Privy Council Appeal No. 19 of 1993

Hubert Graeme Mossman *Appellant*

v.

(1) Laurence George Chilcott
(2) Peter Charles Chatfield and
(3) Bank of New Zealand *Respondents*

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 16TH MAY 1994

Present at the hearing:-

LORD TEMPLEMAN
LORD LANE
LORD MUSTILL
LORD SLYNN OF HADLEY
LORD WOOLF

*[Delivered by **Lord Templeman**]*

By a debenture dated 17th May 1971 ("the first debenture") Mandalay Receptions Limited, subsequently Shoreville Mandalay Limited ("Mandalay"), charged in favour of the respondent Bank of New Zealand ("the Bank") by way of floating charge all the undertaking and assets of Mandalay to secure all moneys at any time due from Mandalay to the Bank, including any money due under any guarantee entered into by Mandalay.

The business of Mandalay was the operation of the reception and entertainment centre at Newmarket, Auckland in premises held on lease. The shareholders of Mandalay were the appellant, Mr. Mossman, his wife and a Mr. and Mrs. Conroy.

By an agreement dated 12th June 1987 Mr. and Mrs. Bisley ("the Bisleys") agreed to purchase all the shares in Mandalay for $1.2 million, of which $450,000 were to be secured by a second debenture subject to a first debenture priority of $650,000 and interest. No moneys were at that date due under the first debenture. The trial judge found that at that stage the vendors believed that the first debenture priority of $650,000 was intended to be for the

purpose of building up the business of the company and not for the payment of the purchase price of shares in the company.

By a letter dated 21st July 1987 Mr. Bisley sought a loan of $650,000 from the Bank on the security of a first debenture from Mandalay and for the purpose of enabling him to purchase the shares. According to the information supplied to the Bank the asset value of Mandalay was $90,833 but it enjoyed annual earnings of about $1 million. On 3rd August 1987 the Bank advanced $650,000 to Mr. Bisley's solicitors and debited Mandalay. The sum of $650,000 was employed in payment of part of the purchase price for the shares of Mandalay and the purchase was duly completed, the remainder of the purchase price being provided by the second debenture. The rate of interest on the first and second debentures exceeded 25% per annum.

In these proceedings Mr. Mossman has at all times argued that the Bank advanced $650,000 to the Bisleys and not to Mandalay and that therefore the first debenture never became security for that advance. The courts below held that the advance was first made to Mandalay and then advanced by that company to the Bisleys to enable them to purchase the shares. There was a good deal of inefficiency on the part of the Bank's officers and on the part of the Bisleys' solicitors. The transactions were not properly documented or recorded and Mr. Mossman says that the vendors of the shares never knew that the Bank was advancing $650,000 for the completion of the purchase. Nevertheless the Bank would never have advanced $650,000 without the security of a first debenture from Mandalay. So far as the Bank were concerned the advance was made to Mandalay and then went on by Mandalay to the Bisleys.

In his detailed and thoughtful written case and in the course of his powerful oral submissions Mr. Mossman relied on the rule in *Royal British Bank v. Turquand* (1856) 6 E & B 327, 119 E.R. 886 for the proposition that the Bank should have discovered that the vendors, then the directors of Mandalay immediately before completion of the purchase of the shares, had not authorised the acceptance by Mandalay of an advance from the Bank. Mr. Mossman also relied on *Sims v. Lowe* (1988) N.Z.L.R. 656 for the proposition that the Bank were not protected by paying $650,000 to the Bisleys' solicitors. Mr. Mossman did not represent Mandalay. Mandalay has never disputed and, in the light of the correspondence and events since the date of the advance, could not now dispute that the advance was secured by the first debenture. It is now too late for Mr. Mossman to complain. In November 1987 he prepared a resolution of Mandalay backdated to 3rd August 1987, describing the Bisleys as employees of Mandalay and authorising the advance of $650,000 from the Bank to Mandalay and resolving that the "first debenture funds" of $650,000 and the "second debenture funds" of $450,000 be lent to the Bisleys "to provide them with financial assistance to complete the purchase of the shares in Mandalay ...".

Mr. Mossman informed the Board that he drafted that resolution and prepared the accounts of Mandalay in accordance with that resolution as a result of legal advice and in order to avoid a breach of section 62 of the Companies Act which forbids loans to purchasers of shares who are not employees. In these circumstances the Board cannot interfere with the concurrent findings of the courts below that the Bank advanced $650,000 to Mandalay on the security of the first debenture.

Following the completion of the purchase, Mr. Bisley and, after his death on 1st September 1987, his widow and their advisors operated, as one group, Mandalay and two other companies, Shoreville Holdings Limited ("Holdings") and Shoreville Caterers Limited ("Caterers") which were controlled by the Bisleys. With the consent of the Bisleys, the Bank created three principal bank accounts. Bank account 0432667 recorded the advance of $650,000 made to Mandalay on the security of the first debenture and recorded the steady increase in interest and bank charges which the Bank allowed to remain unpaid. Bank account 0432704 was labelled Shoreville Holdings Limited and there were sub-accounts (whatever that expression means) which recorded, under one sub-account, moneys paid in to the credit of Mandalay and, under three other sub-accounts, overdrafts of Caterers and Holdings. Account No. 0384984 had three sub-accounts; one recorded an overdraft of Caterers, another was a small credit account of Caterers and the third recorded moneys now admitted to have been paid in by or on behalf of Mandalay. The Bank obtained from the Bisleys a set-off letter dated 3rd August 1987 which is remarkable for its obscurity so far as its application to the Bisleys' companies are concerned. The trial judge and the Court of Appeal differed about the effect of the set-off letter as construed in the light of the accounts maintained by the Bank. The Court of Appeal held that the Bank was entitled to set off the sub-accounts in account 0432704 thus wiping out the credit balance of moneys paid in by Mandalay. The Court of Appeal held that the Bank was not entitled to set off the Mandalay credits in account 0384984 against the Caterers' debits but that the Mandalay credit could be set off against the Mandalay debenture debt maintained under account 0432667. Their Lordships see no reason to disagree.

The Bank also sought cross-guarantees whereby Mandalay, Holdings and Caterers would each guarantee the debt owed to the Bank by the other two companies. As a result of more inefficiency by the Bank and its solicitors, the documents intended to create the cross-guarantees were, if strictly construed, meaningless. The guarantees were executed as guarantors by the companies intended to be guaranteed. The courts below held that the intention to create cross-guarantees was clear and that, on the true construction of the correspondence and the documents, there came into existence the intended

cross-guarantees which were effectively evidenced in writing. Again their Lordships see no reason to disagree.

On 27th February 1989 the Bank set off the Mandalay credits in their accounts with the Bank against the moneys then owing to the Bank by Holdings and Caterers. On the following day the Bank demanded from Mandalay sums amounting in the aggregate to nearly $1.9 million, no doubt vastly increased since that date by interest. The aggregate sum constituted the first debenture debt of $650,000, swollen by interest and bank charges to the sum of $959,426.48, and the amounts owing by Holdings and Caterers to the Bank and guaranteed by Mandalay. The first and second debenture holders appointed receivers on 10th March 1989. The companies became under the control of the receivers appointed by the Bank and in these proceedings those receivers sought directions from the court as to the amounts owing to the Bank by Mandalay, the priorities of the Bank and the rights of set-off and guarantee.

The trial judge and the Court of Appeal held that the Bank's loan of $650,000 had been advanced to Mandalay on the security of the first debenture, and that Mandalay had guaranteed the debts of Holdings and Caterers. The Court of Appeal held that, upon the true construction of the set-off letters and the accounts maintained by the Bank, the credits and debits in account 0432704 could be set off, that the debits and credits in account 0384984 could not be set off as against Mandalay but that the amount standing to the credit of Mandalay in account 0384984 could be set off against the debt owed by Mandalay to the Bank recorded in account 0432667. Their Lordships agree.

Both the first debenture loan of $650,000 and the second debenture loan of $450,000 were made in breach of section 62 of the Companies Act which forbids a company to grant loans or other assistance for the purchase of shares in the company. The Bank knew that it was lending $650,000 on the security of the first debenture to enable the Bisleys to purchase the shares of Mandalay. The second debenture holders knew that they were lending $450,000 on the security of the second debenture to enable the Bisleys to complete the purchase of the shares. The debentures were disastrous. The company, which to the knowledge of the Bank and the second debenture holders had trifling capital assets, was loaded with debt of $1.2 million at crippling rates of interest. The trial judge in the absence of unsecured creditors exercised his discretion under the Illegal Contracts Act 1970 to grant relief to the Bank and the second debenture holders for their breaches of section 62. He said that the company was at all times solvent and no creditors could have been detrimentally affected by the arrangement. On the contrary, the company was never in a position to pay its debts at any time after the loan of $1.2 million had been incurred and the only creditor who has salvaged anything from the inevitable and foreseeable wreckage is the Bank. The judge said that the company

benefited from "an injection of new blood into its management" and because of "the reasonable expectation that there would be substantial extra capital assistance to the company as a result of the Bisleys taking it over". New blood and expectation without foundation are promised by every adventurer and are not usually accepted by a bank as security or accepted by the law as excuses for a breach of section 62. After the purchase of the shares by the Bisleys, the Bank then piled on the agony by allowing the interest payable on the first debenture, which should have been paid by the Bisleys in exoneration of Mandalay, to accumulate to the detriment of the second debenture holders and by procuring from the Bisleys on behalf of Mandalay the set-off letters and guarantees so that in the result Mandalay became indebted to the Bank in the sum of $1.9 million.

Mr. Mossman is labouring under a strong sense of grievance concerning the conduct of the Bank although he is hampered by the fact that the second debenture was made in breach of section 62 of the Companies Act. There was no appeal against the exercise by the trial judge of his discretion to excuse the breaches of section 62. Mr. Mossman complained of the ineptitude of the Bank in not ensuring that the Bisleys were capable of paying off and did pay off the first debenture capital and interest and in not obtaining proper security, and he complained also of the panic stricken and ruthless activities of the Bank in obtaining and operating the set-off letter and guarantees with the result that Mandalay was ruined and the second debenture became valueless. There is considerable force in the complaints of Mr. Mossman. Unfortunately for him the Bank had no responsibility in law for the fate of Mandalay or the second debenture holders but it is to be hoped that the Bank will not only take steps in the future to conduct its loan business with efficiency and without breach of the law but will also adopt a more responsible attitude to its borrowers and to other creditors of its borrowers. The Board gave the parties an opportunity to settle their differences. No agreement has been reached and the law must take its course. Their Lordships can see no grounds in law for interfering with the orders made by the Court of Appeal and will humbly advise Her Majesty that this appeal should be dismissed. There will be no order as to costs.