 to 13781 inclusive, and 13829 (the Lumber), into a separate interest bearing account that is in credit.

(b) No funds paid or received into such a separate account pursuant to order (a) herein are to be disbursed, or dealt with in any way by the respondent or any of its officers, agents, or employees without the further order of the High Court.

(c) The respondent forthwith provide a copy of this order to its banker or any other party nominated to receive proceeds from the sale of the Lumber on the respondent's behalf.

(d) The respondent give such instructions to the purchasers of the Lumber and any other parties as necessary to give effect to the requirement

that proceeds from the sale of the Lumber be paid or received in accordance with order (a) herein.

[44] We remit the case to the High Court for further consideration in the light of this judgment. Any application to vary or revoke the interlocutory injunction in light of changed circumstances must be made to the High Court.

[45] The respondent must pay the appellants costs for a standard appeal on a band A basis and usual disbursements.

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