waterline

waterstone INSOLVENCY

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INSIDE:

FED Up?

Distraction was a fun TV program hosted by comedian Jimmy Carr. The acerbic host would ask the participants questions while shooting them with a paintball gun or shocking them with an electric dog collar.

It lasted two glorious seasons and is now immortalized on YouTube for future generations to ponder if this was the exact point that Western Civilisation lost its way.

It wasn't. A much bigger game is afoot across the Pacific. As our American friends are distracted over the sexual infractions of Hollywood types and whether Haiti is a shithole or merely an open sewer, the American enterprise hangs by a fraying thread.

Their last big recession was in 2008. This was a decade using the old calendar, two Obama's and a quarter Trump in the new. Standard Keynesian economics, the prevailing paradigm, tells us a government should run a deficit during a recession and a surplus during a boom. This isn't happening. Obama's last year saw a deficit of over half a trillion dollars and Trump is on track to run annual deficits even larger. US Sovereign debt now tops twenty trillion dollars, well over their entire GDP.

This sounds bad but US interest rates are lower than the ethical standards of a LA casting agent. The Federal Reserve rate recently rose from 1.25% to 1.5%, or in economic terms from stuff-all to buggar-all. If you can borrow money and not pay interest on the debt, then you can roll the debt over forever. The cost of borrowing money is practically free.

Currently the US spends only 6% of its annual budget on interest costs, around $250 billion. This is actually less than the cost in 2008 when the debt was a third of its current levels but interest rates were higher.

Alongside this problem is the issue of the Federal Reserve. It's sitting on nearly five trillion in assets, much of it government debt. In essence, when the government borrows money it issues a bond, and the Federal Reserve brought nearly five billion dollars' worth using printed money.

How low is too low?

Here is the existential problem facing the Americans. The Federal Reserve wants to raise interest rates and to unwind its massive asset position; but this will place intolerable pressure on the Federal Government's budget. So it cannot unless Congress and the President get fiscally responsible and run a surplus, which is about as likely as the current president adopting a healthy diet.

If interest rates return to 2008 levels Washington will be spending close to a trillion on servicing the debt, on top of an unsustainable fiscal position. At some point, even with the Fed keeping rates low punters are going to get wary of holding US Government bonds as a default by way of inflation becomes inevitable and will demand higher interest.

Something is going to give. Either they balance the budget or the Fed abandons all sense of prudence and prints money.

Making this even worse, the US is running expansionary fiscal and monetary policies at the top of the economic cycle. The US is at the end of a decade long bull-run. If they suffer a reversal the usual tools to reflate the economy will not be available. If a crash comes in the next couple of years it will be epic.

Cancelling a Shareholder GSA

Down in the Hutt lives a reclusive insolvency practitioner by the name of David Petterson, formerly of McCallum Petterson, the Waterstone of the 1980s. He doesn't come out very often but when he does he can be masterful, as Waterstone discovered once to our regret.

Back in 2007 McConnell Dowell engaged a firm called Polyethylene Pipe Systems Limited (PPS) to lay polyethylene pipes under the Lyttelton Harbour. It didn't go well and several of the welds broke and McConnell Dowell ran up several million dollars in losses.

This was unfortunate for PPS who had signed an indemnity to McConnell Dowell when they got the contract. Undaunted, the directors, David Browne and his wife, went about some good old fashioned restructuring.

There were two related firms, David Browne Contractors (DBC) and David Browne Mechanical (DBM) that, in addition to David Browne himself had advanced funds to PPS. Now on notice as to a large potential legal claim PPS repaid 1.25m to the related firms DBC and DBM as well as to the director.

	OUT	IN
DBC		$565k
DBM		$347k
Browne	$340k	
Browne (GSA)		$450k

David Browne repaid himself the $340,000, then took out a shareholder GSA and advanced the company $450,000. He went from being an unsecured to a secured creditor.

Nixing the GSA

There is a rarely used section of the Companies Act that allows a liquidator to ask the High Court to set aside a shareholder GSA. Section 299 if:

> *"…the court considers that, having regard to the circumstances in which the security or charge was created, the conduct of the person…if it is just and equitable to make the order"*

Petterson went to court to have Browne's GSA set aside. The High Court found in favour of Browne but the Court of Appeal found that;

A shareholder GSA may not be the best asset protection.

- The restructuring was designed to improve Browne's financial position
- That it was just and equitable to set the GSA aside.

Section 299, unlike other voidable transaction remedies, does not rely on the company being insolvent at the time of the transaction. Although this was an issue with the other payments, discussed below, this was not an issue for the court in discussing setting aside Browne's GSA.

Clawing Back

Petterson issued a voidable transaction notice against both DBC and DBM. Neither firm responded and as per the law these amounts were automatically set aside.

Now, this will get a little technical but it might come in handy.

Section 292 and 293 describe what transactions are voidable

Section 294 of the Companies Act says if a liquidator serves a notice to set these aside, the affected party has 20 says to respond to the transaction or it is automatically set aside

Section 295 outlines the judges options once set aside; including repaying cash, returning property etc.

Section 296 are defences a person has once a transaction has been set aside; acted in good faith, provided value and no knowledge of insolvency.

At the High Court the two Browne companies claimed that under Section 295 the judge could, if he was so inclined, use discretion not to set the transaction aside, and the High Court judge agreed. He took the view that PPS was solvent and that the director was entitled to discount the McConnell Dowell claim.

The Court of Appeal took a different view, and pleasingly for Waterstone drew on one of our Court of Appeal cases, Lotus Gardens, where we had set a transaction aside under Section 294 and then proceeded to issue a statutory demand.

The view of the Court of Appeal is that the High Court has no discretion under Section 295 when it comes to the setting aside. The transaction is set aside and the judge's discretion is limited to the alternative recovery options.

This matters, because you receive a voidable transaction from a liquidator and you do not respond, then the notice is set aside automatically and you will be forced to rely on the Section 296 defences, which for a related party are a high hurdle to overcome.

Supreme Court

This matter was sent to the Supreme Court, who upheld the Court of Appeal's findings.

Robert Jones verses Stephen Lawrence

A knight, we like to think, acts with the highest standards of chivalry. When we hear the term knight the likes of Sir Galahad and Sir William Marshall come to mind. Sadly, this is to overlook the inherent nature of medieval knightly chivalry; where the courtesies were restricted to one's peers. Common folk, and servicing wrenches in particular, could expect little in the way of honourable treatment.

Liquidators, on the other hand, conjure up images of grubby little merchants feeding like carnivorous hobbits on discarded carrion of greater beasts.

So, with these two images in mind we come to the epic battle between two of New Zealand's most pugnacious protagonists. In the Blue corner we have Sir Robert. Coming off a gilded career, having slayed Robert Muldoon and his Stalinist regime, survived the 1987 crash with everything but his hair intact and having written more books than Muldoon had ever read.

In the Red corner we have Stephen Lawrence, one of the nation's most tenacious insolvency practitioners.

Mr Lawrence is the liquidator of Northern Crest Investments (NCI), a scion of the magnificently insolvent Blue Chip empire that failed in June 2011. It was formerly called Blue Chip Financial Solutions Limited but it wasn't one of the key Blue Chip entities.

The liquidation of NCI didn't follow the typical path. A supplier issued a statutory demand for $142k resulting from NCI guaranteeing a debt from a related entity. Unwisely, NCI elected to challenge the statutory demand, asserting a counter claim.

The risk with challenging a statutory demand is that the Court can, if it rejects the challenge, order the company to be placed immediately into liquidation. This is what happened. Messrs Anthony McCulloch and Stephen Lawrence found themselves in office; and the fun began.

Now, directors of some firms prefer to choose their own liquidators. There is a perception, based on fact and historical evidence, that liquidators appointed by the shareholders are less likely to tackle the directors than ones appointed by the courts. The Northern Crest directors would have expected that, even if they lost the challenge to the statutory demand, they would have a few months to appoint their own liquidator. They were caught by surprise.

NCI's documents were mostly stored in Australia and the Australian directors weren't being helpful. The liquidators needed to obtain accreditation in Australia and obtain search warrants before finally getting access to the, partially shredded, documents.

Unhelpful Australians

NCI had assets on both sides of the Tasman. The liquidators obtained recognition in Australia and, facing obstruction by the directors, sought and executed search warrants. They found some records and much shredded paperwork.

Despite these challenges Lawrence identified that $750k had been paid to RJH, but not from Northern Crest, but by two related Australian entities. He set to work.

The Overpaid Rent

NCI had leased the 12th floor of the old Qantas House, now the Crombie Lockwood Tower, at 191 Queen Street. The building was owned by RJH Limited; Robert Jones Holdings for those interested.

NCI, optimistically, signed up a six year lease in 2005 but abandoned it in 2008. RJH wasn't deterred and pursued NCI with vigour. To the tune of the 12 Days of Christmas;

Four statutory demands,
Three Settlement Agreements,
Two Summary Judgements Applications,
One Liquidation,
And Seven Hundred and Fifty Thousand dollars in cash.

The money in question was paid after NCI had left Qantas House and the cash had not come from NCI but from two related entities.

The Litigation

For six years and as many judgements Jones and Lawrence slogged this case through the courts. RJH had the advantage of a personal and corporate fortune larger than some small Caribbean nations while Lawrence had no assets, a liquidated company with no assets and mostly reconstructed shredded paperwork.

RJH sought discovery orders, lost, reviewed and appealed these losses, won and lost cost orders and was, according to Justice Downs, 'stalling'.

However, never underestimate the tenacity of a dedicated liquidator.

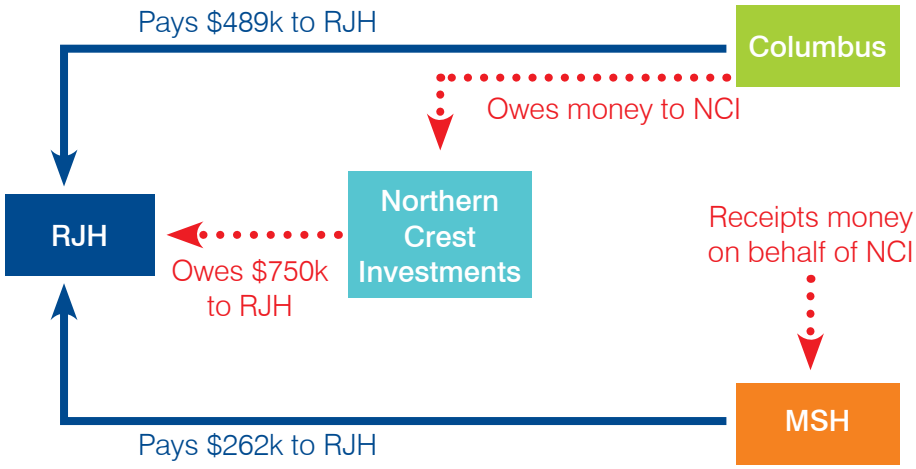
The Transactions

The lease was signed by NCI in July 2005 but the defaults began in 2008. By September 2009 RJH had obtained a judgement for $258k and over the next few years payments were made by two Australian firms, Columbus and MSH to RJH on behalf of NCI.

Lawrence looked at these payments and decided that they were voidable.

For a payment to be voidable it must be;

- Within two years of liquidation
- Made by an insolvent company



- Allow the person who benefitted to gain an advantage over other creditors.

RJH claimed that because the payments didn't come from Northern Crest but the two related entities they were not transactions of the company. This issue has been litigated before and the courts look beyond the form to the function of the transaction. In this case the money was either Northern Crest's money because Columbus owed Northern Crest money and paid cash to RJH on Northern Crest's behalf. The MSH acted as the treasury for Northern Crest in Australia.

The Pen-Ultimate Judgement

In September last year the High Court gave its decision. The total in $750k were voidable transactions as defined under the act. The fact that the money came from a related entity did not matter, it was Northern Crest's money and RJH was obligated to pay it back. With interest.

RJH has a defence to a voidable claim; namely that it;

- Acted in Good Faith *and*
- Had no knowledge of insolvency *and*
- Gave Value

For a creditor in RJH's position to succeed in this defence they must show they can tick all three boxes. RJH failed on the second. The extent of litigation required to extract the money from Northern Crest will have left RJH in no doubt as to the insolvency of their former tenant.

The Specified Period

An argument was had over the start of the Specified Period. This is the two years before liquidation that a transaction can be clawed back. Payments over than two years are not subject to the voidable transaction regime.

However, in the case of a court liquidation this two years begins at the time liquidation application is filed in court. In the case of NCI there was no liquidation application as the court ordered liquidators appointed through an unconventional route. The liquidators sought to extend the two year period by claiming that the date NCI sought to set aside the statutory demand should be considered as a liquidation application date. This was initially accepted by the Associate Judge who liquidated NCI but not by the judge who finally decided the matter.

A Bridge Too Far

The liquidators sought a novel addendum to their cause of action; that RJH not be allowed to claim in the liquidation for the money they would be forced to pay under the voidable transaction regime.

It is unclear why, other than a sense of frustration, that the liquidator's sought this additional ruling but it was rejected. The court found that there wasn't a punitive element in the regime.

An Improper Purpose?

RJH made a claim that the pursuit of the impugned payments was for the sole purpose of satisfying the liquidator's fees. Specifically, because when the liquidators began the voidable cause of action they would have had considerable unbilled time on the clock. By taking this claim, RJH alleged, the liquidators knew that any recoveries would have gone to their fees and would have produced nothing for the creditors.

This was rejected. The court helpfully explained;

> *The liquidators have a duty under the Act to take possession of the assets of NCI and to distribute those assets to its creditors. As part of that duty, the liquidators are required to identify and act upon voidable transactions of NCI, as they have done. The duty does not cease to exist simply because any money so recovered is required by statute to be paid towards the liquidator's fees.*

The case is being appealed.

Our mascot Prudence was invited to Bombay.

One Key to Rule them All

There is an old saying that there are only four ways to get serious money;

Make it

Marry it

Inherit it

Steal it

All viable options although the last one can, in theory, come with some action from the state. If you steal something, especially if you do so in broad daylight with a paper trail so obvious even Hansel and Gretel could find their way home, you may expect that the government would spend some of its eighty billion annual budget chasing down the perpetrators.

You might be surprised. The latest craze in online theft are shares and directorships. If you are a minority shareholder in a company and want to become the sole shareholder, you can negotiate with the other shareholders, haggle a price and try to do a deal. Or you can get a copy of the company key from the Ministry of Business, Innovation and Employment and just take the shares in question.

Minimal paperwork. Only takes a few minutes and once you are the sole shareholder you can remove any directors you disapprove of and prevent anyone else getting the company key.

Now; this, to be fair, is fraud. Blatant, criminal and easier to prosecute than apostasy in Saudi Arabia but relax. There isn't any need to worry. When fielding such a complaint you can be fairly confident that the Companies office will do very little.

At least this is the anecdotal evidence from a few cases that Waterstone has observed. It is possible readers have had different experiences but we have seen several cases of blatant misuse of the Companies Office registry. This is disappointing.

Ellis, Ellis, who the heck is Ellis?

The Star Chamber was a wonderfully English institution whose origins lie in antiquity but by the time of King Henry VIII it had devolved from its initial purpose of a speedy application of the King's justice into a form of oppression.

Witnesses brought before it were forced to take the *ex-officio* oath, swearing before God to answer all questions honestly. This placed guilty defendants in the awkward position of the 'cruel trilemma'.

A lie was a breach of a religious oath and both perjury and a mortal sin. Silence was considered contempt of court. If neither of those two appealed that only left self-incrimination.

Some tried to fall back on the Latin principle of *nemo tenetur se ipsum accusare*; no man is obligated to accuse himself but in the face of a determined monarch such niceties fell by the wayside.

Given how integral the right to silence is enshrined in English law it may surprise some readers that parliament has given liquidators the right to interview anyone with 'knowledge of the affairs of the company' under oath.

Yes. Under oath. Lying to a liquidator counts as perjury and, even better for liquidators, those unfortunate to be before us have no right to silence. The must answer our questions.

It's a remarkable power and if you have ever met some of the questionable people plying insolvency as a trade you may want to consider the wisdom of granting this power to the collection of failed accountants and frustrated lawyers who eke out a living as insolvency practitioners.

Still. Across the ditch Australian liquidators have sought and obtained an even more remarkable power. In *Grosvenor Hill (Qld) v Barber, 1994,* the Federal Court ruled that the court had discretion under the Corporations Act to compel the directors of the company to provide personal financial information for the purpose of letting the liquidators know if suing the directors was a wise economic decision.

This, the Federal Court declared, was based on a 'power of long standing'. Since the Grosvenor case Australian liquidators have sought and obtained a widening of this power to compel directors to display their financial undergarments.

Sadly, no such liquidator has had the fortitude to test this expansion over here so the industry was fortunate that the case of Brian Ellis and Wenztro Co-Operation (in Liquidation) came into the hands of McDonald Vague.

McDonald Vague teamed up with leading insolvency lawyer Kalev Crossland to test if Grosvenor could be applied in New Zealand.

Brian Ellis is a lawyer who was also a director of Wenztro and the liquidators wanted to know if Ellis was worth taking legal action against. This appears more out of a concern that Ellis had most of his assets in trust rather than he'd failed to accumulate sufficient assets over a long legal career.

The liquidators wanted to know what assets Ellis had and their request included historic tax returns, worldwide bank details, personal debts and details of all trust arrangements.

This, on the surface of it, seems outrageous. Ellis is a different legal entity from Wenztro. The hubris of the liquidators in wanting him to outline all of his personal financial details! But consider the purpose of the investigative power in the Companies Act. Liquidators come to the company knowing nothing and in most firms the financial affairs of the company and its owners is hopelessly intermingled. In many cases the solvency of the business is underpinned by the willingness of the director to fund the enterprise. When many directors consider the finances of their business they mentally include their own finances.

Wanting to know the personal finances of the directors is often necessary to understanding the financial position of the business.

In considering this issue the Court of Appeal was required to consider *Grosvenor* and the development of case law in Australia. Given the very similar wording of our Companies Act and the Australian Corporations Act on this issue and the desire for harmonisation, McDonald Vague and Kalev Crossland must have been feeling confident.

The English Law, however, had not gone down the Australian route. English judges had viewed the liquidator's inquisitorial powers as being remarkable and were concerned that liquidators did not obtain a collateral advantage in litigation nor acted oppressively.

In reviewing the Australian case, the Court of Appeal took the English approach and went further, throwing considerable shade on their Trans-Tasman colleagues. At 42 of the Ellis judgement they declare;

> *"…We question the principled basis for the Australian decisions. The Full Court in Grosvenor anchored its reasoning on the earlier English authorities…. We do not read those cases as supporting a right of cross-examination on a prospective defendant's judgement worthiness…"*

The Court of Appeal tacked back to earlier English cases, the right to silence enshrined in the New Zealand Privacy Act and their own reading of our legislation that only allowed a liquidator to enquire under oath into the affairs of the company.

However, if the liquidator could show that the director had assets of the company and the purpose of an interview under oath was to trace missing company assets, then the Court of Appeal indicated that it would look favourably on such a request.

Not everyone practicing insolvency is reputable.

Are Directors Liable for Liquidation Costs?

By Brent Norling

Directors breach their duties. It happens.

If a liquidator is appointed, the liquidator may elect to pursue the director for the losses of the company; often including the costs of the liquidation.

I have been involved in pursuing many directors for breaching their duties and have also assisted directors who have had allegations of breaches made against them.

A recent example is the case of *Central Tyres Waipukurau Limited (in Liquidation) v Pallesen* where the liquidators were successful in obtaining judgment for an overdrawn current account.

The liquidators were also successful in all other claims in respect of Mr Pallesen's failures and breaches of duties as a director. As a result, Mr Pallesen was held liable to all the creditors of the company, and for the liquidators' fees and legal costs.

While there has been a mixed reaction, many directors have been found liable to cover the costs of the liquidator. The Court of Appeal has sent a firm message to liquidators, however, that this approach may not be viable going forward.

Mr and Mrs Shaw

Mr and Mrs Shaw are trustees of their family trust that owned a farming enterprise. One of its suppliers refused to supply materials to a trust. Consequentially, the Shaw's incorporated Aluminium Plus for this purpose. The Shaw's were the sole directors.

Aluminium Plus was a conduit for the Trust. It didn't have a bank account. It simply passed supplies from the supplier to the Trust. The Trust paid the suppliers invoices directly. However, the Shaw's later took the view that supplies were defective and caused both entities not to pay.

The supplier later obtained judgment by default against Aluminium Plus (not defended). Aluminium Plus was later liquidated by the High Court.

The Liquidators' Claim

The liquidators issued a proceeding in the High Court. Justice Brown upheld the liquidators' claims that the Shaw's were guilty of reckless trading and negligence in breach of their duties.

The Shaws' recklessness arose from their election to release the Trust from its obligation to pay its suppliers on Aluminium Plus' behalf for supplies of materials. This decision exposed the supplier to the risk of loss because Aluminium Plus had no income or assets to pay the invoices then outstanding.

Brown J ordered the Shaws to pay compensation of $125,884.59, comprising Aluminium Plus' debts of $99,005.03 plus the costs and disbursements of the liquidation of $26,879.56.

The Court of Appeal Decision on Breach of Duty

The Shaws challenged the decision but the Court of Appeal agreed with Brown J. The nature of Aluminium Plus was that it had no assets or income to meet its liabilities other than from recourse to matching payments made by the Trust. Its solvency was entirely dependent upon the Trust's financial support.

The nature of the directors' decision was to release the Trust from its contractual obligation to indemnify Aluminium Plus against all liabilities. Insolvency was its inevitable and immediate consequence, leaving the creditors' interests without protection.

The Court of Appeal Decision on Compensation

However, the Court of Appeal held that Brown J erred in allowing all the liquidators' costs of $26,879.56.

The Court considered that a compensation award should reflect the financial measure of the director's contribution to the loss suffered by a company as a result of the acts or omissions underpinning his or her relevant breach of duty. However, the question of whether compensation should include the liquidators' costs in undertaking the liquidation is less straightforward. The costs of administering a liquidation will generally be incurred regardless of whether the company's directors are liable.

This was not an orthodox company liquidation or liquidator's claim. The supplier was Aluminium Plus' only significant creditor when it was wound up. The other two creditors were for relatively minor amounts.

Ultimately, The Court of Appeal held that the Liquidators were entitled to follow the course pursued but they cannot expect to recover more than the usual award of legal costs if successful. The purpose of an award of compensation is to recoup or indemnify the company for its losses attributable to a director's breaches. While it may be appropriate to incorporate an allowance for the liquidator's costs where they are necessarily incurred because of the relevant breach, care is required to ensure that the award is truly proportionate to the company's actual loss.

The Court of Appeal held:

> *It is telling that the final award in the High Court — inflated by credit consultant's and liquidation costs — more than doubled the suppliers actual debt. On any cost-benefit analysis, pursuit of this litigation was not a commercially rational exercise.*

Ultimately the Court of Appeal removed the costs of the liquidation as compensation awarded to the Liquidators.

Our Comments

It has become a common practice for Liquidators to seek delinquent directors to pay liquidation costs. Some commentators criticise this practice and would suggest that this should never occur. I somewhat disagree.

Many delinquent directors substantially increase the costs of the liquidation by the way in which they engage (or not engage) with the Liquidators. They hide assets, information and documents. They frustrate the process by being untruthful. The level of behaviour and the impact on liquidators and their resources cannot be underestimated. These directors ought to pay these increased costs of liquidation.

However, for other directors, who have not engaged in this delinquent behaviour, like the Shaw's, the Court ought to be slow to burden them with these additional costs. The purpose and scheme of the Act does not justify such an approach.

Finding the right balance will be key.