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Sometimes, you have to accept your foundations are melting away. Directors hold on too long. In this issue we look at the risks of holding on and the advantages of going early.

Scrap for Cash

One of the great frustrations of being a liquidator is the Great New Zealand Shell Game. Here company directors keep moving their assets from one shell company to another. By the time we get appointed the assets have moved two or three shells on. Sometimes the crooked directors win. Sometimes they don't.



We were appointed by the courts to liquidate a company, 123 Metals. 123 Metals used to be called Cash for Scrap, and we knew the business was still running. It had six sites in the North Island, from Whangarei to New Plymouth.

We got the appointment from the Auckland Court on the 23rd of May 2008. Feeling fearless, and not having much on that day, we made our way down to the scrap metal yard in Tidal Road, Mangere to see what we could do.

What we saw was a thriving business. Trucks coming and going, staff cutting scrap metal, customers going about their business. The place was busier than a bordello in a outback mining town.



But then we were hit by the first shell. The lease on site in Mangere was not held by 123 Metals, but by another company, called Bairds Road Scrap. No assets held by 123 Metals here, we were told. Round one to the Shell Game. We went away to consider our options. The Cash for Scrap boys heard nothing more from us for almost a week. They must have thought they had got away with it. Again.

The great thing in commercial life is often those who cheat do so because they are too lazy to make money honestly. Trouble is, being lazy means they don't pay attention to the details. The Shell Game requires careful attention to detail.

We did some homework. Cash for Scrap had not bothered to change the lease on two of their sites, Whangarei and Mt Maunganui. Both had leases in the original company. So we sent staff members to each site and closed them down on Thursday morning, six days after we got the initial appointment. This caused the Cash for Scrap boys considerable distress and the accusations and allegations were flying thick and fast.



The jewel in the Cash for Scrap crown (or rather the copper in the Cash for Scrap bin) was the Tidal Road Mangere site. It brought in 70% of the business's revenue.

We then found that Bairds Road Scrap was being put into liquidation at the Auckland High Court. We went to see the petitioning creditor, and they gave us the appointment.

Bairds Road Scrap went into liquidation on Friday, the 30th of May. We went back to

Tidal Road that day, curious to see what the Cash for Scrap boys would do next.

Upon our arrival they presented us with a lease assignment between Bairds Road Scrap and their next shell "North Island Metals Limited". Again, however, it is all about homework. This lease assignment would have been a good trick had the landlord agreed in writing. He hadn't, and we asked the Cash for Scrap boys to leave.

This was not the end of the matter, however. There was still the problem that the new shell company North Island Metals Limited claimed they owned most of the assets and the staff were employed by a new entity, Cash for Scrap (2008) Limited. After a long process, and a highly contentious series of creditors meetings, we established control over the business and all shell companies.



Asset Protection: Waterstone staff preventing vehicles leaving the site on the day we took control.



One of the more unconventional accounting systems we have seen.

Almost all crooked business leave themselves vulnerable, and the liquidators tool kit is a powerful one. If you or your client has been a victim of a shell game, we would like to help.

It's our job to be fair

The IRD once had this as their jingle. At the time it seemed odd. Surely the IRD's job was to enforce the tax laws, fair or unfair.

However, consider Cash for Scrap from a fairness perspective. Cash for Scrap in its various entities did not pay its bills. PAYE payments were done on an entirely voluntary basis, which usually meant not at all. GST was seen as an opportunity rather than as an obligation.

Despite its reputation, there are a large number of honest individuals and firms in the scrap metal business. They pay their taxes, remit PAYE back to the IRD, and abide by council environmental requirements.

The management of Scrap for Cash did not do this. By under reporting and under paying their taxes (and virtually every other bill that came across their desk) they not

only increased the tax burden on other tax payers, they also gave themselves a competitive advantage over those business who were paying their taxes and enriched themselves at the expense of the wider community.

Sometimes it does not seem economic to liquidate a company that is not paying their bills. If you do go to this length, however, be assured, you are doing good work.

The Quick and the Solvent

Commercial Glass and Glazing is an example of what can be achieved when a firm in trouble goes quickly, as opposed to holding on for too long.

Commercial Glass and Glazing Limited was placed into liquidation by its shareholder on the 31st July 2008. It became apparent that the business was viable as a going concern, and the decision was made that morning to try and trade the business on. With the support of the staff, and the shareholder, the doors remained open.

A tender process for potential purchasers of the business was undertaken. We decided that a quick process was best given the circumstances. The invitation was open for a week and closed at noon on the following Wednesday. A number of expressions of interest were received and information on the business was sent out.

It is not uncommon for liquidators to trade businesses on during liquidation, especially if there is a chance that the business can be on-sold. Once a business shuts its doors, it decreases the chance of it being sold dramatically.

There was a General Security Agreement (GSA) held by the Bank. However, the Bank had indicated to us that they were willing to work with us and not appoint a Receiver.

Most of the staff continued to work. A few left but those that stayed on to continue the work in progress were paid by the liquidation. We also had someone from our offices on-site managing the business for

the duration we kept the business going.

It came down to only two serious players when the invitations of offer came to a close. We entered into negotiation with one of the parties and signed a sale and purchase agreement on the Thursday.

The process was quick and the deal was good. Settlement took place on the Friday. Since the purchaser hailed from China, he thought it a good omen to have the settlement on 08/08/08.

The staff kept their jobs, a tenant remains in the building for the landlord, work in progress gets completed, the Bank will be repaid in full, which relieves the Director of most of his personal guarantees. We were in and out within 7 days.

The Director/Shareholder did the right thing by getting us in early. The business was insolvent, but there was enough there to salvage and sell as a going concern. Had the company been insolvent for much longer all we could have done was strip the assets and sell them. It was unlikely there would have been enough to clear the debt to the Bank and the staff would have had to find a new job.

The above example is a typical Waterstone result, and one that we take we pride in.

If you know anyone that is considering their options because business is difficult, tell them to get some good advice and to get it fast. Examples like the above don't happen every day, but they do happen.



Showroom & office: Situated at 2 Crum Ave, New Lynn

The National Enforcement Unit

Tucked away at the back of the Companies Office, between the Official Assignee and just around from the guy that keeps the filing cabinet with all the company keys, is the National Enforcement Unit.

This is a great little body that does some impressive work. It needs much greater resource.

For all the publicity of the high profile business failures there are thousands of small firms impacted by hundreds of serial offenders moving from one corporate failure to the next.

The Companies Act has a large number of offences, and the penalties attached to those offences are fearsome. However, there is no organisation other than the National Enforcement Unit to enforce breaches of this Act.

They successfully prosecuted 45 people and firms in the 12 months ending 30 June 2008, including 23 for breaches of the Companies Act, of which 19 were sentenced to some form of a custodial sentence.

Although this is satisfying, it is not nearly enough. There is little point in the impressive body of legislation that is the Companies Act if no one is around to enforce breaches of it.

"Men are not hanged for stealing horses, but that horses may not be stolen."
17th Century English Statesman, George Savile.

The use of family trusts

There is a lot of controversy in the popular press about the use of family trusts by the likes of Messers Bryers and Petrocivc to hide assets from their creditors. The image is of bankrupt directors driving around in expensive vehicles owned by family trusts and living in expensive houses owned by their long suffering spouses.

There are many abuses of the law around family trusts, and often the enforcement of breaches is lax.

However, there is a public policy benefit of company directors using family trusts and limited liability protection.

Most company directors who fail are not like Bryers and Petrocivc. They have an idea and open a business. Sometimes these businesses succeed and add value to those who trade with it. In a small

minority of cases these business fail owing significant amounts of money. In an even smaller number of cases those business failures are caused by the reckless behaviour of the directors.

By removing the protection of family trusts we would increase the risk of every small business person, resulting in less new business opportunities, and we would lose the opportunity to trade with the wide variety of businesses that spring to life each year. Some of them turn into the business engines of tomorrow.



Reckless Trading

The most commonly heard phrase we hear as liquidators is "Why have you not taken a reckless trading prosecution?"

It is a good question, and we have two simple answers:

- a) A business failure is not proof of reckless trading
- b) It costs a ton of money.

The relevant provision is section 135 of the Companies Act 1993:

A director of a company must not:

- a) Agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or
- b) Cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

Lets have a quick look at some cases, and then on the economics.

South Pacific Shipping

This company failed in February 1998. The liquidators, PricewaterhouseCoopers, with the backing of a motivated creditors' committee took the directors to task. The facts are important:

- The company lost six million in 1994.
- The director in question, Klaus Lower, owned some of the ships being used by the company.
- Despite such huge loses and appalling management reporting the directors continued trading.

To quote liquidator Gary Traveller in 2004: *"It should have been apparent to the directors from late 1993 and early 1994 that the company was incurring further losses, that the projections of profit were hopelessly adrift and that the trading environment was becoming increasing difficult."*

The Judge took into account the commercial advantages accruing to Mr Lower as, a result of his ownership of eight of the firms eleven ships, which gave him the ability to generate 'substantial collateral advantages'. The judge found that this conflict of interest caused Mr Lower to gamble with the firm's creditors' money whilst enjoying significant commercial advantages. He further found that the firms accounting practices were "lamentable".

To quote from the High Court Judge 2004: *"In those circumstances, I think Mr. Lower can fairly be regarded as having forfeited the protection of limited liability for what*

followed. Given his wish to permit South Pacific Shipping to continue to trade despite insolvency ... he ought to have been prepared to put his own money up by capitalising the company... His behaviour departed so markedly from orthodox business practice and involved such extensive and unusual risks to the creditors that it can fairly be stigmatised as reckless."

Mr Lower was found guilty of reckless trading. As a consequence he was liable for the company losses, some seven million dollars.

Cellar House

In this case the company had a one million debt due to Customs, dating from 1992. The director disputed the debt and did not properly account for it in the company accounts.

The court found, after what was no doubt thrilling expert accounting testimony, that this unorthodox treatment did not exclude the director from liability. Because there was a additional one million dollar liability the company was insolvent. He was convicted of reckless trading and found liable for the company's debts, \$1.7m.

Global Print Strategies

This is, in some ways, the most worrying for many directors.

The company had been surviving because the main shareholder and director, Graeme Grant, had been defrauding his factoring company. Mr and Mrs Lewis were minority shareholders and inactive directors of the business.

As Mr Grant found himself in prison, the liquidator took Mr and Mrs Lewis to task. They had received notices from the IRD about unpaid taxes, and were aware that the accounting was lax, at best.

The high court found for the unfortunate Lewis's, declaring that negligence was not enough to pass the hurdle of reckless trading. However, the Court of Appeal did not. The Lewis's, inactive and silent directors, were found guilty of reckless trading and held personally liable for the debts of the company.

Three principles:

- a) Ignorance (or negligence) is not a defence. If the company is insolvent then a director should know it is insolvent.
- b) Trading a business on when there is no reasonable prospect of survival is reckless.
- c) Trading an insolvent business where there is a reasonable prospect of survival is not reckless; the failure of a business is not proof of reckless trading.

That's the Theory. What about the application.

Lawyers do pro bono work. They tend to limit this to worthy projects and by and large they do not feel that reckless trading prosecutions meet these criteria. Thus, taking a reckless trading prosecution requires funding. Lots of it. There is unlikely to be much change from \$30,000 if the case is not defended. It can run into the millions if the director puts up a fight.

Looking at the South Pacific Shipping example. According to the final liquidators report from PricewaterhouseCoopers, Liquidators fees, legal and related costs to the reckless trading action were \$2.3m. The amount recovered from settlements was \$1.8m. There was another million dollars in liquidation fees unrelated to the reckless trading action.

In essence, despite a clear and unambiguous case, it took the liquidators nine years

to settle this reckless trading action, and it cost the creditors \$500,000. Total distribution to unsecured creditors was \$2.1m on \$23m in debt.

Taking a reckless trading prosecution, therefore, is akin to using a nuclear weapon against your neighbour.



Winston Peters and the trivialisation of The Right to Silence



In 1990 Parliament legislated the Serious Fraud Office into existence. One of the most controversial powers held by this office was the power of the SFO Director, in certain limited circumstances, to compel a witness to testify against him or herself. This breach of the right to silence was deemed necessary because of the high level of complex offending occurring at the time.

The Right to Silence, or more accurately the right to avoid self-incrimination, is a touchstone of our civil liberties. Confessions gained under duress were the building blocks of the infamous Star Chamber used by Henry the VIII and others to enforce political discipline. It is famously codified in the United States Constitution as the fifth amendment and is replicated in most modern democratic jurisdictions.

Legitimate concerns exist at the implications of giving any government body the power to compel a witness to implicate themselves. The SFO legislation placed restrictions on this authority, being only available to the director of the SFO and only where exceptional circumstances merit it.

The Law Commission, headed by the redoubtable and enduring Geoffrey Palmer, has recommended that the SFO be absorbed into the Police Force giving rise to a new agency with the awful acronym OFCANZ, the Organized and Financial Crime Agency of New Zealand.

This is a mistake, but one largely of the SFO's own doing.

Serious fraud has great and very real implications, and the SFO has done some great work. Alas, it has also tended to lose focus, concentrating too heavily on the 'public interest' component of its legislative charter.

The recent troubles of Winston Peters highlight the failings of the SFO. Winston Peters has been a fearsome critic of the SFO, making a number of vacuous, politically motivated self-serving criticisms, all completely without merit and often behind the protection of parliamentary privilege.

However, we now face the spectacle of an elected politician, stripped of his right to silence, being brought to task by the very organisation that has been the subject of his attacks.

Winston Peters is an elected parliamentary leader guilty of no more than the dubious distribution of money donated to him by

fair weather political supporters and being selective with the truth. Hardly serious fraud. Definitely public interest. An issue that needs to be sorted out on November the 8th.

Peters is now at the mercy of an unelected body with the powers to compel to testify against himself and was convicted by the dubious impartiality of Parliament's own privileges committee. Who was the victim here? Owen Glenn? The Vela brothers? Robert Jones? These folks donated money to Peters presumably for access and influence. If Winston did not use it the way they intended then let them sue. No doubt Brian Henry will have some spare time coming up, hopefully Winston can get him at his usual hourly rate.

Using the onerous powers of the SFO on such a trivial matter is an abuse of these powers. If this is the most serious case the SFO has on their books they can come knocking at the door of any insolvency practice in the country. We all have real cases of people doing real economic harm that could do with some assistance from the SFO, or even the OFCANZ.

More to the point, who is holding the likes of Petrocivic to account? The afore mentioned underfunded overworked National Enforcement Unit of the Companies Office. Petrocivic has caused real people real suffering and he deserves the full attention of the relevant authorities. Winston Peters is a Piñata.

The SFO has taken to the stage in the Winston Peter's Circus, prancing like a clown in tights while white collar thieves make off with the savings of the innocent.

Liquidators and the Right to Silence

It is not only the director of the SFO that has the right to compel a person to give evidence against themselves.

The Companies Act invests liquidators with this very same power. A liquidator can compel a company director, lawyer, accountant or staff member to give evidence under oath, even if this testimony is damaging to the interest of the person giving evidence.

A key difference between the powers of the Director of the SFO and a liquidator is that any evidence given under oath to a

liquidator cannot be used in a criminal trial (except purgery). It can, however, be used in a civil case, primarily for civil recovery.

This is a very powerful tool for liquidators. Of course, it is useless if a company director decided that they do not wish to be subject to such an investigation and refuses to attend any such meeting, or indeed, flees the country. Then it becomes a matter for the courts to compel the attendance of the recalcitrant director. In such a case the liquidator must apply to the court for an order. The director can be hauled before a high court to testify under oath.



Our mascot Prudence admires stupas in Pagan, Burma.

Shock and Yawn

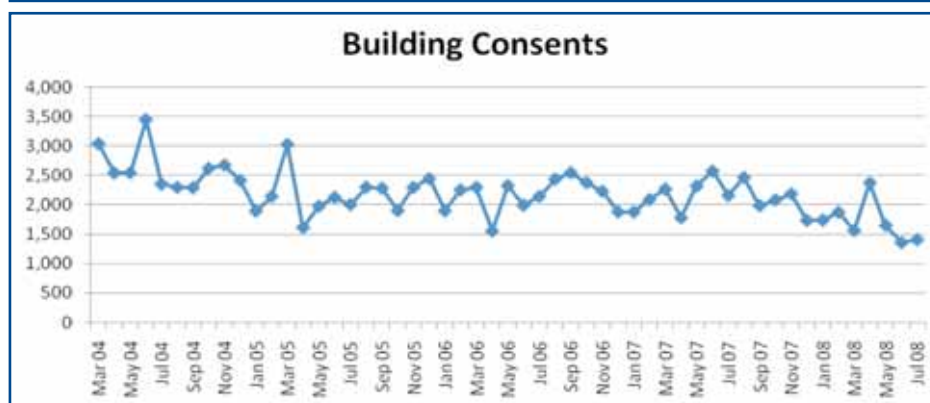
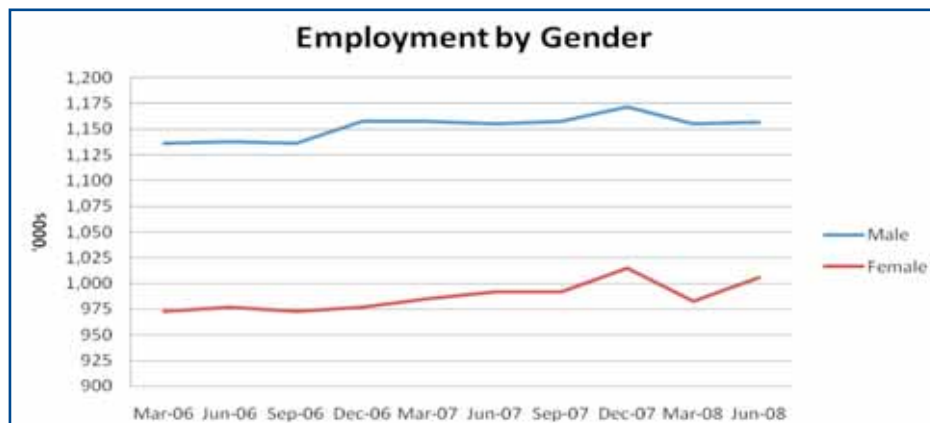
You may recall the banner headlines when employment fell by 23,000 earlier in the year. This was widely reported as a calamitous event. Well, turns out it wasn't as calamitous as all that. The drop was caused by a dramatic reduction in the number of females employed. The speculation at the time was that this was auxiliary staff being laid off. Seemed probable. Plausible. The latest statistics, however, show that fifteen thousand of those women have found their way back into the work force. Maybe they were different women from those who lost their jobs in March. No data on that.

NZ stats is offering no explanation this time and the popular press have let it go largely unreported.

Alas, we are able to offer no explanation other than perhaps the drop in March and the bounce in July reflects a movement between industries. The labour market, at least the female component part of it, is showing a high degree of flexibility. Labour flexibility is a good sign for economy generally, and shows the benefit of the liberalisation of the labour market that occurred with the introduction of the much maligned and equally beneficial Employment Contracts Act in 1991.

Although there was a small increase in employment generally, building consents continue to lag at historic lows.

Importantly, although the level of building is heavily reduced, it has not ceased. There



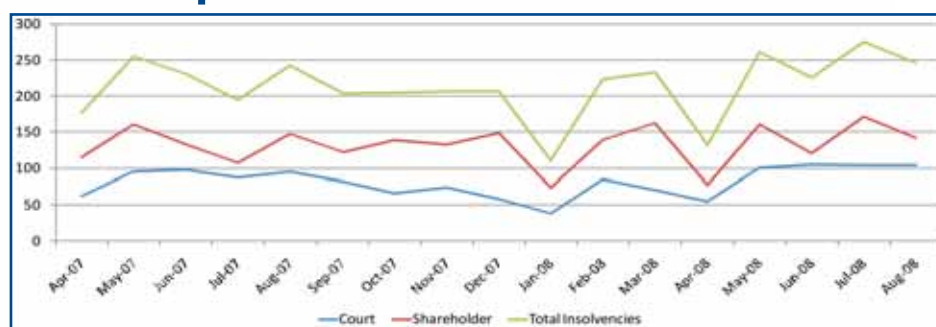
is a base level of economic activity that is required in a modern well functioning economy. The country has over four million people. They all need to eat, (too well given the obesity epidemic), txt and frequent the growing number of malls sprouting up in the suburbs. A recession is only a temporary cessation of growth. Businesses

that need growth to survive will not do so. Those that supply the goods and services that people need each and every day will continue to cover their costs.

A recession will also weed out the badly run undercapitalised firms, leaving a greater market share to those firms remaining.

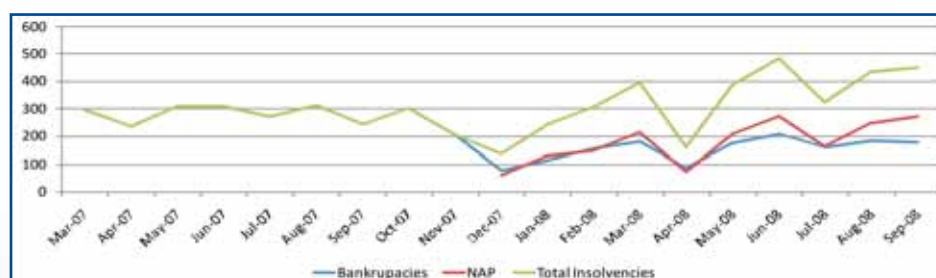
Liquidations Inch Up

It has taken some time but finally there is some movement in the total number of commercial insolvencies. We have edited the data to exclude multiple insolvencies (one business, six companies) as much as we can, and of course the number of liquidations reported in the gazette is a very crude measure of underlying performance. However, it does show both the lag between the onset of harder economic times and the impact of business failure.



Personal insolvencies on the rise

In addition to business failure is the personal misery of bankruptcy. The popularity of the No Asset Procedure can be clearly seen. With No Asset Procedure, introduced in December last year, debtors can apply for a one year mini-bankruptcy if their total debts are under forty thousand dollars.



Recession? Or a permanent change?

For the last two hundred years, those of us in the Western world have enjoyed remarkable economic growth.

One element underpinning all of this growth has been the endless bounty provided by Mother Earth. Oil, coal, trees, fish, metals, etc. Our increasing capacity to consume this bounty was less than Mother Earth's ability to supply.

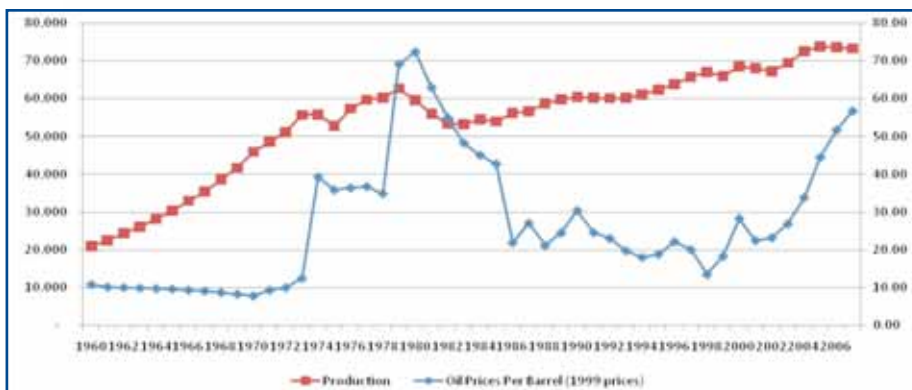
We have also been assisted in this by the relative economic inactivity of a large part of the rest of the world. We have been able to use undeveloped nations as places to extract cheap raw materials and expand trading businesses. The relative poverty of developing nations means that their consumption of the Earth's bounty was limited. This process clearly benefitted both parties. Poor nations received income, technology, and infrastructure. It gave them the tools to become developed nations themselves. (Don't believe any of the nonsense produced by the 'Fair Trade' do-gooders; they would rather Mexican workers were paid five pesos a day milling corn than thirty dollars a day working for Toyota. If you want to help workers in the third world buy an Ipod made in China.)

However, we in the West now face a new challenge. Large parts of the Third World have become prosperous, and increasingly populous. This increase in both wealth and population means exponential growth in demand for all of Mother Nature's bounty, from abalone to zinc. To this end we have seen dramatic rises in global prices in commodity prices (recent slumps notwithstanding.)

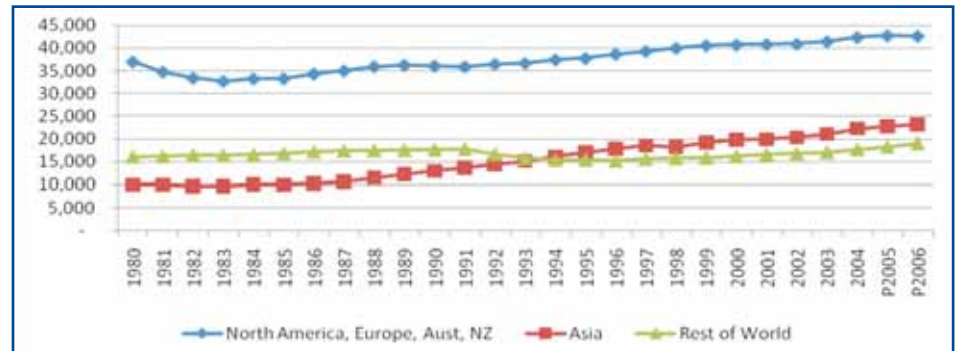
The most ubiquitous commodity product is petroleum, and it is a useful barometer of what is happening in the commodity markets generally:

World Petroleum Output vs. Oil Prices

(Source: US Dept of Energy)



World Petroleum Consumption



Long before the Peak Oil brigade got excited about the demise of Western civilisation (and these cardigan wearing hand wringers really do seem excited about the return to stone buildings and anaesthetic free dentistry) Thomas Malthus was already on the case.

He proposed a theory in 1798 that exponential human growth would, at some point, come up against the linear increase in food production, resulting in mass starvation. (He recommended letting those unable to earn their own food starve to stop overpopulation. Malthus was no humanitarian.)

Malthus was wrong because he failed to take account of advances in technology that would allow for exponential increases in food consumption to match exponential increases in human population. However, he did have an underlying point. Earth's resources are not endless, especially things like metals and fossil fuels.

World output of petroleum does appear to be coming up against physical constraints. The world's desire for petroleum does not appear to face any such constraints.

The graph above plots the West's petroleum consumption against that of Asia's. Their demand is increasing at a much faster rate than the West's. The key issue here is that the West is being outbid for

limited stocks of petroleum by the increasing wealthy East. When you consider that there are 200m more people in China than in all of the OECD, you start to see the potential for Asia's demand to outstrip that of the West, leaving us with a rapidly shrinking share of a possibly reducing natural resource.

If petroleum, and commodities like it, are the primary driver of our standard of living, then we are not facing a cyclical challenge but rather a permanent reduction in our economic quality of life. Our children will be poorer than our parents were, although they will have better video games and larger televisions.

We are seeing the direct economic impact of this development in our economy. Higher commodity prices mean we are paying more for products like oil and cheese, reducing a consumer's disposable income. Products and services that would have been successful five years ago will not be so now. Consumers must consume less and unless you are a commodity producer you will face a reduction in income.

Malthus was proved incorrect because he failed to anticipate the bounty produced by technological advances in agriculture. The West may avoid a drastic reduction in its quality of living if it can achieve dramatic advances in the productivity of the raw materials it purchases. If we can achieve the same mileage from one litre of petrol than we once could from ten litres then we will be relatively unaffected.

Of course the best way to avoid an expensive dependence on commodity pricing for energy would be to tap the one resource for which there is virtually limitless available raw material, and which has the added benefit of zero carbon emissions. The really unfortunate truth for the Greenies is that the best way to save the planet and avoid relying solely on horses for transport (and possibly for heat at night) is to build nuclear power plants.

Where does the money go, and how do liquidators get paid?

How liquidators distribute funds depends on where the money came from in the first instance.

There are four possible sources of revenue in a liquidation, and each one is treated differently.

Secured Assets

The most obvious example here is a vehicle. If a car has a 'hook' or a registered finance charge on it, the liquidator, upon selling the car, must give the funds back to the secured party. Sometimes the secured party simply takes the asset. If there is a surplus, ie: the car is sold for more than the debt owing on it, the surplus becomes available for unsecured creditors.

In some cases a secured creditor will have a General Security Agreement (GSA), also called a debenture, over the entire company. In this case all of the companies assets are secured, and the secured party can lay claim to all of the assets.

Unsecured Assets

In this case unsecured assets, which often includes the debtors, are collected and this is where the liquidators will try and get paid. Liquidators have a priority claim over all unsecured assets for their costs, and it is not uncommon in small liquidations where the liquidator is the only party paid. If the liquidator is trading the business on, they can use funds from the unsecured

assets to cover trading costs post liquidation before paying out any other debts.

After the liquidator's costs come any court costs associated with the liquidation, if these have been agreed to by the court. Usually two to three thousand dollars only. Then come unpaid staff wages and holiday pay, up to a maximum of \$16,640 per staff member. There are a number of rules and time frames around this calculation.

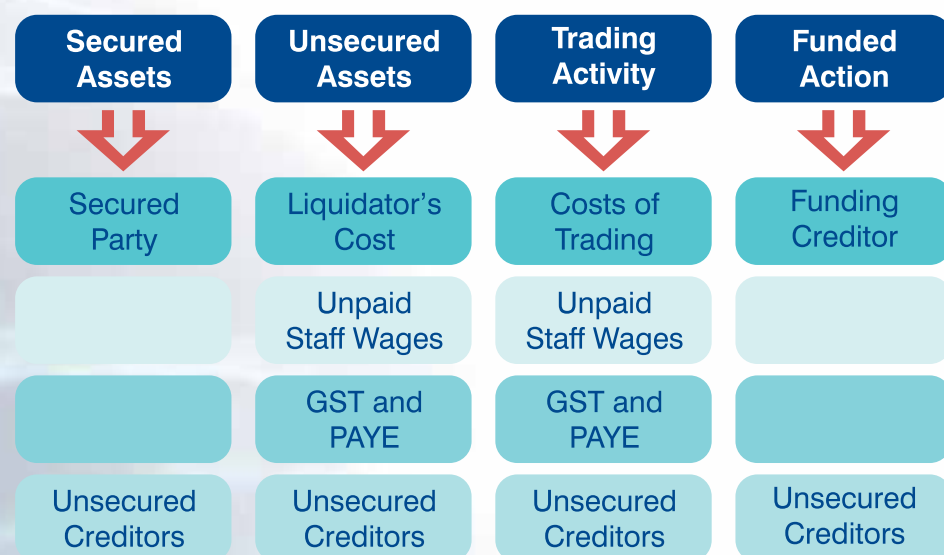
Next in priority is the Inland Revenue, for unpaid GST and PAYE. The IRD does not have a priority claim over unpaid income tax. This is the largest hurdle. It is rare for a liquidation to overcome this hurdle and for any funds to reach the unsecured creditors.

Trading Activity

Liquidators can trade firms on in liquidation. Where they elect to do this any revenue that comes from trading activity is allocated initially to costs, including liquidators costs, from the ongoing running of the business.

Funded Action

A recent change to the legislation allows unsecured creditors to fund action to recover the liquidation firm's assets. If an unsecured creditor chooses to take up this option they will be the beneficiary of any funds recovered from this activity, up to the level of their unsecured debt.



Book Review

Dealing with businesses failing gives us an interest into what makes some companies succeed and others fail. Two books, written some years apart by the same author deal interestingly with these issues.

"Built to last" & "Good to Great"

Some companies last, others fade out over time. Why?

The author looks at eighteen well known companies that have shown staying power and looks at what separates them from less durable contemporaries. What has made these companies "Built to Last?"

The answers are prosaic. Firms with a clear vision, ambitious goals, internal promotions and where management focused on building the company as much as its products and services seemed to develop staying power greater than comparison firms that did not go the distance.

This widely popular book, published in 2001 did not, however, give any guidelines for how business that were not 'built to last' could become so.

The authors thus set aside five years to investigate companies that were good that became great. The key elements they unearthed were based around the nature of the leadership, (humble and effective rather than brash and showy; think Geoffrey Palmer, not David Lange), a focus on the right people before the right business plan (with an emphasis on removing non-performers), facing the hard truth, disciplined staff and managers and most importantly it seems, being the best in your narrow chosen field.

Both books focus heavily on impact of leadership on the success of businesses. This approach has attracted criticism, and there is no data on the number of firms that follow the prescribed approach and fail.

The real value of this type of book may be simply that it forces the reader to think about their business.

