IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

CIV-2015-404-1612
[2016] NZHC 1750

UNDER	s 119 of the Insolvency Act 2006 and Part 18 of the High Court Rules
IN THE MATTER	of an application for a vesting order in respect of land of the bankruptcy of Mark Richard Hadfield
BETWEEN	THE FISH MAN LIMITED (IN LIQUIDATION) Plaintiff
AND	MARK RICHARD HADFIELD First Defendant
	HALEY PETRINA HADFIELD Second Defendant

Hearing: 23 June 2016

Appearances: K H Morrison and C P Eason for Plaintiff
J D Noble for First Defendant
A Barker as Amicus Curiae

Judgment: 29 July 2016

JUDGMENT OF FOGARTY J

This judgment was delivered by Justice Fogarty on
29 July 2016 at 3.00 p.m., pursuant to
r 11.5 of the High Court Rules

Registrar/Deputy Registrar
Date:

Solicitors:
Meredith Connell, Crown Solicitors, Auckland
Boyle Mathieson, Auckland
Copy to:
Andrew Barker, Auckland

Introduction

[1] The plaintiff, the Fish Man Ltd (the Fish Man), is a limited liability company in liquidation. The liquidators of the plaintiff have lodged a number of caveats over a property at 1/16 Cameron Place, Ranui (the property). That property is registered in the name of the defendant, Mr Hadfield. The second defendant, Mrs Hadfield, is his wife who has registered a claim over the same property pursuant to s 42(2) of the Property (Relationships) Act 1976 (the PRA).

[2] The Fish Man was the corporate vehicle of Mr Hadfield's business. As the name of the company suggests, Mr Hadfield raised and sold ornamental fish, from his home. There were 14 fish tanks on the property, stocked with tropical fish. The business was his financial downfall. In the course of business he cut his finger and, for a time, could not work. He took on an employee. The cost of the employee, and probably the inability of Mr Hadfield to work, lowered the turnover of the business. Mr Hadfield then fell behind in his PAYE and GST tax liabilities. He never recovered from the arrears. It was the arrears, and particularly the interest and penalty payments thereon, which pushed the Fish Man into liquidation on 3 November 2010 and Mr Hadfield into bankruptcy, on 6 June 2013. While he fell behind in the tax liabilities Mr Hadfield continued to use revenue of the company to meet mortgage payments over the property.

[3] Mr Hadfield has since been discharged from bankruptcy. At the time of the hearing it was thought he automatically discharged from bankruptcy on 6 June 2016. The only doubt was as to the precise date in the month. On any view of it, he has now been automatically discharged.[1]

The company is a creditor of Mr Hadfield

[4] On 19 August 2011 last, the Fish Man obtained a default judgment against Mr Hadfield in the sum of $148,409.96. There have been some payments against this judgment totalling $14,988.41, made between the period of 19 August 2011 and 6 June 2013. On the later date Mr Hadfield was adjudicated bankrupt and the Fish Man filed an unsecured creditor's claim in his estate, in the sum of $133,457.85.

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1 Insolvency Act 2006, ss 290-291.

[5] Since 1 September 2004, Mr Hadfield had been the sole registered proprietor of 1/16 Cameron Place, Ranui. There was a mortgage over the title in favour of the ANZ Bank granted on 10 March 2008. On 11 March 2011, the liquidator of the Fish Man registered a caveat over the property. The caveat contended the Fish Man had a beneficial interest in the property arising from breach of fiduciary duties by Mr Hadfield to the company. On 23 November 2011 the liquidator registered a charging order against the property. On 16 April 2013, just before the bankruptcy, Mrs Hadfield registered a notice of claim under s 42 of the PRA. The Fish Man registered another caveat on 14 November 2013.

The consequences of the Official Assignee's disclaimer of the house property in the bankruptcy of Mr Hadfield

[6] Following Mr Hadfield's adjudication bankrupt on 6 June 2013, the property vested in the Official Assignee. A little over five months later, on 27 November 2013, the Official Assignee disclaimed the property as, according to the Official Assignee's calculation at the time, there was no equity in the property.

[7] The power of the Assignee to disclaim onerous property of the bankrupt is contained in s 117 of the Insolvency Act 2006 (the IA) which provides:

> **117 Assignee may disclaim onerous property**
>
> (1) Subject to section 120, the Assignee may disclaim onerous property.
>
> (2) Subsection (1) applies even if the Assignee has taken possession of the property, tried to sell it, or otherwise exercised rights of ownership in relation to it.
>
> (3) The Assignee must, within 10 working days after the disclaimer, send a written notice of the disclaimer to every person whose rights are, to the Assignee's knowledge, affected by it.
>
> (4) For the purposes of this section and section 120, onerous property—
>
> (a) means—
>
> (i) an unprofitable contract; or
>
> (ii) property of the bankrupt that is unsaleable, or not readily saleable, or that may give rise

to a liability to pay money or perform an onerous act; or

(iii) a litigation right that, in the opinion of the Assignee, has no reasonable prospect of success or cannot reasonably be funded from the assets of the bankrupt's estate; but

(b) does not include—

(i) a netting agreement to which sections 255 to 263 apply; or

(ii) any contract of the bankrupt that constitutes a transaction under that netting agreement

[8] The effect of a disclaimer is set out in s 118 of the IA:

118 Effect of disclaimer

A disclaimer by the Assignee—

(a) brings to an end, on and from the date of the disclaimer, the rights, interests, and liabilities of the Assignee and the bankrupt in relation to the property disclaimed:

(b) does not affect the rights, interests, or liabilities of any other person, except in so far as is necessary to release the Assignee or the bankrupt from a liability.

[9] Of critical importance is s 118(a). Once a property is disclaimed that brings to an end any rights of the Official Assignee in relation to the property.

[10] In the intervening time since disclaimer there has been a boom in Auckland in the prices of residential properties. The setting of the case is that the property now has equity. That explains the application by the liquidator of the Fish Man.

The competing claims

[11] In substance, there are three competing claims to a share of the equity in the property: one by the Fish Man for the benefit of the Inland Revenue Department. Another by Mr Hadfield, and a third by Mrs Hadfield. There is an issue as to the competing merits because none of the three claimants has an absolute right by way of a Land Transfer Act title or registrable interest over the property.

[12] It is common ground that the Official Assignee cannot undo a disclaimer.

Remedies being pursued by the Fish Man

[13] The liquidators of the Fish Man seek an order vesting the property in the Fish Man on the ground that the Fish Man has a proprietary interest in the property, because the Fish Man spent $49,159 to satisfy mortgage repayments.

[14] The majority of that claim relates to payments on the ANZ Bank mortgage, of $29,572 between 1 April 2009 and 30 November 2010. These repayments were part of the District Court judgment against Mr Hadfield.

[15] The remaining part of the claim relates to payments on the ANZ Bank mortgage of $19,586.55 between 1 April 2008 and 31 March 2009. There is no judgment in favour of the Fish Man for this amount. It does not appear that this amount has been the subject of a claim in the bankruptcy of Mr Hadfield.

[16] These payments were for the personal benefit of Mr Hadfield, at the expense of the Fish Man and its creditors.

[17] The application to this Court relies on s 119(1)(b) and (3) of the IA 2006 which provides:

> **119 Position of person who suffers loss as result of disclaimer**
>
> (1) A person suffering loss or damage as a result of disclaimer by the Assignee may—
>
> (a) claim as a creditor in the bankruptcy for the amount of the loss or damage, taking account of the effect of an order made by the Court under paragraph (b):
>
> (b) apply to the Court for an order that the disclaimed property be delivered to, or vested in, that person.
>
> (2) The bankrupt may also apply for an order that the disclaimed property be delivered to, or vested in, the bankrupt.
>
> (3) The Court may make an order under subsection (1)(b) or (2) if it is satisfied that it is fair that the property should be delivered to, or vested in, the applicant.

[18] The Fish Man seeks a further order that the property be sold by the company and that the proceeds of sale the to are to be used (in order of priority):

(a) To pay of the costs of sale in this proceeding;

(b) To pay of the amount secured by the mortgage;

(c) To pay up to $133,457.85 to the Fish Man; and

(d) Any surplus is to be applied as the Court considers appropriate.

Mr Hadfield's claim

[19] Similarly, Mr Hadfield also applies under s 119 for the property to be vested in him, in his case under subs (2).

Mrs Hadfield's interest in the property and the remedy sought

[20] On 4 December Mrs Hadfield filed a statement of defence and counterclaim. She advised that her relationship with Mr Hadfield began in May 2006 and that they were married in December 2009. She argues that the relationship entitles her to a half share in the equity of the property and that throughout the relationship she has been paying the mortgage over the property, having paid half the mortgage payments until 2013, and half of the payments since then. She also seeks protection under s 20B of the PRA, which provides for a protected interest in the family home of $103,000. She asks the Court to define and quantify her interest in accordance with this. Mrs Hadfield also seeks a declaration that she is entitled to half the equity after the ANZ Bank mortgage, and an order to that effect.

The issues

[21] First, I must determine whether each applicant qualifies for a remedy. Then I must determine whether or not this Court is satisfied "that it is fair" that the property should be delivered to, or vested in either the Fish Man (subject to the ANZ Bank mortgage), to Mr Hadfield or to Mrs Hadfield, or some combination thereof.

Overview of the parties' positions

[22] Mr Hadfield's claim for fairness is that he has been discharged from bankruptcy. Counsel agree that was on or about 6 June 2016, being three years from the adjudication. The law providing for discharge from bankruptcy has the public policy of allowing a bankrupt to start afresh with all indebtedness cleared, subject to consequential restraints imposed by the Official Assignee. There have been no consequential constraints on Mr Hadfield.

[23] Mrs Hadfield's claim for fairness is that she has, by law, a protected interest in the property on top of which consideration should be given to the fact that she preserved the home by paying all the mortgage interest and other outgoings of the property. She says that the gain in the property's value occurred after the disclaimer. So, in fairness, she should be the registered proprietor by herself or in conjunction with her husband.

[24] The claim by the liquidator of the Fish Man is simple. The company had a proprietary interest in a portion of the property prior to the disclaimer. The property represents the only source of recovery for the liquidated estate of the company. The Fishman submits that it is fair that the disclaimed property vest in the company and be sold to satisfy Mr Hadfield's liabilities.

[25] I turn now to consider the arguments that underlie the competing claims.

Survival of the Fish Man debt

[26] This Court has the benefit of the submissions of Mr Andrew Barker as amicus curiae. The approach he has taken is to outline the contrary arguments that could be raised to the claim by the Fish Man in liquidation in order to help retain the adversarial attention that usually exists. Within that context he has generally endeavoured to take a broader approach to the issues raised by the case and its appropriate resolution.

[27] As to the claim by the Fish Man, Mr Barker submits that the question is whether it survives Mr Hadfield's discharge from bankruptcy and that, in turn,

depends on whether the claim by the Fish Man against Mr Hadfield is a claim in fraud as that term is used under s 304 of the Insolvency Act. If the claim does survive Mr Hadfield's discharge from bankruptcy, then the appropriate order would be to vest the property in Mr Hadfield on the condition that he sell the property with the subsequent orders made by the Court as to the application of the proceeds of sale. But if the claim of the Fish Man does not survive Mr Hadfield's discharge, then the appropriate order would be to vest the property in Mrs Hadfield. The justification would be that if the property has any equity now it is only because Mrs Hadfield has been paying the mortgage since the property has been disclaimed.

[28] In this regard, there is also another distinction: Mrs Hadfield obviously always had a claim against the property under the PRA, she and Mr Hadfield being married. So, to the extent that she paid the interest on the mortgage it was in her self-interest to do so to protect her property right under the PRA in the family home.

[29] The critical question which potentially resolves the case is whether or not the claim of Fish Man against Mr Hadfield for a breach of fiduciary duties can in any event survive Mr Hadfield's discharge from bankruptcy. If not the proprietary/tracing issue probably does not arise.

[30] Section 290 of the Insolvency Act provides:

> **290 Automatic discharge 3 years after bankrupt files statement of affairs**
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> (1) A bankrupt is automatically discharged from bankruptcy 3 years after the bankrupt files a statement of affairs under section 46 or section 67, but may apply to be discharged earlier.
>
> (2) However, a bankrupt is not automatically discharged if—
>
> (a) the Assignee or a creditor has objected under section 292 and the objection has not been withdrawn by the end of the 3-year period referred to in subsection (1); or
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> (b) the bankrupt has to be publicly examined under section 173 and has not completed that examination; or
>
> (c) the bankrupt is undischarged from an earlier bankruptcy.

[31] Section 304(1) provides:

304 Debts from which bankrupt is released on discharge

(1) On discharge, the bankrupt is released from all debts provable in the bankruptcy except those listed in subsection (2).

(2) The bankrupt is not released from the following debts:

(a) any debt or liability incurred by fraud or fraudulent breach of trust to which the bankrupt was a party:

(b) any debt or liability for which the bankrupt has obtained forbearance through fraud to which the bankrupt was a party:

(c) any judgment debt or amount payable under any order for which the bankrupt is liable under section 147 or section 298:

(d) any amount payable under a maintenance order under the Family Proceedings Act 1980:

(e) any amount payable under the Child Support Act 1991.

[32] The relevant qualification is said to be s 304(2)(a), a debt or liability incurred by fraud or a fraudulent breach of trust.

[33] The question then becomes whether or not the breach of fiduciary obligation of Mr Hadfield, as a director, to pay the PAYE and GST, is "fraud or fraudulent breach of trust".

[34] That question has to be answered against a consideration of the purpose of the policy of the IA to discharge bankrupts from all debts.[2]

[35] My attention has been drawn to the High Court decision of *FE Investments Ltd v Klisser*.[3] Mr Klisser was director and shareholder of a company called Leisureworld. As a financing arrangement, FE Investments Ltd purchased goods from Leisureworld's suppliers to be shipped to their country of destination. Leisureworld was to purchase these goods from FE Investments before the goods cleared Customs. The allegation was that at the direction of Mr Klisser, Leisureworld sold FE Investments' goods receiving the proceeds of sale and

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2 Interpretation Act 1999, s 5.
3 *FE Investments Ltd v Klisser* [2010] 2 NZLR 217 (HC).

applying them for their own purposes, rather than repaying FE Investments. FE Investments commenced proceedings against Mr Klisser personally in 2007 alleging dishonest assistance. Then Mr Klisser was adjudicated bankrupt on his own application in April 2008 and accordingly proceedings against him were stayed. The case before the High Court was an application for leave to continue proceedings against Mr Klisser under s 76(2) of the IA. In this context FE Investments argued that these proceedings would survive Mr Klisser's bankruptcy under s 304(2)(a) of the IA.

[36] It is sufficient from this record of the material facts for it to be clear that the alleged fraud was a deliberate thwarting by Mr Klisser of the contract between FE Investments Ltd and Leisureworld. The diversion of the proceeds of sale personally by Mr Klisseer was clearly a fraud on FE Investments.

[37] Not surprisingly, Stevens J held that the term "fraud" in that subsection included equitable fraud. It is clear in making that finding that Stevens J saw himself as dealing with "dishonest assistance", repeatedly using that description.[4]

[38] The conduct of Mr Hadfield here is not dishonest assistance. Rather, it is a common case of a director of a company continuing to spend on the necessary inputs, such as food for the fish and retaining the employees, ahead of the tax debts. He did not do this with an intention to defeat the Inland Revenue in the long run, but rather to save the business. Stevens J's judgment can therefore be distinguished on the basis that it reinforces the importance of confining s 304(2)(a) to dishonesty, the presence of which creates an exception to the public policy of discharging bankrupts from all debts after three years.

[39] It will be recalled that the Fish Man proved its debt against Mr Hadfield in his bankruptcy. Essentially the Fish Man is now endeavouring to pursue that debt notwithstanding Mr Hadfield's automatic discharge from bankruptcy, after three years.

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4 See [46], [47] and [48].

[40] It has long been recognised that it is in the public interests for bankrupts to be discharged after a period of time. On the other hand, it is not in the public interest for fraudulent people to be released from the consequences of fraud. In my view that is the purpose of s 304(2)(a) and (b), as a qualification of the general policy of discharge after three years.

[41] It is a common place event for companies under financial stress to fall behind in tax and for tax arrears to accrue. This is not normally regarded as fraud or fraudulent breach of trust. I find that s 304(2)(a) does not apply to the preference Mr Hadfield gave to his current expenses ahead of the tax liabilities.

[42] As for the exception s 304(2)(c), it adds nothing that the debt held by the liquidator of the Fish Man is a District Court judgment. But it is plain that the exception does not apply. Section 147 only applies to contributions ordered to be paid by the Official Assignee and s 298 applies where a Court may grant or refuse a discharge.

[43] I conclude that s 304(1) of the Insolvency Act applies, and subs (2) does not apply, so that Mr Hadfield was released automatically from all debts that were provable in the bankruptcy.

The liquidator's tracing argument for a proprietary claim

[44] It may be arguable that though Mr Hadfield has no debt to the Fish Man, the Fish Man still has property in his home. So I go on to consider the proprietary claim by the Fish Man. This argument was presented by Ms Morrison as counsel, and may I say that it was both an argument of the highest quality and expertly presented.

[45] The argument opened with the proposition that the Fish Man suffered a loss following the Official Assignee's disclaimer of the property. The property represents the only source of recovery for the liquidated estate of the company. It is said to be fair, therefore, that a share of the disclaimed property vest in the Fish Man and the whole property be sold to satisfy Mr Hadfield's liabilities. The loss is of a kind referred to subsection (1) of s 119 of the IA. I set out the section again for convenience:

119 Position of person who suffers loss as result of disclaimer

(1) A person suffering loss or damage as a result of disclaimer by the Assignee may—

(a) claim as a creditor in the bankruptcy for the amount of the loss or damage, taking account of the effect of an order made by the Court under paragraph (b):

(b) apply to the Court for an order that the disclaimed property be delivered to, or vested in, that person.

(2) The bankrupt may also apply for an order that the disclaimed property be delivered to, or vested in, the bankrupt.

(3) The Court may make an order under subsection (1)(b) or (2) if it is satisfied that <u>it is fair</u> that the property should be delivered to, or vested in, the applicant.

(Emphasis added.)

[46] The Fish Man's argument is that "it is fair" is argued on the basis that the company has proprietary interest in the property by reason of Mr Hadfield's breach of his fiduciary duties as a director to make payment of the tax. It then says that this proprietary interest should be prioritised against the sale proceeds ahead of Mrs Hadfield's protected interest in the property, assuming that her interest is proved. In response to Mrs Hadfield's argument that there is a protected interest in the property by reason of the PRA, Ms Morrison submits is not a proprietary interest. Accordingly, the proprietary interest should have priority over the protected interest. This argument depends on proving that the Fish Man can trace diverted funds into the proceeds of sale of the property.

[47] The Fish Man's proprietary claim stems from Mr Hadfield's use of the company's funds to meet his personal mortgage repayments, at a time when the Fish Man was insolvent. These mortgage payments are said not to have been for legitimate business expenses, such as rent or salaries. Rather, the Fish Man says the payments were for Mr Hadfield's benefit at the expense of the company and its creditors.

Breach of fiduciary duty

[48] The first argument in support of the Fish Man having a proprietary interest in the property is that the expenditure by Mr Hadfield as director of the Fish Man to pay the funds of the company to reduce mortgage payments was in breach of his fiduciary duties as a director of the company. I do not have any difficulty with this proposition. The Fish Man relies on four decisions. The first is *Selangor United Rubber Estates Ltd v Craddock (No.3)*.[5] In that case the defendant's directors misapplied company funds and were held liable in equity to account as trustees to the plaintiff company. In the second decision, *Karak Rubber Company Ltd v Burden (No.2)*,[6] likewise, a director misapplied company funds. The Court held that the director was a trustee of the funds in the company's account and went on to hold Barclay's Bank liable as constructive trustee for paying out on the company's cheque and circumstances where a reasonable banker would have been put on inquiry. The Court upheld a claim against the bank in equity. In the third case, *Victoria Street Apartments Ltd (In Liquidation) v Sharma*,[7] a director had misapplied company funds at a time the company was insolvent. The Court held that he had breached his fiduciary duties. Finally, in a judgment of Woolford J in *Torbay Holdings Ltd v Napier,*[8] a director had misappropriated company funds which were used by the director to purchase and construct a house for himself. The Judge found the director had used the company funds to pay his personal creditors, which jeopardised the company's ability to pay its own debts. Accordingly, the use of such funds was not to the benefit of the company and the director was in breach of his fiduciary duties.

[49] The hurdle in the Fish Man's argument is to move from a finding that the director misapplying the funds was in breach of fiduciary duties to the company, to a finding that the company has a proprietary interest in the property of the director. In this regard, Ms Morrison, counsel for the Fish Man, argued that the breach of fiduciary duty by Mr Hadfield gave rise to a constructive trust, and that the funds could be traced.

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[5] *Selangor United Rubber Estates Ltd v Craddock (No.3)* [1968] 2 All ER 1073.

[6] *Karak Rubber Company Ltd v Burden (No.2)* [1972] 1 All ER 1210.

[7] *Victoria Street Apartments Ltd (In Liquidation) v Sharma* HC Auckland, CIV-2009-404-8377, 14 October 2011.

[8] *Torbay Holdings Ltd v Napier* [2015] NZHC 2477.

Constructive trust

[50] The liquidator's case is to contend that, as a consequence of breach of fiduciary duties, a constructive trust arises as a remedial device that could be, and should be, shaped to fit the circumstances of the case, citing Hammond J in *Dickie v Torbay Pharmacy (1986) Ltd*:[9]

> As to the nature of a constructive trust, there has been a great deal of juristic debate as to whether such is a substantive institution, or a remedial device. And, is such declaratory of something that always existed — and hence is more like an express trust? Or, is it "constituted", and hence essentially a remedial vehicle? Or, is there more than one kind of constructive trust? My own view is that, functionally, constructive trusts can (and do) serve a variety of purposes. And whether such should be decreed must turn less on abstract theory than on the facts of a given case; the nature of the "wrong" committed; whether proprietary relief is appropriate at all; and the variety of discretionary considerations which routinely attend an exercise of this kind.
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> In my view, in this case there has been a breach of fiduciary duty. It is appropriate that there should be proprietary relief: how else is real property to be "restored" to the rightful beneficiaries? The Court constitutes the trust in a case such as this. If that is so, it can, where appropriate, nominate the beneficiaries. If this conclusion is correct, the issue comes down to whether, in the exercise of the Court's discretion in this case, B should be excluded?

[51] The facts of that case were far removed from here. The setting in the *Torbay Pharmacy* case was the acquisition of a site at Takapuna across the road from a medical practice. The plaintiffs were the doctors who owned the medical practice. The original concept had been a co-venture between the doctors and a businessman, Mr Buchanan, (B). Negotiations ensued with Mainzeal and looked as though they would fall through. B then conceived a scheme which could be put in place as a back-up agreement which would have his friend, J, enter into a conditional agreement to buy the site directly from its owner, Steel and Tube, so that if the Mainzeal negotiations fell through at least the site would be secured and could still be developed in some manner by B with the plaintiffs. This back-up concept was put to the plaintiffs and they agreed to Bs suggestion the nominee should be J. J utilised the company, Torbay Pharmacy (1986) Ltd (Torbay). Torbay entered into a contract to purchase the site. The contract was conditional on the directors of Torbay's approval, really J. The plaintiffs became aware shortly thereafter that J was claiming to be an actual participant, not a nominee. The plaintiffs refused to accept J

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[9] *Dickie v Torbay Pharmacy (1986) Ltd* [1995] 3 NZLR 429 (HC) at 441.

as a partner. B stood by J rather than the plaintiffs. B and J formed another company and proposed to transfer the title to this company "Redmount". Redmount acquired the site. The plaintiffs sought a declaration that Torbay and Redmount were trustees for them.

[52] The Judge found that J was the agent for the plaintiffs and B and no more. Therefore, J could not take the property in his own right and his company Torbay, so that Torbay and/or Redmount held the land on a constructive trust for the plaintiffs and (possibly) B. The Judge found that B was a fiduciary as between himself and the doctors that he had breached that relationship by making the unauthorised agreement with J. The Judge recognised the remedy of constructive trust which he saw as proprietary relief. He did not apply a tracing remedy.

[53] For a tracing remedy, Ms Morrison relied on the leading case of *Foskett v McKeown*[10] and particularly on the judgment of Lord Millett. The facts of that case involved a situation where a number of purchasers had entrusted funds to M and an associate for a property development in Portugal. The scheme was never carried out, and M, in breach of trust, used some of the purchasers' money to pay two annual premiums on a whole of life insurance policy. M divested himself of any beneficial interest, and appointed the policy to be held for the benefit of three children. M subsequently committed suicide, whereupon the insurers paid £1 million Sterling to the trustees of the policy.

[54] Ms Morrison took the Court carefully through *Foskett v McKeown*,[11] but did not compare the material facts of that case with the material facts of this case, maybe because one cannot. She then concluded that the remedy was a combination of either recognising a constructive trust imposed on Mr Hadfield or tracing. I am going to focus first on whether or not *Foskett v McKeown*, is an authority which justifies tracing in this case.

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[10] *Foskett v McKeown* [2001] 1 AC 102 (HL).
[11] Above.

[55] The House of Lords held that the purchasers had a proprietary interest in the policy moneys by tracing the money through the premiums which were paid by M with their funds. Lord Millett said:[12]

> The simplest case is where a trustee wrongfully misappropriates trust property and uses it exclusively to acquire other property for his own benefit. In such a case the beneficiary is entitled at his option either to assert his beneficial ownership of the proceeds or to bring a personal claim against the trustee for breach of trust and enforce an equitable lien or charge on the proceeds to secure restoration of the trust fund. He will normally exercise the option in the way most advantageous to himself. If the traceable proceeds have increased in value and are worth more than the original asset, he will assert his beneficial ownership and obtain the profit for himself. There is nothing unfair in this. The trustee cannot be permitted to keep any profit resulting from his misappropriation for himself, and his donees cannot obtain a better title than their donor. If the traceable proceeds are worth less than the original asset, it does not usually matter how the beneficiary exercises his option. He will take the whole of the proceeds on either basis. This is why it is not possible to identify the basis on which the claim succeeded in some of the cases.
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> (Emphasis added.)

[56] Clearly this is not a case like that.

[57] Lord Millett goes on to say:[13]

> A more complicated case is where there is a mixed substitution. This occurs where the trust money represents only part of the cost of acquiring the new asset. As James Barr Ames pointed out in "Following Misappropriated Property into its Product" (1906) 19 HarvLRev 511, consistency requires that, if a trustee buys property partly with his own money and partly with trust money, the beneficiary should have the option of taking a proportionate part of the new property or a lien upon it, as may be most for his advantage. In principle it should not matter (and it has never previously been suggested that it does) whether the trustee mixes the trust money with his own and buys the new asset with the mixed fund or makes separate payments of the purchase price (whether simultaneously or sequentially) out of the different funds. In every case the value formerly inherent in the trust property has become located within the value inherent in the new asset.

Again this is not one of those cases. The money diverted to servicing the mortgage cannot in any way be described as a cost of acquiring the property.

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[12] At 130 A-C.
[13] At 130 F-G.

[58] Lord Millett goes on to examine the rule, and its rationale, as stated by Samuel Williston,[14] again confining the rule to where money has been furnished with which to acquire a certain investment, "and the proportion it formed of the whole money so invested is known or ascertainable".[15]

[59] Earlier in his judgment Lord Millett had emphasised:[16]

> Tracing is thus neither a claim nor a remedy. It is merely the process by which a claimant demonstrates what has happened to his property, identifies its proceeds and the persons who have handled or received them, and justifies his claim that the proceeds can properly be regarded as representing his property.

[60] Lord Millett goes on to distinguish *In re Hallett's Estate; Knatchbull v Hallett*[17] and reaffirm that a claimant can trace an equity into a mixed fund and then goes on to state the rule:[18]

> Accordingly, I would state the basic rule as follows. Where a trustee wrongfully uses trust money to provide part of the cost of acquiring an asset, the beneficiary is entitled *at his option* either to claim a proportionate share of the asset or to enforce a lien upon it to secure his personal claim against the trustee for the amount of the misapplied money. It does not matter whether the trustee mixed the trust money with his own in a single fund before using it to acquire the asset, or made separate payments (whether simultaneously or sequentially) out of the differently owned funds to acquire a single asset.

[61] The difficulty with the present case is that it cannot be said the relatively small amount being pursued by the liquidator, of $49,000 was, in any meaningful sense, the cost of acquiring the property. Assuming a table mortgage, there being no evidence to the contrary, the bulk of that sum would be paying the interest on the mortgage and thereby merely preventing the ANZ Bank from exercising a power of sale.

[62] Ms Morrison relied also on the recent decision of Woolford J in *Torbay Holdings Ltd v Napier,*[19] applying the Privy Council's decision in *Republic of Brazil*

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14 Samuel Williston "The Right to Follow Trust Property when Confused with other Property" (1888) 2 HarvLRev 28 at 29.

15 *Foskett v McKeown*, above n 10, at 130, H.

16 At 128, D.

17 *In re Hallett's Estate; Knatchbull v Hallett* (1880 13 Ch D 696 at 709.

18 *Fosket v McKeown*, above n 10, at 131, G-H.

v Durant.[20] *Torbay* was a case where the trust moneys were spent on the construction of a house.

[63] The defendants, Mr and Mrs Napier, were employed to run the rest home business of the plaintiff. They had cheque signing authority over the company's bank accounts and day to day control of its finances. They were trusted. There were no effective checks and balances. The plaintiff found that Mr Napier had misappropriated company funds. The amount received by Mr and Mrs Napier and/or their family trust as unauthorised payments over seven years amounted to in excess of $1 million which, coupled with overpayment of salaries, made a total sum of losses to Torbay Holdings and Torbay Rest Home of $1,440,288.56.

[64] Woolford J found that at the time, Mr and Mrs Napier as directors of Torbay Holdings and Torbay Rest Home, owed duties to these companies as directors and it was as a result of breach of those duties that the company suffered a loss. He held that they were personally, jointly and severally liable. There were some exceptions for the liability of Mrs Napier. The Judge went on to address liability on the part of the couple for money had and received. But there were problems of tracing the common law of money had and received.[21]

> …it is now impossible to identify the total amount of the unauthorised payments that actually ended up in the possession or control of Mrs Napier and/or the Napier Family Trust, for the purposes of the claim for money had and received. …The mixing of legitimately and illegitimately obtained funds makes determining the proportions of each difficult.

[65] There was, however, no doubt that Mr Napier had a personal liability to account. Likewise, to a more qualified sense, did Mrs Napier.

[66] Woolford J then moved to the fifth pleaded cause of action which alleged that the property owned by Mr and Mrs Napier was subject to a constructive trust in favour of Torbay Holdings and Torbay Rest Homes because the company's funds had been used to acquire and/or improve the property. The misappropriation of funds coincided with the construction of the house on this property. Some of the rest home

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19 *Torbay Holdings Ltd v Napier*, above n 8.
20 *Republic of Brazil v Durant* [2016] AC 297 at [40].
21 *Torbay Holdings Ltd v Napier*, above n 8, at [174].

cheques could be traced directly to purchases of goods and services in the construction. The value of those cheques was quantified as $101,473.38. That led to the conclusion of Woolford J that:[22]

> [210] I consider that the right which Torbay Holdings and Torbay Rest Homes had to the money which was misappropriated by Mr Napier can be traced into the property, giving it an equitable interest in the property. A constructive trust therefore exists over the property up to the value of $101,473.38.

[67] The Judge then turned to the mixed funds. He relied on a number of cases including *Foskett v McKeown*. He particularly relied on the proposition that where a trustee wrongfully uses trust money to provide part of the cost of acquiring an asset, the beneficiary is entitled at his option to claim either proportional share of the asset or to enforce a lien on it.

[68] That led to his key finding of fact:

> [230] The loans in this case were also clearly acquired before the money necessary to make principal and interest payments was acquired, and even once it was acquired (gradually, over a period of years) the series of transactions across the accounts of Mr and Mrs Napier and the Napier Family Trust make it difficult to consistently track which deposits were used toward which payments, and whether at times the deposits into the accounts which were used to make principal and interest payments were legitimate or not. I am, however, of the view, based in part on my analysis of the principal and interest payments made on 15 December 2011 and 29 December 2011 in [112] and [113], that there is sufficient evidence of Mr Napier's misappropriation of funds throughout the accounts to "establish a coordination between the depletion of the trust fund and the acquisition of the asset which is the subject of the tracing claim, looking at the whole transaction, such as to warrant the court attributing the value of the interest acquired to the misuse of the trust fund."[23] *Republic of Brazil v Durant* clearly endorses the ability to claim property rights in the property obtained using loans which were financed by misappropriated money, as occurred here. This is supported by New Zealand case law.[24] This reflects that paying down the loan allowed the defendants to acquire a significant, valuable asset with less debt encumbrance. This is an increase in the value of the house to the Napiers.

[69] I agree with Woolford J's reasoning. The material facts of *Torbay Holdings* justify a finding that the misappropriated funds were used to acquire an asset, the house. By contrast here, unlike *Torbay Holdings*, *Foskett v McKeown* and *Durant*,

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22 At [210].
23 *Republic of Brazil v Durant*, above n 20, at [40].
24 *Shannon Agricultural Consulting (in liq) v Shannon* [2015] NZHC 1133.

the relatively small amount of money paid to meet mortgage payments can by no stretch be posited as payments to acquire an asset. Nor has it been proved that they were significant enough to prevent the house being sold. It needs to be kept in mind that there was evidence that Mrs Hadfield was a significant contributor to the mortgage payments.

[70] I had the benefit of submissions from Mr Andrew Barker as amicus curiae. He began with what he described as "general problems with the alleged proprietary claim". Of the sum of $49,159 used to pay the mortgage, the majority of that sum, $29,572 was paid between 1 April 2009 and 3 November 2010. The payments were part of the judgment obtained against Mr Hadfield in the District Court. It was a judgment for money sum only. The remainder of $19,586.55 relates to payments made earlier between 1 April 2008 and 31 March 2009. There has been no judgment in favour of the Fish Man in this amount and moreover, it does not appear that this amount has been the subject of a claim in the bankruptcy of Mr Hadfield. Mr Hadfield challenges the claim.

[71] More substantially, Mr Barker queries the availability of tracing as a remedy to follow these small sums.

[72] Mr Barker further submitted "the usual rule is that funds cannot be traced, either in law or equity, once they are paid to discharge a debt" citing *In Re Diplock*[25] and *Re Registered Securities Ltd*.[26]

[73] He recognises there has been some movement on this issue recently, citing the Privy Council decision in *Federal Republic of Brazil v Durant International Corpn & Anor*.[27] That was a case of tracing bribes received by the former Mayor of Sao Paulo and his son during the Mayor's time in office. The funds had been transferred between various accounts. Between 9 January and 6 February 1998, 13 payments totalling US$10.5 million were paid into the "Chanani" account (based in New York). Between 14 to 23 January 1998, six payments were made totalling US$13.12 million from the "Chanani" account into the "Durant" account (based in

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25 *In Re Diplock* [1948] Ch 465 at 584.
26 *Re Registered Securities Ltd* [1991] 1 NZLR 545 (CA) at 554.
27 *Republic of Brazil v Durant*, above n 20.

Jersey). Between 22 January and 23 February 1998 four payments were made totalling $13.5 million from the "Durant" account into the "Kildare" account (also based in Jersey). The Federal Republic of Brazil and Municipal of Sao Paolo sought the recovery of the initial US$10.5 million. The defendants argued that their liability was for US$7.7m on the basis that it is not possible for the Court to backwards trace. They argued:[28]

> …that the last three payments into the Chanani account identified as proceeds of the bribery were made on dates between 26 January and 6 February 1998, and so came after the final payment from the Chanani account to the Durant account. It is submitted that those three payments into the Chanani account cannot be traced to the defendants because there is no sound doctrinal basis for "backwards tracing".

[74] In addition, there were periods when legitimate withdrawals from the accounts had reduced the account balance below that level of the bribes paid in at that time.

[75] The Privy Council described the problem as follows:[29]

> The doctrine of tracing involves rules by which to determine whether one form of property interest is properly to be regarded as substituted for another. It is therefore necessary to begin with the original property interest and study what has become of it. If it has ceased to exist, it cannot metamorphose into a later property interest.

[76] The Privy Council then reviewed the academic debate on backward tracing between Professors Smith[30] and Conaglen[31] and concluded:[32]

> More particularly the plaintiffs submit, as Professor Smith argues, that money used to pay a debt can in principle be traced into <u>whatever was acquired in return for the debt</u>. That is a very broad proposition and it would take the doctrine of tracing far beyond its limits in the case law to date. As a statement of general application, the Board would reject it. The courts should be very cautious before expanding equitable proprietary remedies in a way which may have an adverse effect on other innocent parties. If a trustee on the verge of bankruptcy uses trust funds to pay off an unsecured creditor to whom he is personally indebted, in the absence of special circumstances it is

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28 At [10].

29 At 17.

30 The argument of Dr Lionel Smith in *The Law of Tracing* (1997) was referred to by Sir Richard Scott V-C in *Foskett v McKeown*, above n 10.

31 Matthew Conaglen "Difficulties with tracing backwards" (2011) 127 LQR 432.

32 *Federal Republic of Brazil v Durant International Corporation*, above n 20, at [32].

hard to see why the beneficiaries' claim should take precedence over those of the general body of unsecured creditors.

(Emphasis added.)

[77] The Board went on then to state the principle as follows:[33]

> The Board therefore rejects the argument that there can never be backward tracing, or that the court can never trace the value of an asset whose proceeds are paid into an overdrawn account. But the claimant has to establish a co-ordination between the depletion of the trust fund and the acquisition of the asset which is the subject of the tracing claim, looking at the whole transaction, such as to warrant the court attributing the value of the interest acquired to the misuse of the trust fund. This is likely to depend on inference from the proved facts, particularly since in many cases the testimony of the trustee, if available, will be of little value.
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> (Emphasis added.)

[78] Applying the principle to the facts, the Board held:[34]

> The development of increasingly sophisticated and elaborate methods of money laundering, often involve a web of credits and debits between intermediaries, makes it particularly important that a court should not allow a camouflage of interconnected transactions to obscure its vision of their true overall purpose and effect. If the court is satisfied that the various steps are part of a co-ordinated scheme, it should not matter that, either as a deliberate part of the choreography or possibly because of the incidents of the banking system, a debit appears in the bank account of an intermediary before a reciprocal credit entry. The Board agrees with Sir Richard Scott V-C's observation in *Foskett v McKeown* [1998] CH 265, 283 that the availability of equitable remedies ought to depend on the substance of the transaction in question and not on the strict order in which associated events occur.
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> …
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> In the present case the Royal Court and the Court of Appeal were justified in concluding that the necessary connection between the bribes itemised in schedule 3 and the receipts itemised in schedule 5 was proved, having regard in particular to the admission in the pleadings as to the link between the sums received by the defendants and the Chanani account. …

[79] The reader would have noted that as with Lord Millett's judgment in *Foskett v McKeown* all of these underlined passages in *Durant* reflect the use of money to acquire wholly, or in company with others, an asset.

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33 At [40].
34 At [38] and [42].

[80] None of these cases have material facts in any way similar to the material fact of this case, the use of revenue from the trading of the Fish Man to meet the mortgage liabilities for a relatively short period of time over the director's personal property, where the bulk of the money is simply going to meet the interest rates.

[81] I was also cited another decision of Woolford J, that of *Shannon Agricultural Consulting Ltd (in Liq) & Ors v Shannon.*[35] The liquidators of the plaintiffs sued the directors and shareholders of the insolvent company and also claimed a proprietary interest in a Te Awamutu property owned by the defendants as a consequence of the defendant's use of company funds to repay their personal mortgage. The defendants did not defend the claim. The claim proceeded by way of formal proof. The defendants, Mr Shannon and Ms Moorhouse had had a joint current account with their company. Current accounts are commonly used to record advances made by a company to its shareholders or vice versa. As at 31 March, Mr Shannon and Ms Moorhouse owed over $500,000 to the company under their joint current account. The company books showed that Mr Shannon and Ms Moorhouse were making irregular drawings from the company for their personal benefit, and inconsistent with the business expenditure of the company. Some of these drawings were coded as loan payments and were made to meet Mr Shannon's personal obligations to the ANZ Bank, whose indebtedness was secured by a mortgage in favour of the bank over the property. The liquidators identified payments totalling $76,534 as such loan payments.

[82] Woolford J readily found this was behaviour in breach of the fiduciary nature of the duties which Mr Shannon and Ms Moorhouse, as directors, owed to the company. He had no difficulty, therefore, in exercising the jurisdiction under s 301 of the Companies Act 1993 to require the directors in breach of their duties to repay money or return property. He then moved on to calculate the liability and gave judgment in favour of the liquidators in the sum of $878,105.16.

[83] Then, in [41] of the judgment he made a declaration that the company is entitled to trace the payments of $76,534 into and has an equitable proprietary interest in the property. This followed a finding that those payments were "thereby

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[35] *Shannon Agricultural Consulting Ltd (in Liq) & Ors v Shannon* [2015] NZHC 1133.

increasing the defendant's equity in the property by $76,534 (see [24] of the judgment).

[84] It would appear that Woolford J justified a tracing order over a relatively small sum by reason of his interpretation of *Durant* in the *Torbay* decision.[36]

[85] One final authority cited to me was *Taj Construction Ltd (in Liq) v Singh*.[37] This was another formal proof. The first plaintiff was a building and construction service company. It ceased trading and was placed in liquidation on the application of the Inland Revenue Department. In these proceedings the liquidators were seeking to recover from the defendant shareholder an overdrawn current account of about $260,000, compensation for various breaches of duty imposed on him as a director, and then a third cause of action, a declaration they were entitled to trace into his family home payments in the sum of $20,828.04. Brown J treated this as a constructive trust cause of action. He cited Woolford J's judgment in *Torbay Holdings*. Brown J followed Woolford J in *Torbay Holdings*, particularly where Woolford J cited the *Republic of Brazil v Durant.*[38]

[86] I distinguish *Shannon* and *Singh* on their material facts, and because I do not think that *Durant* is authority for tracing any small payment made off a mortgage into an interest in property.

[87] I do not believe that *Durant* or any of the House of Lords and Privy Council decisions are authority for the proposition that any misappropriated payment used to pay current mortgage liabilities can be traced into a proprietary interest in the property. I do not think that the authorities go that far.

[88] However, it has to be acknowledged that in *Shannon* and *Singh* there is judicial support for the proposition that the use of funds obtained in breach of fiduciary duty to make mortgage payments can give rise to a proprietary claim.

[89] I agree with this submission of Mr Barker:

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36 *Torbay Holdings Ltd v Napier*, above n 8, [227]–[229].
37 *Taj Construction Ltd (in Liq) v Singh* [2016] NZHC 584.
38 *Republic of Brazil v Durant*, above n 20.

> I have not found any significant discussion of this in (other) authorities. It is an approach, however, that I think gives rise to a range of problems. If the Court were to accept payment of a debt that is giving rise to a constructive trust over the asset purchased with the debt, then I submit that the extent of that interest could only extend to the amount of the principal repaid. It could not extend to interest.

[90] Tracing is a practical remedy of following money where it is converted into property. It is not some principle of converting money to a property right. There has to be a direct and substantial link between acquiring the property and the use of the misappropriated money. Reflecting on *Shannon* and *Singh,* I think it is a question of degree as to the point at which one can find money has been used to acquire or retain an asset.

[91] Repayment of a debt is properly not usually treated as the use of money to purchase an asset. In support of this proposition of law, Mr Barker relied on the decision of Abbott AJ in *Fletcher Steel Ltd v Nahal Contractors Ltd*[39] and the United Kingdom authority *In Re Gorman (a Bankrupt).*[40] He also argued it is consistent with the analysis in *Foskett v McKeown,*[41] which requires a focus of what the payment actually achieves and whether it acquires ownership of an asset.

[92] I think that trying to turn mortgage payments into a proprietary interest in the equity of a home, at least on this set of facts, is pushing tracing out of its natural confined scope.

[93] All of the authorities to which I rely upon establish that tracing is available where money, wrongfully obtained, is used to acquire an asset. But tracing is not, however, available where that money is used to pay a debt unless it also materially acquires an asset. It is for the Court to determine whether on the particular facts of each case the money has been used to acquire an asset or to pay a debt.

[94] In this case, it is a fact that Mr Hadfield did not use company money to acquire an asset. The overall purpose and effect of his actions was to use small sums of money belonging to the Fish Man to pay off a small part of debt he owed

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39 *Fletcher Steel Ltd v Nahal Contractors Ltd* HC Auckland CIV-2006-404-498, 24 May 2007.
40 *In Re Gorman (a Bankrupt)* [1990] 1 WLR 616.
41 *Foskett v McKeown*, above n 10.

personally in relation a mortgage on his property. The overall effect of the payment was to prevent ANZ from exercising a power of sale under the mortgage. It cannot be said that Mr Hadfield acquired any property in making these payments. It follows that this is not a case where tracing is available.

[95] I find the Fish Man has no proprietary interest in the property. The remedy of tracing is not available. There is no constructive trust.

Mr and Mrs Hadfield's entitlement to the property

[96] As I have concluded that the Fish Man has no claim to the property under s 119 of the IA, the issue around whether Mrs Hadfield has a protected interest falls away. I must now consider whether I should vest the property in either Mr Hadfield or Mrs Hadfield.

[97] As the registered proprietor, Mr Hadfield can make a claim that the property vest in him by reason of s 119(2) of the Insolvency Act.

[98] Mrs Hadfield, as the proprietor's wife, claims an entitlement to a half share in the property under the PRA. Given the length of the marriage under the PRA, Mrs Hadfield has a substantial argument for a half-share in the property. This is particularly so following the recent decision of the Supreme Court in *Clayton v Clayton.*[42]

[99] I will receive submissions from Mr Hadfield and Mrs Hadfield as to how they would like the title to be reconstituted, jointly, or one of them or the other, and possibly as to separate portions.

[100] Failing any agreement I favour re-vesting the home in both Mr and Mrs Hadfield in equal shares, by using the IA, s 119 and the PRA in combination. I will receive submissions if Mr and Mrs Hadfield cannot agree.

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[42] *Clayton v Clayton [Claymark Trust]* [2016] NZSC 30, [2016] 1 NZLR 590.

Costs

[101] Mr Hadfield who has counsel is entitled to costs against the liquidator on a 2B basis. Mrs Hadfield was supported only by the amicus curiae.

[102] I also direct pursuant to s 99A of the Judicature Act 1908 that Mr Barker's costs be paid by the liquidator, cognisant of the fact that the principal creditor is the Inland Revenue Department and that this litigation has effectively been taken in the public interest by the Commissioner of Inland Revenue.