waterline

waterstone
INSOLVENCY

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INSIDE:

Some dogs don't hunt.

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Waterstone, Deloitte and Sleeping Dogs

Death by falling out of bed isn't something that gains a lot of media or scholarly attention but 32 people found their way into the afterlife in just this manner in 2011. By comparison only a single person fell victim to contact with a spider.

Humans, it seems, are not very good at perceiving risks. We can detect rustling in the distant trees but fail to notice that the frosty donut in front of us is far more dangerous. From Darwin's perspective this makes sort of sense. Heart attacks get us after our reproductive days are over and in the good old days we were grandparents by 30 and dead not long after.

Reckless trading isn't as headline grabbing as shark attacks or white tailed spiders but, relative to the shocking mortality gained from falling out of bed, it gets a lot of attention. Law firms often like to write up the cases and accountants fret endlessly over the risks.

Indeed this humble publication has contributed to this trend. What is lacking, however, is data. How great is the risk?

In short. Not much.

Reckless trading cases are usually brought by a liquidator. In theory creditors can bring actions themselves but this is exceptionally rare. About as rare as the Moa.

Reckless trading is a broad term and it is better to talk in terms of breaches of director's duties; usually sections 131 through to 137 of the Companies Act. A liquidator must first prove that a director has breached one of these duties and then apply to the court for relief under Section 301 of the Companies Act.

Therefore a review of all of the cases that reference Section 301 is a good guide to how many directors are held to account in any one year.

In 2015 there were 2,147 liquidations advertised in the Gazette. There were thirteen judgements with a reference to Section 301.

Thirteen. Even better; those thirteen were split between just two insolvency firms. Deloitte with ten and Waterstone with three.

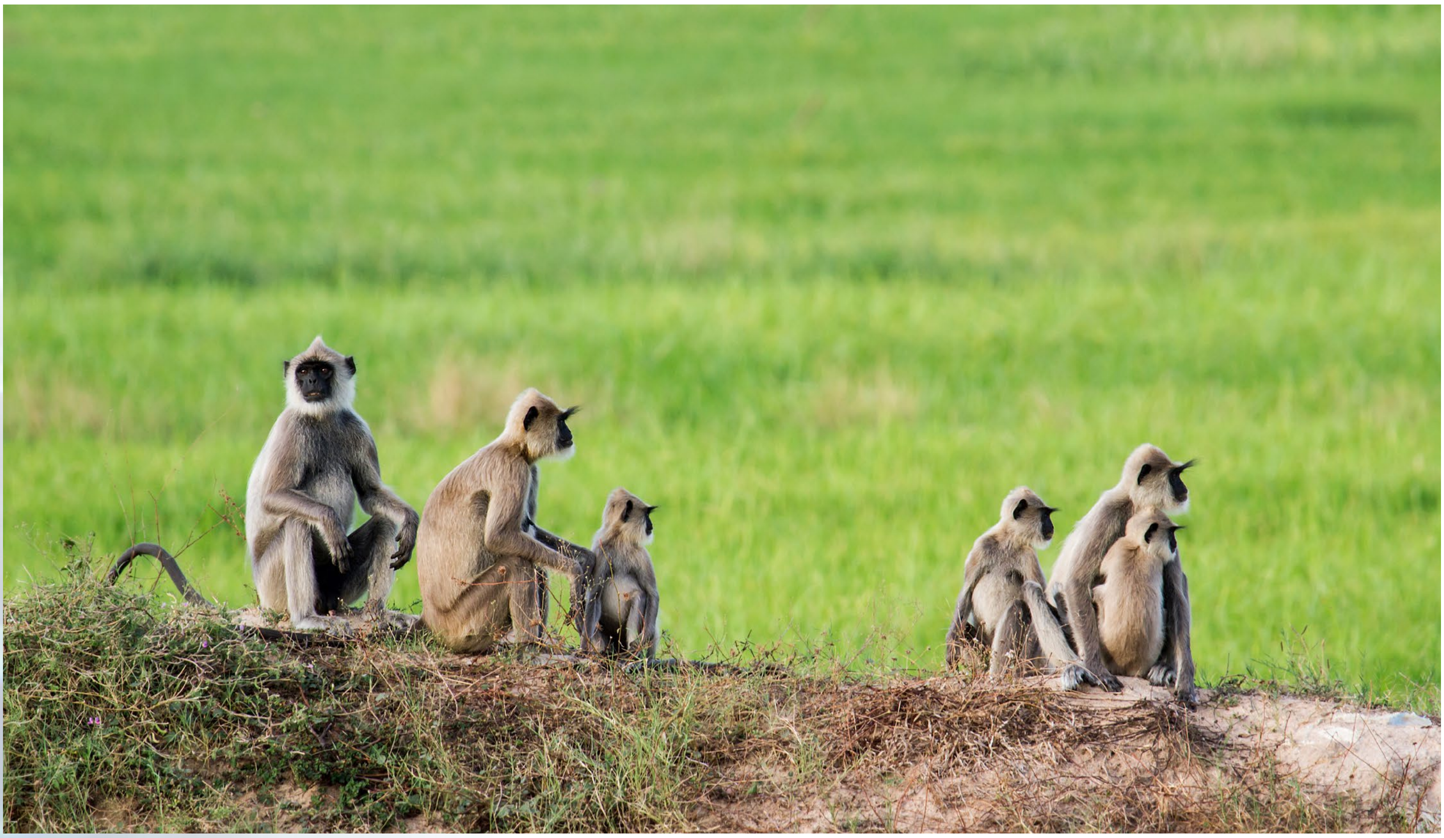
No other insolvency firms got any judgements. This doesn't mean that they didn't take cases and these settled but anecdotal evidence indicates that if a firm never gets any judgements they never take any cases. In fact there are a number of high profile insolvency practitioners that never, ever, not once, on any issue, have any hostile judgements to their name. There are even some firms that have gone decades without ever seeing the inside of a court room.

Insolvency is by its nature confrontational. A liquidator is faced with more claims than they have assets and from what Waterstone sees the majority of failures have some degree of director culpability.

Still; liquidators are usually constrained by a lack of resources in the file and in most cases a director of a failed company simply isn't worth the effort of taking to court. However; if a liquidator never takes a case that more likely reflects the temperament of the liquidator than the nature of the insolvencies that come across their desk. Put simply; some dogs don't hunt.

This is excellent news for directors seeking shelter from the chilly winds that can blow from the Sea of Insolvency but disappointing for creditors who can reliably expect to get nothing.

The animal on the cover is a North American Prairie Dog, that, despite its name is actually a rodent and a strict herbivore; it doesn't hunt.



We have evolved to watch for lions in the long grass.

Main Seal

Mainzeal. Seemed a solid company. Had a former Prime Minister on the board. Didn't work out so well and subcontractors lost eighteen million in retentions.

This is sad but in the wider commercial world it doesn't matter. Retentions are like a discretionary bonus paid by an employer. They are nice to get but no one plans paying their mortgage by them. Some developers get a reputation for honest dealings on retentions and others don't. Contractors quickly learn who is who and price accordingly.

This should be the end of this story. It isn't.

Mainzeal appeared on television and Nick Smith felt he had to do something. In response to what was never a real problem Smith and the clueless bureaucrats who advise him cobbled perhaps the worse piece of legislation since the 1896 English Tax on Windows lead to dark manor houses.

Retentions, the Construction Contract Amendment Act 2015 airily declares, shall henceforth be considered to be trust moneys. Developers who use retentions shall be required to hold these funds in trust. Parliament then added this remarkable rider:

> *Retention money held in trust…*
>
> > *Does not need to be paid into a separate trust account*
> >
> > *May be comingled with other moneys*

This creates a number of real problems and solves precisely no existing ones. The critique below is based on what happens in the event of an insolvency, which is what this legislation is specifically meant to address.

Firstly; retentions aren't cash. It's a debt obligation that arises after a set period of time and under certain conditions, sometimes years after the end of the project. This law, potentially, brings the actual cash cost to the developer forward to the time that the retention amount is 'deducted'; turning an accounting obligation into a cash requirement.

Second; allowing the co-mingling of funds means that there possibly isn't a real trust relationship. The Construction Contracts Act has created a statutory trust which conflicts with the Companies Act rules on how liquidators should treat cash.

Third; because there is a statutory trust, it is probable, but not actually clear, that any cash should be treated by the liquidator as being outside the assets of the liquidation. Money in the bank, usually claimed by preferential creditors, including staff, must now be used to pay firms owed retentions.

Fourth; in a liquidation claims by staff are relatively easy to determine. Retentions can take years to resolve. By inserting retentions above staff in the priority list potentially means waiting years for claims to crystallise.

Fifth; it isn't clear how far this statutory trust relationship extends. Potentially, any money that comes into a company is caught. What happens if a company holding retention trust money in a co-mingled account uses that money to purchase a physical asset in the days before liquidation; does the GSA holder or the retention-trust have a claim over that asset? How can the GSA claim it if the money was never part of the assets of the company in the first place?

Sixth; this legislation nicely creates a potential fiduciary relationship between a director and the developer's contractors who are owed retentions. Given the multiple breaches we usually see in a construction company failure this is perhaps moot but it just another way the corporate veil is being shredded by risk-adverse cardigan wearing Wellington mandarins.

Seventh; the act requires the developer to provide, at no cost, an accounting to retention holders of money held on their behalf. No guidelines are provided for this accounting, but presumably a few notes on a napkin are not going to do the trick. Thankfully regulations will be provided on this issue because the one thing the construction industry really needs are more regulations.

Finally, and perhaps most pernicious; honest developers, (both of them) will seek to set aside actual cash in a separate trust account. A ten million dollar project may have a million in retentions that normally aren't due until after the project is finished and the client has paid. Now an additional million of capital is required during the life of the project. Playing by the rules envisioned by this act will place a significant capital burden on honest firms and give a competitive advantage to dishonest ones. Some larger projects will either not get built because of the capital cost and financiers who are aware of the complexities created by this trust relationship may want a higher level of comfort before investing.

An Example;

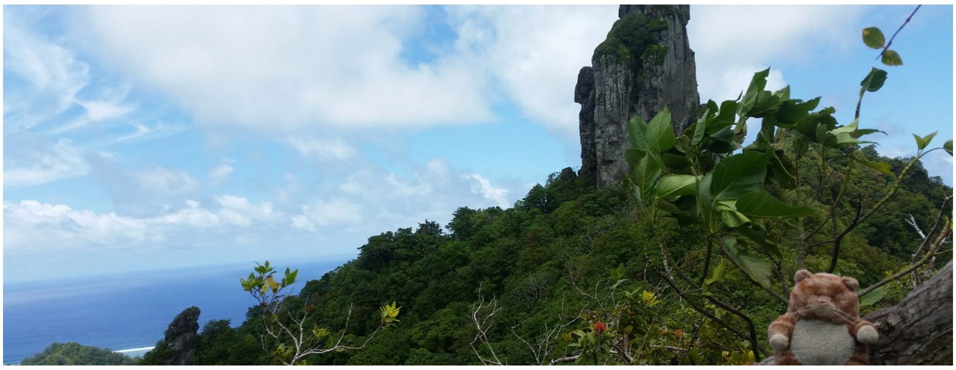
Let's imagine a simple scenario. A large construction firm fails, owing two million in retentions. There is a million dollars in cash and bonds that the liquidators feel are covered by this new statutory trust. There is half a million dollars in staff claims.

Before Nick Smith worked up a sweat on this issue the liquidators (after taking their very reasonable fees) would have paid the staff their holiday pay. Now the liquidators pay the staff precisely nothing and hand over the balance of the cash to construction companies, large and small, some of their retentions.

This is exactly what the new law achieves. Except, of course, if the stakes are high the liquidators will have to value these retentions. Normally retentions are worthless in a liquidation so it doesn't matter what nonsense contractors submit. Now that have a real value; which is a win for construction and insolvency lawyers and indeed the liquidators who will get to claim fees while managing this mess.

This isn't a theoretical point. In Mainzeal staff were paid over five million dollars although this appears to have been from receivables, not cash. It wouldn't be difficult for retention creditors to raise a claim that their retention money had been used by the company to do the work that lead to those receivables. When the stakes are in the millions someone will want to make that claim.

It is hard to imagine a more reckless, stupid and intellectually lazy piece of legislation.



Our mascot Prudence trekking in Rarotonga.

The Great and the Good

Thankfully; given both the economic benefits and low risks involved with reckless trading Paul Goldsmith has decided to tackle this problem by appointing a panel of experts.

This panel includes a small select of the great and the good. A partner each from KPMG, Deloitte and PwC; to ensure balance, two lawyers from large law firms, someone from the Official Assignee and the Executive Director of Debtworks.

We, at Waterstone, do not wish to pour cold water on this panel. All the people involved here are competent and experienced but they all, save for one, come from within the insolvency industry. It is hard, if not impossible, to see the wider picture when you are in the painting.

The Terms of Reference of this group are broad and the formal terms of reference have been written by bureaucrats well versed in polite language. For the aid of reference and in an attempt to have engaged readers we have tried to interpret what Minister Goldsmith is actually worried about.

Voluntary Liquidations

How to fix the problems of patsy liquidators using the voluntary liquidator regime to shield directors from their obligations; with special reference with the building industry and Phoenix Companies.

Voidable Transactions

Since the Supreme Court made a ruling that the repayment of an old debt can be a valid defence to a voidable claim is there any point in still having a voidable regime? Should parliament legislate to reinstate voidables or is it time to move on?

Ponzi Schemes

In light of the unfortunate result of the Ross Asset Management cases does New Zealand need a special law to deal with Ponzi schemes?

Regulating Insolvency Practitioners

Design a regulatory regime for insolvency practitioners.

There is a theory in economics called Regulatory Capture. The idea is that low paid government regulators are easily swayed by the wealthy, charming and seductive business people they are meant to regulate. This is especially in a case where regulators eventually seek employment with the very firms that they are regulating.

This cross over in employment isn't very likely in the insolvency profession but the industry has a clear agenda. We want voidable transactions reinstated, strict regulation of insolvency practitioners and no change to the lucrative patsy liquidator regime. By appointing a committee formed almost exclusively from the industry it's to be expected that their advice will not necessarily reflect the wider interests of the commercial community where there is a divergence from the interests of the wider commercial industry and those inside the profession and their advisors.

It is a shame Goldsmith did not seek a wider cross section of the commercial community for this panel.

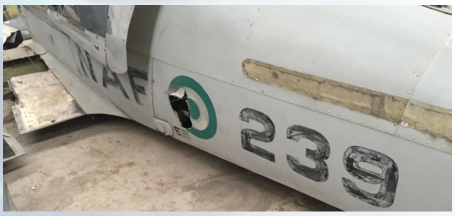
The Nigerian Air Force

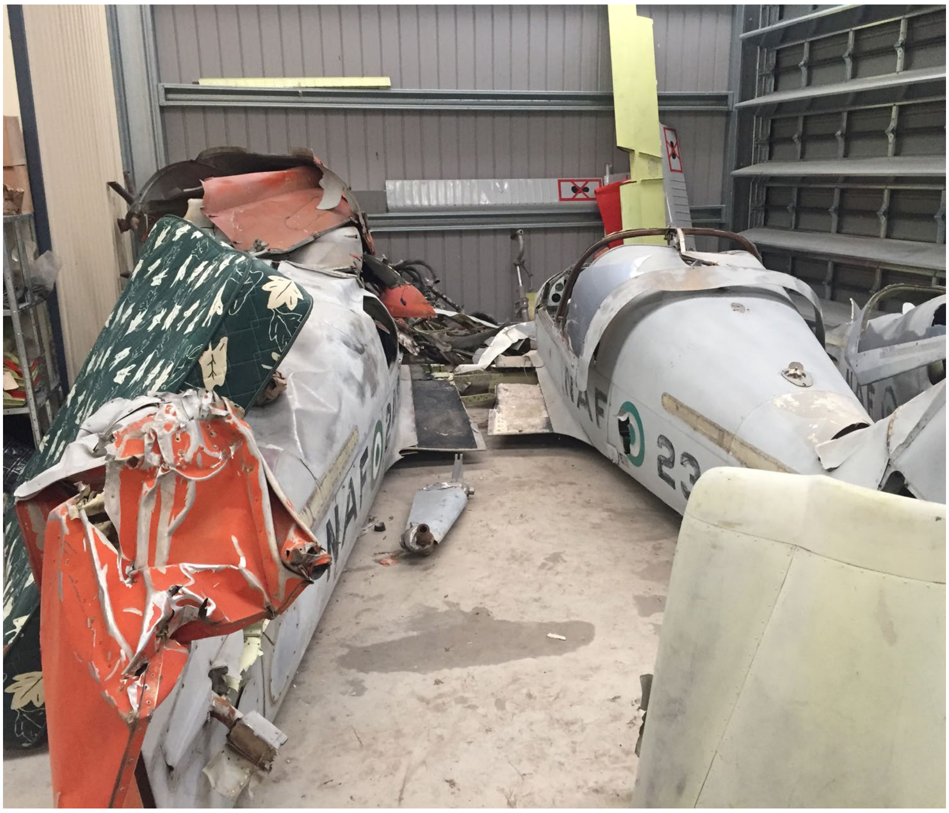
Last year we came face to face with the Nigerian Air Force, or at least part of it. A small firm based in Palmerston North, the grandly named Milson Aerospace, was in the business of importing old planes.

The director, we're told, went to Nigeria and found a nice plane or two, and asked to have them shipped to New Zealand. Sadly, he should have been a little more specific.

Rather than disassemble the plane and placing the component parts carefully into a container, the Nigerians simply took a chainsaw, or similar, and hacked the wings off before shoving them in the container alongside the fuselage.

It wasn't a great success.





The economic advantages of Reckless Trading

Let's consider the economics of reckless trading.

If a director has an economic interest in their business the wealth of the director is directly linked to the fortunes of the enterprise.

For the sake of simplicity let's assume the director owns 100% of his company; reckless trading being an almost exclusively preserve of men with the exception, it seems, of former Prime Ministers.

At the heart of reckless trading is the accusation that the director is gambling with the creditors' money and not his own. If a liquidator wants to hold a director liable for this it must be shown that this risk taking was excessive and not foreseen or foreseeable by the creditors.

A director faces a choice; close the doors or keep trading and take a risk. Suppose a gamble has a 20% chance of success but an 80% probability of failure. If the 20% comes in the creditors will get paid and the director will get rich. If the more likely 80% occurs the creditors will get burnt and suffer a large loss.

Let's also assume that the risk of being held liable by the liquidator was 100% and that the director would be liable for the entire costs of their creditors and held liable by the courts for the costs incurred by the liquidator.

How do the odds look if the stakes are a million dollars and the director makes the decision to trade on? He is now trading recklessly. By doing so he has a 20% chance of earning a million dollars and an 80% chance of losing a million dollars and being sued by a liquidator for these losses, plus 100k in liquidator and court costs, which makes his total exposure $1.1m.

On a net-present value analysis this isn't a good bet because the maths look like this; (in thousands)

80% * ($1,100)	= (880)
20% * ($1,000)	= 200
NPV:	(680)

However, even in this worst case example; let's add another assumption; that the director's net worth is zero. The house is in trust. His entire wealth is in his company. He has no independent assets to lose. In the event that there is a judgement against him for $1.1m he will simply be pushed into the gentle embrace of the Official Assignee.

Bankruptcy isn't without its costs, inconvenience and lost opportunity. Our director may assess these as likely to cost him $250,000.

His choice then looks more like this:

80% * ($250)	= (200)
20% * ($1,000)	= 200
NPV:	0

However; this dramatically overstates the risk. Thanks to this issue of Waterline our director now knows how to select an appropriate insolvency firm for his needs; thereby minimising the risks. He takes his gamble with a 20% chance of success and when it fails appoints a liquidator of his choice.

Even if he chooses wrong; there is no more than a 5% chance that the liquidator will ever do anything and even better, in the unlikely event that any action is taken a settlement can almost always be reached for a fraction of the actual losses.

If we price in the risk that a self-appointed liquidator will pursue a director at five percent, and this is remarkably high. Even at Waterstone we usually do not pursue claims because of a lack of creditor support, constraints on our internal resources or concern at the ability of the director to pay a judgement debt. Let's also assume that although the total claim might be $1.1m there is a near certainty that a liquidator would quickly settle for a third of this amount.

The maths to work out the cost of reckless trading is therefore;

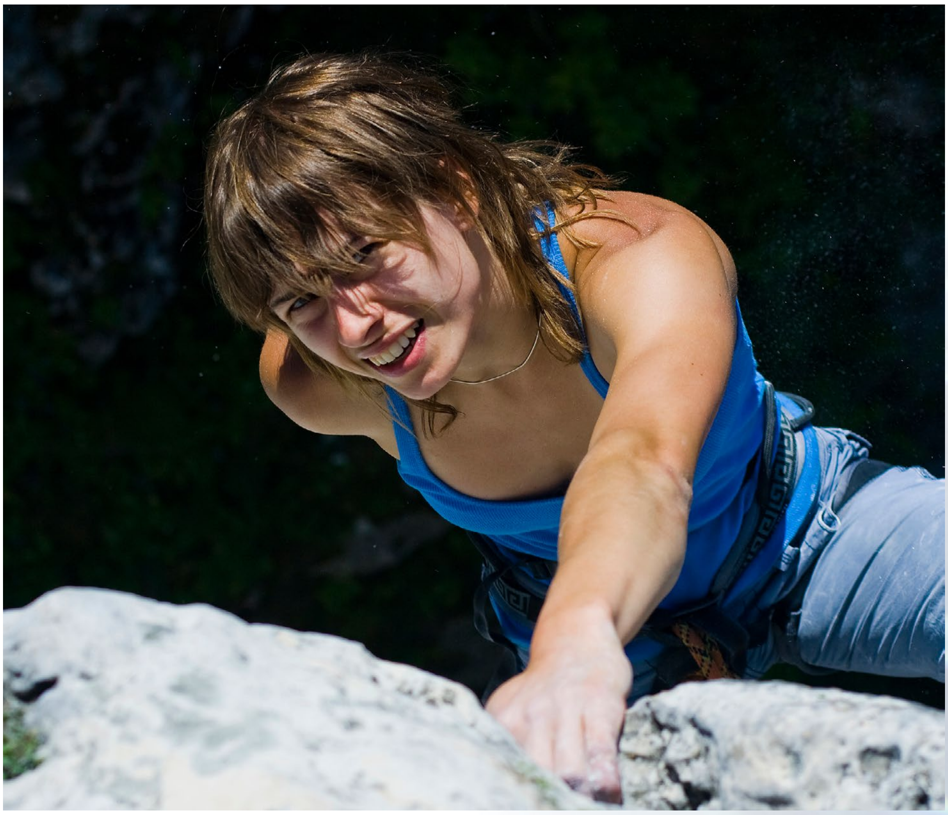
The chance of failure (80%), multiplied by the chance of a self-appointed liquidator doing anything (5%), times the maximum value of the claim (1,100,000) divided by the discount a liquidator would certainly accept (1/3)

His choice then looks more like this:

(80%*5%*$1,100)/(1/3)	= (15)
20% * ($1,000)	= 200
NPV:	185

Add to this equitation the fact that there is no punitive element to a breach of director's claim. A director can never be held liable for more than the losses of the company save for the liquidator costs.

As far as gambling goes; trading a company recklessly is one of the best economic bets around.



Reckless Trading isn't that risky.

Who gets the work?

According to the Companies Office there are around 4,000 liquidations per annum, but in the calendar year 2015 only 2147 advertised in the Gazette. This is awkward. We have no explanation for this discrepancy other than a lot of liquidations are simply not advertised.

As in half of them. We may not be innocent in this area ourselves. The fact is there isn't any consequence for failing to advertise in the gazette. Worse, it costs money; something those of us who ply this unfortunate profession for a living are habitually shy of. Still; we think the Companies Office number is wrong.

Regardless; we did a tally of all liquidations advertised in 2015; solvent and insolvent. We ignored Voluntary Administrations and receiverships and we present, for your amusement, the results.

It's always interesting to see what the competition is up to.

Firm	Liquidations
PwC	260
Official Assignee	144
KPMG	133
Shephard Dunphy	110
Deloitte	105
Reynolds, Grant	90
McDonald Vague	82
Rodgers Reidy	73
Insolvency Management Ltd	70
Meltzer Mason	52
Waterstone	52
C and C Strategic	50
Corporate Restructuring Services	47
BDO	43
Thompson, Kim	36
Gerry Rea	31
Allott, Murray	31
EY	30
Fisher White	30
Smith, Bryce	30
Horton, Chris	26
Ecovis KGA	20
Kamal, Imran	17
PKF Auckland	17
PKF Christchurch	16
Thomas, David	16
Nexia	15
Laing, Trevor	15
Young, Craig	15
Grant Thornton	14
CS Insolvency	14
Biz Rescue	14
Patel, Pritesh	14
Whittfield and Associates	14
RES Corporate	13
Surendran, Biju	13
Pattison, Tony	12
Scutter, John	12
Taurus	12
Bennett & Associates	11
Managh, John	11
Norrie & Daughters	10
Nair, Daran	10
Staples Rodway	10
BWA	9
Fisher DK	9
HFK	8
i-Insolvency	7
Chapman Atkins	7

What happened to Section 194?

Financial Reports are, in failed companies, mostly missing. Sloppy accounting and business failures do not necessarily go hand in hand but companies that end up in liquidation often have poor accounting.

In 2013 parliament rubber stamped changes designed by Steven Joyce's minions in the Ministry of Business, Innovation and SkyCity Grants. Uncharacteristically this was a lowering of the regulatory burden on business, at least for some business.

For our purposes the key changes relate to Section 194 of the Companies Act; the requirement to keep accounting records.

The old legislation was quite prescriptive and mandated that accounting records must;

- Correctly record and explain the transactions of the company
- Will at any time enable the financial position of the company to be determined with reasonable accuracy
- Will enable the directors to ensure that the financial statements of the company comply with section 10 of the Financial Reporting Act 1993
- Will enable the financial statements of the company to be readily and properly audited
- Record the assets and liabilities of the business
- Record opening and closing stock
- Record goods brought and sold
- Accounting records must contain entries of money received and spent each day

The new legislation is more permissive, merely stating that accounting records must;

- Correctly record the transactions of the company
- Enable the company to comply with generally accepting accounting standards
- Enable financial statements to be audited

At the same time as Section 194 changed the Financial Reporting Act 1993 was replaced by the Financial Reporting Act 2013. The new Financial Reporting Act makes provisions that large companies must prepare detailed accounting records. A large company is defined as having $60m in assets or $30m in revenue over two consecutive years. Overseas owned companies must also provide detailed financial records.

Smaller firms, therefore, are only bound by the loose wording of Section 194 of the Companies Act, although minority shareholders can insist on the accounts being audited.

Under Section 300 of the Companies Act directors who fail to comply with Section 194 can be held liable for the losses of the business. How the courts will view this lower standard hasn't been tested yet although Waterstone did obtain judgement against a director for breaches of these new standards in the case Central Tyres Waipukurau and Pallesen. However, in this case the director had failed to keep any accounts for a period of three years prior to liquidation and the case was uncontested.

tempest
LITIGATION FUNDERS

Waterstone is pleased to announce the launch of our litigation funding business; Tempest; in conjunction with John and Michael Chow.

We are primarily interested in funding litigation in insolvency, property and contractual disputes in the range of $500k to $5m.

In the first instance please email us at enquiries@litigaitonfunders.co.nz or lodge a request through our website.

litigationfunders.co.nz

Interview: Bob Everest

An Interview with Bob Everest, the head of the Financial Markets Authority.

Waterline Good morning Bob. Thanks for coming in today.

Bob Everest Glad to be here. Do you have any better coffee? This Moccona is, hmmm.

WL Sorry Bob, we're a privately run insolvency firm operating from the industrial wastelands of Albany. Instant is all we have. Let's press on shall we. Now, you're the new head of the Financial Markets Authority, did you have any regulatory experience before getting this role?

BE I spent most of my working career at Merryl Lynch; so, you know, we came across regulators there pretty often. I understand you Kiwis like people with merchant banking backgrounds.

WL Ok. Ok. Now, the FMA has come under some criticism for continuing to register people who have been running Ponzi schemes.

BE That's not fair.

WL What, you haven't been registering as financial advisors people who have been running scams?

BE Oh, sure, we've done that at least twice, but there hasn't been any real criticism, except for you guys, and no one listens to self-promoting insolvency practitioners operating from a warehouse in the industrial wastelands of Albany. I mean, come on, you don't even have a real coffee machine. Moccona! Please.

WL Fair point.

BE And let's make one thing clear, since the FMA came into being, the level of financial fraud in the second tier finance industry has been pretty minimal.

WL Well…

BE It's true, isn't it?

WL Yes, but only because you have regulated that sector so hard there isn't a second tier finance industry any more.

BE That misses the point. Our role is to introduce confidence into the finance industry, not to ensure that there is a finance industry.

WL So by strangling innovation, placing impossible barriers to entry and imposing crippling regulatory costs you decimate the industry so completely there is no activity therefore no fraud?

BE Again, you are being unfair.

WL How is that?

BE Well the term decimate refers to an old roman custom where one tenth of a legion was killed by the remaining members; to instil discipline. I like to think that the FMA has reduced the finance industry by far more than one tenth. In fact, I'd say it's a tenth of the size it would otherwise be, not nine tenths.

WL Yes. I see your point. Can we talk about Arena Capital?

BE Certainly. One of our successes.

WL Really? Wasn't it a Ponzi scheme? In fact, didn't the Companies Office tell you guys that a guy who called himself Jack Ryan, a conman, was involved in this company before you registered it?

BE Yes, but we looked into that. We emailed the director and he said it was all good.

WL You emailed the director?

BE Yes. We asked him, specifically, "is Jack Ryan involved in this company?" and the director said he wasn't.

WL Was the director telling the truth?

BE Oh, no. Ryan was involved, it was a Ponzi and investors lost nine million dollars after we granted them registration. But a great FMA success.

WL How do you figure that?

BE We de-registered them and appointed receivers. We showed that the FMA can act quickly and decidedly to stop fraud.

WL After you first register the fraudsters?

BE Let's move on.

Bob Everest

WL Jonathan Graham West?

BE Before my time, but yes, we registered him as a financial advisor in 2011.

WL He was recently convicted of a 1.4m fraud. Do you have any concerns over your registration process? You seem to register a lot of conmen.

BE Not at all. The registration process is pretty simple. Anyone can be registered. Ex bankrupts, failed businessmen, even people convicted of violent crime may become registered financial advisors. There really isn't a very high standard. People should understand this.

WL Do you think they do? Is it possible that, because you register any idiot to be a financial advisor this is leading people to place misplaced trust in some of these people?

BE Oh, unquestioningly, but that isn't our job. Our job is to register people and remove their registration after they steal their investors' money, not before. It's a very simple system.

WL I thought your role was to instil confidence into the financial sector? How does registering conmen do that?

BE That's why we register them. People wouldn't have any confidence in these chaps if they weren't registered. No. We want people to have confidence in the small parts of the industry that have not been regulated to death.

WL Is that why you need 170 staff?

BE Yes. We need 170 staff to convince the financial community that we are tough and vigilant. People need to know that we are there.

WL Mr Everest, thanks for coming in today. Sorry again about the coffee.