waterline

waterstone
INSOLVENCY

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INSIDE:

Reasonable Force.
How far will the law let you go?

0800 CLOSED

Aron Salomon v A Salomon Limited (in liquidation)

The case of Salomon and Salomon has been passed down like an heirloom, with each generation of law and commerce students understanding its significance less. It is hard, from this perspective of a century and a quarter, to appreciate the case's importance. After all, the decision was prosaic. A company was a separate legal entity from its shareholders. This is obvious, isn't it? So why was the case so important?

The 1856 and 1862 Companies Acts

The case needs to be seen in context of the slow emergence of shareholder's limited liability. The Crown or Parliament restricted who could form a company as we might understand it today. Business was instead done through a complex form of partnership called a *Deed of Settlement Company*. Being a partnership, any investor faced the prospect of being held personally liable for the entire losses of the enterprise.

Adding to the complexity, such companies were entirely contract based, not having any legal identity separate from their owners. Similar to partnerships still in use.

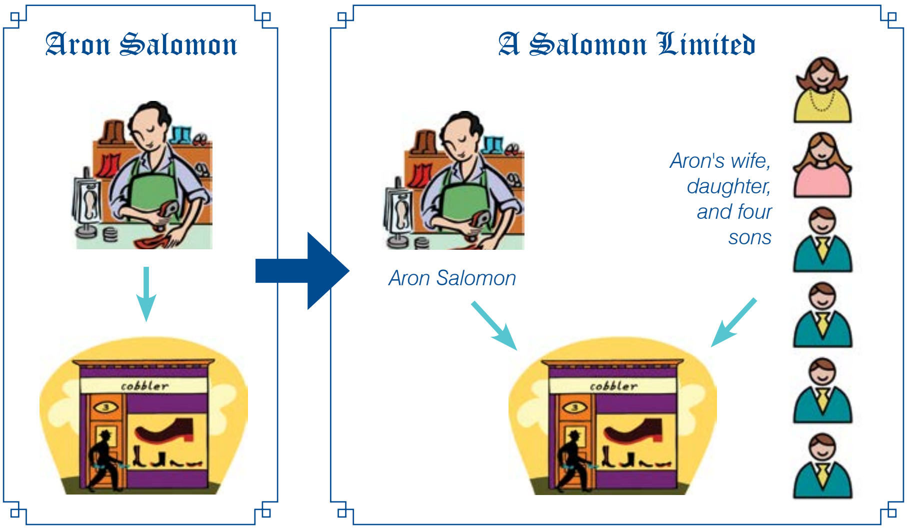
In 1844 a law change allowed these business entities to be registered but they were still partnerships and limited liability wasn't available. This was a common complaint and Parliament responded with the 1856 and 1862 Companies Act that did allow an incorporated company's shareholders to have limited liability.

The new legislation also provided that a company must have seven shareholders, amongst a number of other specified restrictions. If a company didn't meet these criteria then the protections afforded under the Act, including Limited Liability for shareholders, would not apply.

Despite this excellent piece of legislation most small enterprises preferred the status quo of the *Deed of Settlement Company* regime.

Aron Salomon; Cobbler

Into this uncertain stage stumbled Aron Salomon, a cobbler operating in Whitechapel. He had a good business and his sons wanted to get involved. Aron, being a family man, obliged. Following the law at the time Aron incorporated his business. The new company had the required seven shareholders. Aron issued 20,001 to himself and one each to his wife, daughter, and their four sons.



The business was sold for £39,000; £29,000 in cash and £10,000 was vendor financed secured by a floating charge over the business.

Sadly, the company fell on hard times. Aron had to borrow £5,000 and assigned his security to a gentleman named Edmund Broderip. This wasn't enough and Broderip appointed a receiver who successfully recovered sufficient assets to repay his loan, at which point the security and the £5,000 balance reverted to Aron Salomon.

The receivers became liquidators.

It was at this point that things became interesting. The company had;

Assets	£6,000		
Unsecured Creditors		£7,000	
Salomon Security		£5,000	
Shortfall			**£6,000**

There was a court case with three protagonists.

Liquidators:
The company is a sham. The business was in truth Aron Salomon and he should be liable for the total losses of the company as if he was a sole trader

Unsecured Creditors:
Aron Salomon's security was based on a nonsense, you can't sell your own business to yourself and his security should rank behind the unsecured creditors

Aron Salomon:
The company was incorporated according to the 1862 Act. It was a separate legal entity, not a sham, and he isn't liable for the losses of the business

High Court and the Court of Appeal

Both the High Court and the Court of Appeal agreed with the liquidators and unsecured creditors. The Court of Appeal declared that Salomon was abusing the limited liability protection provided for in the 1862 Act. Further, the company was a proxy from him, the shareholders were not independent and the company was;

> *…a trustee improperly brought into existence by him to enable him to do what the statute prohibits. It is manifest that the other members of the company have practically no interest in it, and their names have merely been used by Mr. Aron Salomon to enable him to form a company, and to use its name in order to screen himself from liability.*

This view reflected that of the commercial community. Companies did not automatically provide for limited liability. To appreciate their thinking consider how we view trusts today. A trust, if formed for improper purpose, will fail if challenged. A company then, considered the Victorian businesses community, would fare no better.

This is why the case of Salomon and Salomon matters. The House of Lords were emphatic in their judgment. Lord Halsbury wrote;

> *I have no right to add to the requirements of the statute, nor to take from the requirements thus enacted. The sole guide must be the statute itself…*
>
> *Either the limited company was a legal entity or it was not. If it was, the business*

belonged to it and not to Mr. Salomon…. If it was not, there was no person and no thing to be an agent at all; and it is impossible to say at the same time that there is a company and there is not.

Another Lord, Baron Macnaghten, wrote;

The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act.

By means of a private company…. a trade can be carried on with limited liability, and without exposing the persons interested in it in the event of failure to the harsh provisions of the bankruptcy law.

The unsecured creditors of A. Salomon and Company, Limited, may be entitled to sympathy, but they have only themselves to blame for their misfortunes. They …had full notice that they were no longer dealing with an individual, and they must be taken to have been cognisant of the memorandum and of the articles of association.

Both Lord Halsbury and Baron Macnaghten were politicians. Both had been elected to the House of Commons before being elevated to the House of Lords and Halsbury served three times as Lord Chancellor (similar to the Attorney General). Parliament meant what it said and judges, especially lower court judges, shouldn't second guess parliament.

However, the Salomon case did not deal with any liability that Mr Salomon had to his business. There was no allegation that he was reckless or had acted with financial irresponsibility; only that he should not be allowed to hide behind that the plaintiffs held was the fiction of his company.

The Disestablishment of the Capital Maintenance Doctrine

Once upon a time, before the Solvency Test, there existed a strange custom in the commercial community called the Capital Maintenance Doctrine.

Shares, when they were issued, had a capital value; the par value. Shareholders were required to pay this to the company for their shares. Sometimes this was done immediately but sometimes it remained an obligation that could be called on. This provided the company with the working capital needed to trade. Before a dividend could be paid the level of capital in the firm must be no less than the level of capital originally set. This level of capital was supposed to provide a buffer for creditors and must be maintained. Thus; the Capital Maintenance Doctrine.

There were many issues with this Doctrine and measuring the level of capital, especially when dealing with depreciating fixed assets, gave plenty of scope for creative accountants. There was also the issue that the level of capital a firm needed would vary over the course of a firm's life.

Still; dividends could only be paid from trading profits and trading profits was partly defined as the increase in a firm's capital from one year to the next.

In 1993 New Zealand swept the Capital Maintenance Doctrine aside and replaced it with the now familiar Solvency Test. Dividends could only be paid if the company would pass the Solvency Test *after* the dividends were paid. Directors who voted for the dividend are required to sign a solvency certificate declaring this.

Paying dividends is a two-step process. First the board must authorise the payment and then the company must actually pay the cash. The 1993 Companies Act has a provision, Section 52(3), that if the board ceased to think that the company would be solvent between the authorisation and the payment then the authorisation was deemed not to have happened.

This matter came before the High Court and Justice Heath in 2002.

The company was James Product Limited (JPL) and it had two shareholders. The minority 25% shareholder was the plaintiff and had issued a statutory demand because a dividend had been authorised by the board but the director was refusing to pay it out.

The director defended his position. Between the board resolution and the time to pay the firm's solvency situation had changed. JPL imported clearing products from France. The French supplier had changed the terms of trade and effectively stripped JPL of cash; leaving the company in a delicate position. To pay out the $80k the minority shareholder wanted would cause JPL to fail the solvency test. So he didn't and Justice Heath agreed he was right to do so.

It is never wise to drop your …er…last piece of capital.

A Stern Result

Arthur Morgenstern was an experienced property developer with a large problem. His development company, Morning Star Enterprises was in trouble. Worse, he owed the failing enterprise over a million dollars.

If the company fell into liquidation, Mr Morgenstern might have to repay this debt.

Awkward. Still. You don't get to be a successful developer without a bit of lateral thinking.

But First, Some Background...

There are two companies in this story. Morning Star Enterprises (MSE) and MS St Lukes. MSE had a number of other projects in various stages of success and distress and over the years Mr Morgenstern had tapped it for funds as required.

MS St Lukes had been, since 2003, doing a seventy million development in St Lukes and initially this project had gone really well. By 2006 over a hundred apartments and a row of commercial properties had been completed.

Then, however, the Taniwhas hit him. Stage two was roaring ahead faster than the company could get its resource consents issued.

That was a mistake. Work on the project stalled and between 2006 and 2010 the developer was locked in a protracted dispute in order to get the required resource consent for work already completed.

The Share Swap

Mr Morgenstern owned 99 shares in MS St Lukes and a Ms Lavas held the other share. He was also the shareholder and director of MSE, the company which he owed over a million dollars to.

The solution was simple. In March 2007, Morgenstern arranged for MSE to acquire shares in MS St Lukes for $3,500,000. $3,465,000 was credited to his current account, and $35,000 to Ms Lavas.

Mr Morgenstern did take advice, or claimed that he did. His accountants (supposedly) advised him he needed to resolve his overdrawn current account and when Mr Morgenstern brought the share sale scheme to them he was advised to get a valuation.

He arranged his financial advisor to run the numbers, showing the future revenues of the project but didn't explain why he wanted the analysis. It was this crude calculus that he used to jury-rig a value for the shares and got his accounting firm to arrange the required journal entries.

His debt to MSE was gone. When the company fell into liquidation in August 2007 there was no debt owing.

Grant Thornton's View

The liquidators were from Grant Thornton and they took a dim view of this transaction. They took a number of cases to the court but we will focus only on the share swap here.

They argued;

> One; The shares in MS St Lukes were worthless. They were subsequently sold for $1. The transfer was under value, as per Section 297.
>
> Two; The director failed to get an independent and proper valuation for the shares, and therefore he breached his duties;
>
> 131; To act in the best interest of the company
> 135; Not to trade recklessly
> 137; To act in good faith

The Court Decided;

Section 297
The liquidators needed to show what the value of the shares were, not just that they were under value. Therefore the court could not make any order. This was especially important for Ms Lavas, who escaped any liability.

Section 131
131 is a subjective test, it depends on what the director knew. The director knew that the project was suspect and the shares were worthless. He breached 131.

Section 135
The defence argued that the sale was a single transaction, and reckless trading was, well, trading. The judge disagreed and concurred that a single transaction could count as trading. Morgenstern was in breach of Section 135.

Section 137
Morgenstern did not act in good faith. He swapped something of value, his overdrawn current account, for something worthless, the shares in MS St Lukes. The court declared;

> *In a very real sense, MSE surrendered a bird in the hand for one in the bush.*

He was in breach of 137.

The Consequences

Even though the liquidators failed to provide a value of the shares, which prevented the court from giving an award for the transaction under value, the court ruled that Morgenstern swapped something of value for something worthless. Discretion was used to reinstate the company the nominal 3.5m value of the shares transferred. Not just the value of the shares sold by him, but also those sold by Ms Lavas.

The Appeal

Morgenstern appealed and failed. One of the grounds of appeal was interesting; the director should not be liable for more than the value of the creditors, he argued, because as the sole shareholder he was merely paying himself.

The Court of Appeal responded with a line that surely will warn liquidators' hearts from the winterless north to the frozen glaciers of Southland;

> *Nor do we accept Mr Walker's submission that the maximum amount payable under s 301 should be the loss suffered by the creditors. The problem with that approach is that it does not leave any funds to pay the respondents (the liquidators). We see no reason why Mr Morgenstern should not be ordered to pay the full $3,499,999 on the basis that, if there is a surplus in the liquidation, the money will be returned to him as the sole shareholder in any event.*

Our Mascot Prudence, hitching a ride on Puffing Billy in Melbourne.

Kiwisaver Cluster Bomb

Does a bankrupt's Kiwisaver go to the Official Assignee or not? This seems an obvious question with a simple Yes or No answer. When the Official Assignee (OA) went to court earlier in the year they were no doubt expecting exactly that.

What they got instead was the administrative equivalent of a cluster bomb, lobed by the High Court into the very heart of the bureaucracy.

The OA sought to clarify three issues;

1) Is a Bankrupt's Kiwisaver *property* under the 2006 Insolvency Act?
   If yes
2) Does this property vest with the OA and if so at what date?
   If yes
3) Can the OA get access to the invested money under the Serous Financial Hardship provisions of the Kiwisaver scheme?

The issue became complex because the 2006 Insolvency Act and the 2006 Kiwisaver Act overlap. Trustees Executives, the guardians of the Kiwisaver scheme in this test case, opposed the OA's position.

The OA claimed that a Kiwisaver account was *property* as defined under the Insolvency Act. It was a *Choose in Action*, or a right to money enforceable in law. The Trustees pointed out that in Australia a superannuation scheme that didn't mature until the contributor reached a certain age was merely an *expectancy*, and therefore not property.

The court decided that in New Zealand a member's account was property.

The next issue was; does the property then vest with the OA when someone becomes bankrupt?

Again, the Trustees got creative, claiming that under the Kiwisaver Act a member's interest are not assignable and therefore could not be transferred. The OA countered; the Act also stated that a member's interest could be released if required by law.

However, if the Kiwisaver accounts were to be vested with the OA wouldn't that give the OA multiple accounts? This was prohibited by legislation. This was a clever argument by the Trustee's lawyers, but not an argument that swayed the judge.

The court again found for the OA. Once a person becomes bankrupt, any assets held by the member vest with the OA.

However, just because a person becomes bankrupt does not mean that the OA can cash up their scheme. Contracts entered into before bankruptcy remain enforceable after. When the person leaves bankruptcy the Trustee must create a new account for the individual and the old scheme is then kept going until the member turns 65, at which point it will be handed over to the OA.

If someone is released from bankruptcy when they are 25 their Kiwisaver scheme will be held for their creditors for forty years! Clearly, this isn't practical so the OA relied on the Get-Out-Of-Penury clause in the Kiwisaver Act, allowing for the release of the funds if the person suffers from Severe Financial Hardship.

Surely, Your Honour, bankruptcy counts as severe financial hardship?

Well, no. One of the individuals who was caught up in this test case, a Mr T, pointed out that his financial life was better now that he was bankrupt. Clearly, the judge found, Mr T would not benefit from His Kiwisaver fund being released to the OA.

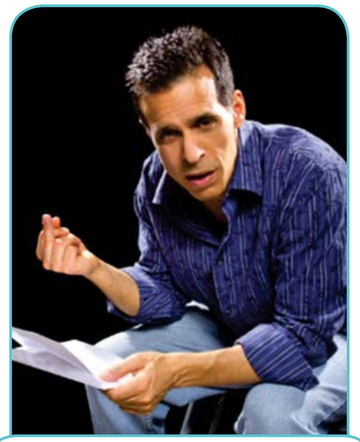
However, the other bankrupt in this test case was in the situation where his superannuation was greater than his debts. In that case, the judge found, the Severe Financial Hardship might be relieved if the OA got the Kiwisaver funds as his bankruptcy would end.

Severe Financial Hardship was defined in the Act and included a number of crises that could befall an individual, including physical injury to the member or a relative or something as basic as being unable to meet mortgage repayments.

In this situation, the Trustees could then decide between paying the cash to the OA, or giving the money to the bankrupt to relieve their severe financial hardship.

The Official Assignee, upon learning that he must wait until a bankrupt turns 65 before he can access and distribute their Kiwisaver account.

Unless…



Cashing up the scheme would end my bankruptcy and ending the bankruptcy would relieve the Severe Financial Stress I'm under.

Unless…

Now I'm bankrupt I can't pay the mortgage, so the Trustees can pay the Kiwisaver to me directly and the creditors get nothing.

Reasonable Force?

What is reasonable force and why would an insolvency firm be writing about it?

Recently Waterstone was involved in taking possession of a boat. It didn't go smoothly and at various stages the Police became involved and one of our staff ended up with a bloody nose.

The fact that it was a staff member and not one of the liquidators who shed blood tells you all you need to know about the valour of Waterstone liquidators.

Prior to the nose being bloodied there was a discussion with a police officer and one of the Waterstone liquidators declared, with pompous certainty, that he had a right to use Reasonable Force to protect company assets.

> *"Is that right; what section of the Crimes Act is that then?"* Was the officer's retort.

The liquidator had no response other than a look of bewildered foolishness as the wind in his pompous sails flagged. (This is such a regular occurrence a rational observer might wonder why the liquidator in question tone down the outbursts of pompous certainty given how many of them resulted in deflated looks of bewildered foolishness but the story is getting derailed, or marooned in a stagnant eddy, to keep the metaphors nautical.)

A Moveable Asset

The Crimes Act does, as it happens, allows a person in "…peaceable possession of any moveable thing…" is "…justified in using reasonable force to resist the taking of the thing by any trespasser… if…he does not strike or do bodily harm to the trespasser."

The use of reasonable force is justified only if you have both peaceable possession and have a claim of right over the asset.

Peaceable Possession?

Peaceable Possession isn't defined in the Act and worse, was described by the Crimes Consultative Committee in 1991 as being virtually impossible to define but in their recommendation to Parliament helpfully both failed to define it and suggested that it be retained.

The Supreme Court finally laid down a definition in December 2013 in the case of Taueki v R; a matter of otherwise trifling nonsense where a member of a local iwi grabbed the shirt of a boat club member because the accused wasn't happy over the impending use of a speed boat.

Mr Taueki was unsuccessful and was ordered to serve his 60 hours of community service but before the Supreme Court could resolve this matter they addressed the issue of how to define Peaceable Possession.

They said this:

> *Overall, the meaning of "peaceable possession" which best fits the context of the Crimes Act is simply possession that has been achieved other than in the context of an immediate or ongoing dispute. In brief, it is possession obtained and maintained before the employment of the physical force the use of which the person seeks to justify.*

Peaceable possession is not synonymous with 'peaceful'. If it was the mere presence of the trespasser would be disrupting the peace and prevent the rightful owner using force to evict them.

Claim of Right?

The Act makes reference to a claim of right rather than ownership. The claim of right is defined in section 2 of the Crimes Act as a belief in a proprietary or possessory right in property even though that belief may be based on ignorance or mistake of fact.

Thus; if you are renting a boat, or are minding it for someone else, then you have a right to be in possession and by extension peaceable possession of it and are entitled to use reasonable force if appropriate.

CRIMES ACT 1961

52 Defence of movable property against trespasser

Every one in peaceable possession of any movable thing, and every one lawfully assisting him, is justified in using reasonable force to resist the taking of the thing by any trespasser or to retake it from any trespasser, if in either case he does not strike or do bodily harm to the trespasser.

53 Defence of movable property with claim of right

Every one in peaceable possession of any movable thing under a claim of right, and every one acting under his authority, is protected from criminal responsibility for defending his possession by the use of reasonable force, even against a person entitled by law to possession, if he does not strike or do bodily harm to the other person.

54 Defence of movable property without claim of right

Every one in peaceable possession of any movable thing, but neither claiming right thereto nor acting under the authority of a person claiming right thereto, is neither justified in nor protected from criminal responsibility for defending his possession against a person entitled by law to possession.

55 Defence of dwellinghouse

Every one in peaceable possession of a dwellinghouse …is justified in using such force as is necessary to prevent the forcible breaking and entering of the dwellinghouse by any person if he or she believes, on reasonable and probable grounds, that there is no lawful justification for the breaking and entering.

Reasonable Force

Reasonable is a very elastic term and by its very nature subjective but the Act does helpfully point out that striking someone or doing harm to them isn't reasonable. There are no hard-set rules that we could see from case law but physically lifting someone against their will and removing them from your property appears to be acceptable, as is physically preventing them access and even perhaps actively restraining them if need be.

Once the issue gets a little hairy and turns to fisticuffs remember there is no disgrace in winning a fight by a hundred meters.

Defence of dwelling house

There is a subtle difference here in that the belief of the person in peaceable possession is definitive not the actual underlying legal position and the restriction "does not strike or do bodily harm to the other person" is absent. This would seem to give those defending the homestead a little more latitude than those defending a vehicle.

The Limits of Self Remedy

The law recognises the limits of the State to resolve every dispute by allowing individuals in some circumstances to exercise force to defend their interests. It also seeks to balance this with the danger of permitting self-enforcement by those temperamentally ill-suited to self-assess how much force maybe legitimate. As a result, not every right can be defended by the use of force.

Coming back to the liquidators and the boat; because the boat had been in the director's possession for some time after the date of liquidation, the liquidators, seeking to take possession of a moveable asset that was not in their peaceable possession, would have been breaking the law had reasonable force been used.

Had, however, the asset been seized immediately upon liquidation, it could be argued that the *company* had been in peaceable possession. The change of authority in the company that occurs on liquidation would have made the liquidators the agents of the company and therefore reasonable force could be used to wrestle control of a moveable asset that the director was not willing to relinquish.

Sometimes using force can get you into trouble.

Just Say No

Why do we say Yes to things we do not want to do?

Saying Yes at work can mean saying No to your family.

A recent column in the Financial Times by economist Tim Harford explains that the reason is something called 'hyperbolic discounting'. The present is more valuable to us that the future and in the present we can get the warm glow of agreeing to complete some task whilst the pain of completing the task is pushed off to the future.

This concept is similar to the Time Value of Money and Tim Harford proposes a tip to avoid being pressured into accepting unwanted tasks by thinking; 'If I had to do this task today, would I agree to it?'

Harford makes the point that every time we agree to do something we are rejecting doing something else and we should consider these things. This is the Opportunity Cost of saying yes and often that cost can be other work obligations or it might be spending time with your family or quality time on Twitter.

There is a cost in refusing to do a task, being the disappointment or disapproval of the person asking. The problem is that we have to wear that cost the moment we say No, but we do not derive the benefit until the future.

We at Waterstone, however, looked at this problem as an opportunity. If people say *Yes* to get the gratitude of their peers in the present and disregard the future costs then they will say *Yes* to a future commitment to avoid the unpleasantness of a confrontation now if the future costs can be postponed.

An example might be an employee asking for a pay rise or a landlord putting up the rent. To say no is to cause a confrontation but the extra costs are in the future and will be discounted. So long as the increase is slight the future costs will likely be accepted.

A Lesson in Litigation Risk

We have a saying at Waterstone; Sometimes we win and sometimes we learn.

We celebrate the wins and share the knowledge when we get a lesson.

The latest lesson was in the intricacies of the Property (Relationship) Act 1976 (PRA). Before we delve into this, let's give some background.

Monocrane

Monocrane was a closely held family company with an estranged couple holding most of the shares. The business was in some trouble and a year before our appointment the shareholders/directors completed a deal under the auspices of the PRA. He took the shares and the liability, she got some common property and resigned as a director. He remained as the sole director and agreed to be responsible for her debt to the company.

Despite the agreement, the liquidators pursued the former director for the overdrawn current account. This was disputed and the former director maintained that she protected by the PRA agreement. The company was not a party to this agreement.

The case hinged on if the former director could use the PRA agreement to extinguish her liability to the company, even though the company was not a party to the PRA agreement.

The RPA

The former director claimed that the debt was a relationship debt, as defined by the PRA. Further, that her shares in the company were relationship property, even if the value in them was negative. The Act states quite clearly at Section 4(4):

> *Where, in proceedings that are not proceedings under this Act, any question relating to relationship property arises between spouses or partners, or between either or both of them and any other person, the question must be decided as if it had been raised in proceedings under this Act.*

The liquidator's responded by referring to Section 20(a);

> ***20A Rights of creditors preserved***
> *(1) Secured and unsecured creditors of a spouse or partner have the same rights against that spouse or partner, and against property owned by the spouse or partner, as if this Act had not been passed.*
>
> *This section… applies except as otherwise expressly provided in this Act.*

The Decision

The court took the view that there was precedent that a closely held company like Monocrane didn't need to be directly privy to a contract affecting it. That it could be bound by the decisions of its directors and shareholders even if the company did not explicitly adopt the contract.

The key paragraphs were:

> *The Moncurs' shares in Monocrane were relationship property. Their current account liability was relevant to the net value of those shares. How that liability was allocated was essential to their overall division of property. As a distinct source of liability to them, it was also an issue in itself. As sole shareholders and directors they could, conceivably, have passed a resolution allocating the entire current account liability to Mr Moncur. That they did not cannot be fatal to their agreement.*
>
> *In short, I conclude, Monocrane is not a third party creditor in the sense that s 20A contemplates.*

The former director was relieved of her obligation to repay the company her debt to it. The liquidators lost.

There is a further provision in the PRA that agreements that have the effect of defeating creditors are void if the intention is to defeat creditors, but that was not found to be the case here. The intention was to split the matrimonial property, defeating creditors was merely a consequence. If the effect, but not the intention, is to defeat creditors there is a two year window for the agreement to be set aside, which the liquidators missed.

The Conclusion

We were surprised by this decision but this may reflect our myopic Companies Act view of the world. We have a deep, almost obsessive knowledge of the parts of this Act that affect us (and remember, that most of the Companies Act does not affect insolvency practitioners at all).

It is our view that a company, even a closely held one, is an absolute separate entity from its shareholders and for this we look back to Salomon and Salomon, but at least in this instance it isn't.

At first glance this seems an odd result. A company director who is indebted to the company can escape their liability by getting their spouse to take on the debt. On reflection, although we will test the issue, consider the situation but ignore the fact that the company is in liquidation. If the remaining director had decided to pursue this debt, equity would probably prevent him from being successful.

Once we step even a few centimetres outside our base of knowledge we are like children lost in a bewildering forest.