IN THE SUPREME COURT OF NEW ZEALAND

I TE KŌTI MANA NUI

SC 103/2017
[2018] NZSC 62

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

Hearing:	22 February 2018
Court:	Elias CJ, William Young, Glazebrook, O'Regan and Ellen France JJ
Counsel:	A M Glenie and G A Barkle for Appellant S M Bisley and O C Gascoigne for Respondents
Judgment:	16 July 2018

JUDGMENT OF THE COURT

A **The appeal is dismissed.**

B **The appellant is to pay the respondents costs of $25,000 and usual disbursements.**

REASONS

WILLIAM YOUNG, GLAZEBROOK AND O'REGAN JJ
(Given by William Young J)

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The appeal

[1] Part 14 of the Companies Act 1993 (the Act) provides a process by which compromises between a company (usually insolvent or near-insolvent)[1] and its creditors can be implemented even though not all of those affected agree. An approved

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1 Lynne Taylor and Grant Slevin *The Law of Insolvency in New Zealand* (Thomson Reuters, Wellington, 2016) at [31.1].

compromise is binding on the company and all creditors to whom notice of the proposal was given.[2] The underlying principle is that creditors representing a majority in number and 75 per cent in value of the debts (a qualified majority) can commit all creditors to a compromise.[3] As well, the legislative scheme incorporates, but does not define, a concept of classes of creditor. Where there is more than one class of creditors, a qualified majority of creditors within each class must vote in favour of the compromise.[4] Under s 232 of the Act, a creditor may apply to the court for a declaration that the compromise does not apply to a particular creditor or class of creditor or similar relief. The grounds for such an order include material irregularities in the obtaining of approval[5] and unfair prejudice to a creditor, or to the class of creditors to which that creditor belonged, who voted against the compromise.[6]

[2] This appeal turns primarily on the approach which should be taken to the classification of creditors where: (a) some are closely associated with the company (in the sense of being insiders) so that their interests are not closely aligned with those of the outside or arm's-length creditors; and (b) the returns offered on debts are not proportional to the amounts owed.

[3] Trends Publishing International Ltd (Trends) provides printing, publishing marketing and advertising services. In May 2015, its directors proposed a compromise with all of the unsecured creditors which: (a) provided no direct return for those associated with the company; (b) favoured smaller over larger creditors; and (c) placed all of the creditors within one class for voting purposes. The proposal was considered at a meeting of creditors held on 22 May 2015 where the compromise was approved by a qualified majority.

[4] The respondents (the challenging creditors) voted (or in one case unsuccessfully attempted to vote) against the proposal. They sought orders under

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2 Companies Act 1993, s 230(2).
3 Under cl 5(2) of sch 5 of the Act a resolution at a meeting held for the purposes of s 230 is adopted if a majority in number representing 75 per cent in value of the creditors votes in favour of it.
4 Section 230(3).
5 Section 232(3)(b).
6 Section 232(3)(c).

s 232 and were successful in the High Court.[7] Heath J concluded that the insider creditors should have been placed in a different class from the arm's-length creditors due to their disparate interests.[8] He saw the grouping of the insiders with the arm's-length creditors as designed to ensure that the proposal would be approved and amounted to manipulation. Such manipulation constituted unfair prejudice for the purposes of s 232.[9] The Judge therefore set aside the compromise. In doing so he rejected, or did not see as material, other complaints about the process which had been advanced by the challenging creditors. These included complaints as to the lack of information about the financial affairs of Trends which had been supplied to unsecured creditors.[10]

[5] The Court of Appeal upheld the judgment of Heath J albeit on slightly different grounds.[11] It was of the view that:

(a) the insider and arm's-length creditors ought not to have been classed together;[12]

(b) Callaghan Innovation (Callaghan), one of the challenging creditors, should have been placed in a separate class or alternatively (and more realistically) should have been excluded from the compromise;[13]

(c) the information which had been supplied in support of the proposal was inadequate and that this was a material irregularity under s 232(3)(b);[14] and

(d) setting aside the compromise was appropriate.[15]

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7 *Advicewise People Ltd v Trends Publishing International Ltd* [2016] NZHC 2119 (Heath J) [*Trends* (HC)].
8 At [94].
9 At [102].
10 At [103]–[106].
11 *Trends Publishing International Ltd v Advicewise People Ltd* [2017] NZCA 365, [2018] NZCCLR 7 (Cooper, Asher and Clifford JJ) [*Trends* (CA)].
12 At [90(a)].
13 At [90(f)].
14 At [76].
15 At [93]–[94].

Overview of these reasons

[6] We propose to address the case by reference to:

(a) the background facts;

(b) the statutory scheme;

(c) the background to the classification issue;

(d) our approach to classification; and

(e) whether the compromise ought to be set aside.

The background facts

[7] Trends is under the control of Mr David Johnson, who is now its sole director. Also under the control of Mr Johnson is its principal creditor, Thecircle.co.nz Ltd (Thecircle). For a number of years Trends has occupied business premises in Auckland which are owned by Thecircle.

[8] Since the global financial crisis, Trends has been under financial pressure. From 2009 it has been behind in rent payments owed to Thecircle. It is at least arguable that Trends has been insolvent from around 2013. From early 2014 it was, on occasion, unable to pay staff on time.

[9] On 2 April 2014, Trends obtained an "R & D Growth Grant" from Callaghan. The purpose of the grant was to fund "Eligible R & D Expenditure", an expression which was closely defined in the associated funding agreement. The funding agreement provided that, in certain circumstances, Callaghan could suspend and terminate the agreement and require repayment of funding already provided.

[10] Between May and October 2014 Callaghan paid a total of $382,911.97 to Trends pursuant to the agreement.

[11] In early November 2014, Callaghan commissioned Deloitte to provide a report addressing: (a) whether the funding already provided had been applied to Eligible R & D Expenditure; and (b) as to the solvency of Trends. In an interim report of 10 December 2014, Deloitte said that it had "found indications that Trends may have intentionally set out to mislead Callaghan to obtain funds". It also noted that based on a "restated statement of financial position" prepared by Deloitte, "[Trends'] financial ratios indicated poor liquidity and negative equity as at 30 September 2014".

[12] On 17 December 2014, Callaghan suspended the funding agreement with Trends. In doing so, it provided Trends with an executive summary of the 10 December report and gave it the opportunity to respond. As well, Callaghan issued a press release which announced the suspension and also stated that Callaghan had referred its suspicions to the Serious Fraud Office. There can be no doubt that this press release had an adverse impact on the ability of Trends to continue trading.

[13] On 13 February 2015, Trends gave Thecircle security over all its present and after acquired property. The total indebtedness secured was around $3,500,000 most of which represented unpaid rent.[16] The associated directors' resolution recorded that the company was able to pay its debts and was "not engaged… in business for which its financial resources [we]re unreasonably small".

[14] On 30 March 2015, Trends' solicitors wrote to Callaghan threatening proceedings for damages associated with the instigation of the audit process conducted by Deloitte, referral to the Serious Fraud Office and the press release and associated negative publicity.

[15] Deloitte issued its final report on 1 April 2015. It found that there were "potential breaches" of the funding agreement involving the use of funding for purposes other than Eligible R & D Expenditure and a "high risk" of insolvency.

[16] On 21 April 2015 Callaghan terminated the grant. At the same time, it demanded repayment of all money previously paid to Trends and interest.

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[16] At the creditors' meeting it was suggested that around $500,000 represented cash advances.

[17] On 12 May 2015, the directors of Trends put forward a proposal to creditors of the company under Part 14 of the Act.[17] This was prepared with the assistance of Mr Steven Khov, an insolvency practitioner.

[18] The proposal identified 62 unsecured creditors whose debts totalled $4,343,843.23. Of this:

(a) $3,080,361.80 was owed to Thecircle for unpaid rent. Thecircle was classified as an unsecured creditor as it had waived its security in respect of this amount. As well, $120,030 was owed to Trends' general manager, Ms Louise Messer and $30,000 was owed to one of its then directors, Mr Paul Taylor.[18] Thecircle, Ms Messer and Mr Taylor are the insider creditors to whom we have referred.

(b) $396,791.10 was owed to Callaghan (being the total advanced under their agreement and interest).

(c) The balance of the debts, including those owed to the other challenging creditors, Advicewise People Ltd, Mediaworks Radio Ltd, and Webstar (a division of Blue Star Group (New Zealand) Ltd) had been incurred at arm's-length and in the ordinary course of business. Of these debts, a total of $9,927.78 (owed to 23 creditors) was made up of amounts of $1,000 or less. Another five creditors were owed less than $2,000.

[19] Under the compromise as proposed:

(a) $50,000 – defined as the "initial pool" – was to be made available for the purposes of the compromise.

(b) Trends was to fund a "subsequent pool" by making nine additional monthly payments of $13,300.

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17 We note, in passing, that we agree with comments made in the reasons of Elias CJ and Ellen France J at [109] that, in promoting the proposal, the directors were required to act in good faith and in what they believed to be the best interests of the company.

18 Mr Taylor resigned as a director of Trends the day the compromise was adopted.

(c) With the exception of the insider creditors, the unsecured creditors would be paid in full up to the first $1,000 of their debts and would share pro rata in what was left of the initial pool and the subsequent pool. They would otherwise forgo payment of their debts.

(d) The compromise managers were to be Mr Khov and his associate, Mr Damien Grant.

[20] A meeting of creditors to consider the proposal was called for 22 May 2015.

[21] A statement relating to the compromise which was circulated to creditors accompanying the proposal contained information that was incomplete. It asserted that Trends' financial difficulties were due to the revocation of the Callaghan grant. No reference was made to the financial problems which had been apparent well before that revocation, and indeed, well before the December 2014 press release. No justification was offered for the 13 February 2015 grant of security or the accompanying resolution of the directors. The statement referred to the introduction of "fresh capital" as part of a "strong and coherent strategy to rebuild value", in a context where the "fresh capital" was limited to $50,000 which was to be provided by an unidentified business friend of Mr Johnson. There was a conclusory statement – that on liquidation, unsecured creditors would be unlikely to receive a dividend – but no analysis of the likely consequences of liquidation.

[22] Between 12 and 22 May 2015, there was correspondence between the proposed compromise managers and Buddle Findlay, the solicitors acting for Callaghan. In this correspondence, Buddle Findlay challenged the merits and bona fides of the proposal. In response, very limited additional information was provided. Trends refused to provide its accounts for 2013–2015, an explanation of the relationship between it and Thecircle, or details of the "fresh capital".

[23] At what must have been an acrimonious meeting on 22 May 2015, a number of questions were asked of the Trends representatives by or on behalf of creditors. Some of the responses were vague. For instance, Trends was not able to provide much information as to intercompany indebtedness. There was an acknowledgement that

the security granted to Thecircle would probably be set aside by a liquidator but, apart from a general reference to legal advice, no attempt was made to justify it. There was also an acknowledgment that Trends' directors had liability insurance.

[24] Ultimately 39 creditors (representing 81.25 per cent of the creditors by number) voted in favour of the compromise. The creditors who voted in favour included: (a) the three insider creditors; and (b) 17 "minor creditors", that is creditors owed $1,000 or less. Nine creditors voted against the proposal, including all of the challenging creditors save for Mediaworks, whose vote was disallowed due to being late.

[25] The insider creditors' debts represented 74 per cent of the total debt owed by Trends and 75.73 per cent of the debts of those voting. If they had not voted, the creditors who supported the compromise would have represented:

(a) 80 per cent of creditors by number; but

(b) only 28 per cent of creditors by value.

[26] The impact the differential treatment of creditors had on voting is more difficult to quantify. However, it is plausible to assume that the prospect of the proponents of the compromise achieving a majority in number was significantly enhanced by the favourable treatment offered in respect of the first $1,000 of each debt.

[27] On our analysis, and assuming all payments contemplated by the compromise are made (that is, the payments into the initial and subsequent pools), the respondents can expect to receive in respect of their debts:

(a) Callaghan ($396,791.10): $46,889.33.

(b) Advicewise ($19,285.50): $3,120.08.

(c) Mediaworks ($18,291.48): $3,004.83.

(d) Webstar ($13,214.65): $2,416.21.

At best, the challenging creditors can thus expect to receive between 11 and 18 per cent of the debts owed to them.

[28] Currently awaiting trial are proceedings by Trends against Callaghan[19] in which Trends seeks damages for what it claims are breaches of the funding agreement and defamation (associated with the press release issued by Callaghan and the complaint to the Serious Fraud Office).

The statutory scheme

Part 14 of the Act

[29] Section 228 sets out who may propose a compromise with creditors. This includes the board of directors of the company concerned.[20] As well, under s 228(1)(d) any creditor or shareholder may do so if leave of the court has been first obtained. Section 228(2) provides:

> Where the court grants leave to a creditor or shareholder under subsection (1)(d), the court may make an order directing the company to supply to the creditor or shareholder, within such time as may be specified, a list of the names and addresses of the company's creditors showing the amounts owed to each of them or such other information as may be specified to enable the creditor or shareholder to propose a compromise.

[30] Notice requirements are specified in s 229. These require the proponent of the compromise to "compile, in relation to each class of creditors of the company, a list of creditors known to the proponent who would be affected by the proposed compromise". This list must set out:[21]

> (a) the amount owing or estimated to be owing to each of them; and
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> (b) the number of votes which each of them is entitled to cast on a resolution approving the compromise.

[31] Schedule 5 of the Act provides for the giving of notice and the conduct of the meeting. Clause 5(2) of that schedule provides that a resolution is adopted if a

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19 Brought by way of counter-claim to the proceedings challenging the compromise.
20 Companies Act 1993, s 228(1)(a).
21 Section 229(1).

majority in number representing 75 per cent in value of the creditors or class of creditors, voting in person or by proxy vote or by postal vote, vote in favour of the resolution.

[32] Section 230 deals with the effect of a compromise:

> **230 Effect of compromise**
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> …
>
> (2) A compromise, including any amendment, approved by creditors or a class of creditors of a company in accordance with this Part is binding on the company and on—
>
> (a) all creditors; or
>
> (b) if there is more than 1 class of creditors, on all creditors of that class—
>
> to whom notice of the proposal was given under section 229.
>
> (3) If a resolution proposing a compromise, including any amendment, is put to the vote of more than 1 class of creditors, it is to be presumed, unless the contrary is expressly stated in the resolution, that the approval of the compromise, including any amendment, by each class is conditional on the approval of the compromise, including any amendment, by every other class voting on the resolution.

[33] The powers of the court are provided for in s 232:

> **232 Powers of court**
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> (1) On the application of the proponent or the company, the court may—
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> (a) give directions in relation to a procedural requirement imposed by this Part, or waive or vary any such requirement, if satisfied that it would be just to do so; or
>
> (b) order that, during a period specified in the order, beginning not earlier than the date on which notice was given of the proposed compromise and ending not later than 10 working days after the date on which notice was given of the result of the voting on it,—
>
> (i) proceedings in relation to a debt owing by the company be stayed; or
>
> (ii) a creditor refrain from taking any other measure to enforce payment of a debt owing by the company.

(2) Nothing in subsection (1)(b) affects the right of a secured creditor during that period to take possession of, realise, or otherwise deal with, property of the company over which that creditor has a charge.

(3) If the court is satisfied, on the application of a creditor of a company who was entitled to vote on a compromise that—

(a) insufficient notice of the meeting or of the matter required to be notified under section 229 was given to that creditor; or

(b) there was some other material irregularity in obtaining approval of the compromise; or

(c) in the case of a creditor who voted against the compromise, the compromise is unfairly prejudicial to that creditor, or to the class of creditors to which that creditor belongs,—

the court may order that the creditor is not bound by the compromise or make such other order as it thinks fit.

…

(emphasis added)

Part 15 of the Act

[34] Part 15 of the Act provides for court approval of compromises (along with arrangements and amalgamations). The primarily operative provision is s 236(1) which provides:

(1) Notwithstanding the provisions of this Act or the constitution of a company, the court may, on the application of a company or any shareholder or creditor of a company, order that an arrangement or amalgamation or compromise shall be binding on the company and on such other persons or classes of persons as the court may specify and any such order may be made on such terms and conditions as the court thinks fit.

[35] Section 236(2) allows interested parties to seek a preliminary court order convening meetings of affected parties[22] with a view to approving a proposed

[22] By affected parties, we mean those parties listed in s 236(2)(b), in particular, "creditors or any class of creditors of a company".

compromise but does not stipulate what majority is required for approval.[23] The power under s 236(1) to approve a compromise is not expressly subject to approval at court ordered meetings albeit that there are no reported cases in which a compromise has been sanctioned without prior approval of the creditors.[24]

The background to the classification issue

General

[36] As will be apparent, Parts 14 and 15 both contemplate that there may be more than one class of creditors but are not specific as to what constitutes a class.

[37] Trends' position is that the creditors should be classified by reference to their legal rights. Since all of its unsecured creditors had the same legal rights against Trends, they constituted a single class. In contrast, the challenging creditors maintain that the interest which the insider creditors had in the continued operation of Trends distinguished them from the other unsecured creditors. It is said that the insider creditors had an interest in avoiding liquidation which may have led to potential claims against the directors or scrutiny of the legitimacy of the debt owed to Thecircle. On this basis, the challenging creditors argue that it was not right to include in a single class both insider and other unsecured creditors. There is also an issue as to the particular position of Callaghan and its ability to set-off against Trends' counter-claim the money which it argues is owed to it.

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23 In *Bruce Moroney Electrical Ltd v K & N Thomsen Ltd* [2010] NZCCLR 15 (HC), the Court sanctioned a compromise under s 236 without any prior orders being sought by the parties under s 236(2) but where creditor approval had been obtained at meetings convened directly by the company. Whilst the section does not stipulate what level of approval is required, courts have generally directed that the practice utilised under the Companies Act 1955 be followed: see *Weatherston v Waltus Property Investments Ltd* [2001] 2 NZLR 103 (CA) at [32]. We say generally as Part 15 of the 1993 Act envisages a flexible statutory regime and thus the level of support required will depend on the facts of a particular case: see, for example, *Relf v Zekor Ltd* (1997) 8 NZCLC 261,436 (HC).

24 The Part 15 procedure is not without conceptual difficulty, as is illustrated by two judgments in respect of the same proposal in *Suspended Ceilings (Wellington) Ltd v Commissioner of Inland Revenue* [1995] 3 NZLR 143 (CA) [*Suspended Ceilings (No 1)*]; and *Suspended Ceilings (Wellington) Ltd v Commissioner of Inland Revenue* (1997) 8 NZCLC 261,318 (CA) [*Suspended Ceilings (No 2)*]. If a proponent were to proceed straight to s 236(1) approval, it would be open to the court, on its own motion, to order a meeting to consider and vote on the proposed compromise: see s 236(2)(b).

[38] Trends' argument relies heavily on authority as to the application of legislation in other jurisdictions corresponding to s 205 of the 1955 Companies Act. For this reason, it will be necessary to refer to the s 205 procedure and to the authorities in relation to creditor classification under that and like provisions elsewhere.

The s 205 procedure

[39] Prior to the Act coming into force, compromises with creditors or members of a company (referred to as schemes of arrangement) were provided for under s 205 of the 1955 Act. Under the s 205 procedure as it applied to creditors:

(a) The person proposing a scheme of arrangement would apply to the court for procedural orders. The court was empowered to call a meeting of creditors or class of creditors to vote on the proposal. Any questions as to classification were to be determined by the court "as in the circumstances it [thought] proper".[25]

(b) If at least 50 per cent by number and 75 per cent in value of creditors voting at a meeting or meetings agreed to the proposal, the proponent of the scheme would apply to the court to sanction the scheme. Upon being sanctioned the scheme would, at that point, come into effect and bind the creditors.[26]

[40] In *Re C M Banks Ltd*, Smith J summarised the general principles to be applied in respect of scheme sanction in this way:[27]

> In the light of the cases cited, the duty of the Court may be summarized as follows: The duty of the Court is to see (1) that there has been compliance with the statutory provisions as to meetings, resolutions, the application to the Court, and the like; (2) that the scheme has been fairly put before the class or classes concerned; and that if a circular or circulars have been sent out, as is usual, whether before or after the making of the application to the Court, they give all the information reasonably necessary to enable the recipients to judge and vote upon the proposals; (3) that the class was fairly represented by those who attended the meeting and that the statutory majority are acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent; and (4) that the scheme is such

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25 Companies Act 1955, s 205(1).
26 Section 205(2).
27 *Re C M Banks Ltd* [1944] NZLR 248 (SC) at 253.

> that an intelligent and honest man of business, a member of the class concerned and acting in respect of his interest, might reasonably approve.

This formulation was approved by the Court of Appeal in *Re Milne and Choyce Ltd*.[28]

[41] Although there are differences between s 205 of the 1955 Act and Part 14, it is clear that the concept of classes of creditors which is incorporated in Part 14 was borrowed from s 205.

Sovereign Life Assurance Co v Dodd

[42] The first significant case to consider classification was *Sovereign Life Assurance Co v Dodd*.[29] Sovereign owed Mr Dodd approximately £2,000 on policies which had fallen due. Prior to them falling due he had borrowed from Sovereign and, at the date the policies fell due, he owed approximately £1,200. Under an arrangement approved under legislation broadly similar to s 205, his entitlement to £2,000 from Sovereign was, arguably, replaced with an entitlement to receive from another insurance company approximately £535. When sued by Sovereign for repayment of the money he had borrowed, he successfully pleaded a set-off of the money which was payable to him under his two policies. On appeal to the Court of Appeal, one of the issues to be determined was whether he was bound by the arrangement.[30] Amongst the reasons advanced in support of this argument was that the interests of policyholders whose policies had not matured were sufficiently different from those who had accrued entitlements as to make it inappropriate to place them in a single class for voting purposes.

[43] In addressing the classification argument, Lord Esher MR observed:[31]

> [Policyholders whose claims had matured] must be divided into different classes [from policyholders whose claims had not matured] ... because the

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28 *Re Milne and Choyce Ltd* [1953] NZLR 724 (CA).

29 *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573 (CA).

30 The arrangement had already been sanctioned by the Court. The view, which prevailed, that he was not bound by it would appear to presuppose that Mr Dodd was entitled to challenge the validity of the arrangement in separate proceedings. Compare the comments made in the Court below by Charles J: see *Sovereign Life Assurance Co (in liq) v Dodd* [1892] 1 QB 405 (QB). The case is complicated by the fact that there were highly arguable interpretation issues; such as whether references in the scheme to "policies" applied to Mr Dodd's particular policies and, if so, whether the arrangement should be construed so as to defeat an accrued right of set-off.

31 At 580.

> creditors composing the different classes have different interests; and, therefore, if we find a different state of facts existing among different creditors which may differently affect their minds and their judgment, they must be divided into different classes.

Bowen LJ also stated:[32]

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

Lord Esher and Bowen LJ saw Mr Dodd's accrued cause of action against Sovereign as the factor which distinguished his situation from that of policyholders with policies that had not matured.[33] The third Judge, Kay LJ, relied on the further and more cogent factor that Mr Dodd had, by reason of his accrued claim, a right of set-off.[34]

[44] It will be noted that Lord Esher referred to the "interests" of the policyholders whereas Bowen LJ referred to their "rights". As we will see, this has prompted some debate – albeit primarily in other jurisdictions – whether classes of creditors should be defined by reference to their interests or their rights. This debate has arisen most commonly in respect of two particular situations. In the first, the issue has been whether those who are closely associated with the control of the company (insiders) should be permitted to vote with those whose legal rights (whether as creditors or members) are the same but who are not closely connected to the company. In the other, the issue has been whether those who have two different relationships with the company should be separately classed, for instance whether shareholders who are also

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32 At 583.

33 At 580 per Lord Esher MR and 583–584 per Bowen LJ.

34 At 585–586 per Kay LJ. In *Re Hawk Insurance Co Ltd* [2001] EWCA Civ 241, [2001] 2 BCLC 480 at [29] Kay LJ's approach was seen by Chadwick LJ as representing the ratio of the case. We confess to some reservations as to the weight placed on the difference between contingent and vested claims given that the difference could be reflected in the values attributed to the claims: see *Re Hawk Insurance Co Ltd* at [30] and [44]; and the comments of Winkelmann J in *Bank of Tokyo-Mitsubishi UFJ Ltd v Solid Energy New Zealand Ltd* [2013] NZHC 3458 at [161]–[163]. *Sovereign Life Assurance*, above n 29, is open to more than one interpretation: see Michael Josling "An analysis of the rights test in determining classes of creditors" (2010) 18 Insolv LJ 110; and Lord Millett NPJ in *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* (2001) 4 HKCFAR 358 at [19].

debenture holders should be classed separately from those who are only shareholders or debenture holders.

The New Zealand cases

[45] The leading New Zealand cases on s 205[35] were the two decisions to which we have already referred, *Re C M Banks Ltd* and *Re Milne and Choyce Ltd*.[36] In the latter case, the scheme in issue had adjusted the rights inter se of shareholders and debenture holders. Approval of the scheme was resisted on the basis that because many of the shareholders were also debenture holders the meeting of the debenture holders "was not a fair test of their interests".[37] This argument was dismissed on the perhaps pragmatic basis that, on the votes at that meeting, the scheme would have been approved by debenture holders even if the votes of those who were also shareholders had been ignored.[38]

[46] In *Re Stewart & Sullivan Farms Ltd* Barker J observed:[39]

> When … an application for convening meetings of creditors is before it, the Court must be given full information to enable a decision to be made; the cases indicate that the Court will err on the side of calling separate meetings and will err on giving a liberal meaning to the word "class" of creditor or shareholder.

[47] When applying s 205, New Zealand courts did not engage closely with the issue whether creditors should be classed by reference to rights or interests. The drift of the later cases, however, suggests that in cases of doubt, separate classes were likely to be appropriate.[40] We have some reservations about whether this approach was entirely consistent with the third principle stated by Smith J in *Re C M Banks Ltd* and approved in *Re Milne and Choyce Ltd*.[41] This is because the third principle contemplates a pragmatic assessment by the court at the end of the process extending

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35 *Re C M Banks Ltd* and *Re Milne and Choyce Ltd* were decided under s 159 of the Companies Act 1933, a section which was re-enacted as s 205 of the Companies Act 1955 in materially the same terms.

36 *Re C M Banks Ltd*, above n 27; and *Re Milne and Choyce Ltd*, above n 28.

37 At 753.

38 At 753–754.

39 *Re Stewart & Sullivan Farms Ltd* [1981] 1 NZLR 712 (HC) at 719.

40 See, for example, the comments of Barker J above at [46]; *Re National Dairy Assoc of New Zealand Ltd* [1987] 2 NZLR 607 (HC); and *New Zealand Municipalities Co-operative Insurance Co Ltd v Dunedin City Council* (1989) 4 NZCLC 65,044 (HC).

41 See above at [40].

to what happened at the meeting or meetings. The availability of such an assessment to cure any unfairness arising out of classification at least limited the necessity of an approach which produced more rather than less classes. More generally, we read both judgments as proceeding on the basis that the classification of creditors was not to be regarded as an end in itself, but rather as a mechanism for ensuring that creditors should be bound only by the votes of other creditors where such votes were fairly reflective of their interests.

Cases from other jurisdictions

[48] In some English cases concerning the equivalent of the s 205 procedure, a rigid approach was taken to classification in that judges would decline to sanction a scheme if the creditors had been wrongly classified.[42]

[49] In issue before Templeman J in *Re Hellenic & General Trust Ltd* was a proposed reconstruction of a company so that it would become a wholly owned subsidiary of Hambros Ltd.[43] This reconstruction was to be effected by a scheme of arrangement. Fifty-three per cent of the shares in the company were owned by Merchandise & Investment Trust Ltd (MIT), a subsidiary of Hambros. Only one meeting of shareholders was called and at this meeting the scheme was approved. The votes of MIT were vital in securing approval of the scheme, as if it had not voted, the requisite majority would not have been achieved. When the scheme came back before the Court for approval, the dissenting shareholders contended that there were two classes of shareholders being: (a) MIT; and (b) the other shareholders. Therefore, the other shareholders argued that MIT should have been excluded from their meeting.

[50] In his judgment, Templeman J referred to the passages we have cited from *Sovereign Life Assurance* and then went on:[44]

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

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42 *Re United Provident Assurance Co Ltd* [1910] 2 Ch 477 (Ch); *Re Hellenic & General Trust Ltd* [1976] 1 WLR 123 (Ch); and the principle was endorsed in the practice note issued by Eve J: see *Practice Note* [1934] WN 142.

43 *Re Hellenic & General Trust Ltd*, above n 42.

44 At 126.

And a little later:[45]

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

Accordingly, Templeman J found that MIT should have voted in a class separate from the other shareholders and refused to sanction the scheme.

[51] In *Re Hawk Insurance Co Ltd*, Chadwick LJ considered the focus of the inquiry should be:[46]

> [B]etween whom is it proposed that a compromise or arrangement is to be made? Are the rights of those who are to be affected by the scheme proposed such that the scheme can be seen as a single arrangement; or ought the scheme to be regarded, on a true analysis, as a number of linked arrangements?

He emphasised that the focus is specific to the particular arrangement proposed:[47]

> In each case the answer to that question will depend upon analysis (i) of the rights which are to be released or varied under the scheme and (ii) of the new rights (if any) which the scheme gives, by way of compromise or arrangement, to those whose rights are to be released or varied. It is in the light of that analysis that the test formulated by Bowen LJ in order to determine which creditors fall into a separate class – that is to say, that a class 'must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest' – has to be applied.

[52] Australian courts have generally taken the approach that classes should be defined by reference to the rights of their members.[48] This emerges clearly from the judgment of Street J in *Re Jax Marine Pty Ltd*.[49] In issue there was whether insider creditors should be classed with the general body of unsecured creditors. The argument against doing so was that their status as insiders meant that they had a special interest in the approval of the scheme. Street J, adopting the language of Bowen LJ in *Sovereign Life Assurance*, concluded that the particular interests of the insider creditors did not preclude them from being in the same class as the other unsecured

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45 At 126.

46 *Re Hawk Insurance Co Ltd*, above n 34, at [23].

47 At [30].

48 See *Re Chevron (Sydney) Ltd* [1963] VR 249 (SC); *Re Landmark Corp Ltd* [1968] 1 NSWR 759 (SC); and *Re Opes Prime Stockbroking Ltd* [2009] FCA 813, (2009) 179 FCR 20.

49 *Re Jax Marine Pty Ltd* [1967] 1 NSWR 145 (SC).

creditors.[50] He did, however, consider that the interests of the insider creditors were material to whether the scheme should be approved by the Court:[51]

> To say that the [insiders'] interests do not preclude their being members of the class is, of course, far from saying that their vote will, if and when a petition is subsequently presented, carry equal weight to that of an unsecured creditor who is not shown to have any special interest. When the petition, if there be a petition, comes before the Court there is ample room within the Court's statutory discretion to decide the petition in accordance with the requirements of justice and equity as those requirements appear to affect the rights of the class and its members. Quite frequently it is necessary to discount, even to the point of discarding from consideration, the vote of a creditor who, although a member of a class, may have such personal or special interest as to render his view a self-centred view rather than *a class-promoting view*.

[53] The rights approach is also exemplified by the judgment of Lord Millett NPJ in *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin*.[52] That case involved schemes of arrangement which had been approved by creditors in respect of a group of 25 companies. In respect of each company only one meeting of creditors was held. In issue was whether separate classes should have been provided for in respect of: (a) creditors owed preferential debts associated with employment; and (b) creditors who were members of the same group of companies. In his judgment, Lord Millett observed:[53]

> The principle upon which the classes of creditors or members are to be constituted is that they should depend upon the similarity or dissimilarity of their rights against the company and the way in which those rights are affected by the Scheme, and not upon the similarity or dissimilarity of their private interests arising from matters extraneous to such rights.

He analysed *Re Hellenic* as being consistent with his rights-based approach:[54]

> … it is true that Templeman J consistently referred to the parties' respective "interests" rather than their "rights". But it is important not to be distracted by mere terminology. Judges frequently use imprecise language when precision is not material to the question to be decided, and in many contexts the words "interests" and "rights" are interchangeable. The key to the decision is that [MIT] was effectively identified with [Hambros]. It would plainly have been inappropriate to include [MIT] in the same class as the other shareholders if it had been buying their shares; it should not make a difference that the purchaser was its parent company.

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50 At 148.
51 At 148 (emphasis added).
52 *UDL*, above n 34.
53 At [17].
54 At [22]–[23].

> But this was not because [MIT] and the other shareholders had conflicting interests, nor because they had different rights to start with. [MIT]'s legal rights at the outset were the same as those of the other shareholders. What put [MIT] into a different category from the other shareholders was the different treatment it was to receive under the Scheme. The other shareholders were being bought out. In commercial terms [MIT] was transferring its shares to its own parent company and obtaining for its parent company the right to acquire the remainder of the shares from the other shareholders. The rights proposed to be conferred by the Scheme on [MIT] and the other shareholders were commercially so dissimilar as to make it impossible for [MIT] and the other shareholders to consult together with a view to their common interest, for they had none.

[54] Lord Millett explained the rationale for this approach in these terms:

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

[55] There are also many Canadian judgments which address classification under statutory provisions akin to s 205. The cases have generally adopted a requirement for commonality, but not identity, of interest with a recognition of the need to avoid fragmentation of classes to the point that approval of a scheme might be impossible. An illustrative case is *Re Woodward's Ltd*.[55] In that case, Tysoe J held that:[56]

> … it is the legal rights of the creditors that must be considered and that other external matters that could influence the interests of a creditor are not to be taken in account.

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55 *Re Woodward's Ltd* (1994) 84 BCLR (2d) 206.

56 At [14].

He added, however, that:[57]

> It would be appropriate to segregate two sets of creditors with similar legal interests into separate classes if the plan treats them differently. Conversely, it may be appropriate to include two sets of creditors with different legal rights in the same class if the plan treats them in a fashion that gives them a commonality of interest despite their different legal rights.

[56] Writing after the decision in *Re Woodward's Ltd*, Douglas Knowles and others commented that although Tysoe J described his approach to classification in terms of "legal rights", the over-riding consideration was:[58]

> … the treatment of these various rights in the context of the plan and its overall effect upon them. He clearly recognized that different legal rights could be commercially affected in the same manner depending upon their treatment under the plan and should therefore be grouped in the same class.

They concluded that the courts were applying a method of classification whereby creditors would be placed in the same class if they had a "'commonality of commercial interests' when viewed in the context of the impact of the plan upon the rights of those creditors".[59]

[57] Interestingly, s 22 of the Companies' Creditors Arrangement Act, RSC 1985 c C-36 (which currently provides for the equivalent of the s 205 procedure) now provides criteria for classification:

> **22. Company may establish classes**
>
> (1) A debtor company may divide its creditors into classes for the purpose of a meeting to be held under section 4 or 5 in respect of a compromise or arrangement relating to the company and, if it does so, it is to apply to the court for approval of the division before the meeting is held.
>
> (2) For the purpose of subsection (1), creditors may be included in the same class if their interests or rights are sufficiently similar to give them a commonality of interest, taking into account
>
> (a) the nature of the debts, liabilities or obligations giving rise to their claims;
>
> (b) the nature and rank of any security in respect of their claims;

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57 At [14].

58 Douglas Knowles, Edward Sellers and Alec Zimmerman "Further Developments and Trends in the Companies' Creditors Arrangement Act: 1994" (paper presented at the IIC Fifth Annual General Meeting, 1994) at [140].

59 At [145].

(c) the remedies available to the creditors in the absence of the compromise or arrangement being sanctioned, and the extent to which the creditors would recover their claims by exercising those remedies; and

(d) any further criteria, consistent with those set out in paragraphs (a) to (c), that are prescribed.

(3) A creditor who is related to the company may vote against, but not for, a compromise or arrangement relating to the company.

This section was introduced by way of amendment with effect from 18 September 2009.[60]

The legislative history of Part 14

[58] The Law Commission reviewed the Companies Act 1955 in 1989.[61] In relation to compromises with creditors it observed:[62]

> In the course of consultation with insolvency practitioners about possible changes to the statutory law on corporate insolvency and liquidations it became clear that compromises with creditors under section 205 of the 1955 Act are rarely attempted. The present procedure is perceived as slow, complex and expensive with an unnecessary degree of involvement by the Court. As a compromise should be a constructive alternative to liquidation of a company, the present state of affairs is most unsatisfactory. Part 13 of the draft Act[63] is designed to provide a more useful procedure which features a greater provision of information by those proposing a compromise but limits the role of the Court to one of review on specified grounds.

[59] It attached a draft Bill which included provisions to the same effect as Part 14. Of these provisions, the Commission observed:[64]

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

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60 An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005, SC 2007 c 36, s 71.

61 Law Commission *Company Law: Reform and Restatement* (NZLC R9, 1989).

62 At [635].

63 Part 13 of the draft Act became Part 14 in the Act.

64 At [638].

[60] The Companies Bill 1990 as introduced to Parliament was based on the Law Commission's report and its draft Act.[65] The explanatory note to Part 13 (now Part 14) stated that it was "designed to provide a more useful procedure for effecting compromises with creditors".[66] The Part 15 procedure was not recommended by the Law Commission and was not provided for in the Bill as originally introduced. It was inserted during the parliamentary process[67] and its purpose includes the provision of a mechanism for the approval of compromises in circumstances in which resort to Part 14 may be impractical.[68]

Differences between s 205 and Part 14

[61] There are some similarities between s 205 of the 1955 Act and Part 14. In both instances, the legislature provided for compromises to be effective if supported by a qualified majority of creditors. As well, s 205 referred to classes of creditors in very much the same way as Part 14 does. There are, however, some important differences.

[62] Under s 205, the court was involved at two stages; first in calling the meetings and secondly in sanctioning the scheme as approved at the meeting or meetings.[69] The orders made at the first stage required some judicial consideration, and at least provisional endorsement, of the classes as proposed.[70] For the purposes of the second stage, s 205 did not specify the grounds upon which sanction should be granted or withheld. The principles applied by the court in determining whether to sanction a scheme were as stated by Smith J in *Re C M Banks Ltd*, which included a business judgment test along with whether:[71]

> … the class was fairly represented by those who attended the meeting and that the statutory majority are acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent … .

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65 Companies Bill 1990 (50-1) (explanatory note) at i.

66 Companies Bill 1990 (50-1) (explanatory note) at ix.

67 Justice and Law Reform Committee "Report of the Justice and Law Reform Committee on the Companies Bill" [1991–1993] XXIII AJHR I8A at [5.1], recommendation 15.

68 *Bank of Tokyo-Mitsubishi UFJ Ltd v Solid Energy New Zealand Ltd*, above n 34, at [93]; and see also *Suspended Ceilings (No 1)*, above n 24, at 148.

69 Companies Act 1955, s 205(1) and (2).

70 *Dominion Income Property Fund v Takeovers Panel* (2006) 3 NZCCLR 946 (CA) at [22]. Although the discussion in that case relates to Part 15 of the Act, the cases relied on by the Court addressed the s 205 procedure.

71 *Re C M Banks*, above n 27, at 253.

As well, as was apparent from the pragmatic approach taken in *Re Milne and Choyce Ltd* to the classification of those with different rights and interests, New Zealand Court of Appeal authority supported a purposive rather than a formalist approach to classification.[72]

[63] By way of contrast, under Part 14:

(a) There is no need to seek court orders (and thus a prima facie endorsement of the classes as proposed by the proponent).

(b) A compromise does not require the court's sanction. Rather, a compromise is effective once approved by a qualified majority of creditors.

(c) Under s 232(3)(b), a material irregularity in obtaining approval permits, but does not require, the court to intervene in respect of a compromise.

(d) The grounds for intervention available to the court under s 232(3) are expressed in general terms but with a focus (given the specificity of the language) on providing a remedy for prejudiced creditors.

Our approach to classification

A restated approach

[64] The purpose of Part 14 was to provide a mechanism for the approval of compromises which was easier and cheaper to negotiate than the s 205 process. In light of this purpose and the differences between Part 14 and s 205, we consider that a restated approach to classification is required under Part 14. As will become apparent, however, the approach we favour builds on the purposive approach taken by earlier authorities.

[65] Consistently with the views expressed in *Re C M Banks Ltd* and applied in *Re Milne and Choyce Ltd*, we regard the classification of creditors not as an end in itself

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72 See the discussion of *Re Milne and Choyce Ltd* above at [45].

but rather as instrumental; that is as facilitating a process that will produce compromises which, in accordance with the policy of the Act, appropriately bind those who voted against them. The appropriateness or otherwise of classification decisions is to be assessed in light of this purpose.

[66] The policy of Part 14 is that the approval of a compromise which reflects a fair business assessment by creditors should be given effect to. This is based on the working assumption that such a business assessment will reflect the common interest of all those who are to be bound by it. If all creditors share a common interest in maximising the return on their debts and can be expected to vote accordingly (which will usually be the case), differences between them (whether in terms of rights or interests) will be of no practical moment. Those advancing a proposed compromise, and the courts in dealing with any challenges to it, are entitled to take a broad approach to classification. For classification purposes, a complete identity of rights or interests is not required. This means that creditors can be classed together, where, despite differences in interests or rights, they can be expected to vote on the basis of a "class-promoting view".[73] Differences in rights or interests which are not material to whether creditors can be expected to vote on this basis can thus be ignored.

[67] But where, on the other hand, such common interest as the creditors share is, for some creditors, outweighed by other considerations, the working assumption may well be displaced. In that situation, the votes of the creditors can no longer be taken to represent the best interest of all members of the class. Where creditors whose pre-compromise rights and interests are materially the same are treated differently under the proposed compromise, however, separate classes will almost certainly be required. Also relevant will be the benefits and drawbacks of the proposal for particular creditors or groups of creditors. Allowance must therefore be made for the possibility that creditors might, by reason of other interests in a company (for instance as shareholders or directors), not share the same class-promoting view as other creditors.

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[73] This was the expression used by Street J in *Re Jax Marine Ltd*: see above at [52].

[68] There may be other circumstances in which the working assumption could be displaced but classification should be based on an assessment of the rights and interests of the creditors in relation to the company and not on matters extraneous to the company. Within any group of creditors, there will be some whose personal circumstances make them more or less willing to accept a compromise. Thus a creditor who is facing financial pressure may be particularly inclined to accept a proposal which offers an immediate payment. Similarly a creditor who feels personally let down by the company might, for this reason, be inclined to reject a compromise. We see no need for separate classification of such creditors.

[69] We see the approach outlined above as broadly consistent with at least the policy considerations which underlie the judgment of Lord Millett in *UDL* and also with the approach taken by Winkelmann J in *Bank of Tokyo-Mitsubishi UFJ Ltd*, which is the leading New Zealand case in which this question has been addressed in the context of Part 14.[74] The primary responsibility for classification rests with the proponent of a compromise. In determining what classification is appropriate, it is appropriate for the proponent to look to whether a compromise approved in the manner proposed will be able to withstand challenge under s 232(3).

Section 232(3)(b) and (c)

[70] Part 14 does not make explicit provision for challenges to classification decisions made by the proponent of a compromise. This means that such challenges must be determined in accordance with s 232(3) and, in particular, paragraphs (b) and (c). Despite the repetition, it is convenient to set out s 232(3) again:

> (3) If the court is satisfied, on the application of a creditor of a company who was entitled to vote on a compromise that—
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> (a) insufficient notice of the meeting or of the matter required to be notified under section 229 was given to that creditor; or
>
> (b) there was some other material irregularity in obtaining approval of the compromise; or
>
> (c) in the case of a creditor who voted against the compromise, the compromise is unfairly prejudicial to that creditor, or to the class of creditors to which that creditor belongs,—

[74] *Bank of Tokyo*, above n 34.

> the court may order that the creditor is not bound by the compromise or make such other order as it thinks fit.

A challenge to a compromise based on a misclassification complaint can be accommodated under either or both of subs (3)(b) and (c).

[71] There will be situations in which subs (3)(b) is engaged other than by misclassification; for instance if misleading information is supplied to creditors or where the meetings are not convened or conducted in accordance with the requirements of the Act.[75] But, assuming appropriate candour on the part of the proponent and properly convened and conducted meetings, there will be little or no scope for resort to this subsection where creditors have been classified in accordance with our approach.

[72] The position in respect of subs (3)(c) is broadly similar. In assessing unfair prejudice under s 232(3)(c), the focus is on the substantive fairness or otherwise of a compromise. A compromise may be substantively unfair if the outcome for creditors is less satisfactory than would result from liquidation (which in most cases will be the alternative to a compromise). This is said to involve a vertical comparison.[76] Substantive unfairness may also arise where creditors are not treated equally under a compromise. In this instance, the comparison is said to be horizontal.[77] While unfairness of both kinds could, in theory, arise independently of a misclassification complaint, we think that cases in which this might arise will be rare, as we will now explain.

[73] Whether a vertical comparison results in substantive unfairness will usually depend on an evaluation of uncertain and perhaps contested contingencies. Such an evaluation will seldom be precise and may be susceptible to more than one opinion. More significantly, the scheme of Part 14 is that such an evaluation is primarily for the

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75 For example, in *Polperro Corp Ltd v International Marine Services Ltd* HC Auckland CIV-2006-404-2390, 16 July 2007, Associate Judge Doogue accepted that the vote of an individual who was not in fact a creditor of the company was counted as part of the requisite majority in number and value of creditors who supported the majority. The inclusion of a non-qualified creditor was a material irregularity for the purposes of s 232(3)(b) as the vote was necessary to reach the value threshold.

76 See *Bank of Tokyo*, above n 34, at [185].

77 At [185].

creditors affected. In the normal course of events, it is not for the court to second-guess that evaluation.[78] We accept that there may be some cases, albeit not often, where the balance of advantage is so clearly weighted one way (that is either in favour of the compromise or against it) as to be an important consideration in terms of s 232(3)(c). It does, however, seem plausible to assume that demonstrable substantive unfairness for particular creditors will not arise in the absence of misclassification. This is because, as we have noted, the scheme of the legislation is that the required business assessment can be left to a qualified majority of the creditors who can be trusted to understand their own interests.

[74] A compromise which proposes differential treatment of creditors is not necessarily unfair. But differential treatment between creditors in the same class will almost inevitably raise concerns as to classification; this because differentially treated creditors are unlikely to share sufficient common interest to warrant classification together.

Whether the compromise ought to be set aside

The particular position of Callaghan

[75] Callaghan's legal position as a creditor was, in a sense, different from that of the other unsecured creditors. This is because it faces a claim for damages from Trends and it claims to be entitled to off-set whatever Trends owes it against any liability it may be under to Trends. However, under cl 4(c) of the compromise it will lose this practical right of set-off. In that sense, Callaghan might be thought to be in a situation akin to that of Mr Dodd in *Sovereign Life Assurance*.[79]

[76] We have reservations whether this consideration warranted excluding Callaghan from the general class of creditors. Callaghan's claim to be entitled to the return of the money it paid to Trends is dependent upon Callaghan establishing that it was entitled to terminate the funding agreement. If it cannot establish that, it is not a creditor and, accordingly, could not claim to be prejudiced by the compromise. If, however, Callaghan can establish a valid termination, most of the claims by Trends

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78 A similar point was made in *Bank of Tokyo*, above n 34, at [182].
79 *Sovereign Life Assurance*, above n 29.

against it would fall way. Whether this is true of the defamation claim may be open to question. For present purposes, it is sufficient to say that we were not taken to any material to suggest that the defamation claim is of sufficient practical moment to mean that the loss of a practical right of set-off against any damages that might be awarded is of sufficient materiality to justify the conclusion that separate classification of Callaghan was required.

Was there material irregularity/unfair prejudice to the challenging creditors?

[77] Mediaworks can rely only on s 232(3)(b) as it did not vote against the compromise. The other challenging creditors are able to rely on both paras (b) and (c). Given there is substantial overlap between the analysis under paras (b) and (c) we will confine the details of our discussion to s 232(3)(c).

[78] There is scope for debate as to the substantive fairness of the compromise.

[79] For the purposes of a vertical comparison, we accept that on a liquidation, the unsecured creditors would be likely to receive nothing from the realisation of the assets of Trends. The best prospect of the unsecured creditors doing better under a liquidation would involve proceedings by the liquidator against those associated with Trends, perhaps in terms of a claim for reckless trading against the directors.[80] At trial, the challenging creditors adduced evidence to suggest that such a claim (or other similar claims) might be brought. Although the success of such claims would be subject to contingencies, the evidence shows that there is potential for litigation. We note that no justification was offered for the security in favour of Thecircle. The apparent lack of bona fides of the directors in relation to that transaction might be thought to cast a shadow over their more general conduct. This is of some moment as the money owed to Thecircle raises an issue as to why Trends continued to trade when it has been unable to pay its rent for such a prolonged period.

[80] A horizontal comparison of the benefits derived under the compromise also suggests unfairness. As we have noted, under the compromise, the larger the debt, the less the percentage return. The most obvious reason for structuring the compromise

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[80] Companies Act 1993, s 135.

in this way was to facilitate the obtaining of the votes of a majority in number of the creditors. Although Trends denied an attempt to manipulate the voting, no other detailed justification for the differential treatment was offered.[81]

[81] As will become apparent, we see both elements of potential unfairness as being material to, and best addressed in terms of, classification.

[82] We regard the approach of Chadwick LJ in *Re Hawk Insurance* as providing a useful starting point for the classification analysis.[82] It will be recalled that he proposed that such analysis start with the question, "between whom is it proposed that a compromise … be made?".[83] We see this question as material to both the inclusion of the insider and arm's-length creditors in a single class and also the preference which the compromise provides for smaller creditors.

[83] We regard the inclusion of the insider and arm's-length creditors in a single class as objectionable. The primary bargain which the compromise represented was between those who wish the company to keep on trading – that is Trends and the insider creditors – and those who are owed money which they are seeking to recover – that is the arm's-length creditors. The deal which the compromise represents is:

(a) on the side of the arm's-length creditors, release of debt in consideration for allowing the company to continue to trade; and

(b) for the insider creditors, procuring the payment of some money to the arm's-length creditors in consideration for the company being permitted to continue to trade.

[84] Looked at in this way, the reality is that the insider creditors were on both sides of the transaction, which was essentially the problem in *Re Hellenic*.[84] It is neither

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81 In his affidavit, Mr Johnson said he thought the initial payment of $1,000 to each creditor was a good idea as it meant the vast majority of creditors would get a high percentage of their money back.

82 *Re Hawk Insurance Co Ltd*, above n 34.

83 See above at [51].

84 *Re Hellenic*, above n 42.

fair, nor in accordance with the policy of Part 14, for dissenting arm's-length creditors to be bound by a decision made by those on the other side of the bargain. There was thus no sufficient common interest to justify the arm's-length creditors being classed with the insider creditors. Indeed, as between at least the challenging creditors and the insider creditors, their respective interests were diametrically opposed.

[85] This conclusion turns on substance and not form. The preceding analysis could have been applied even if the compromise had provided for some payment to the insider creditors. Provision for such payments would not have precluded the conclusion that the interests of the insider creditors were primarily associated with continuation of the company rather than getting the best return on their debts.

[86] The preference which the compromise provides for small creditors is also objectionable; this for two reasons:

(a) The creditors who were owed less than $1,000 were getting – at least in substance – what they were owed. They were not, in any real sense, compromising their rights. There was thus no practical necessity to include them in the compromise. If Trends had simply wished to ensure that they were paid, it could have done so independently of the compromise. Of course, had they been paid, they would no longer have been creditors and thus would not have been able to vote at the creditors' meeting. As well, the treatment they were to receive under the compromise was so different from that of larger creditors that they ought not to have been classified with them.

(b) The impact of this preference was not confined to those owed less than $1,000. This is because proposed payment in full of the first $1,000 of debts incentivised those who were owed small debts to support the compromise. By way of example, one of the creditors was owed $1,039.60. For that creditor the compromise offered a return of more than 90 cents on the dollar.

[87] We were not offered an analysis of the voting figures which established that the illegitimate inclusion of the creditors owed $1,000 or less in the compromise and the preference for small creditors were critical to the compromise attracting the support of a majority in number of the creditors. Such analysis would have involved some element of evaluation as to who should be regarded as a small creditor[85] and would thus have been contestable. The reality, however, is that there would be an appearance of substantial unfairness if creditors who are offered a return of 11–18 per cent on their debts were bound by the votes of creditors who receive substantially better returns. So to come back to the approach of Chadwick LJ, such creditors are being offered different deals and thus should not be classed together.

[88] For the reasons given we are satisfied that the classification of creditors miscarried because:

(a) the inclusion of insider creditors along with arm's-length creditors was inappropriate as they were on opposites sides of the underlying bargain; and

(b) the payment in full of the first $1,000 of debts meant that the creditors owed $1,000 or less should not have been included in the compromise and that a single classification of all arm's-length creditors was inappropriate given the vastly different treatment accorded to their debts.

We are accordingly satisfied that there was unfair prejudice for the purposes of s 232(3)(c). We are also satisfied that, in the same respects, there was a material irregularity for the purposes of s 232(3)(b).

Other complaints

[89] As we have noted, the Court of Appeal found that there were other problems with the process followed, particularly in terms of the information supplied. Given

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[85] Obviously creditors who were owed less than $1,000 would be "small" for these purposes as would a creditor who was owed $1,001. Deciding on a cut-off point above $1,001 would, however, have been difficult.

the conclusions already reached, it is not necessary for us to express a view on this aspect of the case.

[90] Because of the misclassification issues just discussed, the question whether the limited nature of the information supplied would have independently warranted relief under s 232(3) is hypothetical. We therefore see no point in engaging further with this aspect of the case.

What, if any, orders should be made under s 232?

[91] It will be recalled that s 232(3) provides that where grounds for intervention have been established "the court may order that the creditor is not bound by the compromise or make such other order as it thinks fit".

[92] Trends argued that relief more limited than the setting aside of the compromise is appropriate, such as an order that the compromise does not bind the challenging creditors. In support of this, we were told that a number of payments have been made and accepted under the compromise.

[93] On this aspect of the case, the Court of Appeal said:[86]

> Heath J decided to make an order that the compromise of 22 May 2015 be set aside. There is not an express power to set aside in s 232(3) of the Act. However, the power is to make an order that a creditor is not bound by the compromise "or make such other order as it thinks fit". There are no words of limitation, and in a case where there has been a serious irregularity and there is evidence of severe unfair prejudice, an order for setting aside can be appropriate. This is such a case.
>
> There was no contest before us about Heath J's jurisdiction to make an order setting aside the compromise. We consider that Heath J chose the right remedy when he set it aside.

[94] As will be apparent, we consider that the process which resulted in the approval of the compromise was fundamentally misconceived. In those circumstances, we see no reason to differ from the conclusion reached by the Court of Appeal. Accordingly, the compromise should be set aside.

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86 *Trends* (CA), above n 11, at [93]–[94].

Disposition

[95] The appeal is dismissed and the appellant is to pay the respondents costs of $25,000 and usual disbursements.

ELIAS CJ AND ELLEN FRANCE J
(Given by Elias CJ)

The appeal and summary of conclusions

[96] The appeal arises out of a proposal for creditor compromise under s 228(1) of the Companies Act 1993, contained in Part 14. The proposal was put forward by the board of directors of Trends Publishing International Ltd, comprising David Alan Johnson and Paul Desmond Taylor. The compromise put forward by the board of Trends was adopted on 22 May 2015 by a majority of creditors entitled to vote on the compromise representing more than 75 per cent of the value of the compromised debt.

[97] A compromise of debts between a company and its creditors may be put forward under Part 14 of the Act by its board, by a receiver or by a liquidator.[87] With the leave of the court, it may also be proposed by any creditor or shareholder of the company.[88] If a compromise is passed at a meeting of creditors or a class of creditors conducted in accordance with Schedule 5 of the Act, it binds all those creditors or classes of creditors to whom notice of the proposal has been given, even if they vote against the compromise.[89] A compromise is passed if it is approved by a majority of creditors with 75 per cent of the value of the debts the subject of the compromise.[90] The effect is that a creditor who voted against the compromise loses the ability to pursue repayment and to put the company into liquidation if the debt is not paid.[91]

[98] A compromise may act as a confiscation of an interest in property. It is not surprising therefore that under the legislation failure to observe the notice and

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87 Companies Act 1993, s 228(1)(a)–(c).
88 Section 228(1)(d).
89 Section 230(2).
90 Clause 5(2) of Schedule 5.
91 In the present case the express terms of the compromise prevent application for liquidation, as they prevent further action on the debt or for its enforcement. It may be noted that if the company is subsequently put into liquidation, the court may make orders relating to the extent to which the compromise will continue in effect and be binding on the liquidator: s 233(2).

information requirements of the Act or any other "material irregularity in obtaining approval of the compromise" gives rise to a right to apply to the court for orders for relief from the compromise whether or not the creditor voted against it.[92] In addition, a creditor who voted against the compromise can apply to the court for relief on the ground that "the compromise is unfairly prejudicial to that creditor, or to the class of creditors to which that creditor belongs".[93] On application under s 232(3) of the Act by an affected creditor, the court "may order that the creditor is not bound by the compromise or make such other order as it thinks fit".

[99] The four respondents were creditors entitled to vote who opposed the compromise. Advicewise People Ltd, Callaghan Innovation, and Webstar, a Division of Blue Star Group (New Zealand) Ltd (respectively the first, second and fourth respondents) voted against the proposal. Mediaworks Radio Ltd also voted against the proposal but its vote was received late and was not counted.

[100] The respondents applied to the High Court for orders under s 232(3) of the Act that they should not be bound by the compromise. They claimed that it was obtained by material irregularity and was unfairly prejudicial to them. The principal ground for these claims was that the necessary majority for the compromise was manipulated by including creditors associated with the company in the class of unsecured creditors to whom the compromise was put for approval to ensure the 75 per cent value was reached and by structuring the compromise to favour small creditors to achieve the approval of a majority of the creditors.

[101] In the High Court, Heath J made an order that the compromise be set aside with immediate effect.[94] He considered that the insider creditors[95] should not have been included in the same class as the arm's-length creditors and that failure to set them up in separate classes for the purposes of the compromise constituted unfair prejudice.

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92 Section 232(3)(a) and (b).

93 Section 232(3)(c).

94 *Advicewise People Ltd v Trends Publishing International Ltd* [2016] NZHC 2119 (referred to throughout as *Trends* (HC)).

95 By which he meant Thecircle.co.nz Ltd (a company associated with Mr Johnson which leased premises to Trends), Louise Messer (Trends' General Manager) and Paul Taylor (one of Trends' directors): at [6].

[102] An appeal by Trends was dismissed by the Court of Appeal for reasons generally in agreement with those given in the High Court but which also relied on additional grounds for relief.[96] The Court of Appeal agreed with Heath J that the insider and arm's-length creditors should not have been included in the same class,[97] but took the view in addition that Callaghan should have been in a distinct class because of the potential set-off it had in relation to the damages claimed against it by Trends.[98] Because of these deficiencies in structuring the classes of creditors, the Court of Appeal found that the compromise was unfairly prejudicial to the challenging creditors and confirmed the High Court order setting the compromise aside.[99] As well, the Court of Appeal considered that the information provided in support of the proposed compromise was deficient. It considered the informational deficiency to be "material irregularity" which was "relevant to the court's ultimate discretion once all the factors set out in s 232(3) are considered", even though on its own it "may not have been sufficient to warrant an order setting aside the compromise".[100]

[103] On further appeal by Trends to this Court, we would vary the order made in the High Court and upheld in the Court of Appeal, but would otherwise dismiss the appeal. Our reasons differ from those given by William Young J in reaching the conclusion that the appeal should be dismissed. We do not agree that a class of creditors constituted for the purposes of Part 14 of the Act must be limited to those who have common "economic interests" or "commercial goals" (as the Court of Appeal considered was required by Part 14).[101] Nor do we agree that a class is comprised of those with sufficient "common interest" to enable a "business assessment" which reflects "the common interest of all" in a "class-promoting view" (as William Young J at [66] considers is the "working assumption" behind Part 14). It does not matter for the purposes of constituting a class to vote on a compromise under Part 14 that some creditors may be seen as insiders (who may have particular interests in the continuation of the company) and some are at arm's length.

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96 *Trends Publishing International Ltd v Advicewise People Ltd* [2017] NZCA 365, [2018] NZCCLR 7 (Cooper, Asher and Clifford JJ) (referred to throughout as *Trends* (CA)).
97 At [56]–[67].
98 At [80]–[88].
99 At [89]–[94].
100 At [77].
101 At [55].

[104] Part 14 does not entail close court supervision of a proposal, including as to classes, such as is provided for under Part 15 and was formerly the sole method of achieving a compromise with creditors under s 205 of the Companies Act 1955. Instead, Part 14 was enacted as a simpler and "more useful procedure"[102] for achieving creditor compromise without court order. It would substantially undermine the usefulness of the Part 14 procedure if those proposing a compromise must set up different classes according to creditors' different economic or other goals (whether their "common interest" enables a "class-promoting view" or whether they are seen as "insiders"). These are classifications that will often be uncertain and contestable and are likely to give rise to practical difficulties at the front-end when constituting classes under Part 14. Part 14 does not require classes to be constructed on this basis. Nor is it consistent with the case-law on court-sanctioned compromises in both New Zealand and in other jurisdictions where creditor and shareholder compromises are available under statutory provisions equivalent to the former s 205 of the Companies Act 1955.

[105] Classes of creditors for the purposes of compromise must be differentiated according to whether their legal rights as creditors of the company and the new rights for which they are to be exchanged under a proposed compromise are materially similar. If they are identified on the basis of such rights, there is no irregularity in the constitution of the class, justifying relief under s 232(3)(b) of the Act. Nor could putting a compromise to a class of creditors whose legal rights are materially similar constitute of itself unfair prejudice to a creditor who is included in and votes against the compromise, justifying relief under s 232(3)(c). There is no justification in either case for relief under s 232(3) because those creditors included in a class for the purposes of compromise may have different economic or other interests if their legal rights are materially similar.

[106] This view is supported by authority dealing with constitution of classes for the purposes of arrangements sanctioned by the court (as is available under Part 15 and as was the case under the former procedure provided by s 205 schemes of arrangement). The cases are discussed at [127]–[132]. As explained at [133], this approach would

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102 Law Commission *Company Law: Reform and Restatement* (NZLC R9, 1989) at [635].

keep New Zealand law consistent with other jurisdictions in relation to court-sanctioned compromises.

[107] Despite this approach, we conclude that the first, second and fourth respondents who voted against the compromise were unfairly prejudiced in it and would grant them relief under s 232(3)(c). We would order that they are not bound by the compromise.

[108] We also consider that the Court of Appeal was correct to find that the information supplied to the creditors was deficient. The policy behind Part 14 was explained by the Law Commission as being based on "a greater provision of information by those proposing a compromise".[103] It is because of the information to be provided that the Law Commission considered the role of the court could be limited to "one of review on specified grounds".[104] The compromise may be left to the creditors affected to resolve as they see fit only if the information provided is sufficient to enable the compromise to be properly considered. Adequate information is therefore the condition on which creditors are empowered to come to their own solution without court sanction. The essentiality of compliance with the statutory requirements explains why relief under s 232(3)(a) and (b) is not limited to those creditors who voted against a proposal. On the basis that there was material irregularity in the compromise through inadequacy in the information, we would grant all four respondents relief by orders that they are not bound by the compromise.

[109] Although not pressed on the appeal and it is unnecessary to resolve the matter, we are of the view that Heath J was right to raise questions about whether the proponents of the compromise acted in good faith.[105] The proposal was made by the two directors of the company who, in exercising powers as directors, were obliged to act in good faith and in what they believed to be the best interests of the company.[106] Their powers to propose a compromise were powers that had to be exercised for "proper purpose" under s 133. Although Mr Johnson and Mr Taylor disclosed that they were interested in the compromise as creditors themselves (Mr Johnson,

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103 At [635].
104 At [635].
105 See *Trends* (HC) at [135(b)].
106 Companies Act, s 131.

indirectly through his interest in Thecircle.co.nz Ltd), they could not have proposed a compromise as creditors without the leave of the court under s 228(1)(d). As directors, they could have promoted the compromise between the company and its creditors only if they acted in good faith and in what they believed to be the best interests of the company.

[110] As William Young J points out at [79] the evidence before the Court shows that there is potential for a claim against the directors in a liquidation. That raises questions of conflict of interest in the promotion of a compromise to avert liquidation. The company seems to have been unable to pay its rent for a considerable period before the immediate financial difficulties arose. The circumstances and timing around the granting of security to Thecircle are not explained. There was no disclosure in the information provided to the creditors of potential liability of the directors and insufficient information was provided about the financial position of the company to enable creditors to assess whether the compromise was more advantageous to their interests than any recovery available through liquidation.

[111] The effect of the orders we would make would not affect the compromise adopted by the other creditors and therefore differs from the result in the High Court and Court of Appeal. Although the Court is not limited in the orders it can make under s 232(3), we do not think it is necessary to provide wider relief than by declaring the respondents are not bound by the compromise. If, as would seem likely, the result of the orders that they are not bound is that the company is put into liquidation, any consequences for other creditors may be addressed directly under s 233 of the Act (which permits the court to make such orders as it thinks fit).

Background

[112] The compromise was proposed to creditors on 12 May 2015, apparently in order to fend off liquidation of Trends. It followed demand made in April 2015 by Callaghan that Trends repay it innovation grants totalling $382,911.97 advanced from 2014 under a funding agreement. The funding agreement had been intended to last for three years but was first suspended by Callaghan in December 2014 and then terminated in April 2015. The termination is the subject of counterclaims for damages

brought against Callaghan by Trends for breach of contract but for the purposes of the compromise proposal Trends did not dispute the debt and treated Callaghan as being owed the grants advanced.[107]

[113] Although demand was not made formally by Callaghan for repayment of the grants until April 2015, Trends had been on notice since early December 2014 that Callaghan considered the grants had been induced by misrepresentation and the matter had been the subject of an investigation by Deloitte (giving rise to a draft report, the executive summary of which was provided to Trends in December 2014) and a complaint the same month by Callaghan to the Serious Fraud Office. In December 2014 Callaghan had also made a press statement that it was suspending its grants to Trends. The press statement is the subject of a claim in defamation made by Trends against Callaghan, also brought by way of counterclaim in the present proceedings.

[114] In February 2015, Trends gave security over all its undertaking to Thecircle, the owner of the premises it has occupied for some years. The security was in respect of a debt of $3.5 million, approximately $3 million of which was for unpaid rent. Mr Johnson, now the sole director of Trends (following the resignation of Mr Taylor when the compromise was adopted), is also the sole director of Thecircle and appears to be its ultimate owner.[108] Thecircle waived its security over $3,080,361.80 of the money owed to it in order to be included to that amount with the unsecured creditors for the purposes of the compromise.

[115] In addition to the indebtedness to Thecircle and to Callaghan, at the time of the notification of the compromise Trends owed Advicewise, Mediaworks and Webstar sums ranging from $13,214.65 to $19,285.50. It also said in the notice of compromise that it owed its general manager, Louise Messer, $120,030 and that it owed Mr Taylor $30,000. The material provided to creditors disclosed a further 55 unsecured creditors, 23 of whom were owed amounts of $1,000 or less.[109]

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107 As Heath J noted, this meant that there was no need for the chair of the meeting to determine the amount in respect of which Callaghan could vote: *Trends* (HC) at [24(a)].

108 Such interest was disclosed by Mr Johnson in the notice of compromise: see *Trends* (HC) at [24(e)].

109 Of these 55 creditors, 23 were owed $1,000 or less, 21 were owed between $1,001 and $10,000, nine were owed between $10,001 and $60,000, and two were owed $76,495.82 and $263,864.10 respectively.

[116] The compromise proposed entailed Trends providing a total of $169,700 from a fund of $50,000 to be provided by an unnamed third party Mr Johnson said was willing to put up the money together with additional monthly payments generated by Trends through expected earnings of $13,300 spread over nine months. Thecircle and Ms Messer and Mr Taylor were not to receive any distribution in the compromise. This was explained by Mr Johnson in an affidavit as a position taken to show their good faith. Under the proposal, all other creditors were to receive full payment up to the first $1,000 of their debts and would share pro rata in what was left.

[117] The compromise was approved at the meeting of unsecured creditors on 22 May in a vote opposed by Callaghan, Advicewise, Webstar and six other creditors. Mediaworks voted against the proposal but its vote was disallowed because received late. Thirty-nine creditors voted in favour of the compromise, including Thecircle (to the extent of its waiver of security in respect of the rental it was owed) and Ms Messer and Mr Taylor. Seventeen of the creditors who voted in favour of the compromise were owed $1,000 or less, and so could expect to be paid in full under the terms of the proposal (they were 35.4 per cent of those entitled to vote but had only 0.17 per cent of the value of the debt between them).

[118] Not surprisingly, with the support of Thecircle and the small creditors, the compromise was carried by a majority of the unsecured creditors voting and representing 75 per cent by value. It accordingly met the statutory requirements contained in Schedule 5 of the Act. If Thecircle and Ms Messer and Mr Taylor had not voted, the compromise would not have passed because the supporting creditors would then have represented less than 30 per cent of the creditors by value.

[119] As noted at [112]–[113], Callaghan's termination of the grants is the subject of the counterclaim brought by Trends in the current proceedings. The matters raised by the counterclaim remain to be determined. An effect of the compromise, if upheld, is that Callaghan is precluded from raising Trends' indebtedness to it in set-off or by way of counterclaim to any damages obtained by Trends. Under the terms of the funding agreement, however, the money advanced to Trends was not repayable as a debt unless the agreement was terminated. If Trends succeeds in the counterclaim on the basis that the advances were wrongly terminated, Callaghan would not be owed the moneys

advanced. In that case, it would not have been a creditor of Trends. Despite the dispute about Trends' indebtedness to Callaghan, the directors admitted Callaghan as a creditor for the purposes of the compromise, although its pleading in the present proceeding says that Callaghan had been wrongly included.

The scheme of Part 14 of the Companies Act 1993

[120] The statement of approach in *Re C M Banks Ltd*,[110] set out in the reasons of William Young, Glazebrook and O'Regan JJ at [40], and approved in *Re Milne and Choyce Ltd*,[111] concerned matters to be considered by the court in sanctioning an arrangement under the former s 159 of the Companies Act 1933.[112] Part 14 in the current New Zealand legislation permits compromise against the changed background of removal of the need for court sanction in all cases and its replacement by powers in the court to grant relief in the case of material irregularity or unfair prejudice. We agree with Heath J that the function of the court under Part 14 is to "protect creditors against the effect of a compromise that is either materially irregular or unfairly prejudicial to a creditor, or a class to which it belongs".[113]

[121] So, under the 1993 Act the statutory requirements as to notice and proper information have to be complied with. If they are not, a creditor who was entitled to vote can apply for orders by reason of s 232(3)(a) and (b). This, it may be noted, corresponds with the first two matters identified as duties of the court in *Banks*,[114] albeit that under the new legislation the creditor applies for relief from the court after the compromise is adopted.

[122] If there is error in constituting the class of those with the same rights who are entitled to vote, there is "material irregularity in obtaining approval of the compromise". This result is not "rigid".[115] Including those with materially different

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110 *Re C M Banks Ltd* [1944] NZLR 248 (SC) at 253 per Smith J.

111 *Re Milne and Choyce Ltd* [1953] NZLR 724 (CA) at 744 per Cooke J for the Court.

112 Section 159 was re-enacted as s 205 of the Companies Act 1955 in materially the same terms.

113 *Trends* (HC) at [54].

114 Being to see (1) that there has been compliance with the statutory provisions as to meetings, resolutions, the application to the Court, etc, and (2) that the scheme has been fairly put before the class or classes concerned and that the circular sent out gives all the information reasonably necessary to judge and vote upon the proposal: *Re C M Banks Ltd* at 253.

115 Compare William Young, Glazebrook and O'Regan JJ above at [48].

legal rights in the same class is a significant irregularity under the scheme for compromises in Part 14.

[123] The third and fourth considerations referred to in *Banks* by Smith J (that the class was fairly represented and the majority, acting bona fide, has adopted a scheme that is reasonable) were explained in *Milne and Choyce* as implicitly importing considerations of fairness and reasonableness.[116] They correspond now to the ability to seek relief where a compromise constitutes "unfair prejudice" to a creditor or a class under s 232(3)(c). It is consistent with the purpose of the reform (as described by the Law Commission in suggesting removal of court sanction of compromises[117]) that only a creditor who voted against the compromise can raise unfair prejudice whereas irregularities in obtaining the compromise can be raised by any creditor entitled to vote. It is also consistent with the purpose of the reform that the creditor must satisfy the court of the matters justifying relief when applying under s 232(3).

Classes are identified by legal rights

[124] Where there is more than one class of creditors, s 230(3) presumes that the approval by each class is conditional on the approval of the compromise by every other class voting on the resolution, "unless the contrary is expressly stated in the resolution". Heath J in the High Court took the view that the need for each class to vote "recognises the need for those who are influenced by materially different considerations to consider and form a reasoned judgement on whether to support the proposal".[118] If by that Heath J intended to suggest that classes must be comprised of creditors who are not "influenced by materially different considerations", we are not able to agree. Nor can we agree with his view that separate classes are necessary where creditors have dissimilar "economic interests",[119] if those different "economic interests" do not arise out of their legal rights as creditors. We disagree too with the view expressed at [47] of the reasons of William Young, Glazebrook and O'Regan JJ that creditor compromise (and indeed the former court sanction of schemes of arrangement under s 205) is a mechanism to ensure that creditors will be bound by the

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116 *Milne and Choyce* at 745.
117 *Company Law: Reform and Restatement* at [635]–[638].
118 *Trends* (HC) at [57].
119 At [85] and [91].

votes of other creditors only where such votes "were fairly reflective of their interests", if "interests" is used in a sense that is wider than legal interests.

[125] It is not the considerations that may influence particular creditors that classify them, but rather the rights they have as creditors. Creditors who have the same legal rights in substance[120] are appropriately classed together for the purpose of voting on proposals. There is no material irregularity in such treatment whether or not they are "insiders" or seek different "economic" ends in the compromise. It is immaterial to constitution of a class whether one creditor who supplies trade goods to a company on an on-going basis has an interest in a compromise that may allow the company to continue to trade while another creditor has no such continuing interest. Similarly, it is immaterial if creditors have interests as employees or directors in the continuation of the company. If their legal rights are essentially similar, they are properly included in the same class for the purposes of voting on a proposal.

[126] Creditors are entitled to act in their own self-interests in voting on a compromise. As long as there is no unfair prejudice to other creditors which may prompt the court to intervene on the application of a creditor who votes against the proposal, the compromise is not irregular because they have been included in a class in which all participants have substantially the same legal rights but may have different wider interests in the outcome. If those who disagree with a compromise where they can point to interests of their own for opposing it are constituted a distinct class for the purposes of Part 14, they would obtain a power of veto which is contrary to the scheme of the legislation.[121]

[127] In Australia and in the United Kingdom, classes are differentiated according to legal rights for the purposes of arrangements and compromises approved by the court under provisions equivalent to the former s 205 in New Zealand, even if the influence

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120 As Chadwick LJ in *Re Hawk Insurance Co Ltd* [2001] EWCA Civ 241, [2001] 2 BCLC 480 at [30]–[33] and Winkelmann J in *Bank of Tokyo-Mitsubishi UFJ Ltd v Solid Energy New Zealand Ltd* [2013] NZHC 3458 at [161]–[163] say, not every difference in legal rights warrants the creation of a separate class. Those whose rights are "sufficiently similar to the rights of others that they can properly consult together" should be required to do so (*Re Hawk Insurance Co Ltd* at [33]).

121 In *New Zealand Municipalities Co-operative Insurance Co Ltd v Dunedin City Council* (1989) 4 NZCLC 65,044 (HC) at 65,052, McGechan J made the point in relation to court sanction under the former s 205 that "[m]ere differences of opinion do not constitute differences in class".

of those interested as insiders may be relevant to the ultimate approval of the court.[122] It is legal rights which determine the classes in which creditors vote. Creditors with the same legal rights may be included in the same class even if they have divergent wider interests. The reason was explained in the Hong Kong Final Court of Appeal by Lord Millett NPJ in *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin*.[123] He referred to the "impracticality in many cases of constituting classes based on similarity of interest as distinct from similarity of rights".[124] He pointed to the risk that, in fragmenting creditors, the procedure would be deprived of much of its value because small groups could veto proposals. And he considered that permitting such fracturing of interests was inconsistent with the "rationale which underlies the calling of separate meetings":[125]

> A company can be regarded as entering into separate but linked arrangements with groups whose members have different rights or who are to receive different treatment. It cannot sensibly be regarded as entering into a separate arrangement with every person or group of persons with his or their own private motives or extraneous interests to consider.

[128] It is suggested that the approach taken in *UDL Argos* is inconsistent with the views expressed in *Sovereign Life Assurance Co v Dodd*[126] by Lord Esher MR in treating separate classes as necessary where there are different "interests". The language of "interests" is said to be used in contrast with the language of "rights" used by Bowen LJ in the same case. It seems to us however that Lord Millett was right to point out that the two terms are often used interchangeably or may both be used of legal entitlements.[127] Such linkage may be seen for example in s 27 of the New Zealand Bill of Rights Act 1990 which protects "rights" and "interests" as "recognised by law". There is nothing in *Sovereign Life* to suggest that Lord Esher was referring to "interests" in any broader sense than interests recognised by law. And the impossibility of identifying "private motives [and] extraneous interests" is reason

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122 *Re Chevron (Sydney) Ltd* [1963] VR 249 (SC) at 255 per Adam J; *Re Jax Marine Pty Ltd* [1967] 1 NSWR 145 (SC); *Re Landmark Corp Ltd* [1968] 1 NSWR 759 (SC); *Re BTR plc* [1999] 2 BCLC 675 (Ch) at 682–683 per Jonathan Parker J; *Re Hawk Insurance Co Ltd* at [23] per Chadwick LJ; and *Re T & N Ltd (No 3)* [2006] EWHC 1447 (Ch), [2007] 1 All ER 851 at [85] per David Richards J.

123 *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* (2001) 4 HKCFAR 358.

124 At [26].

125 At [26].

126 *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573 (CA).

127 *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* at [22].

in itself to doubt that any distinction between "interests" and "rights" was being suggested.

[129] We are also unable to agree with the view expressed by William Young J at [43] that the reasoning between the members of the Court in *Sovereign Life* differs. Kay LJ in that case did not rely on a "further and more cogent factor" than other members of the Court (that Dodd in that case had a right of set-off). All members of the Court of Appeal in *Sovereign Life* agreed that the set-off was available to Dodd because he was a creditor of the company rather than a policyholder at the time of the compromise, as the other members of the class were. He had different legal rights both when the compromise was proposed and in the terms of the arrangement. The arrangement applied to those whose policies had not accrued and exchanged them for new policies at a lower value. The arrangement did not apply to Dodd whose claim for money already due was not released under it.

[130] Nor do the reasons of Templeman J in *Re Hellenic & General Trust Ltd*[128] prompt a different view. In that case Templeman J refused to approve a scheme of arrangement by which the holding company of the major shareholder sought to acquire all the shares in a company. The arrangement proposed in *Re Hellenic* was explained by Lord Millett in distinguishing that case in *UDL Argos* as entailing different treatment and different legal consequences for the majority shareholder and the minority shareholders.[129] We have some doubt as to whether this analysis is correct. But *Re Hellenic* is not compelling as to whether creditor compromises must be put to classes identified by legal rights or wider interests. It was concerned with a scheme of arrangement among shareholders who were required to act in the best interests of the company as a whole.[130] We do not consider that it is properly to be applied to creditor compromises or that, if it is to be taken to suggest a wider view of the similarity of interest required for a class of creditors than legal rights, it should be preferred to the contrary authority provided in cases such as *Re Hawk Insurance Co Ltd*[131] and *Re Jax Marine Pty Ltd*.[132]

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128 *Re Hellenic & General Trust Ltd* [1976] 1 WLR 123 (Ch).
129 *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* at [23].
130 See *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 (CA) at 671 per Lord Lindley MR.
131 *Re Hawk Insurance Co Ltd* [2001] EWCA Civ 241, [2001] 2 BCLC 480 at [23] per Chadwick LJ.
132 *Re Jax Marine Pty Ltd* [1967] 1 NSWR 145 (SC) per Street J.

[131] We agree with the approach taken by Lord Millett in *UDL Argos* that classes follow "the similarity or dissimilarity of their rights against the company and the way in which those rights are affected by the Scheme, and not upon the similarity or dissimilarity of their private interests arising from matters extraneous to such rights".[133] The Canadian case-law and legislation discussed by William Young J at [55]–[57] does not suggest a different approach is taken in that jurisdiction. Nor do the New Zealand authorities of *Banks* and *Milne and Choyce*, properly read, suggest local divergence.

[132] Neither *Banks* nor *Milne and Choyce*, both of which were decided under s 159 of the Companies Act 1933, raised questions about classification according to wider interests or legal rights. *Banks* was a case where the scheme had not been fairly explained and it was not clear that the ordinary shareholders (who had not been consulted as a class) would not be prejudiced by the compromise put only to the preferential shareholders. Not surprisingly, the Court declined to approve the scheme. *Milne and Choyce* was principally concerned with the adequacy of the information provided, again in the context of court sanction for a scheme.

[133] The New Zealand cases before the 1993 legislation do not suggest that classes must be assessed according to wider commonality of interest than legal rights. And since that is the approach taken in the UK, Australia, and Hong Kong, it would be unfortunate to take another path, even if the case had arisen under Part 15 of the Act. It would also be difficult to reconcile with the Act's more recent provisions for court approval of arrangements or amalgamations involving Takeovers Code companies.[134] Schedule 10 makes it clear that classification in that context turns on the "similarity and dissimilarity of shareholders' legal rights against the company (not similarity or dissimilarity of any interest not derived from legal rights against the company)". As it is, introducing a wide concept of "interest" which is extraneous to the legal rights of creditors and turns on motive would largely confound the purpose of Part 14 in moving away from court sanction in all cases. It is likely to encourage highly contestable bases for differentiation of classes which could invite reopening of compromises after the event under s 232(3)(a) and (b) on the basis of material irregularity even if there is no

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133 *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* at [17].

134 Sections 236A and 236B, inserted (with Schedule 10) by the Companies Amendment Act 2014.

unfair prejudice shown and whether or not the creditor voted against the compromise (since relief under s 232(2)(a) and (b) is not limited to those who voted against a compromise).

[134] To the extent that the orders made in the Court of Appeal under s 232(3) relied on irregularity or unfair prejudice by reason only of the inclusion of insider creditors in the class which voted on the compromise, without requiring dissimilarity in their legal rights, we disagree with the approach. Similarly, we disagree with the views expressed by William Young J that the failure to exclude the insider creditors amounts without more to irregularity in the compromise.

[135] The fact that the insider creditors waived rights to receive distributions under the compromise does not justify excluding them from participation in the class voting on the compromise. As Lord Millett explained in *UDL Argos,* there might be force in the submission that non-participating creditors should be excluded if the waiver was "forced on them by the terms of the Scheme".[135] As is the case here, however, the fact that the waiver was part of the arrangement was "a matter of form only":[136]

> In substance they were voluntarily entering into mutual agreements that, if the Schemes were approved, they would waive their respective claims.

[136] We share the reservations expressed by William Young J about the Court of Appeal's view that Callaghan should have been set up in a separate class. If Callaghan did not lawfully terminate the funding agreement, it is not a creditor at all. If on the other hand it did validly terminate the agreement and was a creditor for the purposes of the compromise, Trends' counterclaim for unlawful termination would seem unlikely to succeed. Even if Callaghan could have claimed set-off in respect of Trends' defamation claim, a creditor who may have a right of set-off is not required to be treated as belonging to a different class than other unsecured creditors for the purposes of a compromise under Part 14. That would be to allow such a creditor to veto a proposal which is of benefit to the creditors as a body unless separate compromises can be reached with the different creditors (through exclusion of the effect of s 230(3)).

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135 *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* at [35].
136 At [35].

If the compromise is unfairly prejudicial the court can order under s 232(3)(c) that the prejudiced creditor is not bound.

Material irregularity in provision of information

[137] Section 229(2)(b) requires the proponent of a compromise to give to each known creditor a statement setting out "the terms of the proposed compromise and the reasons for it"[137] and "the reasonably foreseeable consequences for creditors of the company of the compromise being approved".[138] The proponent must also give to each known creditor notice of the intention to hold a meeting of creditors which states "the nature of the business to be transacted at the meeting in sufficient detail to enable a creditor to form a reasoned judgment in relation to it".[139]

[138] The statement provided by the directors as proponents of the compromise in the present case explains the compromise was proposed, essentially, in order to enable the company to keep trading. It attributed Trends' "present difficulties" as arising "due to the revocation" by Callaghan of the funding grant "in June 2014" leading to cashflow difficulties. It said the board was "committed to continuing the business so that it will be viable and financially stable" and had "a strong and coherent strategy to rebuild value". The "introduction of fresh capital" was described as "a key element of this". There was then reference to the commitment "from a third party" to introduce capital.

[139] The statement also dealt with the "reasonably foreseeable consequences" of approval of the compromise. It said:

> If the Compromise is passed, it is reasonably foreseeable that the Company will be able to trade on into the future.
>
> If the Compromise is not approved by the Creditors, the Company is unlikely to be able to continue trading as the Company will not be able to improve its balance sheet or cash flow position.
>
> If this Compromise is not implemented, the Board is of the view that liquidation or voluntary administration of the Company will be the likely

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137 Section 229(2)(b)(iii).
138 Section 229(2)(b)(iv).
139 Section 229(2)(a) and cl 2(2)(a) of Schedule 5.

> outcome. In the event that liquidation or voluntary administration of the Company occurs, unsecured creditors are unlikely to receive a distribution.

[140] As the Court of Appeal noted, the statement circulated by Trends to creditors did not contain any financial information at all.[140] After a request by Callaghan for further information, a one-page summary of Trends' financial position was provided two days before the creditors' meeting. This, however:[141]

> … did not show inter-company balance assets that appeared on Trends' financial statements of $24.8 million and investments in subsidiaries of $7.4 million. From the perspective of Trends' creditors who were considering the compromise proposal, these were assets of the company.

[141] We consider that the Court of Appeal was right to take the view that the notice of proposed compromise failed to provide proper financial information relating to the compromise. The one-page summary provided was inadequate and, in the view of the accountant who gave evidence for Callaghan, Mr Graham, misleading when viewed in the context of information available following discovery. No information was provided as to intercompany indebtedness. In addition, as the challenging creditors submit in this Court, there were no accounts for 2013–2015, no explanation of the relationship between Thecircle and Trends, no details as to the amount and source of the fresh capital,[142] and no information about the potential claims against Callaghan (which might well have constituted a contingent asset which the creditors should have been able to consider when voting on the compromise). Nor was there any information given about the related-party transactions which a liquidator could have investigated, including the late grant of security to Thecircle.

[142] The Court of Appeal considered there was "material non-disclosure" and therefore irregularity in terms of s 232(3)(b).[143] We agree. The inadequacies identified were clearly material in that they are directly connected to the commercial sense in the compromise.

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140 *Trends* (CA) at [72].

141 At [73].

142 Mr Johnson in his evidence referred to his "business friend" having said he would provide $50,000 "to allow for payment of the first initial distribution, if the compromise was passed".

143 At [76].

[143] Although the Court of Appeal considered that on its own the irregularity in the information provided would not justify an order for relief, we are of the view that material irregularity should always be treated strictly because that is the scheme of Part 14 and the justification for not requiring court sanction of compromises. The Court of Appeal was in our view correct in the view that Heath J ought not to have looked to a "causal nexus" between absence of information and the effect on the vote taken on the basis of such irregularity.[144] As it said, the provision of adequate information to enable a proposal to be properly considered is critical under Part 14.[145] That is consistent with the explanation given by the Law Commission, referred to above at [108].

[144] Counsel for Trends submitted that given the Court of Appeal did not find the informational irregularity on its own sufficient to warrant an order setting aside the compromise, this Court should not grant relief on the basis of informational irregularity in the absence of a r 20A notice[146] from the challenging creditors. This submission has no merit.

[145] The issue as to material irregularity on the basis of deficiency in the information provided was the first cause of action in the respondents' statement of claim. On appeal to this Court, Trends' notice of appeal included an appeal against the Court of Appeal finding as to inadequacy of information as one of its three grounds of appeal. In response the respondents' submissions opposing leave maintained that Trends had not challenged the Court of Appeal's assessment that the information provided was in fact inadequate to fulfil the requirements of the Act and emphasised that provision of such information at the outset underpinned Part 14. Material irregularity in the provision of the information was within the terms of the leave granted by this Court. The question of adequacy of information was fully argued before the Court on the appeal. In these circumstances it was not necessary for a r 20A

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144 At [76].

145 At [71].

146 At the time of hearing, r 20A of the Supreme Court Rules 2004 provided:

> If a respondent does not wish the judgment appealed from to be varied but intends to support it on another ground (being a ground that the court appealed from did not decide or decided erroneously), the respondent must give notice of that intention in the respondent's written submissions [for leave].

notice to be given. Trends had notice and fair opportunity to address all points relating to inadequacy of information and its effect.

Unfair prejudice

[146] The "unfairly prejudicial" limb of the relief available under s 232(3) was explained by the Law Commission as providing "a residual power which will be available to prevent abuse of the new procedure" under Part 14.[147] It is part of the scheme of Part 14, therefore, that the power to grant relief is available when the Part 14 procedure causes unfair prejudice even though there has been no material irregularity in the process required by the legislation and despite the requisite majority vote having been obtained.

[147] The compromise promoted by the board of directors of Trends was an abuse of the Part 14 procedure and resulted in unfair prejudice to the creditors who have applied for and are eligible for relief under s 232(3)(c). Mediaworks is not eligible for relief on this ground, but the remaining respondents are.

[148] The abuse arises from the nature of the proposal. It entailed promotion by directors who risked potential liability if the company was put into liquidation and who therefore had a conflict of interest not overcome by disclosure and provision of proper information about the circumstances of the company, nor by the creditor vote that followed.

[149] Mr Johnson's control both of the proposal for compromise and the voting of the major creditor was pivotal to the structure and achievement of the compromise. The proposal was deliberately structured to ensure that the compromise obtained the necessary majorities through:

(a) waiver of Thecircle's security (itself obtained in unexplained circumstances) to enable it to vote $3 million of value in a creditor pool of $4.3 million as an unsecured creditor despite the fact that it did not

147 *Company Law: Reform and Restatement* at [638].

seek any repayment under the compromise so that there was nothing in the compromise for it;[148] and

(b) providing for full repayment or near-full repayment of minor creditors without any suggested rationale beyond the achievement of the majority and in circumstances where the respondents would receive only between 11 and 18 per cent of the debts owed to them.[149]

[150] As already described, the terms of the compromise proposal provided for payment of unsecured creditors in full up to the first $1,000 of their debts, rather than providing for repayment to be pro rata across all creditors. This treatment was to the advantage of the numerically large group of small creditors. The challenging creditors do not suggest that this advantage is itself a reason to grant relief, but say that it is further evidence of manipulation of the vote. We agree. William Young, Glazebrook and O'Regan JJ take the view that the effect is best addressed in terms of classification.[150] We see it as indicating unfair prejudice in the absence of adequate explanation.[151] In the absence of any convincing justification, it may be inferred that the inducement for those owed small amounts despite the confiscation of value from larger creditors was designed to obtain a majority in number of those voting in favour of the compromise. The compromise under Part 14 was unfairly prejudicial to the creditors who voted against the compromise. It constituted "fundamental misuse of the compromise process", as Heath J found.[152]

Conclusion

[151] As indicated above, we conclude there was material irregularity in the compromise through inadequacy in the information provided, and would on this basis

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148 A similarly structured proposal was treated by Panckhurst J in *Commissioner of Inland Revenue v Atlas Food and Beverage Ltd* (2010) 24 NZTC 24,096 (HC) as supporting the inference that the creditors who waived payment under the compromise were "included in the unsecured class of creditors in order to ensure that the 75% vote in favour was secured" (at [50]).

149 See the reasons of William Young, Glazebrook and O'Regan JJ above at [27].

150 See above at [81].

151 See Edward Bailey and Hugo Groves *Corporate Insolvency Law and Practice* (5th ed, LexisNexis, London, 2017) at [9.55(9)]; citing *IRC v Wimbledon Football Club Ltd* [2004] EWHC 1020 (Ch), [2005] 1 BCLC 66 at [18]; *SISU Capital Fund Ltd v Tucker* [2005] EWHC 2170 (Ch), [2006] BPIR 154 at [69]; and *Prudential Assurance Co Ltd v PRG Powerhouse Ltd* [2007] EWHC 1002 (Ch), [2008] 1 BCLC 289 at [86]–[88].

152 *Trends* (HC) at [136].

grant all four respondents orders that they are not bound by it. We also conclude that the compromise was unfairly prejudicial to the first, second, and fourth respondents. We would make orders that they are not bound by it for this reason too.

[152] The scheme of the Act is that an order that a creditor applying for relief is not bound will generally be appropriate. The court is empowered to make any other order it thinks fit, but we do not think there is any reason here to set aside the compromise in full. It is not clear how other creditors would be affected. If, as seems likely, a consequence of the orders that the respondents are not bound by the compromise is that Trends will be put into liquidation at their instance, the court will have powers under s 233 of the Act to make such order as to the extent to which the compromise will continue in effect, on the basis of information not available to us.

[153] The respondents submitted that the choice of order was a matter for the discretion of the High Court (and affirmed by the Court of Appeal) which should not be displaced on appeal unless exercised on a wrong principle, or in error of law, or which was clearly wrong. We have however taken a different view of the substantive question than the Courts below and do not accept that in considering the relief appropriate it is necessary to defer to their view, reached on a different basis. In any event, we do not think it is sufficiently explained why orders that the respondents not be bound is not the more appropriate outcome. The implications of the wider orders made are not apparent. We would accordingly make orders that the creditors who have been successful in challenging the compromise are not bound by it.

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