IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

CIV 2004-404-5795

BETWEEN	NEW ZEALAND BLOODSTOCK LEASING LIMITED First Plaintiff
AND	NEW ZEALAND BLOODSTOCK FINANCE LIMITED Second Plaintiff
AND	GLYN CRAWFORD MORSE JENKINS First Defendant
AND	KATHLEEN MOIRA JENKINS Second Defendant
AND	GLYN BRETT MORSE JENKINS Third Defendant
AND	KIM ST CLAIR JENKINS Fourth Defendant

Hearing: 19, 20, 21 October 2005, 30 & 31 August 2006, 1 September 2006

Counsel: Mr Fardell, Mr Collinge & Ms Edwards 2005, P J Morgan QC & Ms Edwards 2006
DAR Williams QC for First and Second Defendants, Ms Crockett (2005) Ms Lindsay (2006)
M C Black for Third and Fourth Defendants

Judgment: 19 April 2007

JUDGMENT OF WINKELMANN J

This judgment was delivered by me on 19 April 2007 at 4.30 pm pursuant to Rule540(4) of the High Court Rules.

Registrar/ Deputy Registrar

Solicitors:
John Collinge, Auckland
Mahon & Sumpter, Auckland
Kirby Law, Auckland

Counsel:
P J Morgan QC, Hamilton
D A R Williams, Auckland
M C Black, Auckland

Table of Contents

Introduction

[1] The issue in this proceeding is whether the plaintiffs' failure to register a security interest under the Personal Property Securities Act 1999 (the Act) has discharged the first to fourth defendants' obligations as guarantors under deeds of guarantee given in favour of the plaintiffs in respect of the indebtedness of Glenmorgan Farms Ltd (Glenmorgan).

Factual background

[2] Glenmorgan was a breeder of equine bloodstock and for that purpose obtained stallions and mares for the purpose of producing progeny. The first and second defendants, Mr Glyn Crawford Jenkins and Mrs Kathleen Jenkins, were shareholders in Glenmorgan until 31 March 2002 when they sold their shares to the third and fourth defendants, Mr Glyn Brett Jenkins and Mrs Kim St Clair Jenkins. The first and second defendants were also directors of Glenmorgan until 28 March 2002, when they resigned. The third and fourth defendants were directors and shareholders of Glenmorgan at all times material to these proceedings.

[3] In November 1999, Glenmorgan granted a debenture to S H Lock (NZ) Ltd (S H Lock), to secure a trade facility. In broad terms the debenture created a fixed charge over the fixed assets of Glenmorgan, and a floating charge over its stock in trade. The SH Lock debenture was registered in the Companies Office on 19 November 1999.

[4] In August 2001, the stallion Generous was purchased from the Japan Bloodhorse Breeders Association by New Zealand Bloodstock Leasing Limited (NZB Leasing). Glenmorgan simultaneously entered into a lease to purchase agreement (LPA1) dated 31 August 2001 with NZB Leasing. That lease recited that Glenmorgan had requested NZB Leasing to purchase Generous, and that Glenmorgan had agreed to lease Generous from NZB Leasing and then to purchase him upon the terms and conditions set out in LPA1.

[5] LPA1 provided that Glenmorgan would pay rental to NZB Leasing in the amounts set out in the schedule attached to the agreement. The schedule described the amount and date of each rental payment and further provided that a residual value of $275,605 was to be paid on 31 July 2004. On payment of all money owing under LPA1 (rental payments and the residual value), title to Generous would become vested in Glenmorgan.

[6] Each of the first to fourth defendants executed deeds of guarantee which recorded that they guaranteed the payment of the rental and any other payments due under LPA1 and indemnified NZB Leasing against any loss it might suffer should LPA1 be lawfully disclaimed by any liquidator or receiver or otherwise on behalf of Glenmorgan.

[7] On 1 May 2002 the Act came into effect. On that same day, S H Lock registered a financing statement in respect of the security interest created by its debenture. No steps were taken by NZB Leasing to register its security interest in Generous. It is now common ground that LPA1 provided NZB Leasing with a purchase money security interest in the collateral Generous. The transitional provisions in the Act are such that had NZB Leasing taken steps to perfect its purchase money security interest in Generous by registration of a financing statement under the Act at any time during the six months commencing 1 May 2002, that security interest would have had priority over S H Lock's security interest in Generous.

[8] In 2002 Glenmorgan was unable to meet the payments in respect of LPA1, and it became necessary to restructure the debt. A second lease to purchase agreement was concluded between the parties on 28 June 2002 (LPA2) containing a new payment schedule whereby the rental payments were rescheduled to better suit Glenmorgan's cash flow. However, the same legal structure was retained. Title in Generous was to remain with NZB Leasing until all payments under the LPA2 including the residual value payment, were made. At that point, title in Generous was to be conveyed to Glenmorgan. The residual value described in the schedule to LPA2 was $335,869, to be paid on 28 March 2004.

[9] Due to the sale of their shareholding in Glenmorgan and resignation as directors, the first and second defendants asked to be released from their guarantees given in respect of LPA1. NZB Leasing refused to release them, and as part of the restructuring each of the first to fourth defendants entered into "deeds of guarantee" in respect of Glenmorgan's payment obligations under LPA2 (the Leasing Guarantees). The Leasing Guarantees were in the same form as those entered into by the first to fourth defendants in respect of LPA1.

[10] LPA2 provided that NZB Leasing could assign the benefits and obligations under LPA2. On 28 June 2002, NZB Leasing assigned to the second plaintiff, NZ Bloodstock Finance Limited (NZB Finance) all its rights and obligations relating to the leasing of Generous under LPA2, and in particular all the rights of NZB Leasing to receive payments of rental and other moneys payable under LPA2 by Glenmorgan to NZB Leasing, including rights of enforcement. A notice of assignment was given to Glenmorgan directing it to pay to NZB Finance all rental due under LPA2 and all other payments due in respect of the lease of Generous. On the same day NZB Leasing assigned to New Zealand Bloodstock Progeny Limited (NZB Progeny) all of its rights and obligations relating to the title and property in Generous and the right to receive payment of the residual value outlined in LPA2 and any other moneys due under LPA2 in respect of the title to or ownership of Generous. In the same notice of assignment, Glenmorgan was directed to pay the amount of residual value of Generous on the date payable under LPA2 to NZB Progeny and in future deal with that company in respect of all matters relating to the ownership and wellbeing of Generous.

[11] Glenmorgan continued to default in making lease payments. On 22 August 2003 NZB Finance, Glenmorgan and the first to fourth defendants entered into a Refinancing Agreement. The Refinancing Agreement recited that Glenmorgan was in arrears under LPA2 and that Glenmorgan and the guarantors had indicated to NZB Finance that Glenmorgan might not be able to meet future payments in full. Glenmorgan had requested NZB Finance to assist Glenmorgan in the performance of its obligations under LPA2 and NZB Finance had agreed to. The parties confirmed LPA2 and the obligations thereunder in every respect and the first to fourth defendants confirmed that their guarantees under LPA2 remained in full force and

effect. It was acknowledged that the amount owing by Glenmorgan to NZB Financing under LPA2 as at 22 August 2003 was approximately $2.6 million. NZB Financing agreed to lend funds to Glenmorgan on an on-demand basis sufficient for Glenmorgan to meet its obligations under LPA2. The loans were to be separately documented in a "Contract for Current Advances".

[12] The Refinancing Agreement provided that should NZB Finance advance any money under the Contract for Current Advances, Glenmorgan would apply those advances to meet its obligations under LPA2, and authorised NZB Finance to do so on its behalf. Glenmorgan agreed to a schedule of repayments, and it was further agreed that if the scheduled repayments were made, and all of the terms of the LPA2, the Refinancing Agreement and Contract for Current Advances complied with, NZB Finance would not seek earlier payment of the amounts due. However, if the scheduled repayments were not made, NZB Finance could exercise any of its rights under LPA2, the Refinancing Agreement or the Contract for Current Advances. A breach of any agreement entitled NZB Finance to exercise its rights under all or any of the agreements.

[13] On the same date, the guarantors and NZB Finance entered into the Contract for Current Advances. By that contract NZB Finance agreed to make advances to Glenmorgan to enable Glenmorgan to meet its obligations under LPA2, and such other advances as NZB Finance agreed to make at its sole discretion. Glenmorgan undertook that it had used or would use money advanced under the Contract to purchase the bloodstock outlined in the Schedule. Glenmorgan agreed to grant to NZB Finance a security interest in the "collateral", defined as all of Glenmorgan's present and future rights in relation to the bloodstock listed in the schedule to the agreement purchased or acquired with the assistance of the funds advanced under the contract, and the progeny of that bloodstock, and the proceeds thereof. The Schedule to the agreement listed eight horses including the stallion Generous. The horses listed in the Schedule, but excluding Generous, are referred to as the Schedule Bloodstock.

[14] New guarantees (the Finance Guarantees) were executed by the first to fourth defendants guaranteeing payment of money owing by Glenmorgan under the

Contract for Current Advances, and indemnifying NZB Finance should the Contract for Current Advances be lawfully disclaimed by any liquidator or receiver of Glenmorgan. Those guarantees were in like form to the Leasing Guarantees.

[15] From 22 August 2003 on, Glenmorgan met its payment obligations under LPA2, but using funding drawn down under the Contract for Current Advances. Further defaults in payment occurred, but those defaults were now in respect of payments due under the Refinancing Agreement. In particular, Glenmorgan failed to pay the sum of $1,000,000 due on or before 28 November 2003.

[16] On 25 June 2004, Mr Ross Gwyn, the manager of NZB Leasing and NZB Finance wrote to Glenmorgan. He said that he wrote in relation to monies owing by Glenmorgan under "various documents" – the Refinancing Agreement, the Contract for Current Advances and LPA2. He recorded that as at 5 July 2004, the total amount due under "these securities" was $1,132,366.16 including interest calculated to 30 June 2004. He said that:

> As you know, for some time now NZ Bloodstock Ltd has been extremely patient in relation to this debt. We understand from you that Glenmorgan Farm Limited is currently undertaking restructuring of its operations.
>
> Accordingly it is time to ask you to arrange the above sum to be paid on or before Monday 5th July 2004.

[17] On 6 July 2004, the solicitor for NZB Finance and NZ Bloodstock Ltd wrote to Glenmorgan. He referred to the letter of 25 June 2004, and noted that payment had not been received. He said that the purpose of the letter was to advise Glenmorgan of the termination of the financing agreements (LPA2, the Refinancing Agreement and the Contract for Current Advances) and the repossession of Generous. The solicitor also recorded that all moneys due under the agreements were now due and payable and that the sum owing as at 30 June 2004 was $2,400,251.97 exclusive of costs and expenses.

[18] A copy of the 6 July letter was sent to the first to fourth defendant guarantors. The plaintiffs then took possession of Generous overseas and transported him back to Westbury Stud in New Zealand.

[19] In correspondence the solicitors for Glenmorgan and the solicitors for S H Lock protested the lawfulness of the repossession. In particular, the solicitors for S H Lock asserted that the effect of the Act was to give S H Lock a security interest ranking in priority to that of NZB Leasing or NZB Finance. In a series of letters, S H Lock's solicitors stated that unless NZB agreed to an arrangement designed to preserve the status quo pending determination of the parties' respective rights by the Courts, S H Lock could be forced to place Glenmorgan in receivership. No agreement was reached between S H Lock and NZ Bloodstock. On 23 July 2004, S H Lock placed Glenmorgan into receivership and appointed Messrs Waller and Agnew as receivers. On 9 March 2005, Glenmorgan was placed into voluntary liquidation.

[20] In late 2004 this Court determined that S H Lock's security interest in Generous had priority over that of "New Zealand Bloodstock Limited". Accordingly, the receivers assumed control of the sale of Generous. On 29 July 2005, Generous was sold to Alfred Buller Bloodstock Ltd. The price ultimately to be realised on that sale was dependent on a number of contingencies but the evidence before me was that assuming full realisation of all contingencies, and based on the then current exchange rate, the parties estimated a yield of approximately $NZ1,000,000 inclusive of the rental for the 2005 northern hemisphere breeding season.

[21] The Schedule Bloodstock were sold as follows:

a) Morning Rise and Gypsy Way were sold by the receivers privately;

b) Arctic Heroine and Sea Encounter were sold by NZB Leasing on behalf of the receivers and proceeds were paid to the receivers;

c) Miss Shergar, Sheer Classic and Tintinabulation were sold by NZB Leasing for a net sum of $43,220.76. The proceeds were taken by NZB Finance and credited to Glenmorgan.

This proceeding

[22] On 21 October 2004, NZB Leasing and NZB Finance issued proceedings against the first to fourth defendants. The Statement of Claim alleges that Glenmorgan defaulted on payments under the Refinancing Agreement, and the terms of the Leasing and Finance Guarantees are pleaded. The plaintiffs allege that they have made demands upon the first to fourth defendants for payments of money due by them under the guarantees but no payment has been made. Accordingly, NZB Finance (and in the alternative NZB Leasing) seek judgment in respect of amounts owing under the Refinancing Agreement, LPA2 and the Contract for Current Advances.

[23] However, after the hearing, the plaintiffs filed a memorandum stating that although the claim was pleaded in the alternative on behalf of both NZB Leasing and NZB Finance, only the claim of NZB Finance (based upon the Contract for Current Advances and the Finance Guarantees) is now pursued. I accept that indication as an abandonment of the claims of NZB Leasing.

[24] At hearing the first and second defendants resisted the claims of both plaintiffs on the basis that had NZ Bloodstock registered its security interests in Generous under the Act, its claim would have had priority over that of S H Lock. Its security interest would have been a perfected purchase money security interest, which has super priority under the provisions of the Act. (I note that during the course of the hearing the defendants frequently referred to the plaintiffs in an undifferentiated way as NZ Bloodstock.) They allege that it was an express or an implied term of LPA1, LPA2, the Refinancing Agreement and the Contract for Current Advances, that the plaintiffs would perfect their security interest in the collateral so as to be in a position to convey clear title in Generous to Glenmorgan at the conclusion of LPA2, to maintain their rights to the progeny and income streams associated with ownership of Generous and the Schedule Bloodstock, and to retain the right to apply the value of Generous and the Schedule Bloodstock (and associated income streams) in reduction of Glenmorgan's debt, in the event of default.

[25] The first and second defendants also allege that it was a condition or condition precedent of all guarantees that the plaintiffs would perfect their security interests in Generous and the Schedule Bloodstock by registration. Perfection of those security interests was necessary to ensure that the plaintiffs' interest in the bloodstock would remain available to be applied to any monies owed to the plaintiffs under LPA2 and the Contract for Current Advances, and available so that the defendants could exercise rights of subrogation to those interests. The first and second defendants say that the plaintiffs' failure to perfect their security interests by registration was a breach of the principal contracts and/or guarantees that discharged the first and second defendants' liability.

[26] Although not pleaded, the first to second defendants also argued before me that the failure to register was a breach of the equitable duty owed to the guarantors by NZB to perfect the security, which breach has prejudiced the first and second defendants so as to discharge them from all liability. During closing NZB Leasing and NZB Finance objected to that defence being argued because it had not been pleaded. However, I propose to consider this defence as it raises points of law only, and requires no additional factual inquiry. The plaintiffs did not argue that they were prejudiced by the defence being argued, and nor could they since the defence was pleaded and argued by the third and fourth defendants.

[27] The first and second defendants also say that even if the failure to register NZB Leasing and Finance's security interests did not have the effect of discharging the guarantors' liability, by the terms of LPA2, NZB Leasing and NZB Finance are obliged to deduct from the amount they may claim from the defendants the value of Generous as at the date of repossession, whether or not NZB Leasing is entitled to retain the proceeds of sale of Generous.

[28] The first and second defendants' statement of defence also contains an affirmative defence to the effect that LPA2 and related contracts were in substance hire purchase agreements, and the guarantors therefore have rights under the Hire Purchase Act 1971. That defence was not actively pursued at trial by the first and second defendants, but I have no note of its abandonment.

[29] The third and fourth defendants raise, in substance, the same matters by way of defence as the first and second. In addition, they allege that the plaintiffs owed a duty of care, founded in the law of negligence, to Glenmorgan and the third and fourth defendants as guarantors. The content of this duty is said to be to comply with all of the contractual provisions in LPA1 and LPA2, and in particular to ensure that the plaintiffs' security interest and rights in relation to Generous and other bloodstock were perfected, maintained and preserved so that Generous (or its equivalent value) could be applied in reduction of Glenmorgan's financing and lease obligations to NZB Leasing and NZB Finance. It is alleged that the plaintiffs also owed a duty of care to ensure that earnings from Generous and the Schedule Bloodstock would be available to NZB Leasing and NZB Finance in reduction of any liabilities owed by Glenmorgan and thereby also the third and fourth defendants as guarantors. NZB Leasing and NZB Finance are alleged to have breached that duty of care by failing to register their security interests under the Act.

[30] As a further defence, the third and fourth defendants say that they are entitled to rely upon provisions of the Hire Purchase Act 1971 and Credit (Repossession) Act 1977. They allege that LPA1, and LPA2, and related contractual arrangements were in substance or are deemed to constitute hire purchase agreements and as such are subject to the provisions of the Hire Purchase Act 1971. Certain requirements of the Hire Purchase Act have not been complied with, including the requirement that the terms of the agreement be in writing and that the subject matter of the agreement be free from any charge or encumbrance in favour of a third party. By reason of these matters the defendants are said to be discharged from liability under both the Leasing and Finance Guarantees.

[31] Finally, the third and fourth defendants rely upon a set-off and/or counterclaim they allege that Glenmorgan has against NZB Leasing and NZB Finance arising out of the failure by NZB Leasing and NZB Finance to perfect their security interests in the 'collateral' including Generous. They argue that the guarantors are entitled to invoke Glenmorgan's counterclaim even though Glenmorgan is not a party to the proceeding.

[32] As well as claiming the loss of the value of Generous and the Schedule Bloodstock (together with associated income streams and progeny), the third and fourth defendants claim further losses arising from the receivership of Glenmorgan. It is alleged that the wrongful repossession of Generous brought to an end work-out proposals for Glenmorgan. The resulting receivership destroyed the opportunity for Generous and the Schedule Bloodstock to maximise their full earning potential at Glenmorgan and resulted in fire sale prices.

[33] Notwithstanding the abandonment by NZB Leasing of its claims, it remains necessary to consider the defences raised based upon a failure to register the LPA2 security interest, because the defendants argue that through NZB Leasing's default or neglect in this respect, NZB Finance is also precluded from recovering from the defendants.

[34] The issues raised by the claims and defences are as follows:

a) What rights and obligations were created and transferred by the various principal contracts, including security interests?

b) Were either of NZB Leasing or NZB Finance under an equitable duty to perfect security held in respect of LPA2 or the Contract for Current Advances?

c) Was there any failure to maintain security interests that the defendants can rely upon as discharging their liability to NZB Finance?

d) Was it a term of LPA2, the Refinancing Agreement or the Contract for Current Advances that the plaintiffs would take steps to maintain their security interest in Generous and the Schedule Bloodstock through registration?

e) Was it a condition precedent or term of the Finance Guarantees that security interests would be perfected?

f) Did NZB Finance or NZB Leasing owe a duty of care to the defendants to maintain their security interests?

g) Do the provisions of the Hire Purchase Act apply to the transactions, and if so, what is the effect of that on the defendants' liability to NZB Finance?

h) Do the defendants have a contractual right to deduct the value of Generous as at the date of repossession from any amount for which they are liable to NZB Finance?

i) Can the defendants rely upon claims that Glenmorgan has against the plaintiffs, to extinguish any liability they have?

[35] I also record that after hearing, the first and second defendants sought leave to adduce further evidence, namely the evidence of Mr Michael Thomson, confirming that the first and second defendants are no longer guarantors of the S H Lock debenture. This is relevant to the issue of whether the first and second defendants were prejudiced by any failure to register (issue c) above. The plaintiffs did not oppose the grant of leave. I confirm that leave is granted to adduce the evidence of Mr Thomson.

What rights and obligations were created and transferred by the various principal contracts, including security interests?

[36] Key issues in this proceeding are what steps NZB Leasing and NZB Finance could have taken to perfect their security interest in Generous and the Schedule Bloodstock, and the effect that any failure to take those steps has upon the security position in general, and the position of the defendant guarantors in particular. But a prior issue is necessarily the effect on the various parties' rights of the refinancing, and payments made under that refinancing. This is because it is first necessary to determine the extent of any potential security interests, before considering what steps should have been taken to better maintain or perfect those security interests.

[37] During the course of hearing little attention was focused on this prior issue, either in evidence or submission. The defendant guarantors' argument proceeded upon the basis that they need only point to the consequences of the failure to register and perfect NZB Leasing's security interest, as determined by the Court of Appeal in the appeal from the High Court decision referred to earlier (*Waller v New Zealand Bloodstock Limited* [2006] 3 NZLR 629) and that this failure was sufficient evidence of a breach of contract and/or duty on the part of NZB Leasing and NZB Finance to discharge the guarantees. The defendants failed to address the significance to the security position of the June 2002 assignments or the 2003 refinancing, or to focus on the effect of the refinancing on rights and obligations under LPA2 and the Leasing Guarantees. Accordingly, on 29 November 2006, I issued a minute providing parties with further opportunity to make submissions on the following issues:

a) Given the refinancing of LPA2 by NZB Finance, would NZB Finance have been entitled to NZB Leasing's purchase money security interest in Generous (assuming it had been registered) once it had advanced funds to Glenmorgan sufficient to repay the amounts owing under LPA2 in full or at any other time?

b) What is the significance of the assignment of all rights and obligations relating to title and property in Generous to NZB Progeny by NZB Bloodstock? In particular what impact would that have on the ability of NZB Finance to obtain a security interest in Generous?

c) How can it be said that NZB Finance has failed to perfect its security in Generous when it was NZB Leasing that failed to register a financing statement in relation to its purchase money security interest?

d) Is it argued that NZB Finance in some way failed to perfect its security interest in the other bloodstock listed in the Schedule to the Contract for Current Advances, and if so on what basis?

[38] I received helpful supplementary submissions in response to this minute which brought more focus to the issues to be resolved in this proceeding.

[39] When considering the transactions the subject of this proceeding, in chronological terms, the starting point is LPA1, an agreement superseded for all purposes by LPA2. The security position in respect of LPA2 was considered in the earlier litigation (referred to previously) between the plaintiffs and S H Lock to determine the relative priority of the interests of NZ Bloodstock and S H Lock in Generous. In *Waller v New Zealand Bloodstock Limited* the Court of Appeal concluded:

a) The lease to purchase agreements, being leases for more than one year, for the limited purpose of fixing priorities for competing priority interest, created a "security interest" in Generous (s 17(1)(b)).

b) By s 40(3) of the Act, Glenmorgan, which apart from the Act had no property rights in Generous, secured "rights" in Generous. Instead of enjoying its previous inviolable title to the stallion, NZB's interest, now a "security interest" was liable to be overridden by a competing security interest.

c) The S H Lock debenture executed by Glenmorgan was also a security agreement as defined in s 16.

d) Whether the S H Lock debenture as a security agreement was "effective according to its terms" (s 35 of the Act) to capture Glenmorgan's rights in Generous was a question of construction which the Court of Appeal resolved in favour of S H Lock.

e) Given such construction, Glenmorgan's statutory rights in Generous potentially formed a part of S H Lock's security, provided that they attached (s 40 of the Act). The attachment conditions of s 40 were satisfied by S H Lock.

f) S H Lock had perfected its security in Generous by registration (s 41 of the Act).

g) Because New Zealand Bloodstock had not perfected its security interest, S H Lock's security interest took priority (s 66(1)(a)).

[40] These findings of the Court of Appeal are not challenged by the parties to this proceeding. It is common ground that the security interest created by the lease to purchase agreement, being a lease for more than a term of one year, was a purchase money security interest, although treated as simply a security interest by the Court of Appeal. As previously noted, it is also common ground that NZB Leasing's failure to perfect its purchase money security interest within the six month transition period had the effect of surrendering priority in respect of NZB Leasing's security interest in Generous to S H Lock.

[41] The security interest created by the lease to purchase agreement falls into more than one category of purchase money security interest as defined in s 16 of the Act. Although structured as a lease, the transaction was in substance a means of financing the purchase of Generous by Glenmorgan. It can also therefore properly be characterised as a security interest taken in collateral by a seller to the extent that it secures the obligation to pay all or part of the collateral's purchase price (refer definition of purchase money security interest (a)(i) in s 16(1) of the Act).

[42] I also note that the Court of Appeal judgment refers to New Zealand Bloodstock as an undifferentiated reference to New Zealand Bloodstock Limited and New Zealand Bloodstock Finance Limited, because it was accepted by the parties that it was not necessary to distinguish between the two entities. While it may have suited the parties to argue the issues raised in that proceeding in that manner, I intend to make reference to the legal entities involved in the transactions, NZB Leasing and NZB Finance.

[43] The next significant development in terms of the legal structure of the subject transactions is the June 2002 assignment. The Notice of Assignment was produced into evidence, but any Deed of Assignment between NZB Leasing, NZB Finance and

NZB Progeny was not. It is an agreed fact that such an assignment took place, and I proceed upon the basis that the Notice of Assignment is the best evidence before me of the terms of the assignment. The Notice of Assignment records the assignment to NZB Finance of "all rights of the lessor to receive payments of rental as and when they shall become due and other monies payable under the same Agreement by the lessee to the lessor or in respect of the lessor enforcing such rights and receiving such payments as are prescribed by [LPA2]".

[44] It was not argued by any party that the assignment to NZB Finance of NZB Leasing's rights and obligations and in particular the right to receive payments of rental under LPA2, created a fresh security interest. It also seems common ground that the assignment of the security interest did not extinguish or affect the priority of that security interest, which must be correct. Section 69 of the Act provides:

> A security interest that is transferred has the same priority as it had at the time of the transfer.

[45] The defendants argue that by reason of the assignment, NZB Finance acquired NZB Leasing's security interest in Generous. The plaintiffs submit that the split of rental proceeds to NZB Finance, and title and property to NZB Progeny, indicated that title, and accordingly any security interest created by the Act, was to reside with NZB Progeny, not NZB Finance.

[46] I interpret 'enforcement rights' in the Notice of Assignment to include NZB Leasing's purchase money security interest in Generous to the extent that that secured payment of the rental payments, as the ability to take possession of and sell Generous was one of the principal enforcement rights conferred on the Lessor by LPA2. The assignment to NZB Progeny of title in Generous and the right to receive payment of the residual payment, is not inconsistent with this interpretation. Section 17 of the Act provides that the existence of a security interest is to be determined without regard to the form of the transaction, and the identity of the person who has title to the collateral.

[47] Therefore, after the assignment to NZB Finance, NZB Finance acquired the security interest NZB Leasing had in Generous, to the extent that it secured the

payment of the rental payments under LPA2. It acquired this right at a time when the security interest could have been perfected by registration within the transition period.

[48] The next issue that arises is the effect that the refinancing had on the security interest held by NZB Finance in Generous as assignee of some of NZB Leasing's rights under the LPA2. The Refinancing Agreement confirmed that LPA2 and the Leasing Guarantees remained in full force and effect, and it is clear that the refinancing did not immediately effect a repayment of the amounts outstanding under LPA2. Rather, NZB Finance progressively made advances to Glenmorgan to enable it to meet its obligations under LPA2. Mr Gwyn confirmed that NZB Finance appropriated the advances to repayment of the LPA2 debt as it was authorised to do. In reality this was done by way of accounting entry in the records of NZB Finance. As at 28 March 2004 Glenmorgan's debt under LPA2 was thereby extinguished, and replaced with a debt to NZB Finance under the Contract for Current Advances.

[49] Under the Leasing Guarantees the defendants guaranteed:

> When demanded in writing, the due and punctual payment of the rental provided for in the Bloodstock Lease to Purchase Agreement together with all and any other payments and monies due by the Lessee to the Lessor under the said Agreement or otherwise including but not limited to interest payable thereunder and all of the Lessee's covenants agreements obligations and undertakings to the Lessor required of the Lessee under the Bloodstock Lease to Purchase Agreement at the times and in the manner required by the said Agreement.

[50] Therefore, once all moneys due under LPA2 were paid, the defendants were discharged in respect of their guarantee of Glenmorgan's payment obligations under those guarantees. Because NZB Leasing's claim against the defendants under the Leasing Guarantees was in respect of payment obligations, the performance by Glenmorgan of all payment obligations under LPA2 would have been a complete answer to NZB Leasing's claim against the defendants. As now confirmed by the plaintiffs, NZB Leasing does not pursue that claim.

[51] The first and second defendants contend that the LPA2 did not come to an end in March 2004 with full payment because they argue that all of the transactions are so interconnected to make singling one of them out, as NZB Finance now seeks

to do, wrong. In particular the first and second defendants point to provisions in the Refinancing Agreement that record the background to the refinancing, to the confirmation that LPA2 and the Leasing Guarantees remain in full force and effect, to the provisions in the Refinancing Agreement and Contract for Current Advances which record that the advances under the Contract for Current Advances are to be utilised to make payments under the LPA2, and also to the following cross default provisions in the Refinancing Agreement:

> 5(b) Should any such payment not be made on due date then, without limiting any other rights of [NZB Finance], the whole of the amount due under the Contract for Current Advances shall forthwith become due and payable and [NZB Finance] may exercise any or all of its rights at its discretion under the Lease to Purchase Agreement, the Contract for Current Advances, this Refinancing Agreement or at law forthwith.
>
> 5(c) Further, a breach of any of the provisions of the Lease to Purchase Agreement, the Contract for Current Advances and this Refinancing Agreement shall entitle NZBS to exercise any or all of its rights under all or any such Agreements.

[52] These provisions relied upon by the defendants do no more than reflect the basic structure of the refinancing transaction; the LPA2 debts were not immediately extinguished, over time NZB Finance would advance the money needed by Glenmorgan to meet its obligations under LPA2, and until full repayment was made the LPA2 obligations remained. Cross default provisions may be necessary where for a period of time multiple contracts remain on foot between the parties. As Mr Gwyn confirmed, NZB Finance would not wish to remain bound to perform its obligations under one contract, if Glenmorgan was in default under another. Clause 2(a) of the Contract for Current Advances provides that the financial accommodation is made on the terms and conditions set out in that agreement and subject to the terms of the Refinancing Agreement. The provisions of LPA2 are not incorporated into the refinancing transactions.

[53] The provisions relied upon by the defendants therefore do not evidence any intention on the part of the parties to merge the rights and obligations under the various agreements. I am satisfied that the refinancing took effect in accordance with the express provisions of the refinancing documentation. The Contract for

Current Advances and Finance Guarantees created separate rights and obligations to those recorded in LPA2.

[54] By way of alternative argument the first and second defendants say that whether or not LPA2 remained in effect after March 2004, NZB Finance remained entitled to the LPA2 purchase money security interest in Generous, because the refinancing was merely a restructuring of the existing loan. They rely upon the Canadian case *Werner v Royal Bank of Canada* (2000) 2 PPSAC (3d) 199 (Sask QB), where the Court considered the effect of a refinancing by the original lender consequent upon a borrower's default, within the context of a statutory regime very close to that contained within the Act. The Court accepted that "a consolidated or new loan used to pay out an existing loan secured by a purchase money security interest passes the interest to the lender".

[55] I accept that there is nothing in the statutory regime that would preclude such an outcome. There is no reason why a lender should lose its security interest merely by reason of a restructuring of the loan, and that could be so even when the refinancing is undertaken by the assignee of the rights of the original lender. However, in each case it is necessary to look at the overall effect of the refinancing transaction. If the terms and effect of that refinancing transaction negatives an intention to retain the security interest from the original transaction, I see no basis for the courts to impose a contrary outcome on the parties. In this case the refinancing is not a simple restructuring of a loan. The advances made pursuant to the refinancing were intended to be, and were applied over time to performance of Glenmorgan's payment obligations under LPA2. Glenmorgan agreed to the provision of separate security for the advances made by reason of the refinancing. What was plainly envisaged was that LPA2 would proceed through to completion, Glenmorgan would acquire title in Generous, and NZB Finance would have a security interest in Glenmorgan's rights to Generous, securing the amounts outstanding under the Contract for Current Advances. I am satisfied that this negatives any intention to retain the LPA2 security interest after payment of all amounts outstanding under it with advances under the Contract for Current Advances. The LPA2 purchase money security interest was therefore extinguished by March 2004.

[56] The defendants did not seek to argue that the refinancing itself created a purchase money security interest in Generous on the grounds that the funds advanced thereunder were value given for the purpose of enabling the debtor to acquire rights in Generous and that the value was applied to acquire those rights. I observe however that there is Canadian authority which suggests that a refinancing can give rise to a new purchase money security interest: see for example *Battleford's Credit Union Ltd v Ilnicki* (1991) 82 DLR (4th) 69 (Sask CA). In one case a new purchase money security interest was found to have been created even where the loan refinanced had not initially created a purchase money security interest: *Unisource Canada v Laurentian Bank of Canada* (2000) 15 PPSAC (2d) 105 (Ont CA). The basis of the reasoning in that case was that the refinancing allowed the debtor to acquire rights in the collateral, which the debtor did not previously have.

[57] In the New Zealand text *Personal Property Securities in New Zealand* (Gedye, Cuming & Wood, 2002), the authors identify some of the difficulties presented by recognising purchase money security interests created in this manner as follows (at 73.4):

> Under the *Ilnicki* and *Unisource* approach SP2 [the refinancier] could claim pmsi status because its advance has allowed [the debtor] to acquire rights in the collateral that [the debtor] did not previously have. If this is correct, the potential for abuse is obvious. A financier that failed to comply with the s 73 formalities could get a second chance by rearranging the transaction and later general financiers could hunt out existing pmsi in an attempt to improve their priority status.

The fundamental risk identified by the authors is that the approach in *Ilnicki* and *Unisource* would have the potential to undermine the scheme for priorities created by the Act.

[58] I consider that the *Unisource* and *Ilnicki* approach, which allows that a new purchase money security interest can be created by a refinancing, is inconsistent with the scheme and intent of the legislation to give effect to transactions in accordance with their substance rather than their form. In reality the refinanced debtor acquires no greater right to the economic value of the collateral by reason of the refinancing; the debtor merely exchanging one creditor for another, or one financing structure for another. In this case, when the substance of the transactions is considered,

Glenmorgan acquired no more interest in the value of Generous after the refinancing than it had before. Although ultimately title in Generous may have passed to Glenmorgan, a third party creditor continued to have a security interest in Generous securing at least as much debt as before the refinancing. The refinancing creditor has not increased the asset pool of the company. The increase to the asset pool is, of course, the justification for the super priority accorded to purchase money security interests created by loans to acquire collateral. The policy behind the according of super priority in this manner, is that without it, creditors may be unwilling to lend to companies that have entered into security agreements that include after acquired property clauses (such as that in the S H Lock debenture) (Gedye et al at 73.1).

[59] In this case, s 73 of the Act provides an additional obstacle to the creation of a purchase money security interest on a refinancing. Section 73 provides:

> A purchase money security interest in collateral or its proceeds, other than inventory or intangibles, has priority over a non-purchase money security interest in the same collateral given by the same debtor if the purchase money security interest in the collateral or its proceeds is perfected not later than 10 working days after the day on which the debtor, or another person at the request of the debtor, obtained possession of the collateral, whichever is earlier.

Here, the collateral (Generous) had been in the possession of Glenmorgan well in excess of 10 working days before the refinancing. Therefore any interest created by the refinancing could not have achieved super priority.

[60] The parties to the Contract for Current Advances clearly intended to grant a security interest in Generous as security for the advances made under that contract, and I consider that the provisions of that contract were sufficient to do so, although not a purchase money security interest, and not a perfected security interest due to the absence of registration.

[61] In the case of the Schedule Bloodstock, it is clear that no purchase money security interest was created, since the evidence was that all funds advanced pursuant to the refinancing were applied in payment of Glenmorgan's obligations under LPA2. Indeed it is arguable no security interest of any kind was created in that bloodstock, since the security interest granted by the Contract for Current Advances

was in the bloodstock "purchased or acquired with the assistance of the monies advanced hereunder". Although the contract contemplated that funding unrelated to Generous could be made available, and Glenmorgan covenanted to use it to purchase the bloodstock listed in the schedule, the evidence was that no advances beyond those relating to Generous were made. It is not, however, necessary to resolve this issue in this proceeding, and I do not propose to do so.

Were either of NZB Leasing or NZB Finance under an equitable duty to perfect security held?

[62] The defendants' primary argument is that the defendants' guarantee obligations have been discharged through breach of the principal contract, or failure of a condition precedent to the guarantee obligations. However it will assist in the analysis of these issues to deal first with one of the alternative arguments; that breaches of the creditor's equitable duty to maintain security has discharged the guarantors.

[63] The defendants say that the failure to register NZB Leasing's security interest in Generous was in breach of the equitable duty owed to the defendants to maintain any security held by NZB Leasing for the principal debt.

[64] Whilst accepting the existence of such a duty, NZB Finance argues that the duty has been excluded by particular clauses in the guarantee, which have the effect of converting the guarantee to an indemnity or preserving the defendants' liability notwithstanding any failure to register security interests. Alternatively, it argues there has been no breach of duty.

[65] NZB Finance relies upon the following clauses in the Finance Guarantees:

> 1. No waiver release delay granting of time or other indulgence variation or modification of these obligations given by the Creditor to the Borrower or to the Borrower's successors or assigns or alteration to the terms or the renewal of the Contract for Current Advances or any other thing whereby the Guarantor would have been released had the Guarantor been merely a surety shall release prejudice or affect the liability of the Guarantor as a guarantor or as indemnifier.

> 2. As between the Guarantor and the Creditor the Guarantor may for all purposes be treated as the Borrower and the Creditor shall be under no obligation to take proceedings against the Borrower before taking proceedings against the Guarantor.
>
> …
>
> 7. This Guarantee shall be a principal obligation and shall not be treated as ancillary or collateral to any other obligation howsoever created or arising and in particular shall be independent of and be no way affected by any other security which the Creditor now holds or contemporaneously holds or may hereafter hold for any indebtedness or liability of the Borrower to the Creditor.

[66] Identical clauses appear in the Leasing Guarantees. However, the Leasing Guarantees are not relevant, as NZB Leasing does not now pursue its claims thereunder.

Analysis

[67] Equity recognises a duty owed by a creditor to guarantors to maintain security granted by the principal debtor for the debt. The security must be maintained so that it is available to be applied in reduction of that debt, and so the guarantor may exercise its right of subrogation to the security, if the guarantor makes payment of the principal debt. The equitable duty extends to a duty to perfect by registration any securities obtained from the principal debtor as security for the guaranteed debt: *Wulff v Jay* (1872) LR 7 QB 756; *Yorkshire Bank plc v Hall* [1999] 1 All ER 879, 893.

[68] Parties to a guarantee can, by contract, exclude the usual operation of the principles of suretyship which absolve guarantors of liability if the creditor has released, or through positive actions or through neglect, impaired securities: *Bank of New Zealand v Baker* [1926] NZLR 462, 476 and 487. The contractual provisions relied upon must be interpreted in light of the principle that contracts of guarantee are to be construed strictly in favour of the guarantor. No liability should be imposed upon the guarantor unless it is clearly and distinctly imposed by the contract: *Blest v Brown* (1862) 4 De GF & J 367, 376); Beale (ed.) *Chitty on Contracts* (29th ed, 2004) at [44-055].

[69] Clause 1 is clearly intended to maintain the guarantor's liability in circumstances where a guarantor would normally be released, and expressly refers to the circumstances of granting of time, or the alteration of the principal contract. However, I consider that the additional words "or any other thing whereby the guarantor would have been released had the guarantor been merely a surety" are wide enough to and do encompass a loss of security or failure to adequately maintain a security.

[70] This interpretation of clause 1 is consistent with, and strengthened by the provisions of clause 7. In clause 7 the guarantor's obligation is said to be a "principal obligation". The liability of a principal debtor is not discharged by a loss of security unless that is contractually stipulated for.

[71] Clause 7 also says that the liability is independent of and in no way affected by any other security held by NZB Finance for any indebtedness or liability of Glenmorgan to NZB Finance. This is an amplification of the effect of the principal debtor provision. It clearly means at least that the obligation of the guarantor to pay under the guarantee is not contingent upon the creditor first realising any security it holds for the indebtedness; a principle which is part of the general law of guarantee: *China & South Sea Bank Ltd v Tan Soon Gin* [1990] 1 AC 536, 545. The first and second defendants argue that the latter part of clause 7 has no effect beyond this. The plaintiffs however argue that the effect of this part of clause 7 is also to exclude the operation of the equitable duty on a creditor to maintain and perfect securities.

[72] If a guarantor is discharged by reason of a failure to maintain and perfect securities, then his or her liability is most certainly affected by those securities, and the guarantor's liability under the guarantee can properly be described as dependent upon the securities being maintained. Yet clause 7 states that the guarantor's obligation is independent of and in no way affected by any security. Clause 7 is therefore widely enough drawn to have the effect the plaintiffs contend for, precluding any discharge of the guarantors' liability by reason of NZB Finance's failure to perfect security.

[73] Clause 2 deals with how the creditor is required to treat the guarantor, in particular when attempting recovery of the principal debt. Although directed to procedural matters rather than the extent of liability, this clause is consistent with an interpretation of the guarantee, that it was intended that as between the guarantor and the creditor, the relationship should be that of principal debtor and creditor.

[74] Clauses to similar effect as clauses 1 and 7 have been recognised as effective to maintain a guarantor's liability in circumstances where the guarantor might otherwise be discharged. In *Bank of New Zealand v Baker* a surety was held to have "contracted himself out of" the right to complain of a loss of security by the creditor by agreeing that between himself and the bank, the relation created by the contract should, for all purposes, be deemed to be that of principal obligant and not that of surety.

[75] In *Orme v De Boyette* [1981] 1 NZLR 576 (CA), the appellant was the guarantor under a mortgage. The guarantee document provided that "the Covenantor shall be deemed to be a principal debtor and liable on all covenants in the mortgage and that the Covenantor shall not be released by any act matter or thing the happening of which would release one liable only as a surety". The covenantor argued that the registration of a memorandum of priority in respect of the mortgage, to which the covenantor was not a party, automatically discharged him. McMullin J recognised (at 580) the basic principle that a material variation in the terms of the contract between creditor and debtor will discharge the surety if it is made without the consent of that surety, but held that on the facts before him the surety was not discharged because of the effect of the principal debtor clause. The Judge then went on to state:

> Because of this principle it is not unusual, indeed it is perhaps more common than not, for a party who guarantees a debt to be made a principal debtor as against the creditor although he remains a surety as against the person whose debt he guarantees. Such an arrangement is commonly entered into where the creditor wishes to avoid the technical rules relating to contracts of suretyship under which the surety may become discharged from liability in various circumstances. In such an event the transaction takes effect according to its terms and the creditor is entitled to treat the surety as a principal debtor in every respect – *Chitty on Contracts* (24th ed, 1977), vol 2, para 4803. *Bank of New Zealand v Baker* [1926] NZLR 462 is an illustration of this practice.

[76] In *Pogoni v R & W H Symington (NZ) Ltd* [1991] 1 NZLR 82 a clause with similar provisions to those in clauses 1 and 7 was held to extend the liability of the guarantors in situations where they would usually have been discharged from liability due to an alteration in the security to which they were not privy. The clause stated in material part:

> … and it is hereby agreed and declared and covenanted by the covenantors [ie the two guarantors] with the lender [Symington] that although as between the covenantors and the company the covenantors may be sureties only yet as between the covenantors and the lender the covenantors shall be deemed to be principal debtors and liable on all covenants in the said debenture and the covenantors shall not be released by any act matter or thing the happening of which would release one liable only as a surety and shall continue to remain liable hereunder to the lender notwithstanding that for any particular reason any covenant or obligation contained in the said debenture may for the time being be unenforceable by the lender against the company.

[77] The Court of Appeal held that the effect of the clause was the same as in *Orme*, and following the reasoning in *Bank of New Zealand v Baker*, the surety was deprived of all rights and protections that he would otherwise have had, and was not entitled to complain of any alteration in the security.

[78] I record that the defendants sought and were granted leave to file supplementary submissions after trial on the issue of the construction of the Deeds of Guarantee because they said they were surprised by the plaintiffs' arguments to the effect that the guarantees provide an indemnity against all liability, the claim having been pleaded and opened on the basis that the defendants were sued as guarantors. The defendants submit that the guarantees are all guarantees, not indemnities as made clear by the structure of the documents and the language of guarantee used. The very clauses relied upon by NZB Finance are also argued by the defendants to evidence that the Deeds are guarantees, not indemnities; if the Deeds created indemnity rather than guarantee obligations it would not be necessary to contractually exclude the ordinary incidence of suretyship. Finally, the defendants refer to the language of the plaintiffs' correspondence and pleadings, where the defendants are referred to as guarantors not indemnifiers or principal debtors.

[79] The defendants' argument as to whether the Deeds of Guarantees record indemnity or guarantee obligations does not assist them, and I do not need to decide

the point. Even if the underlying obligation is that of guarantee (which I do not decide), as argued in the alternative by the plaintiffs, it was nevertheless open to the parties to contract to amend aspects of the rights and obligations flowing from the nature of that relationship as between the creditor and guarantor. They have clearly done so in this case.

[80] The third and fourth defendants argue that the provision in clause 7 that the guarantors' obligations are not to be affected by any other security which the creditor holds relates to the defence where a guarantee can be extinguished or discharged where the creditor takes a 'higher' security. The principle referred to by the third and fourth defendants is the principle that the guarantors' obligations may be merged in a higher, better security given by the guarantors to the creditor (such as a mortgage). However, that interpretation is not supported by the wording of clause 7, which does not refer to any other security given by the guarantor, but simply, any other security held by the creditor.

[81] The first and second defendants say that clause 7 must be interpreted in light of the fact that there were several other bloodstock leases operating at the same time as the lease over Generous, some of which were also in arrears. Clause 7 is said to be no more than confirmation that the first and second defendants, no longer shareholders, are retired from active participation in Glenmorgan's business, and are not to be held liable for Glenmorgan's undertakings with respect to that other bloodstock. The effect of clause 7 is therefore not to increase the first and second defendant's exposure, but to limit it. Clause 7 is also said to establish that, on default of Glenmorgan, NZ Bloodstock did not have to realise its security under the other bloodstock leases before calling on the guarantors.

[82] An interpretation that clause 7 was included to limit the liability of the first and second defendants in this manner is improbable. Clause 7 does not provide such a limitation on the guarantors' liability, and in any event the same provision is included in the Guarantees given by the third and fourth defendants, who remained as directors and actively involved in the business of Glenmorgan.

[83] I therefore find that the parties to the Finance Guarantees agreed to extend the defendants' liability under those guarantees to circumstances in which a guarantor's liability to the creditor would usually be discharged, in whole or pro tanto, and those clauses are sufficient to exclude discharge for a failure to maintain or perfect security.

[84] There was also an issue between the parties as to the effect of any breach of equitable duty; complete or pro tanto discharge of the guarantor. In light of my findings however, this issue does not fall for determination. I also do not need to consider whether the defendants were prejudiced by the failure to register, the issue in respect of which I gave leave to adduce evidence from Mr Thomson.

Was there any failure to maintain security interests that the defendants can rely upon as discharging their liability to NZB Finance?

[85] I proceed to consider this issue, although I have found that the existence of the equitable duty has been contractually excluded so that any failure to maintain security interests would not discharge the guarantors. The issues are relevant to other defences relied upon by the defendants and are largely determined by my earlier findings as to the nature and effect of the assignment and refinancing transaction. In particular:

(a) It is common ground between the parties that by virtue of LPA2, NZB Leasing could have obtained super priority for its purchase money security interest in Generous if it had registered a financing statement on or before 1 October 2002.

(b) I have held that as part of the assignment of the rental stream in June 2002, NZB Finance took an assignment of NZB Leasing's security interest in Generous, to the extent that it secured payment of rental. However, in the absence of registration, that interest ranked behind that of S H Lock under its debenture (para [47]).

(c) I have held that the security interest created by LPA2 was not extinguished by the refinancing, but on each draw down by

Glenmorgan under the Contract for Current Advances, the extent of the security interest was pro tanto reduced. By March 2004, the effect of the refinancing was to extinguish the security interest under LPA2, which NZB Finance held in its capacity as assignee (para [55]).

(d) NZB Finance acquired a separate security interest in Generous, and perhaps in the Schedule Bloodstock. NZB Finance did not perfect those security interests by registration. Even if it had, S H Lock would still have had a prior ranking security interest in Generous and the Schedule Bloodstock (paras [60] to [61]).

[86] It follows that it was NZB Leasing's failure to register the security interest created by LPA2 that resulted in the loss of priority for its security interest in Generous. NZB Finance, as assignee, simply took the security interest subject to its existing priority, but that security interest was in any event extinguished by repayment. NZB Finance did fail to register the security interest in Generous created by the Contract for Current Advances, but that did not result in any loss of priority. On the face of it, therefore, there was no failure by NZB Finance to maintain securities in relation to the refinancing that prejudiced the guarantors in any way.

[87] The defendants argue that upon the assignment in 2002, NZB Finance received the rights to the purchase money security interest in Generous, and all the problems that stem from the failure to register that interest. That would certainly be true were NZB Finance suing on its assigned rights under LPA2. However, NZB Finance abandoned that claim after hearing and relies instead upon the Finance Guarantees, and the debt due under the Contract for Current Advances.

[88] Alternatively, the defendants submit in reply to NZB Finance's claim to rely upon the Contract for Current Advances, and Finance Guarantees, that because of the interconnectedness of the agreements, no one agreement can be singled out as the overriding agreement. Further, NZB Leasing and NZB Finance are part of the same group, and to distinguish between them on the basis that they are separate corporate entities would be to ignore commercial reality.

[89] In *Attorney-General v Equiticorp Industries Group Limited* [1996] 1 NZLR 528, the Court considered a similar argument that the 'commercial and practical reality of the case' required the Court to ignore the technical detail of the form of the transactions, and different legal entities involved and have regard to the substance of the transactions. In rejecting that argument the Court held that it was necessary to examine the actual contracts made by the parties and that once these were accepted as genuine, they could not be disregarded. It said (at 538):

> A court of equity will certainly look at the true nature of a transaction, and will not be deterred by a sham. There is no principle of equity, however, that empowers the Court to ignore the true nature of a transaction and substitute some other transaction.

[90] As I have already held, the Refinancing Agreement and Contract for Current Advances represented a different transaction to LPA2, creating different rights and obligations. NZB Finance took fresh guarantees from the defendants. By May 2004, the security interest in Generous created by LPA2 was fully discharged, so that the effect of any failure to register was spent. The refinancing was implemented in accordance with the contractual documentation. There is no reason (and it was not argued) to conclude that the refinancing documentation was sham so as to be disregarded. The directive in s 17 of the Act to have regard to substance rather than form does not mandate a casting aside of all legal form. Section 17 relates only to determining whether a security interest has been created by a transaction, and cannot be used to support this wider substance over form argument of the defendants.

[91] I record that even if NZB Finance's security interest in Generous created by LPA2 was not extinguished by the performance of all payment obligations under that document, there would be no breach of duty by NZB Finance that would preclude it enforcing the Finance Guarantees. NZB Finance took the leasing security interest as assignee. In a separate transaction it refinanced the leasing transaction. No principled argument was advanced to justify 'tainting' NZB Finance's rights under the refinancing with any failure to perfect the security interest under LPA2 it took by assignment. I have held that the leasing and refinancing were separate, although related transactions. There can have been no breach of duty in respect of those fresh guarantees, when the opportunity to attain the super priority associated with purchase money security interests had already passed.

[92] Finally, the defendants argue that the prior conduct of the plaintiffs precludes NZB Finance from now confining their pleading to the Contract for Current Advances. The defendants rely upon:

(a) The letter of demand sent to Glenmorgan on 25 June 2004 stating there were monies owing under the Refinancing Agreement, the LPA2 and the Contract for Current Advances.

(b) The letter from the solicitor for the plaintiffs on 6 July 2004, advising that NZ Bloodstock were terminating the Refinancing Agreement, the LPA2 and the Contract for Current Advances.

(c) The letter from the solicitors for the plaintiffs on 5 October 2004 referring to both the Contract for Current Advances, the LPA2 and making specific reference to clause 6 of the LPA2.

(d) The statement of claim alleging that there were amounts owing under the Refinancing Agreement, the LPA2 and the Contract for Current Advances; and

(e) The written opening submissions of the plaintiffs making reference to relevant clauses in LPA2.

[93] There can be no doubt that there has been a significant degree of confusion on the part of legal advisors involved in the enforcement phase, both for NZB Finance and the guarantors, as to the effect of the various transactions. However, the fact that correspondence and pleadings include reference to LPA2 cannot revive that agreement. There was no argument that an estoppel operated to prevent reliance on the Contract for Current Advances and the Finance Guarantees, nor was there any evidence led on the basis of which a finding of estoppel could be made. It is also of note that in the statement of claim, NZB Finance pleads that it seeks recovery of the amounts outstanding by virtue of the refinancing under the Finance Guarantees refinancing. Accordingly, I reject the argument that NZB Finance is now precluded by its conduct from pursuing that claim.

Was it a term of LPA2 the Refinancing Agreement or the Contract for Current Advances that the plaintiffs would take steps to maintain their security interests in Generous and the Schedule Bloodstock through registration?

[94] All defendants submit that it was an express term of LPA2, the Refinancing Agreement and the Contract for Current Advances that "New Zealand Bloodstock" would be able to convey title in Generous to Glenmorgan at the end of LPA2. The intention underpinning LPA1 and LPA2 was that legal ownership would eventually pass to Glenmorgan. Clause 7(e) of LPA2 provided that upon payment of all money owing under the agreement, title to Generous would become vested in Glenmorgan. NZB Leasing was obligated to do all things within its power to perfect the title of the Lessee, including handing over change of ownership documents. The agreements were therefore predicated upon title to Generous being retained by New Zealand Bloodstock in order for ultimate transfer to be possible.

[95] In terms of the Refinancing Agreement and Contract for Current Advances, the parties confirmed their obligations under LPA2, so they were entered into on the understanding title to Generous would pass to Glenmorgan at the end of LPA2. The defendants submit that the purpose of the interconnected agreements was to finance and facilitate the purchase of Generous by Glenmorgan. In addition, the Contract for Current Advances created a new security over the Schedule Bloodstock and income and progeny flowing from that bloodstock.

[96] It is argued that it was also a term of LPA2 and the refinancing that if the agreements were terminated for non-performance, Generous could be sold, and the proceeds of sale applied in reduction of the debt. Also applied in this way, could be any income produced by Generous in the form of stud fees.

[97] It is therefore said to be an express or implied term of these agreements that the plaintiffs would take all necessary steps to maintain the security interest in Generous, and the Schedule Bloodstock, which obligation necessarily entailed an obligation to register that security interest to maintain its priority.

[98] The failures to register NZB Leasing's security interest arising from LPA2, and NZB Finance's security interests arising from the refinancing are said to be

breaches of those agreements, which have the effect of discharging the contracts, and Glenmorgan's obligations thereunder.

[99] The plaintiffs say in reply that any failure to perfect a security interest in Generous was not a breach of LPA2 or the Contract for Current Advances. Requirements for security were inserted for the benefit of the lender, not the borrower. If the lender did not avail itself of all possible protections from default by the borrower that does not provide a defence to the borrower in circumstances where it had pledged its property twice.

Analysis

[100] There are three broad classes of contractual term implied by law:

(i) those implied into certain types of contract by statute or custom,

(ii) those implied from the express terms of the contract (often referred to as the implicit term), and

(iii) those implied to give business efficacy to the contract.

[101] Often the second and third type of implied term shade into each other. Any attempt at rigid classification is therefore unhelpful and to be avoided: *Vickery v Waitaki International Ltd* [1992] 2 NZLR 58.

[102] The defendants' argument is based on either the second or third category. The defendants say that an obligation on NZB Leasing and NZB Finance to perfect any security interest is to be implied into LPA2 and Contract for Current Advances, either on the basis of the overwhelming logic of the inclusion of such a term, or to achieve business efficacy.

[103] A leading decision in New Zealand in relation to implication from the express terms of the contract is that of the Court of Appeal in *Vickery*. Vickery had entered into a written contract with Waitaki for cleaning and catering with freezing

works. In 1986 Waitaki closed the freezing works permanently and Vickery sought compensation for his losses. The issue for the Court of Appeal was whether it was an implied term of the contract that Waitaki would provide a workforce to enable Vickery to perform its services. After canvassing the terms of the agreement which emphasised the presence of the employees in the freezing works, Cooke P said (at 65):

> Considering cumulatively the features and provisions of the agreement just traversed and having regard to the whole purpose of the agreement, I come without much difficulty to the conclusion that to close the works is a breach of the company's contract with the plaintiff. It was implicit in the contract that the company would provide a work force.

[104] Richardson J too agreed that the term was implicit. He said (at 66):

> Against that background the underlying substratum of the agreement into which the parties entered was the continuing provision of an adequate catering service of the employees of the Longburn Freezing Works … It is implicit in that contract that for its part the company would maintain the work force clientele for the catering service by continuing to operate the Works.

Gault J agreed at 67 that:

> It is implicit in the language of the contract that [Vickery] was entitled to expect the level of business he contracted for and in the absence of that should be compensated by the respondent.

[105] All three Judges referred to the case of *Stirling v Maitland* (1864) 5 B&S 840; 122 ER 1045 where a company had contracted that if a person should be displaced from his agency, they would pay another person a certain sum. There was held to be a displacement when the company transferred the business to another company, and wound up their own affairs. Cockburn CJ said at 852:

> … If a party enters into an arrangement which can only take effect by the continuance of a certain existing state of circumstances, there is an implied engagement on his part that he shall do nothing of his own motion to put an end to that state of circumstances, under which alone the arrangement can be operative.

(See also *Rod Milner Motors Ltd v Attorney-General* [1999] 2 NZLR 568 and *Avondale Hotel No.1 Ltd & Anor v Portage Licensing Trust* (2005) 6 NZCPR 702.)

[106] As to terms to be implied to give business efficacy to the contract, the five-step test from *BP Refinery (Westernport) Pty Ltd v Shire of Hasting* (1977) 180 CLR 266 is now well established. There the Privy Council said that for a term to be implied, the following conditions (which may overlap) must be satisfied:

1. It must be reasonable and equitable;
2. It must be necessary to give business efficacy to the contract, so that no term would be implied if the contract is effective without it;
3. It must be so obvious that "it goes without saying":
4. It must be capable of clear expression;
5. It must not contradict any express term of the contract.

[107] I accept that it was a term of LPA1 and LPA2 that NZB Leasing would retain title in Generous because title in Generous was its security for payment, and because it was obliged, on payment of all amounts owing under the LPA2, to pass title in Generous to Glenmorgan. There is express provision that title in Generous would remain with the lessor.

[108] It cannot be seriously argued however that NZB Leasing owed Glenmorgan a contractual duty to perfect its security interest in Generous to prevent Glenmorgan creating a prior ranking security interest in it. Title was retained by NZB Leasing to provide it with security, not to constitute it custodian of title for the benefit of Glenmorgan and with the task of preventing Glenmorgan itself encumbering the asset. If the parties had been asked at the time of entering into LPA1 or LPA2, "does NZB Leasing have a duty to prevent Glenmorgan creating prior ranking charges over Generous?" they would most certainly both have replied no, although acknowledging a contractual duty on Glenmorgan to refrain from encumbering the horse. Indeed, by clause 5(v) of LPA2, Glenmorgan expressly covenanted not to:

> Mortgage charge or encumber the Animal without the prior consent of the Lessor … and not to assign mortgage charge or encumber the Lessee's interest as Lessee hereunder.

[109] The implication of such a term was therefore not necessary to provide NZB Leasing with the security it had contracted for. The implication of such a term was also not necessary to enable NZB Leasing to convey title at the end of the agreement.

At the end of LPA2, on performance by Glenmorgan of all its obligations, NZB Leasing was in a position to convey title, as it was contractually obliged to do, notwithstanding the failure to register. Although the title conveyed was or would have been subject to any other security interests that Glenmorgan had created, that was always going to be the case, irrespective of any actions NZB Leasing might have taken. Registration of NZB Leasing's security interest would have preserved its priority but would not have prevented S H Lock also having a security interest under the terms of the Act.

[110] There are therefore no express terms in LPA2 that impose upon NZB Leasing an obligation to maintain title in Generous free of any charges that might be created by Glenmorgan. Nor is the implication of such a term necessary to give business efficacy to the transaction documented in LPA2. LPA2 is clearly effective without the implication of such a term, and the requirement for perfection of securities is not so obvious that it goes without saying.

[111] Further, such a term cannot be implied from the express terms of the contract. The obligation to prevent prior charges is that of Glenmorgan, not NZB Leasing. This is not a case, as it was in *Vickery*, where the operation of the contract was dependent upon the term that was implied.

[112] The case for an express or implied term to assist the defendants is weaker still in relation to the Contract for Current Advances. NZB Finance did not have title to Generous. That interest had been assigned to NZB Progeny. The Contract for Current Advances was a separate transaction, involving no more than the provision of finance, and the associated taking of security for that finance. NZB Finance had no obligation under the contract to pass title to Generous to Glenmorgan. Although Glenmorgan agreed to grant a security interest in Generous and the Schedule Bloodstock to NZB Finance, that provision was clearly included for the benefit of NZB Finance. NZB Finance undertook no obligation to perfect its security interest.

[113] The Contract for Current Advances makes clear that the obligation to ensure that NZB Finance's security interest was first ranking was that of the "borrower", defined in the Contract for Current Advances to include Glenmorgan and the four

defendant guarantors. By clause 8 of the Contract the "borrower" undertook as follows:

> (b) The Borrower owns possesses and has rights to all Collateral presently held and will lawfully own possess and have rights to property to be acquired and which is or to be the subject of the security interest hereby created and has good title thereto free of all prior security interests, charges, encumbrances and liens save as are consented to in writing by the Creditor and the Borrower has fully and accurately disclosed to the Creditor the locations, business operations and records of the Collateral and the Borrower.
>
> …
>
> (h) The Borrower warrants that the bloodstock outlined in the schedule … are not subject to any debenture, mortgage, charge or other security of any kind whatsoever other than as is disclosed to and approved by the Creditor in advance.
>
> (i) The Borrower shall not, while any monies under this Facility remain unpaid, create or permit any debenture, mortgage, charge or other security interest over the bloodstock outlined in the Schedule as amended from time to time without the prior consent of the Creditor in writing.

[114] Such provisions are inconsistent with the obligation now sought to be imposed by implication of a contractual term upon NZB Finance. There is therefore no basis for implying into LPA2 or the Contract for Current Advances an obligation upon NZB Leasing or NZB Finance to perfect the security interests held by them in Generous and the Schedule Bloodstock.

[115] The failure by NZB Leasing to register its security interest did not amount to a breach of its express obligations under LPA2 and did not thereby discharge Glenmorgan or the defendant guarantors. Any failure by NZB Leasing or by NZB Finance to register any security interests similarly did not amount to a breach of NZB Finance's obligations under the Contract for Current Advances, and did not thereby discharge Glenmorgan or the defendant guarantors.

Was it a condition precedent or term of the Finance Guarantees that security interests would be perfected?

[116] The defendants submit that it was a condition precedent or term of the Finance Guarantees that the plaintiffs would take all steps necessary to preserve their

security interest in Generous and the Schedule Bloodstock so as to maintain a first ranking security interest. The argument that it was a condition or condition precedent is based on two grounds. First, that it was a term of the principal contracts that the plaintiffs' security interests would be perfected, and performance by them of those obligations was a condition precedent to the defendants' liability. I have held that there were no such term in the principal contracts, and accordingly this submission is rejected. Alternatively, the defendants argue that it was a condition precedent to their liability as guarantors that NZ Bloodstock's security interest in Generous and the Schedule Bloodstock would be perfected so that NZ Bloodstock would have title to Generous and the Schedule Bloodstock as security for payment, and that the security would be available to the guarantors (exercising rights of subrogation) if they were called upon to make payment under the guarantees. Again reliance is placed upon the commercial rationale of the principal transactions and the references in those transactions to NZB Leasing having title in Generous, and in the case of the Refinancing Agreements, to NZB Finance having a security interest in Generous and the Schedule Bloodstock. The third and fourth defendants also point to express provisions, clauses 5(b) and 7(a) in the Contract for Current Advances which they argue make it clear that the guarantees were given on conditions that New Zealand Bloodstock has breached.

[117] Clause 5(b) provides:

> The execution of the aforesaid Guarantee is a condition of the Creditor providing this Facility and the Creditor will not be under any obligation to make available all or any part of the Facility until such Guarantee has been given to its satisfaction.

[118] Clause 7(a) provides:

> The security specified under the heading security held by or to be held by the Creditor is to be given by the Borrower and/or the Guarantor to the Creditor as a condition of providing this Facility.

[119] The defendants also rely upon the evidence of Mr Brett Jenkins that it was important and essential to his wife (the fourth defendant) and he that New Zealand Bloodstock had security and title over Generous as it meant New Zealand Bloodstock would be able to revert to that ownership or security and thereby reduce

their exposure as guarantors. They rely on this evidence to establish the existence of a condition precedent to a guarantor's obligations under Deeds of Guarantee.

Analysis

[120] A contract is subject to a condition precedent where the liability of one or both of the contracting parties becomes effective only if certain facts are ascertained to exist, or upon the occurrence or non-occurrence of a further event (*Chitty on Contracts* at 12-028). The failure of a condition precedent in the case of a guarantee discharges the guarantor, as the guarantor's obligations do not arise unless the condition is fulfilled.

[121] If the guarantee liability is not expressly conditional upon the taking, or as argued in this case, the taking and maintenance of the security, then the guarantor must show that the creditor knew that the guarantee was dependent upon the taking and maintenance of the security and agreed to that condition. The position was summarised by Purchas LJ in *TCB Ltd v Gray* [1988] 1 All ER 108 (CA) as follows:

> Where a guarantor wishes to make his guarantee dependent on the giving of some other valid collateral security by a third party he must establish that this formed part of the contract under which the guarantee was given. The distinction must be borne in mind that the giving of a collateral security will almost always be a basic requirement of the lender but by no means always a requirement of the guarantor. In the absence of it being established by the guarantor that the taking of a valid collateral security is a term of the contract between him and the lender, the guarantor cannot rely on the failure of the lender to provide himself with a valid collateral security, although he may have indicated that he was going to do so. Moreover, for such a term of the contract of guarantee to be established not only must it be intended subjectively by the guarantor but it must also be brought home to and accepted by the lender.

[122] In the *TCB* case, clauses in the guarantee provided that the liability of the guarantor would not be discharged by anything that would not discharge a principal debtor, and that the guarantee would not be discharged or affected by any failure, irregularity or defect in any security held by the creditor for the debt. The Court also observed that it was unlikely that the bank had agreed to the guarantor's guarantee being subject to the creditor taking a particular security from the debtor, when such a condition would detract substantially from the express provisions of the guarantee.

[123] In this case there is no express provision in the Finance Guarantees or the refinancing documentation that it was a condition precedent or term of the Finance Guarantees that security held by NZB Finance would be perfected, or would be first ranking. The documents make plain that NZB Finance intended to take security for its own benefit, and stipulations (such as those in the clauses referred to by the third and fourth defendants) by the creditor for particular security as a condition of providing the finance are no more than that.

[124] Further, there is no evidence to support the defendants' contention that such a condition precedent was agreed to by NZB Finance. Mr Jenkins' evidence was that it was important and essential to him and his wife that New Zealand Bloodstock had security and title over Generous. He did not say that he told NZB Finance, or any representative of any New Zealand Bloodstock Company, that the guarantees were provided on the condition that security over Generous was or had been taken, and that it was first ranking. He did not give evidence of any agreement with NZB Finance to this effect.

[125] There is also no basis to imply such a condition. It is not necessary to give business efficacy to the transactions in question, nor can it be said to be a term arising from the "overwhelming logic" of the arrangements between the parties, or implicit in the provisions of the Finance Guarantees.

[126] Further, as previously noted, no term will be implied into a contract or deed if it is inconsistent with an express provision. I have previously referred to clause 7 of the Financing Guarantee which is inconsistent with the notion that the existence of the guarantee obligation was dependent upon the existence of a perfected security interest in Generous.

[127] To summarise, I find that there was no such condition or condition precedent to the Finance Guarantees that any security interest that NZB Finance was contractually entitled to would be perfected, or would be first ranking.

Did NZB Finance or NZB Leasing owe a duty of care to the defendants to maintain security?

[128] In the third and fourth defendants' statement of defence, set-off and counterclaim, a defence is pleaded that the plaintiffs owed a duty of care to Glenmorgan and/or the third and fourth defendants to:

(a) comply with all contractual provisions specified in LPA2 and related contractual terms;

(b) ensure that its security interest and rights in relation to Generous and the other Schedule Bloodstock was perfected, maintained and preserved; and

(c) ensure that earnings from Generous and the other Schedule Bloodstock would be available to be applied in reduction of Glenmorgan's liabilities and the third and fourth defendants' liabilities as guarantors.

[129] It is alleged that the duty of care was breached by the plaintiffs' failure to preserve, perfect and maintain its securities. In closing submissions counsel for the third and fourth defendants argued that there was a "general duty" to perfect securities, seemingly combining equitable principles and principles derived from the law of negligence into one overarching duty.

[130] As to the suggestion that the plaintiffs owed a duty of care to comply with contractual terms, it is well settled that there is no duty to take reasonable care to perform a contractual duty: *Rolls-Royce New Zealand Limited v Carter Holt Harvey Ltd* [2005] 1 NZLR 324 at [66].

[131] As to the notion of discharge of a surety occurring by reason of a breach of a common law duty of care, the third and fourth defendants referred to no decided case in which such a duty of care had been recognised. In *China & South Sea Bank Ltd v Tan Soon Gin* [1990] 1 AC 536 the Board rejected the surety's defence that the creditor owed him a duty of care to exercise its power of sale in respect of a security

reducing in value before it became worthless. In overturning the Court of Appeal decision that such a duty existed in the tort of negligence, Lord Templeman said (at 543):

> … the tort of negligence has not yet subsumed all torts and does not supplant the principles of equity or contradict contractual promises …

[132] Although the content of the duty argued for was different in that case, Lord Templeman's analysis of the principles governing relief for a surety applies with equal, if not greater force, to this case. The duty argued for by the third and fourth defendants would in all material respects be identical to the equitable duty. To the extent it is not identical, it is meritless in any case (see [130] above). The inclusion of such makeweight pleading is undesirable. This defence fails.

Do the provisions of the Hire Purchase Act apply to the transactions, and if so, what is the effect of that on the defendants' liability to NZB Finance?

[133] The defendants plead by way of defence, that LPA2 and related contractual arrangements were in substance, or are deemed to constitute a hire purchase agreement and therefore are subject to the provisions of the Hire Purchase Act 1971 (now repealed). This argument was not pursued by the first and second defendants in closing submissions, but as I have no note of abandonment of the defence I will proceed to determine the defence for all defendants.

[134] In closing, the third and fourth defendants argued that by virtue of the application of the Hire Purchase Act and the terms thereby statutorily implied, the plaintiffs guaranteed that they were able to deliver unencumbered title in Generous to Glenmorgan. That Act also imposes requirements as to the form of the documentation. Those requirements were not complied with, such as the requirement that the hire purchase agreement must be in writing (s 5), that particular matters must be provided for (s 6), and that copies of the agreement must be sent to the purchaser after the agreement is executed.

[135] By reason of non-compliance by the plaintiffs with the requirements of the Hire Purchase Act, the principal contracts and the guarantees are claimed to be unenforceable.

[136] It was submitted for the third and fourth defendants that ss 2 to 7 of the Hire Purchase Act bring a wide range of transactions within the ambit of the protections afforded by that Act. Section 2 of the Hire Purchase Act provides:

> (1) In this Act, unless the context otherwise requires, -
>
> …..
>
> Hire purchase agreement means an agreement whereby goods are let or hired with an option to purchase and an agreement for the purchase of goods by instalment payments (whether the agreement describes the payments as rent or hire or otherwise) under which the person who agrees to purchase the goods is given possession of them before the total amount payable has been paid; but does not include any agreement –
>
> > (a) [Subject to subsections (5) and (6) of this section,] under which the property in the goods comprised in the agreement passes absolutely, to the person who agrees to purchase them, at the time of the agreement or upon or at any time before delivery of the goods; or
> >
> > (b) Made otherwise than at retail:
>
> (2) For the avoidance of doubt, and without limiting the circumstances in which a hire purchase agreement may be made at retail, it is hereby declared that for the purposes of this Act a hire purchase agreement shall be deemed to be made at retail if -
>
> > (a) The transaction leading to the agreement was arranged by a dealer or on his behalf; and
> >
> > (b) The agreement would have been made at retail if the dealer had been the vendor.
>
> (3) Where, by virtue of 2 or more agreements, none of which by itself constitutes a hire purchase agreement, there is a transaction which is in substance or effect a hire purchase agreement, the agreements shall be treated for the purposes of this Act as a single agreement made at the time when the last of those agreements was made.

The third and fourth defendants rely in particular upon s 2(3).

[137] NZB Finance sues under the Refinancing Agreement, the Contract for Current Advances, and Finance Guarantees. The Refinancing Agreement and Contract for Current Advances are agreements to provide finance. They do not provide for the leasing or hireage of goods with an option to purchase, or agreements for the purchase of goods by instalment payments. If any agreement could fall within the s 2 definition it is LPA2 (which I do not decide). I have held that the refinancing agreements are not so interconnected with LPA2 so as to form one

agreement or transaction (para [53]), and as a consequence the Refinancing Agreement and Contract for Current Advances cannot fall within the definition of Hire Purchase Agreement, in s 2. I do not therefore consider the arguments advanced in reliance upon the Hire Purchase Act 1976 further. The defence fails.

Do the defendants have a contractual right to deduct the value of Generous from any amount they are liable to NZB Finance for?

[138] As a further defence the first and second defendants argue that they are contractually entitled to deduct from any amount they are liable to pay under the Finance Guarantees, the value of Generous. The defendants rely upon clause 6(c) of LPA2 which provides that upon the termination of LPA2, Glenmorgan would pay to NZB Leasing by way of liquidated damages the amounts outstanding under the lease, the costs of repossession of Generous, together with interest on these amounts less:

> Either of the following: the net proceeds of sale or disposal of the Animal at auction conducted as outlined in the preceding Clause, or if the Animal is not sold or disposed of within two calendar months from the date the Lessor gave notice of termination then the value as at the date the Lessor took the Animal into its possession certified by the bloodstock agent appointed as aforesaid, or if the Animal dies or is destroyed damaged or confiscated and the Lessor is paid the proceeds of an insurance policy in respect of the death destruction damage or lawful confiscation of the Animal the amount of the proceeds of the insurance.

[139] Because Generous was not sold within two months of repossession, the first and second defendants argue that it is the value of Generous as at the date of repossession that the defendants are entitled to have deducted. They argue that the right to have the value of Generous deducted from amounts outstanding does not depend on NZB Leasing or NZB Finance being able to retain the proceeds of sale. Although there is no express provision to that effect, it was NZB Leasing and NZB Finance's responsibility to ensure that it maintained its security adequately to ensure it was entitled to retain the proceeds of sale. The defendants rely upon the evidence of two valuers, Messrs Paul Beamish and Peter Jenkins. Mr Beamish valued Generous at $3.8 million as at 3 December 2003. Mr Jenkins gave evidence that Generous' valuation as at March 2004 was $4 million. If obliged to give credit for (at least) $3.8 million, Glenmorgan's debt to NZB Finance is extinguished.

[140] This argument fails for two reasons. Firstly, any right of repossession that was exercised, was not exercised under the provisions of LPA2. All amounts outstanding had been repaid. The rights purportedly exercised by NZB Finance were those created by the provisions of the Contract for Current Advances.

[141] Secondly, if the right of repossession exercised had been that created by LPA2, then I am satisfied that it is to be implied into the provisions of clause 6 that NZB Leasing was only obliged to deduct the proceeds of sale, or value of Generous, if it was entitled to retain them, but not if it was required to disgorge them to some prior ranking security holder. In terms of LPA2, Glenmorgan had covenanted not to mortgage, charge or encumber Generous without NZB Leasing's prior consent. It is implicit that if, in breach of this clause, Glenmorgan did encumber Generous so that NZB Leasing was not entitled to retain the value of Generous on repossession, NZB Leasing would not have to deduct the value of Generous from any amount due under LPA2.

Set-off: Counterclaim

[142] The first and second defendants plead a set-off arising from the alleged breaches of NZB Leasing's obligations under LPA2, the Refinancing Agreement and the Contract for Current Advances, to maintain and perfect its security interests in Generous and the Schedule Bloodstock. Performance of these obligations was important to ensure that:

a) Title to and property in Generous would, from the date of purchase, be and remain with the plaintiffs;

b) On termination of the Lease by reason of default by Glenmorgan, NZB Leasing and NZB Finance would become entitled to possession of Generous and to retain any proceeds of sale of Generous in reduction of amounts owing to NZB Leasing and NZB Finance;

c) For the 2004 northern hemisphere breeding season, all income received from Generous would be applied in reduction of the debt due

to NZB Leasing and NZB Finance under LPA2 and the Contract for Current Advances.

[143] Breaches of those contractual obligations are alleged to give rise to a set off available to the first and second defendants because the value of the bloodstock, (including proceeds from the 2004 breeding season), was not able to be applied by NZB Leasing or NZB Finance in reduction of the defendants' obligations under the Guarantees.

[144] The claimed set off was not specifically addressed in closing submissions, although this may be because the arguments were subsumed by the first and second defendants' arguments in relation to the terms of LPA2 (para [95]). Nevertheless I propose to consider the set off pleaded, as there was no formal abandonment. The set-off claimed is as follows:

(a) The value of Generous, which the first and second defendants say is around $4 million, notwithstanding actual sale price.

(b) The value of other collateral security and bloodstock, alleged to be between $900,000 and $1.2 million, again notwithstanding sale price.

(c) The loss of earnings from Generous for the 2004 breeding season, said to be approximately $446,884.58.

(d) The loss of income and other profits from other bloodstock held as collateral.

[145] I have already held that NZB Leasing and NZB Finance had no contractual obligation to Glenmorgan to maintain or perfect their security interest in Generous or the Schedule Bloodstock to prevent a prior ranking security interest being created. On this ground alone the claimed set-off must fail. In addition, the creation of the prior ranking security interest was a breach by Glenmorgan of its covenants under the Contract for Current Advances (clauses 8(b) and (h)) and most likely also a breach of clause 5(v) of LPA2). That being the case, Glenmorgan cannot rely upon

its own default as giving rise to a set off, and nor can the first and second defendants claiming through Glenmorgan. This claimed set-off fails.

[146] The third and fourth defendants plead both a set-off and counterclaim said to arise out of:

(a) The plaintiffs' breach and non-performance of the refinancing agreements and LPA2 in failing to perfect their security, which would otherwise have resulted in the value of bloodstock and its associated earnings being applied in reduction of the plaintiffs' claim.

(b) The rights that Glenmorgan has arising out of those breaches, and also out of the alleged wrongful repossession.

(c) The loss of the third and fourth defendants' rights of subrogation in relation to the bloodstock, including its right to purchase under the lease and obtain the benefit of the bloodstock earnings.

[147] The third and fourth defendants say that by reasons of those wrongs, Glenmorgan has suffered damage and the third and fourth defendants have suffered damage. The damage is pleaded as follows:

(a) The value of Generous being between $3 million to $4 million.

(b) The value of the other collateral security and bloodstock was valued prior to receivership as follows:

Weanlings	1,605,000
Weanlings – foal	635,000
Glenmorgan mares	3,105,000
Raceway stock	857,500
All other stock (excluding Generous)	6,202,500

(c) Income and other profits from the bloodstock as income earning chattels, including Generous' earnings of $900,000 per annum, particulars for Generous are referred to in the schedule annexed hereto;

(d) At the time of the receivership of Glenmorgan there was a reasonable expectation that Generous would be an income earning asset (or chattel) for six years. The future income expectancy for Generous was therefore $900,000 for six years being $4.5 million. The net present value at the date of receivership of those future earnings and income at a discount rate of 20% per annum is $3.6 million;

(e) The Third and Fourth Defendants assess the loss of the broodmares as collateral security as follows. Valuations of those mares are contained in a valuation dated 24th of March 2004 from Eclipses Bloodstock. Following the receivership seven mares were sold by the receivers. Details of the broodmares, their valuations and prices for which they were sold are also referred to in the second schedule annexed. The plaintiff's failure to register its security over the other bloodstock and the resulting loss of the broodmares is $655,000;

(f) Funds or monies otherwise held and yet to be accounted for by the Plaintiffs in respect of earnings from Generous, including fees earned from the Northern Hemisphere breeding season. Full particulars of which are not known to the defendants but are known to the plaintiffs;

(g) Any other funds or monies obtained or derived by the plaintiffs from the sale or earnings from bloodstock, full particulars of which are not presently known to the defendants;

(h) Loss of revenue and any other income suffered from reduced service fees incurred while Generous was wrongfully in the possession of the plaintiffs.

[148] As was confirmed in closing, the assumption which underlies at least part of the loss pleaded is that by reason of the wrongful repossession, Glenmorgan lost the opportunity to restructure its affairs in accordance with plans that it was at the time exploring with its advisors, including Turnaround Management Limited. It therefore lost the opportunity to continue to trade with Generous and the Schedule Bloodstock as profit making assets. It is also alleged that by reason of NZB Finance's management of Generous after taking possession of him, his value was ultimately substantially diminished.

[149] The third and fourth defendants claim that not only may they assert Glenmorgan's claims against NZB Finance as a complete defence to NZB Finance's claims, but they may also obtain judgment against the plaintiffs for the amount of Glenmorgan's loss, to the extent that exceeds NZB Finance's claim.

[150] I have previously held that the failure to perfect the security interest in Generous and the Schedule Bloodstock, and income streams associated with that bloodstock, was not a breach of LPA2 or the refinancing agreements. Nor was it a breach of any contractual obligation owed to the guarantors. In particular, there was no contractual or equitable obligation on NZB Leasing or Finance to ensure that the defendants could exercise rights of subrogation in relation to Generous or the Schedule Bloodstock. I do not propose to consider these aspects of the claimed set off further.

[151] However, the claim arising from the alleged wrongful repossession of Generous raises issues not previously considered in this judgment, as follows:

a) Was the repossession unlawful?

b) If so, can the guarantors plead a set off or counterclaim in reliance upon that wrongful act, when Glenmorgan is not party to the proceeding?

c) If they can, would Glenmorgan have a claim to recover any loss from NZB Finance flowing from that wrongful act?

d) If so, what is the value of that counterclaim?

(a) Was the repossession unlawful?

[152] I have held that by the time of the repossession LPA2 was at an end, because all amounts outstanding under LPA2 had been repaid. That being the case, NZB Finance could not exercise its enforcement rights as assignee under LPA2 to repossess Generous. NZB Finance therefore had to rely upon its rights under the Refinancing Agreements. Clause 10(a) of the Contract for Current Advances provides:

> (a) If the borrower shall fail to pay any monies owing by the Borrower to the Creditor or if there is any breach of the terms hereof, then this Agreement shall forthwith be terminated and the Creditor shall have all of

> the rights available at law including if applicable those under the Personal Property Securities Act 1999 relating to the security interest in the collateral.

[153] Section 109 of the Act provides:

> Secured party may take possession of and sell collateral
>
> (1) A secured party with priority over all other secured parties may take possession of and sell collateral when-
>
> (a) The debtor is in default under the security agreement; or
>
> (b) The collateral is at risk.
>
> (2) In subsection (1), collateral is at risk if the secured party has reasonable grounds to believe that the collateral has been or will be destroyed, damaged, endangered, disassembled, removed, concealed, sold, or otherwise disposed of contrary to the provisions of the security agreement.

[154] This provision only gives a right of repossession and sale to the party with a first ranking security interest, in this case, in Generous. There has been significant and justified criticism of the limitation of the repossession right created by the inclusion of the words "with priority over all other secured parties". As the authors of *Personal Property Securities in New Zealand* state, it will not always be obvious which secured party has priority over all others. Sometimes priority will have to be worked out through the Courts, because priority may not always be determined by reference simply to time of registration. The authors give the following examples (at 109.2):

> For example, determining whether a purchaser money security interest has priority over a general security interest for which a registration was made first, may require extrinsic evidence regarding the time that the debtor took possession of the purchase money collateral. In other cases, a secured party may have priority over only part of the collateral to be seized, such as where one secured party has priority to an accession but another has priority to the goods to which the accession is attached. Where processed or commingled goods are involved, the Act can award equal priority to two or more competing security interests. It would clearly be unsatisfactory if issues such as these had to be sorted out before any secured party could seize collateral, particularly in the case of collateral at risk.

[155] Whatever the difficulties with s 109, in this case NZB Finance was not "a secured party with priority over all other secured parties". Although s 109 is a provision that can be contracted out of, the parties did not do so; they expressly

incorporated the rights available under the Act. NZB Finance therefore did not have a right to take possession of and sell Generous. In taking possession of Generous and in selling Generous, NZB Finance prima facie committed an unlawful act, namely conversion.

(b) Can the guarantors plead a set off or counterclaim in reliance upon that wrongful act, when Glenmorgan is not party to the proceeding?

[156] The third and fourth defendants invoke the principle that a guarantor may rely upon any right of set-off or counterclaim which the principal debtor could set up against the creditor in reduction of the guaranteed debt, in reduction of the claim under the guarantee. Although acknowledging that in the usual course a guarantor must join the debtor to the proceeding so as to be able to rely upon the debtor's cross-claim or set-off, they say that where the principal debtor is insolvent there is no need for it to be joined as a party.

[157] The general principle is that a guarantor may invoke a cross-claim available to the debtor against the creditor, by way of set-off, even though it is a claim for unliquidated damages. However, the ability of a guarantor to do so is dependent upon the terms of the contract, and at least where the set-off claimed is for unliquidated damages, also upon the joinder of the creditor as a party to the proceeding. The rationale behind the latter requirement is that it protects the creditor against a subsequent claim by the debtor, and ensures that all relevant material is before the Court before the availability of such a claim is determined.

[158] There is extensive discussion of the availability of such a defence in the leading textbooks; but little in the way of decided case law. The most fully reasoned decision in the area is *Cellulose Products Pty Ltd v Truda and Others* (1970) 92 WN (NSW) 561 where Isaacs J said (at 588):

> This review of the cases lends no support to the submission that a surety when sued is entitled to set up in equity or at law as an equitable plea any cross action for unliquidated damages which the debtor may have against the creditor in respect of the transaction, the performance of which the guarantor had entered upon his guarantee; that is, in the absence of the debtor being before the court in the proceeding so as to be bound by verdict and judgments. This of course does not mean that the guarantor is without

> remedy; when he is sued he has a right immediately to join the debtor as a third party and claim complete indemnity from him. The debtor has then a right to join the plaintiff as a fourth party, claiming damages for breach of warranty and so obtain indemnity either in whole or in part. All the actions would be heard together, the rights of all persons determined and appropriate set-off's made after verdict, and if there be any surplus of damages over and above that which is required to meet the guarantee, the debtor will have recovered that from the creditor who, in the result, will get no more than that to which he would be justly entitled.

[159] Isaacs J therefore suggests that a debtor's claim against a creditor is never available to be pleaded as a defence by the guarantor, but the guarantor may obtain justice following the procedural route he describes. Most commentators suggest that the better approach is that the set-off or counterclaim may be pleaded as a defence by a surety but only where the principal debtor is a party to the proceeding (this is stated to be the preferred approach by the authors of *Rowlatt on Principal and Surety* (Moss and Marks, 5th ed, 1999 at 4-91), and Derham, *Set-Off* (2nd ed, 1996 at 14.4)).

[160] The third and fourth defendants rely upon Australian authorities in which an exception to the requirement of joinder of the principal debtor was recognised where the debtor was bankrupt or in liquidation (*Langford Concrete Pty Ltd v Finlay* [1978] 1 NSWLR 14; *Westco Motors (Distributors) Ltd v Palmer* [1979] 2 NSWLR 93). The reasoning given is that the creditor is not prejudiced where the principal debtor is in liquidation because there is no risk of the creditor facing a claim by the debtor in other proceedings. It is difficult to follow the reasoning adopted in those cases. The fact that Glenmorgan is in receivership and liquidation does not preclude Glenmorgan from pursuing the same claim against the plaintiffs.

[161] Derham comments that the decisions relied upon by the third and fourth defendants may also be explained by insolvency set-off, because such a set-off occurs automatically, and liquidation of the debtor company operates to extinguish the principal debt as at the date of liquidation: *Stein v Blake* [1995] 2 All ER 961. If the cross demands were automatically extinguished to the extent of the set-off upon the occurrence of the liquidation, the principal debt is reduced by that amount and the liquidator could no longer sue the creditor on the cross-demand. Presumably this is also seen as removing the risk of a creditor having to argue the extent of any counterclaim in two sets of proceedings, and the prospect of inconsistent outcomes.

[162] This analysis does not provide any proper support for the "insolvency" exception recognised in the Australian case law. The creditor's proof in the debtor's liquidation will only be reduced by the amount of the set-off, if it is a good claim on the part of the debtor. If the liquidator asserts such a set-off which is then disputed by the creditor, litigation in relation to the creditor's claim filed in the liquidation will ensue, the quantum of the claim ultimately being determined by the Courts. Neither the debtor nor the creditor would be bound by any earlier determination as to that counterclaim in litigation to which the debtor was not a party.

[163] I am satisfied that the reasons for requiring joinder of the principal debtor as a pre-requisite to such a defence being relied upon by a guarantor applies with equal force where the principal debtor is in bankruptcy or liquidation. The joinder of all parties ensures finality of proceedings between the parties, and that all relevant factual material is before the Court. Here guarantors may not rely upon Glenmorgan's cross-claims as Glenmorgan is not a party to the proceeding.

[164] As to the third and fourth defendants' claim for judgment in an amount exceeding the creditors' claims against them, that is a hopeless claim. No principled basis was argued for it, and there can be no basis for such a claim in these circumstances.

(c) If the guarantors can, would Glenmorgan have a claim to recover any loss from NZB Finance from that wrongful act?

[165] I proceed to consider this issue as it raises a further, obvious and fundamental obstacle in the way of such a counterclaim. It is by reason of Glenmorgan's breach of contract in having granted a prior security interest that NZB Finance did not have the enforcement rights it had contracted for. If, as Glenmorgan had warranted and undertaken, Generous was free of prior ranking charges, the repossession would have been lawful. Any claim by Glenmorgan based on wrongful repossession would therefore fail on at least two bases.

[166] Firstly, any claim for damages by Glenmorgan for damages for conversion could be met with a counterclaim by NZB Finance for breach of contract (clause 8 of

Contract for Current Advances). Secondly, such a claim could be met with the plea that Glenmorgan cannot rely upon its own wrong (breach of contract) to found a claim: *New Zealand Shipping Company Ltd v Société des Ateliers et Chantiers de France* [1919] AC 1.

[167] I have found that Glenmorgan would not have been able to bring a claim against NZB Finance for wrongful repossession. I do not therefore need to determine if Glenmorgan had any realistic prospects of trading on if the repossession had not taken place. Nor do I need to consider evidence in relation to valuation of the bloodstock. I also heard evidence from Mr Lane, chartered accountant, as to the consequential loss alleged to have been suffered by Glenmorgan and the defendants directly attributable to the failure of NZB Finance to register its security interest in Generous and the Schedule Bloodstock. That too does not fall for consideration.

Judgment

[168] NZB Finance is therefore entitled to judgment against the defendants on its claim under the Finance Guarantees. I will require memoranda from counsel as to quantum, and as to the form of judgment. Quantum was, at the time of hearing, uncertain.

[169] Counsel are to file memoranda as follows:

(a) Plaintiffs – Friday 11 May 2007.

(b) Defendants – Friday 25 May 2007.

[170] If there are any issues as to costs, they may be dealt with in the same memoranda.

Winkelmann J