waterline

waterstone
INSOLVENCY

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INSIDE:

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Phoenix Company

THE HIVE DOWN

It has been common for businesses in trouble to *Phoenix* themselves, also commonly called a *Hive Down*. Directors of a company that has amassed significant liabilities can set up a new company, transferring the assets and appointing a friendly liquidator to the old company. It works like this:

THE HIVE DOWN TRANSACTION: 1

Company B is established and buys assets for nominal value. Creditors are left behind. Company B must have a totally different name from Company A, including the name that it trades under, if there are common directors.

Company A

Assets
- Cash
- Debtors
- Current Account
- Goodwill
- Customers
- Intellectual Property

Liabilities
- IRD Debt
- Creditors

Company B

Assets
- Cash
- Debtors
- Goodwill
- Customers
- Intellectual Property

Liabilities

Liquidator

Company A (In Liquidation)

Assets
- Current Account

Liabilities
- IRD Debt
- Creditors

THE HIVE DOWN TRANSACTION: 2

Company A is liquidated.

THE HIVE DOWN TRANSACTION: 3

The friendly liquidator has the power to investigate the sale of the assets or recall the overdue current account, but decides not to.

For the director, this is a risky strategy. No liquidator is ever that friendly and she can decide to chase the current account or sue the director or the new company if she thinks that the assets were sold below value.

The Hive Down Trap:

It is against the law to be the director of a failed company, defined as one that has had a liquidator appointed, to be involved in a new business with a same or similar name for a period of five years.

There are four exceptions:

a) If the director follows the process as outlined opposite: the Phoenix Law

b) The High Court gives permission

c) The individual ceased being a director twelve months before the company went into liquidation

d) The new company has been in existence for at least twelve months prior to the first company's liquidation and has been trading during that twelve month period.

Directors who are convicted under this section face a maximum sentence of 5 years in prison and a maximum fine of $200,000. However, at the time of writing only three directors have received a conviction and all were discharged. As an automatic consequence of their convictions they were disqualified as directors for five years.

Directors of Phoenix companies are also personally liable for all of the debts of the Phoenix Company that were incurred while the director was involved.

Directors seeking the sweetness of a hive down can be easily trapped.

THE PHOENIX

If a director wishes to remain in charge of his company after the hive down then he must follow the prescriptive rules laid down by Section 386A of the Companies Act. These are straight forward and allow for an orderly restructuring.

THE PHOENIX TRANSACTION: 1

Company B is established.

THE PHOENIX TRANSACTION: 2

Company A is liquidated. The liquidator can then negotiate the sale of the business and its assets.

Company A (In Liquidation)

Assets
- Cash
- Debtors
- Current Account
- Goodwill
- Customers
- Intellectual Property

Liabilities
- IRD Debt
- Creditors

Sale & Purchase

Liquidator Agreed $

Company B

Assets
- Cash
- Debtors
- Goodwill
- Customers
- Intellectual Property

Liabilities

THE PHOENIX TRANSACTION: 3

The Liquidator sells the business to Company B. Because the sale is done by the liquidator and not the director, it is assumed that the price will be fair, because the liquidator can be sued if it isn't.

THE PHOENIX TRANSACTION: 4

The director of Company B must write to the creditors of Company A advising them of their role in the new company.

If the Phoenix rules are followed then a director cannot be prosecuted under the Phoenix Company laws. This allows for a company to be honestly restructured.

The Phoenix laws were brought in to prevent directors starting multiple companies with similar names and moving their assets to safety but leaving their creditors chasing an endless series of shell companies. Creditors are now at least aware that they are dealing with a new entity, either because the new company uses a distinctively new name or the directors writing to the creditors advising them of the change.

Because the assets are sold by the liquidator there is some assurance that the assets will be transferred at a fair price.

If you are a creditor who has been affected by a Phoenix company or Hive Down and are unhappy the only remedy may be to replace the liquidator. There is a very small window for this to be done and if this window is missed then there is nothing that can, economically, be achieved.

Phoenix Rises From VA's Ashes

The Voluntary Administration regime was designed to provide a mechanism for companies to enter an orderly restructure. At the time the law was enacted many commentators were optimistic that Voluntary Administrations stood a good chance of achieving this, because of the Administrators casting vote and the removal of the IRD preference.

To pass a compromise in an Administration half the creditors by number with over 75% of the debt must vote in favour. However, following the Australian legislation, if there was an impasse between these two then the Administrator could break the deadlock with their casting vote. This created a low barrier for compromises to be approved.

Further, the Act made no reference to maintaining the status of preferential creditors in an Administration, allowing staff wages and unpaid GST and PAYE to be bound by a compromise.

However, when these two issues were tested by the IRD, (CIR v Grant and Khov), both the High Court and the Court of Appeal found that the Administrator held no casting vote unless the number of creditors were tied. The Court also upheld the IRD's preference.

Voluntary Administrations came to a sudden halt.

The advantage of a Phoenix over an Administration is that the debtor does not need to consult with the creditors nor acknowledge the Commissioner's preference. A director with a company trading profitability but unable to repay historical debt is better suited to adopt the Phoenix route.

Prudence; Our mascot, visiting the Grand Canyon.

Voluntary Administration: The GSA Appointment and the Ten Day Rule

The Companies Act allows for a GSA holder to place a company into Voluntary Administration if their GSA covers:

> *... the whole, or substantially the whole, of a company's property.*

Exactly how much is *substantially the whole* is not defined, but the Victoria Supreme Court considered the matter back in 2010. The wording of the Australian regime is identical on this point so their determination is likely to be relevant over here.

The company, Australian Property Custodian Holdings Limited, was placed into Administration by a secured creditor who held 68% of the company's assets. This was not enough, the court declared, and ruled that the appointment was invalid on that basis.

The company's directors supported the appointment of the Administrators so the court used its wide discretion in dealing with Administrations to confirm their appointment. This was fortunate, otherwise the position of the Administrators would have been awkward.

Back on this side of the Tasman insolvent companies who wish to appoint a liquidator or Voluntary Administrator are unable to do so ten days after they have been served with liquidation proceedings.

The Companies Act however does not preclude a secured creditor placing the company into Voluntary Administration (although to call such an appointment voluntary seems an abuse of language) after the ten days has expired. Once the company is in liquidation, the secured creditor can no longer appoint an Administrator but they can appoint a receiver if they were so minded.

Once a company is placed into Administration, all legal action against it ceases, which, we believe, would include a liquidation proceeding.

The purpose of the ten day rule is to prevent shareholders appointing friendly liquidators on the court-room steps. Friendly liquidators must now be appointed sooner, which is helpful to the friendly liquidators. Thank-you parliament.

It is common for shareholders to be unaware of this rule and to find themselves talking to their lawyer well outside the ten days. However, if the shareholders have a GSA over their company, there seems nothing to prevent them appointing a friendly Voluntary Administrator.

Once the company is in Administration the liquidation application is automatically stayed as a result of Section 239ABE, unless the court or the Administrator consents. Once the Administration ends and the company falls into liquidation, the liquidation application becomes redundant. It is possible that the court may allow a liquidation application to proceed in the face of an Administrators appointed in such a manner but it is more likely they would allow the Administration to play out.

Insolvency Chat...

Rising insolvency star, Bruce John-Boy of John-Boy and Sons, talks exclusively with Waterline this week.

What attracted you insolvency Bruce?
Well, I failed accounting at university and did not have the grades to get into law school, even at Waikato. Besides I lacked the people skills needed to be a lawyer but I was really attracted to professional services, so insolvency was a natural fit.

How did you get started in the profession?
I got a job with the Official Assignee. This was back in the 80's when the standards were not that high; all you needed was school certificate and a note from your parents. My mum was pretty distressed, she thought insolvency was not a real career and she wouldn't sign, but my dad wrote a letter saying she was really my grandmother! Turns out my sister was my real mother, it was pretty confusing. Anyway, they let me in. I was stoked.

What made you start your own firm?
Adversity is the mother of opportunity; unless she is really your sister! Anyway, the OA fired me over a misunderstanding with a water-cooler and some missing bottles of ethanol we recovered from a liquidation. After the ERA hearing no one would hire me so I had to go out on my own. It was hard at first, but eventually I began to get some work.

You have a reputation for speaking your mind and your reports make for fun reading!
Thanks. I used to try and tone it down but I get very little repeat business so I figured why not be up front? Too many people in this profession worry about things that do not really matter.

Like the Companies Act.
Yes. I make decisions based on what is fair. Many insolvency practitioners are hung up on the rules. We are dealing with real people here and we have a responsibility to act as people first, liquidators second.

You were criticised heavily in the Court of Appeal last month on just that issue.
(Sighs). Yeah, that was tough. I thought the comments were pretty harsh. It's like the judges have no compassion and stick rigidity to the legislation. There should be more latitude for liquidators to act on what we think is right and wrong and not be so narrowly constrained.

Bruce John-Boy

Will you appeal?
No.

On a positive note, your son has starting working with the firm.
Yes! I am very excited about that. It will be good to have another pair of hands around the shed.

Shed?
We work from the shed, at the back of my sister's house.

I see. Finally Bruce, what do you most enjoy about your chosen profession?
Oh, that is easy. The lack of oversight *(laughs).*

Searching and Seizing

By Kieran Jones, Insolvency Officer

The law of unintended consequences came into force last year with the Search and Surveillance Act 2012 gaining Royal assent.

Up until this legislation was passed a liquidator could rely on section 198 of the Summary Proceedings Act 1957 to obtain a search warrant. The warrant would allow the police to search any premises or location that the liquidator has shown he had reasonable grounds to believe a person has committed or is suspected of committing an offence punishable by imprisonment. The liquidators could assist the police who would actually conduct the search.

A director who fails to deliver all company assets in his possession to the Liquidator and fulfil his duty under section 274 of the Companies Act is liable for a fine not exceeding $50,000 or to imprisonment for a term not exceeding two years, triggering the liquidator's entitlement.

Under the Search and Surveillance Act only those who are specifically mentioned, from officers under the Antarctica Protection Act through to the Wine Act, can apply to the District Court Registrar for a warrant. Liquidators were overlooked.

It was exceptionally rare for a liquidator to exercise this power and it was only used as a last resort and in the face of consistent obstruction by a director. This was the situation we found ourselves in last year after being appointed as Liquidators of a hydroponics company. We knew there were assets but could not find them. Fortunately we were provided information that confirmed the whereabouts of some assets. That same day we made an application to the Court for a search warrant and the following day the police, assisted by Waterstone staff, searched multiple sites in Christchurch and Auckland. We recovered company assets, including company documents, computers and physical assets.

Under the Search and Surveillance Act it is the police who would need to make the court application, for the Liquidator, a slower process.

A Liquidator still has the power to obtain a *search order* under the High Court Rules in Schedule 2 of the Judicature Act 1908. Specifically Rule 33 of the High Court Rules allows the Court to grant a without-notice search order to an applicant with respect to evidence that is or may be relevant to a proceeding or anticipated proceeding brought by the applicant. In order to obtain a Search Order the Court must be satisfied that;

a. The applicant has a strong prima facie case on a cause of action; **and**

b. The potential or actual loss or damage to the applicant will be serious if the search order is not made; **and**

c. There is sufficient proof that evidence may be destroyed or become unavailable for use in the anticipated proceedings.

A search order is not a search warrant. It is an instruction from the High Court to the person subject to the order to provide the documents. The person can refuse, although this would be contempt of court.

Importantly, the search must be conducted by the applicants lawyers. The applicant is not allowed to be present and an independent lawyer must be made available for the person subject to the Search Order.

For a liquidator it is a much less powerful tool than a search warrant. Hopefully the Search and Surveillance Act will come up for review. Waterstone will be making a submission that the ability to apply for a search warrant should be extended to liquidators.

Liquidators and Beagles are naturally inquisitive.

The Bell Tolls for Section 294

By Brent Norling, In-House Counsel

> ***Those who write clearly have readers; those who write obscurely have commentators.***
>
> Albert Camus;
> French Nobel Prize winning author

Legislative ambiguity is a tax paid by those forced to unravel the hidden meaning of badly constructed legislation.

THE AMBIGUITY

Section 292 and 293 of the Companies Act 1993 defines what a voidable transaction is. Section 294 and 295 set out the process of dealing with voidable transactions and section 296 deals with defences that a creditor has against a claim by a liquidator.

What is unclear is the process that a liquidator must use to collect an insolvent transaction.

Section 294 of the Act says:

> *The transaction or charge is automatically set aside... if that person has not objected... within 20 working days after the liquidator's notice has been served...*

Section 295 of the Act continues:

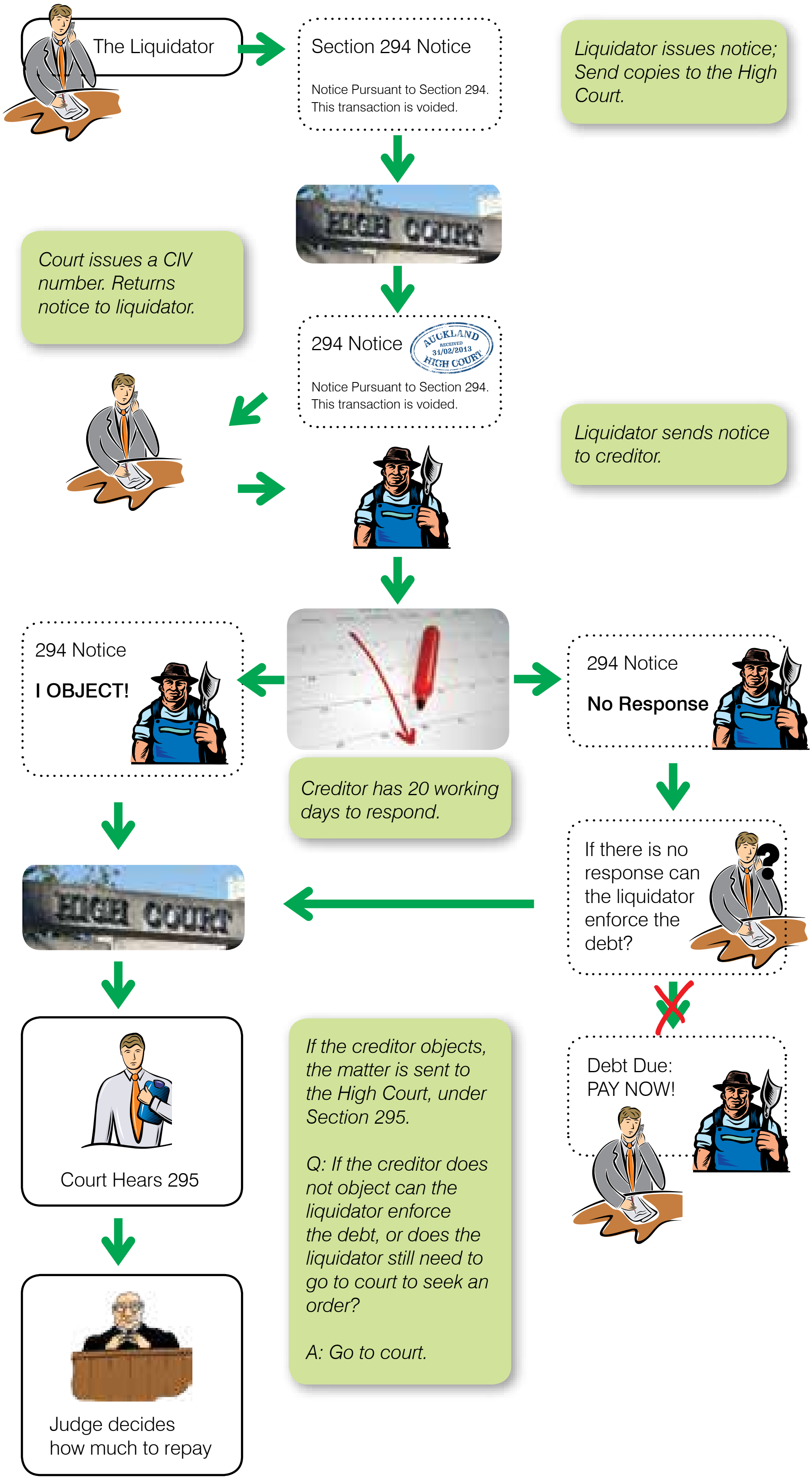
> *If a transaction or charge is set aside under section 294, the court may make one or more of the following orders...*

If there is no objection after twenty days the debt is set aside. The Waterstone liquidators considered that this could mean the amount set aside was now a due debt, and it could be enforced.

However, there was not a consensus on this, with some of our advisors believing a liquidator still needed to go to the High Court to get an order to enforce payment. If this line of thinking was correct, then why bother waiting for the twenty working days for the transaction to be set aside if in all cases the matter needed to go to court?

Further, if a transaction was 'set aside' but the debt could not be enforced, then what did it mean to have the transaction set aside?

The law was vague and the Waterstone liquidators wanted clarity. They got it.



THE FACTS:

Waterstone are liquidators of Quantum Grow Limited. They served a voidable transaction notice on a related company, Lotus Gardens Limited, for $25,576. The Notice was issued pursuant to the process prescribed in section 294 of the Act. Lotus Gardens neglected to object to the voidable transaction notice within 20 working days.

Given that no objection was raised by Lotus Gardens, the liquidators considered that by operation of section 294(3) of the Act, the transactions had been set aside. Demand was made by the liquidators against Lotus Gardens setting out that $25,576 has been automatically set aside and payment of $25,576 is due. Again, Lotus Gardens failed to respond.

Given that the debt was undisputed, the liquidators served a statutory demand on Lotus Gardens. No dispute was raised nor was any application made to set aside the statutory demand.

The liquidators then filed proceedings to liquidate Lotus Gardens. If Lotus Gardens wanted to defend liquidation proceedings, it was required to file and serve its defence within 10 working days of service. It did not. Lotus Gardens filed an application to extend time to file its defence just a few working hours before the hearing. The High Court granted this extension and the issue went to a defended hearing.

The common director of both Lotus Gardens and Quantum Grow, Alan Canavan, gave evidence that the funds were in relation to a loan that Lotus Gardens gave Quantum Grow. Subsequently, Mr Canavan reconsidered his position and deposed that Lotus Gardens was simply a conduit of the funds in relation to a loan to the Bank of New Zealand. Mr Canavan's testimony was the only evidence admitted on this point.

The liquidator's view:

According to section 294(3), the transaction is automatically set aside if there is no written notice of objection within 20 working days of notice being served. Section 294(5) of the Act states that a transaction or charge that is not automatically set aside *may* still be set aside by the Court on the liquidator's application.

If there is no objection, the transactions are set aside and the money is now owed to the liquidators. If the recipient does object then an order for the transaction to be set aside must be made by a Court Order under section 295.

The liquidators claimed their view is consistent with the wording of section 296(3) which sets out that the Court must not order recovery of property whether under the Act, any other enactment, or in law or in equity if the recipient can satisfy the defences available under that section. This wording suggests that recoveries can be pursued outside of the Act and that section 295 is not exclusive. This view, they submitted, was favoured by the late Supreme Court Judge, Sir Robert Chambers when sitting as a High Court Judge. In *McKinnon v Falla Holdings NZ Ltd* (1999) 8 NZCLC 262,034, Justice Chambers held:

> *Nothing in s 295 could be construed as making the s 295 procedure exclusive. If Parliament intended s 295 to be the exclusive procedure for recovery following a setting aside, Parliament would surely have said so.*

In that case, Justice Chambers was considering an application where the liquidator filed summary judgment proceedings in the District Court, which was on appeal to Justice Chambers.

Accordingly, the Waterstone liquidators were of the view that if a recipient of a notice fails to object, the transaction is set aside and the effect is that it becomes a debt that is due.

The Decision of Associate Judge Bell:

Associate Judge Bell disagreed. In his view the liquidators were relying on a common law right to enforce a debt that had arisen from the transaction being set-aside, a right that had been legislated away. As a result, the liquidators should have applied to the court under section 295 to seek an order before issuing a statutory demand.

Because the liquidators had used the wrong procedure, Associate Judge Bell held that Quantum Grow was not a creditor and therefore had no standing to liquidate Lotus Gardens. The liquidation application failed. The key decisions from the Court were:

1. A transaction is automatically set aside if there is no objection but this does not allow a liquidator to demand payment. He must first obtain an order under section 295 before a debt is due.

2. Lotus Gardens is free to contest whether there was a transaction under section 292 and to raise the defence outlined in section 296(3).

3. On the basis that the liquidators did not obtain a Court Order pursuant to section 295, they were not creditors and could not liquidate Lotus Gardens.

Sometimes you win, sometimes you learn. The liquidators are appealing the decision.

The Lotus plant looks lovely, but proved to have a sting for Waterstone.

Follow the Money? Don't bother says the Court of Appeal

Litigation resulting from the collaps of Five Star Finance threw up two interesting questions.

A) Can a lender claim that a debt repayment is not voidable because they have a property interest in their own money advanced to the debtor?

B) Can a Trustee avoid personal liability because a fiduciary acted without proper authority?

The Facts

Five Star Finance Limited went into liquidation in 2008. The liquidators, Messrs Rea and Sargison, identified transactions that they considered voidable, specifically 39 payments totalling $995k that went from the company to the Bowden No. 14 Trust (the Trust).

There had been considerable dealings between the Trust and Five Star. At its peak Five Star owed the Trust $1.7m, although this had been reduced by the 39 payments. It was agreed that Ronald Russell was the sole trustee of the Trust and that Russell had delegated some of his duties to a Mr Kirk, creating a fiduciary obligation to Russell. It was accepted by the Court that Kirk had acted outside of his authority in much of this transactions between Five Star and the Trust.

The liquidators followed the processas prescribed in section 294 of the Companies Act, then, prudently, made an application under section 295 to determine the amount to be repaid. That application was heard by Associate Judge Bell.

Decision A of the High Court

Associate Judge Bell concluded that the transactions did not come within section 292 and that the liquidators were not entitled to an order setting them aside. He viewed that as the Trust had advanced funds to Five Star, it was entitled to receive some of this money back. Five Star was merely "..restoring Trust funds it had received" and the transactions were not part of a continuing business relationship and not transactions as defined by the Companies Act.

The High Court found that the Trust had a propriety claim on the funds it had advanced and it was therefore entitled to receive its own money back. It could, in effect, trace its money into the company's bank, and was thus entitled to claim it back. As a result, the Court found no cause to consider the preference issue.

Decision B of the High Court

Bell also declared that even if they were transactions and that the Trust owed the money back to Five Star, that Russell, as the sole trustee of the Trust, would not have been liable as Kirk had acted outside of the authority that Russell had given to him. Any order would have been limited to the assets of the Trust. Sargison and Rea went to the Court of Appeal.

Court of Appeal: A

The Court of Appeal held that the definition of 'transaction' is sufficiently broad to cover the payments between the Trust and Five Star and regardless of the nature of the payments; the Trust had received a preference at a time that Five Star was unable to pay its due debts. The Court accepted the finding of Associate Judge Bell that the transactions were made in breach of the Trust deed but noted that tracing is a much more limited tool and the assets in question must be readily identifiable. Because the Trusts money had gone into an overdrawn account, there was no traceability or priority claim held by the Trust on funds drawn back from an overdrawn account to pay back the Trust.

> *When money is paid into a bank account, the money as such does not remain identifiable. It becomes legally and beneficially the property of the bank and not the account holder. ...The money is not traced in and out of the account as there is no traceable money in the account.*

Court of Appeal: B

The Court of Appeal also found that Russell, the sole Trustee, could not escape his liability because of the unauthorised actions of Kirk. A trustee is personally liable for the debts of the Trust, the Court of Appeal declared, and ordered Russell to settle the debt.

PMSI Implications of the Decision

This decision may have implications on the position of PMSI holders as they have a proprietary interest in proceeds of the sale of their goods. If the proceeds of those goods were paid into an overdrawn account, then the PMSI holder has no claim against that money.

Funds paid to a creditor from an overdrawn account cannot be traced. This money is the bank's, advanced to the company to pay the creditor. There is no tracing, or marshalling opportunities for creditors seeking to avoid a voidable transaction.