IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

CIV 2012-404-001201
[2014] NZHC 193

BETWEEN	FAI MONEY LIMITED Plaintiff
AND	EDWARD ERROL JOHNSTON First Defendant
	GAVIN CRAWLEY and RICHARD ANTHONY JOHNSTON Second Defendants
AND	CIV 2013-404-003147
AND	CIV 2013-404-003236

Hearing:	18 February 2014
Appearances:	B Gustafson for the Plaintiff S Perese for the Second Defendants
Judgment:	18 February 2014

ORAL JUDGMENT OF ASSOCIATE JUDGE CHRISTIANSEN

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[1] The second defendants apply to set aside judgments entered against them on 14 August 2012. Those judgments formed the basis of requests filed in June 2013 for the issue of bankruptcy notices. Progress upon the adjudication applications awaits an outcome of the second defendants' applications to set aside the judgments entered against them.

The judgment debt

[2] On the 6 March 2012 the plaintiff (FAI) filed a statement of claim. It pleaded breaches of a loan agreement dated 23 December 2009. FAI agreed to loan the first defendant Mr E E Johnston $300,000. The second defendants agreed to provide guarantees and indemnities for the loan.

[3] It was pleaded the loan was in arrears around June 2011 and the parties agreed to a repayment plan contained in a deed dated 9 August 2011 by which:

(a) The first defendant Mr E E Johnston confirmed the debt then due was $386,267.96 on which an agreed interest rate would accrue.

(b) The defendants agreed to execute an admission of claim for the loan balance and all interest accruing.

(c) The debt and interest would be paid by 5 June 2012.

(d) There were agreed interest rates and other sums including costs that would require payment.

[4] It is pleaded the defendants executed an admission of claim on 4 August 2011.

[5] In summary, by its first cause of action FAI claimed Mr E E Johnson, a solicitor, defaulted on an interest payment on 23 June 2011 and that by reason of the deeds of guarantee and indemnity the second defendants were liable to pay all amounts owed, which they have not done despite demand being made. By its second

cause of action and in breach of their negative pledge to the contrary it is claimed the second defendants mortgaged the "security" property.

[6] FAI's proceeding was served but no statements of defence were filed.

[7] On 29 May 2012 FAI presented a judgment by default for sealing. The Court did not seal the judgment. On 13 July 2012 FAI filed an amended statement of claim and a fresh judgment for sealing.

[8] In most respects the amended statement of claim is similar or identical to its predecessor. The differences relate to the change in the manner of pleading of the repayment plan by reference to the deed dated 4 August 2011. Originally it was pleaded that the loan agreement provided for principal and interest to be repaid in full by 5 June 2012. In the amended statement of claim it is added that the repayment plan required payments to be made commencing in June 2011 that is before the execution of the 4 August 2011 deed.

[9] When counsel filed the amended statement of claim he also filed a memorandum explaining the plaintiff's calculation of the sum for which judgment ought to be entered. At that time the Registry was uncertain whether judgment by default should be sealed. The matter was referred to Associate Judge Bell for consideration. In a minute issued on 16 July he noted that the original statement of claim served upon the defendants pleaded that the loan principal and interest would be repaid in full on or before 5 June 2012. He commented it was not clear the plaintiff was entitled to seal a judgment for the unpaid principal before the date of repayment of the loan on 5 June 2012. Noting then that the loan had fallen due for repayment the learned Judge referred to Rule 7.77(3) by which a plaintiff is entitled to file an amended pleading which may introduce a fresh cause of action which may not have arisen when the proceeding was originally commenced. The learned Judge said the new statement of claim now apparently set out a valid claim for repayment of principal. He also noted:

> The amounts that the plaintiff may validly claim have increased between the original statement of claim and the amended statement of claim. Accordingly, the amended statement of claim ought to be served on the defendants to give them the opportunity to oppose if they wish.

[10] By email to the Registry dated 9 August 2012 FAI's counsel noted he had attached a revised version of the judgment. Counsel stated:

> As you will see, the judgment is for the lower amount claimed in the original version of the statement of claim...

[11] Judgment was sealed on 14 August 2012. Handwritten in pencil upon the Court's copy of that judgment at the bottom of the first page is the note:

> Judgment has been sealed according to first statement of claim dated 6 March 2012.

[12] It is that judgment which was filed in support of the request to issue bankruptcy notices.

[13] Despite Associate Judge Bell's suggestion that the amended statements of claim ought to be served on the defendants, it appears they were not. It follows they have only been served with statements of claim which appeared to have demanded repayment of the loan principal before that date when the principal was due.

Application to set aside judgment

[14] The second defendants say the default judgment against them was irregularly obtained because the amended statement of claim was not served upon them, as the Court directed it should be. They also say they have a good defence because any obligations they assumed under the guarantee were expressly limited to the assets of the trust i.e. that they did not assume any independent obligation of their own when guaranteeing payment.

[15] Finally and in relation to being served with the original statement of claim, the second defendants say they took all reasonable steps and instructed the first defendant solicitor on their behalf. Contrary to their expectation the first defendant did not take any steps to oppose FAI's claim. The first defendant has now been adjudicated bankrupt.

Evidence

[16] Mr R Johnston of the second defendants accepts he signed the loan agreement at the time the first defendant borrowed from FAI in 2009. Referring to the loan agreement and the deed of guarantee he notes that by both the liability of the trustee's was limited to the assets of the trust that owned the land over which "security" was given. Indeed, it appears clear that is so.

[17] Mr Johnston said that he and Mr Crawley the other second defendant were independent trustees of the Puketaha Trust, the only asset of which was a large property of about 9000m^3 at Swanson (the Swanson property), being the home of the first defendant and his family at the time. The beneficiaries of the trust were the first defendant's wife, and their two children.

[18] In an affidavit in opposition, Mr Finnigan a consultant to FAI exhibits a copy of a letter from the plaintiff's solicitors to the second defendants' solicitors. That letter rejects claims of irregular service because the amended statement of claim was not served. The letter explains the amended statement of claim was filed to correct some errors in the original amount. Regardless and even if the amended statement of claim should have been served that it did not mean judgment was irregularly obtained. Reasons to support this view were cross referenced by Mr Finnigan to relevant clauses in the loan agreement.

[19] The letter indicated any application to set aside judgment would be opposed because proper justification had not been given by the second defendants for their failure to defend when initially served with the proceeding.

[20] The letter also asserts that the second defendants breached their guarantee obligations because the trust's security property was mortgaged to the Westpac Bank and Dorchester Finance, contrary to advice given and obligations undertaken when finance from FAI was applied for. Further, that funding from Westpac Bank and Dorchester Finance was obtained prior to FAI's loan. In FAI's view the mortgaging of the property was "fraudulent/dishonest or (alternatively) negligent".

[21] It is clear from the submissions of counsel for FAI that it is acknowledged the trustees' liability under the guarantee was limited to recoveries from trust assets unless the breach was a result of the trustee acting fraudulently or negligently. Counsel outlines FAI's position that the trustees' covenants were breached by encumbering the property and later with the sale of the property. It is claimed the property was sold to a related company, of which Mr Richard Johnston was a director, for a figure of $640,000 less than what the first defendant deposed it was worth two years earlier.

[22] It is not clear why FAI did not plead that the obligations of the second defendants were limited to the assets of the first defendant's trust and that the trustees could not be called upon to satisfy any of the borrowing obligations unless they acted "fraudulently, negligently, or in breach of trust".

[23] The statements of claim refer to the breach of a negative pledge which refers to the mortgaging of the "security" property, without more. Unsurprisingly a lot of the evidence provided upon the setting aside application has focussed on whether there has been a breach of the negative pledge.

[24] Mr Finnigan deposes that prior to making the loan FAI was advised by Mr E E Johnston that the Swanson property was unencumbered. He said this was confirmed in writing in a statement of assets and liabilities of Mr E E Johnston and his wife. The statement showed the Swanson property had a value of $1.5M which meant there would be equity to repay FAI's loan if it was necessary to call up the guarantee.

[25] Mr Finnigan then annexes a copy of FAI's letter of loan dated 15 December 2009 which included a special condition which provided that by signing and accepting the loan offer the second defendants undertook not to encumber the Swanson property without the prior written consent of FAI.

[26] The letter in question is addressed to Mr E E Johnston whom the letter refers to as the 'Borrower'. The guarantors are noted as 'the Trustees of the Puketaha Trust'. Under the heading of 'Special Conditions' it is noted:

> This offer is made on the basis of the information FAI currently has about the Borrower and, if any event occurs, or new information comes to the attention of FAI, which in the opinion of FAI, means the borrower's credit worthiness is materially worse than FAI understood it to be at the time of this letter, FAI may decline to enter into the loan agreement, even if the offer set out in this letter has been accepted.
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> The letter requests that the terms of offer be confirmed by the borrower and the guarantors on an attached Acknowledgement and Acceptance form.

[27] It is clear this form was signed by Mr E E Johnston as the borrower and that he also signed for the guarantors as their attorney.

[28] In a schedule attached to the letter of offer special conditions are set out in which it is noted that the borrower undertook to advise FAI of any changes of information required to be provided. In addition the borrower was required to provide a current title search of the Swanson property.

[29] Mr Finnigan's evidence is that the obligations of the second defendant trustees were clear and were reinforced by clause 6.1.1 of the deed of guarantee dated 23 December 2009 which provides that the guarantors undertook to FAI that they would not encumber in any way, including by way of a mortgage or other charge, the Swanson property.

[30] Although that deed was signed by Mr E E Johnston on behalf of the second defendant Mr Crawley, the deed does bear the signature of the second defendant Mr R A Johnston.

[31] Mr Finnigan's position is that although clause 6.1.1 did not expressly say the trustees could not sell the Swanson property (as opposed to merely encumbering it) he believes this was implicit in the clause.

[32] Mr Finnigan deposes that despite the negative covenants the Swanson property was mortgaged and then disposed of by the second defendants.

[33] Finnigan is now aware that at the time of the loan, the Swanson property had in fact already been mortgaged to Westpac, indeed since 2004 and when FAI made its loan in 2009 the Westpac mortgage had a priority limit of $1.1M.

[34] Mr Finnigan acknowledges that his lawyers were at relevant times in possession of a copy of the certificate of title on which Westpac's mortgage was noted. Mr Finnigan explains it seems his lawyers overlooked the fact of the Westpac mortgage. That notwithstanding, he believes subsequent actions by the second defendants provide evidence of a clear breach of guarantor obligations. He explains that in December 2011 Mr E E Johnston provided FAI with an updated statement of assets and liabilities which showed other debts 'against the Swanson property'. Also the statements suggested the value of the property had dropped to $950,000. One of the other loans was supported by a caveat lodged after FAI's loan on the title of the property noting an interest in respect of an unregistered mortgage in June 2005.

[35] The other loan is secured by a mortgage granted in March 2011.

[36] Mr Finnigan says FAI considers that in the circumstances there was clearly a dishonest breach of the negative covenant. Also FAI's solicitors wrote to the second defendants on 30 November 2011 stating that the trustees had breached negative covenants in the loan documentation. Mr Finnigan says that despite being expressly put on notice the second defendants did in February 2012 dispose "of the Swanson property to Seabreeze Trustees Limited and Johnston Associates Trustees Limited", as a title search disclosed.

[37] Company searches disclose that the second defendant R A Johnston is a director of those companies.

[38] Clearly, at the time of the transfer, the mortgages in favour of Westpac and another were discharged. Moreover a recent search has shown the registration of a mortgage in favour of ASB Bank Limited with a priority sum of $1.875M.

[39] FAI's solicitors have requested copies of documentation relating to these transactions, but no response has been forthcoming.

[40] Mr Finnigan believes those transactions involve dishonest breaches of the negative covenants.

[41] The clear evidence is that FAI was aware of the Westpac mortgage and the amount of Westpac's priority. It follows the property was at all times the subject of a mortgage and therefore the quality of the negative pledge supporting the guarantee and indemnity was materially reduced.

[42] It is clear from evidence provided by Mr R A Johnston that the property sold for significantly less than the amount that was owed to Westpac, and that Westpac received all the sale proceeds.

Considerations

[43] Applicants to set aside judgment sometimes focus upon claims that the judgment was irregularly obtained. Invariably such applications do focus upon whether a defendant has a substantial ground of defence. As well consideration is also given to whether or not the plaintiff would suffer irreparable harm if judgment was set aside.

[44] In this case the application focuses upon two issues:

(a) Was the judgment irregularly obtained?

(b) If it was not irregularly obtained is there a genuine defence to the plaintiff's claim?

[45] FAI's position is that the judgment was not irregularly obtained but even if it was FAI argues that judgment should not in any event be set aside.

[46] Counsel for FAI argues that Associate Judge Bell indicated the amended statement of claim ought to be served because the amount had increased from the original statement of claim. Subsequently (other) counsel emailed a deputy registrar and advised that FAI wished to avoid the cost and delay of re-serving and requested whether service could be avoided if the plaintiff agreed to limit the amount of its claim to the amount sought in the original statement of claim. Counsel requested the Deputy Registrar to consult with the Associate Judge. Counsel then forwarded a

revised version of a draft judgment. It is not clear whether the Deputy Registrar spoke to the Associate Judge before sealing the same.

[47] Counsel (new counsel) for FAI submits that Associate Judge Bell's minute did not prevent the Registrar exercising her authority to enter judgment because the judgment sum was a lesser amount than originally sought in the statement of claim and because no statement of defence had been filed. Counsel argued that the learned Judge's concerns were about an increase between the filing of the original claim and the amended claim. In any event counsel submits Associate Judge Bell was incorrect when he stated that the original claim did not set out a valid claim because it pleaded the loan was to be repaid on a date before which it appeared it was due for repayment.

[48] It is clear that the amended statement of claim was not served. Notwithstanding Associate Judge Bell's concerns the plaintiff did have judgment entered on the basis it would not seek judgment for a sum greater than that sought in the statement of claim. The matter was not referred again to the Associate Judge – otherwise a minute would have issued. Instead it was achieved without the benefit of a memorandum of the Court dealing with earlier observations and concerns. Earlier Associate Judge Bell was concerned whether the plaintiff was entitled to seal judgment for the unpaid principal before the date of repayment of the loan i.e. on 5 June 2012. That concern is understandable absent any express pleading of loan repayment acceleration. The amended statement of claim sought to remedy this lack of clarity but that was never served, and it was not the document used for sealing the judgment.

[49] The Court considers the amended statement of claim had to be served and to the extent judgment was obtained at all then it was clearly irregular.

[50] Even if the judgment had not been irregularly obtained the Court would have set the judgment aside because of its concerns about the sufficiency of a judgment which suggests FAI was entitled to recover personally from the second defendants.

[51] FAI's position is that it has provided a sufficient basis to challenge the honesty of the second defendant's actions, in particular by the sale of that same property which FAI was assured was unencumbered.

[52] Counsel for FAI says there is an onus on the second defendants to establish the factual basis for setting aside the judgment. Despite this counsel complains the second defendants have provided no evidence about the financial position of the trusts and the reasons for encumbering and then selling the property.

[53] Also, counsel submits, the second defendants have not adequately explained their reasons for failing to file a defence when the proceeding was served on them.

[54] Counsel submits the second defendants cannot rely on the limitation of liability provisions because of their "dishonestly or negligence"; that despite their pledge they would not encumber the Swanson property they allowed that to happen by permitting the mortgage of another lender to be registered in August 2011, and by permitting disposal of the property in March 2012, within a short time after FAI had through its solicitors specifically drawn the existence of the negative pledge to the second defendants.

[55] For FAI it is submitted that undue delay and considerable cost would be caused if the judgment was set aside; that FAI has incurred fees and disbursements of nearly $30,000 and it would be prejudiced by having to discharge the charging orders it has registered over three properties in which the second defendants have registered interests.

[56] In the Court's judgment the applications to set aside should be granted.

[57] Although the original statement of claim (upon which the judgment was obtained) contained the briefest pleading of particulars of a negative pledge, the original proceeding sought judgment upon an unpaid debt and it was upon that claim judgment was entered. No mention was made by that claim of the limited liability of the trustees or with respect of those reasons why liability should attach to the second defendants for any reason other than the fact the debt was unpaid. FAI's position,

now identified by Mr Finnigan, suggests that the judgment could in any event be maintained because of the second cause of action which pleads the breach of the negative pledge condition.

[58] Mr Perese submits there is a lack of clarity as to how clause 18.1.2 of the deed of guarantee has been breached. There have been loose claims of dishonesty and fraud but nothing more provided in support of these save for Mr Finnigan's assumptions.

[59] It is clear that FAI were aware that the "security" provided by the negative pledge was degraded even before FAI advanced the loan. So the Court agrees with Mr Perese's submission that by its failing to check the title and the encumbrances thereon, FAI missed the opportunity to discover that there was a Westpac mortgage with a priority of $1.1M in a falling market. FAI was also aware it did not have a registered valuation of the property, and was therefore relying on a dated GV.

[60] As the evidence sets out clearly, the trigger for the forced sale of the property was the Westpac mortgage defaults, and not the failure to meet loan payments to other lenders. Also and clearly all the sale proceeds (comprising indeed the total value of the assets in the control of the second defendants) were accounted to Westpac.

[61] FAI knew before it advanced the money that it did not have a caveatable interest in the property. As Mr Perese points out FAI would have known all along that the negative pledge it obtained was a personal obligation, and did not create a caveatable interest.

Conclusions

[62] The judgment against the second defendants was irregularly obtained. The proceeding was served before the debt was due for repayment. The Associate Judge, to whom the application for entry of judgment was referred, suggested an amended statement of claim be reserved. Only in that amended statement of claim was sufficient detail provided of a right to accelerate the date for repayment. This

notwithstanding there was no service of an amended statement of claim. For reasons unclear the plaintiff had the first statement of claim sealed.

[63] In this Court's opinion the judgment was irregularly obtained. But, even if that was not so, then sufficient grounds exist to indicate the second defendants have a defence to the claim.

[64] FAI agreed to advance funds without any registered security being obtained over the property of the borrower. The funds were borrowed by an individual. His statement of assets and liabilities disclosed his family property was owned by a trust of which two others (including his brother) were trustees. The borrower was himself a solicitor. The borrower signed the loan agreement. Guarantees were provided by the trustees but any liability of theirs was limited to the assets of the trust except if the trustees acted in any manner which was dishonest or fraudulent.

[65] Subsequently there was a forced sale of the trust property due to the borrower's failure to meet his loan obligations.

[66] FAI claimed the trustees had covenanted that the property was unencumbered. In fact, as their own solicitors have acknowledged, a title search clearly disclosed the registered mortgage of Westpac Bank with a priority amount which exceeded that obtained by the forced sale of the property.

[67] In that overview of matters the Court cannot accept protestations of dishonest or fraudulent behaviour on the part of the second defendants – at least without a further and full enquiry being made. FAI complains that the second defendants bear an onus upon their setting aside applications to satisfy the Court they have a defence.

[68] That is so, but issues of dishonesty, fraud and the like require better inquiry than is available from evidence contained in affidavits. In this case the Court is some distance from reaching the conclusions that FAI encourages it to do.

[69] To the contrary there is a prospect in the outcome of any trial enquiry that FAI will itself have issues in justifying the sum of the actions and decisions it undertook.

[70] For these reasons the Court considers it inappropriate to assume that any judgment at all be entered against the second defendants.

Judgment

[71] There are orders setting aside the judgments against the second defendants.

[72] There are orders that the bankruptcy notices dated 14 June 2013 served upon Gavin Crawley and 21 June 2013 served on Richard Anthony Johnson, be set aside.

[73] In the circumstances it is appropriate to reserve costs for determination in the cause.

Associate Judge Christiansen