IN THE HIGH COURT OF NEW ZEALAND
TIMARU REGISTRY

CIV-2009-476-000615

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

Hearing: 4 February 2010

Appearances: B M Russell for Applicants
D M Lester for Respondent

Judgment: 26 February 2010

RESERVED JUDGMENT OF HON. JUSTICE FRENCH

Introduction

[1] This is an application for an interim injunction.

[2] The applicants are the receivers of a company called Waimate Timber Processing Limited. They were appointed by the ANZ Bank which has a first ranking registered general security interest over all of Waimate's assets and undertakings including its timber stock.

[3] The respondent Ruby 2005 Limited is in receipt of the proceeds from the sale of some timber which it removed from the Waimate site and sold to two overseas companies approximately two weeks before the receivers were appointed. The receivers claim the timber and its proceeds are subject to the bank's security interest and hence subject to the receivership.

[4] The receivers also claim in the alternative that Ruby holds the sale proceeds as a constructive trustee, on the grounds it received the proceeds knowing they had been procured by a breach of fiduciary duty on the part of the Waimate directors. The statement of claim seeks an order requiring Ruby to pay the proceeds to the receivers.

[5] In order to preserve the position pending the substantive hearing, the receivers have applied for an interim injunction to stop Ruby from dissipating the funds meantime. The receivers contend there is a serious question to be tried and that the balance of convenience and overall justice favour the granting of the injunction.

[6] Ruby opposes the application. It says it took the timber free of the bank charge because of s 53 of the Personal Property Securities Act 1999 and that it is not tenable for the receivers to argue otherwise. Section 53 provides that a buyer of goods sold in the ordinary course of the business of the seller takes the goods free of a security interest given by the seller unless the buyer knows the sale constitutes a breach of the security agreement.

[7] The main issues are:

i) Is there a serious question about the applicability or otherwise of s 53?

ii) Is there a serious question that the Waimate directors breached their fiduciary duty to Waimate?

[8] Balance of convenience was not a significantly contested issue. It clearly favours the receiver, Ruby being unable to point to any particular prejudice which it might suffer as a result of being unable to use the funds meantime.

Factual background

[9] Waimate Timber was incorporated for the purposes of establishing and operating a sawmill at Waimate.

[10] The funding for the establishment of the sawmill was provided by a loan from the local District Council, substantial shareholder contributions as well as a facility from the ANZ National Bank Limited. ANZ registered its security on the Personal Properties Securities Register on 6 March 2003 and then renewed it on 5 December 2007.

[11] From the very beginning of its operations in 2002, Waimate experienced financial difficulties due primarily to the fluctuating New Zealand dollar. As a result, the shareholding directors continued to provide significant financial support throughout the company's existence.

[12] In 2005 the directors decided to establish a separate company (Ruby) as an additional means of assisting Waimate with its cashflow problems. The idea was to create an entity which would purchase timber from Waimate at full market value when Waimate needed to achieve sales.

[13] Ruby was duly incorporated in July 2005, three of its four directors being also directors of Waimate.

[14] The details of the agreement between Waimate and Ruby were as follows:

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 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.

[15] Waimate sold timber to Ruby on this basis from time-to-time between August 2005 and October 2008. The monies injected by Ruby into Waimate were always for the purchase of specific quantities of timber at full market value and invoiced as such.

[16] Ruby was obviously reliant on Waimate to find purchasers for the Ruby timber because Waimate had the necessary expertise and connections.

[17] The driving force behind the establishment of Ruby was Waimate's accountant, Mr Hornsey. Under his supervision, the arrangement operated as

intended. Unfortunately, Mr Hornsey died in 2007 and as a result there was not thereafter the same level of oversight of the dealings between the two companies.

[18] Unbeknown to the directors of either company, in December 2007 Waimate's then general manager breached the agreement. He started taking timber from the Ruby stock and selling it as Waimate stock, despite the fact Waimate did not have sufficient cash to pay Ruby, nor the stock to replace the timber taken. In the process, the manager raised invoices on Ruby's behalf purporting to show a sale by Ruby of its timber to Waimate. These invoices were raised without Ruby's knowledge. On paper they of course had the effect of making Ruby an unsecured creditor of Waimate, something which had never been intended.

[19] By early 2009 most of Ruby's stock had been depleted.

[20] The uncontradicted evidence is that the manager's actions were unauthorised and a breach of the contract between Waimate and Ruby. Ruby had never agreed to give credit to Waimate, and had never authorised the raising of the invoices. As far as the directors of both companies were concerned, as at November 2008 Ruby still had stock to the value of approximately $288,000 which was being stored on the Waimate site, awaiting delivery to Ruby.

[21] The last purchase of timber by Ruby was on 20 October 2008.

[22] It is unclear from the evidence exactly when in 2009 Ruby's directors discovered the true situation.

[23] As at May 2009 Waimate's current liabilities exceeded its current assets by $2,429,561. From that time on, it was insolvent.

[24] 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.

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

[26] As at late-September 2009, the Ruby directors were considering uplifting the replenished Ruby stock. However, it was decided Ruby should instead sell it to offshore clients located by Waimate, these off shore clients having placed orders with Waimate. This was actioned in October 2009, with instructions being given to the freight forwarding agent to name Ruby as the shipper of the cargo rather than Waimate.

[27] The paperwork created to effect the transactions included the raising of invoices in October 2009, showing Waimate selling the timber to Ruby. This was done in order to cancel or balance out the GST effect of the unauthorised invoices raised by the previous manager which, as mentioned, had wrongly shown Ruby selling timber to Waimate. The October 2009 invoices had no GST consequences for Ruby.

[28] Throughout October 2009 Waimate was unable to pay its debts as they fell due. The facilities with ANZ were in default, and on 29 October 2009 Waimate went into receivership.

[29] In terms of volumes, the total volume of sawn timber/lumber dispatched from the mill during October 2009 was 3610 cubic metres of timber. Of that volume, the Ruby component was 1100 cubic metres.

[30] Since 2005, Waimate has despatched a total of approximately 100,000 cubic metres of sawn timber/lumber for sale which equates to approximately 25,000 cubic metres per annum.

[31] On being appointed receivers, the applicants gained access to Waimate's financial records, including the records of the October 2009 transactions involving Ruby. Understandably, the records raised concerns for the receivers. In the absence of a satisfactory explanation, they considered it to be a situation of a related company attempting to offset its unsecured debt by taking timber in lieu of payment, coupled with directors diverting a sales opportunity belonging to Waimate so as to allow the related company to cash up the timber.

[32] In November 2009 the receivers notified Ruby that they considered "the sale of the lumber to Ruby in October 2009" was outside the ordinary course of Waimate's business, and that therefore the lumber and the proceeds of its sale remained subject to ANZ's security interest.

[33] At the time the receivers issued that notice, they were unaware of the 2005 agreement between Waimate and Ruby and the unauthorised actions of the general manager. The evidence as to those matters is compelling, including as it does not only evidence from the directors and the company's accountant but also contemporaneous file notes of Mr Hornsey about the establishment of Ruby together with an affidavit from a Waimate employee. The receivers do not challenge any of the evidence but say it makes no difference to their legal argument that Ruby is not entitled to the protection of s 53.

[34] The receivers also contend that even if the timber was sold to Ruby in the ordinary course of Waimate's business, the Waimate directors breached their fiduciary duty to Waimate by diverting Waimate's business opportunities (the orders Waimate had secured with the overseas clients) to Ruby, thereby giving rise to a constructive trust.

Is there a serious question that Ruby is unable to invoke the protection of s 53?

The principles to be applied

[35] Section 53 states:

> **53 Buyer or lessee of goods sold or leased 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, and a lessee of goods leased in the ordinary course of business of the lessor, takes the goods free of a security interest that is given by the seller or lessor or that arises under section 45, unless the buyer or lessee knows that the sale or the lease 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.

[36] It is well established that the application of s 53 involves a two-stage process:

i) To determine the business of the seller;

ii) To enquire whether the sale was made in the ordinary course of that business.

[37] As regards the first question, it was common ground that Waimate was at all material times in the business of selling timber and held itself out as such.

[38] Counsel also agreed that the second question (i.e. whether the sale was made in the ordinary course of Waimate's business) is a question of fact to be determined having regard to all the circumstances of the sale, including the following factors identified in *Fairline Boats Ltd v Leger* (1980) Carswell Ont 607, 1 PPSAC 218 (Ont HC):

a. transaction type – the transaction should be one that is a normal part of the seller's business;

b. place of sale – if made at the seller's business premises, it is more likely to be in the ordinary course of business;

c. parties to the transaction – if the purchaser is an ordinary everyday consumer, the likelihood of a sale in the ordinary course of business is greater;

d. quantity of the goods sold - if a large number of items are sold, many more than normally sold and forming a substantial portion of the seller's stock, this counts against it being a sale in the ordinary course;

e. price charged – if market price is charged, then the sale is more likely to be considered one in the ordinary course of business;

f. advertising – if the seller advertises, holding itself out to the public as conducting a certain business, the transaction is more likely to be in the ordinary course;

g. percentage of overall sales volumes.

The competing submissions

[39] While counsel agreed on the factors to be considered, they disagreed as to when it was that the relevant sale(s) had taken place – in particular, whether what happened in October 2009 amounted to a sale of timber to Ruby, or whether the proper focus for the purpose of the s 53 enquiry was the transactions between 2005 and 2008.

[40] On behalf of Ruby, Mr Lester submitted it was important to draw a distinction between a sale and the passing of title. In his submission, what took place in September/October 2009 was not a sale. The sale had already occurred. There was only one set of sale agreements, and that was in 2005-2008. The later deliveries, or reallocations, in 2009 were not sales as such, but still attracted the protection of s 53 because s 53 is triggered when title passes, and that happened on the allocation of the timber to the Ruby stock.

[41] However, Mr Russell for the receivers argued that whether the sale to be considered was the 2005-2008 transactions or the 2009 transaction, either way there was a serious question to be tried.

[42] Mr Russell submitted that because the sale transactions between Waimate and Ruby in 2005-2008 were expressly for the purpose of assisting Waimate's cashflow difficulties that of necessity meant they were not sales in the ordinary course of business. They were more in the nature of financing arrangements. Accordingly, even in 2005 Ruby had not acquired the timber free of the bank's security interest. In support of this submission, Mr Russell referred me to a number of Canadian authorities where the Courts have declined to treat disposals made under financial pressure for the purpose of raising money as sales made in the ordinary

course of business: see *MacDonald v Canadian Acceptance Corp Limited* [1955] 5 DLR 344 (Ont CA); *Northwest Equipment Inc v Daewoo Heavy Industries America Corp* [2002] 6 WWR 444 (Alta CA); and *Re 547592 Alberta Limited (Receivership)* (1995) 10 PPSAC (2d) 62 (Alta QB).

[43] Mr Russell further contended that if the exercise of replenishing the stock in 2009 was not a sale, then s 53 could not apply at all because the section is only concerned with sales, and if it was a sale, then it was not a sale in the ordinary course of business. In his submission, at best for Ruby, the unauthorised actions of the rogue manager created a debtor/creditor relationship. Ruby had a claim for the value of its 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 that took place in 2009 was thus a transaction that was entered into primarily for the purposes of satisfying a pre-existing debt, a purpose which according to a leading text Gedye, Cuming QC and Wood, *Personal Property Securities in New Zealand* (2002) at [53.6] means of itself the transaction is unlikely to satisfy the requirement of being a sale in the ordinary course of business. Satisfying the obligation to Ruby by passing over orders to be filled, and the timber with which to fill those orders was, Mr Russell submitted, particularly irregular and could not be said to be in the ordinary course of business.

Discussion

[44] Logically, the correct approach must be to look first at the timber transactions which took place between Waimate and Ruby during the period 2005-2008.

[45] In my view, these were sales in the ordinary course of Waimate's business for the purposes of s 53, notwithstanding the fact they were for the express purpose of assisting Waimate's cashflow.

[46] Under s 53 the focus is on the particular operating methods of the trader in question rather than the manner in which goods of the kind involved are generally sold. The words used are "in the business *of the vendor*" [emphasis added]. Accordingly what might be unusual in the trade may have been normal for Waimate.

As Mr Lester pointed out, these transactions started in August 2005, so that for more than half of Waimate's life it had this relationship with Ruby and adopted those trading methods. The transactions designed to help cashflow became a habitual part of what Waimate did.

[47] The facts in this case are very different from the facts of the Canadian authorities relied upon by Mr Russell, involving as they did what might loosely be called forced fire sales. In the present case, not only was the agreement implemented over an extended period of several years, but Ruby always paid full market value. For that reason, I also do not accept Mr Russell's further argument that such a practice would have the effect of undermining or eroding the bank's security interest.

[48] As regards volume, there is no suggestion that the volumes sold to Ruby in the individual transactions were unusual or that the Ruby transactions in total represented an unusually large percentage of overall sales during the period 2005-2008.

[49] Ruby was obviously not an everyday consumer and the fact Ruby and Waimate were related companies is an important factor. However, as stated in *Fairline Boats*, it is not determinative and in my view is clearly outweighed by the other considerations I have identified.

[50] I am satisfied there is not a serious question to be tried in relation to the 2005-2008 transactions.

[51] Further, in my view correctly analysed what happened in 2009 was simply the performance of those 2005-2008 sale contracts. It cannot be right that Waimate, and thus the receivers, can be in a better position because of the manager's unlawful actions than they would otherwise have been. His actions cannot render invalid what was otherwise valid, or as Mr Lester put it, unravel the sale contract which was affirmed immediately the wrongdoing was discovered. Nor could the manager's unauthorised paperwork have the effect of changing the legal consequences of the contractual arrangements or convert Ruby into an unsecured creditor.

[52] The Court must be concerned with substance. As was said in *Orix New Zealand Limited v Milne & Anor* [2007] 3 NZLR 637 (HC) at [69], the way in which sale transactions are accounted for in the books of the two companies is essentially an internal administrative matter and not determinative. How much more must that be so when the 2009 sale invoices on which the receivers rely were generated simply to correct an error for GST purposes.

[53] Under the sale agreement, the appropriation of the goods to the sale contract and the passing of title was effected when the timber – including swaps – was placed in the Ruby stock.

[54] At all times Ruby was the legal owner of the timber in its stack and it had become so as a result of sales which were in the ordinary course of Waimate's business.

[55] The fact that the timber at issue was not physically the same timber which Ruby had acquired during 2005-2008 cannot alter the position, when the physical exchange of timber was an integral part of the agreement, as was indeed the sale of Ruby stock directly to third party purchasers. In those circumstances, the fact that Ruby chose to sell what was its timber through Waimate, rather than uplift it off site, cannot in my view deprive it of the protection of s 53 or somehow alter Ruby's legal status.

[56] Ruby had already purchased and paid for the timber. In October 2009 it was only uplifting its own property that it had already paid for pursuant to a sale that was in the ordinary course of Waimate's business.

[57] In coming to this conclusion, I have not overlooked the fact that the 2009 timber had been cut to orders obtained by Waimate. As a matter of principle what Ruby did with what I have found to be its own timber should not preclude its purchase from being in the ordinary course of business. However, in any event, making Waimate orders available to Ruby had always been part of the agreement. Further, there was also uncontradicted evidence that Waimate had previously sold

cut lumber to other domestic clients for them to export the lumber independently of Waimate, directly to Waimate's customers.

[58] A further argument raised by Mr Russell was that the storage of Ruby's timber on the Waimate site created a bailment which, being for more than a year, resulted in Ruby having a deemed security interest under s 17 of the Act (the statutory definition of "lease" including a bailment). Ruby's security interest was not registered. It was therefore unperfected and so subordinate to ANZ's perfected security interest. That may well be arguable, but the security interest is a deemed one and cannot per se preclude the application of s 53.

[59] Having regard to all the circumstances, I am satisfied Ruby does have the benefit of s 53 and that accordingly Ruby received clear title to the timber in question notwithstanding the bank's registered security interest. I consider the legal position to be clear cut. The receivers have not persuaded me there is a serious question to be tried on that issue.

Is there a serious question the funds are impressed with a constructive trust?

[60] I turn now to consider the receivers' alternative cause of action based on constructive trust.

[61] What is argued is that the Waimate's directors breached their fiduciary duty to Waimate by diverting Waimate's business opportunities (the orders Waimate had secured with the overseas clients) to Ruby. Ruby must have known of the breach, because its directors were also directors of Waimate and therefore, under well established principles of "knowing receipt", the sale proceeds it received are impressed with a constructive trust.

[62] Mr Lester submitted that because the directors were not a party to the proceeding, the cause of action was not tenable. I do not accept that argument. The claim is not a claim for damages against the directors, but a proprietary one which is correctly brought against the person holding the property in question.

[63] I do, however, accept Mr Lester's second argument that there can be no breach of the duty owed to either the company or its creditors, given that all the Waimate directors were doing was acting in accordance with Waimate's contractual obligations regarding timber that belonged to someone else. This was not a situation of one creditor being preferred over another.

[64] Because of the view I have come to about there being no tenable argument there was a breach, it is not necessary for me to consider a third point raised by Mr Lester namely that Waimate has not suffered any loss and there has been no unjust enrichment.

[65] In coming to the conclusion there is not a serious question to be tried on either issue, I am mindful of the dictum in *Klissers Farmhouse Bakeries Ltd v Harvest Bakeries Ltd* [1985] 2 NZLR 129 (CA) at 142, to the effect where the balance of convenience very clearly favours one party then it will usually be right to be guided accordingly. In this case, as I have mentioned, the balance of convenience does clearly favour the receivers. However, this case is somewhat different from most interim injunction cases, including *Klissers*, in that the facts are not disputed and it is therefore possible to reach a very clear view on the merits of the case.

Outcome

[66] In my view, there is not a serious question to be tried on either cause of action. The application for an interim injunction is accordingly dismissed.

[67] As regards costs, my expectation is that the parties will be able to reach agreement. Should, however, the parties be unable to agree and require me to issue a costs decision, then Mr Lester is to file submissions, followed by submissions from Mr Russell within 10 working days thereafter. It may assist the parties if I indicate my provisional view is that the applicants should pay the respondent costs on a 2B basis.

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