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waterstone INSOLVENCY

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This won't end well

Economic cycles are like the El Nino or La Nina sea patterns. The pacific potters along, well, peacefully and is then hit with one of these events. To an untrained eye these changes appear random. But to those who spend their lives immersed in studying the movement of trade winds on the waters of the oceans, the causes of these episodes are less inexplicable.

Still, even knowing what causes weather patterns is usually not enough to predict when something will happen. We understand what tornadoes and volcanic eruptions are but we cannot predict when they will happen.

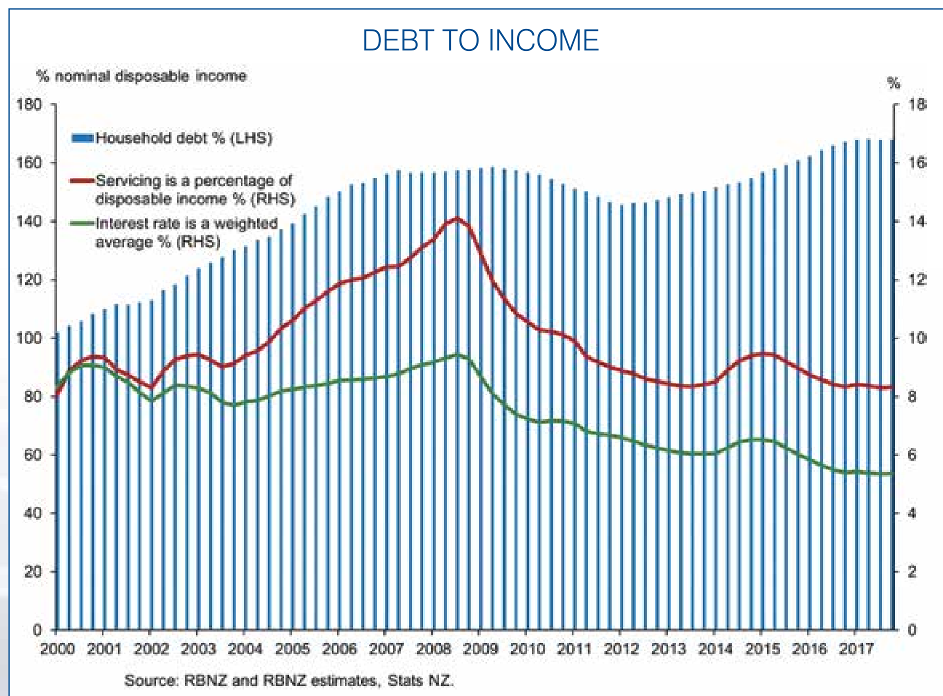
Economics is similar. Economists know what causes an economic downturn but cannot always predict when; but there the two disciplines part ways. Economics is like religion; there are different faiths and they all have very different belief systems.

Science has the advantage of uncovering an objective truth. If mankind were to vanish and the reptiles emerged in a million years as the intelligent species they'd discover the speed of light and what causes water to freeze all over again.

It's unlikely they would get stuck in the debate over the merits of quantitative easing versus sound money. But we have. So we need to consider it. Since the last meltdown in 2008, central banks around the world have been running exceptionally loose economic monetary policy, including our own Reserve Bank. When the global financial crisis hit the Official Cash Rate was 8.25. It has now flat-lined at 1.75, barely a ripple over inflation.

This is awkward because once the US China trade war gets going, or whatever random event causes the next financial panic, we can expect to see another decent downturn. Except this time the Reserve Bank cannot pump cheap money into the system because their system is so full of cheap money people are beginning to drown in it; as the graph below indicates.

One thing economists have got right is the relationship between price and demand.



The effect of a decade of interest rates being lower than the ethical standards of a tobacco lobbyist is people consume more debt. The effect is sobering.

At the turn of the century household income was equal to household debt; where debt includes mortgages, student loans and gambling bets. Servicing this debt cost 8% of household spending. By the GFC, debt to income was up to 160% and the cost to cover this burden was accordingly up by 50% on the 2000 levels.

However, the music stopped and the central banks got busy. Rather than letting people feel the pain of their recklessness, the cost of borrowing was eviscerated and, after a brief pause, the level of household debt actually began to rise. Today household debt is 170% of income even as the cost of servicing this very large money is back to 8%.

This is not a sustainable situation. You do not need to have a PhD in economics to appreciate this. Indeed, as Central Banks are over-run with PhD economists it's possible that this particular qualification is a hindrance to seeing what is brutally obvious to anyone who has ever had to re-pay their overdrawn credit card bill after an epic family holiday.

Unsustainable, however, does not mean imminent. Households clearly could afford to bear a much higher debt servicing cost than they are currently burdened with and there is no hint that the new Reserve Bank governor is keen to begin his reign by bringing forward the economic dystopia that lifting the OCD back to 2008 levels would entail.

So we will continue. Households didn't crash until the debt servicing cost reached 14% of their incomes. Based on the graph household debt to income would need to exceed 200% before we get there. At which point the economy becomes exceptionally vulnerable to the smallest economic shock and the impact of a sudden unravelling will be severe.

Things could get sticky.

The curious case of Stuart Robertson

There are dark pools where the normal rules of commerce do not apply, where tax is seen more as an optional consideration rather than a statutory duty and the Companies Act is a guide than a strict set of rules.

This was the case for Hukatere Coastal Trustees Limited, a corporate trustee that ran afoul of the Commissioner of Inland Revenue for just shy of half a million dollars, although there was some dispute over this by Hukatere's director, Roy Victor Brown.

Now. Roy Brown is an interesting chap who the NBR described as a mysterious front man back in 2011 when a company of his briefly acquired the Kinloch golf course. It didn't go well. Brown was bankrupted and the company went into liquidation with a chap called Stuart Robertson.

Poor Roy Brown did have a run of bad luck around 2011 and a total of thirteen of his companies fell into liquidation, twelve of them with Mr Robertson and one of these was Hukatere.

There was some banter between the IRD and Robertson because, the IRD alleged, that there was an ongoing commercial relationship between Robertson and Brown. A liquidator who has an ongoing business relationship with someone cannot take on their liquidations.

Now, at Waterstone we've had this debate with the IRD because we do not think accepting liquidation appointments, even a dozen, constitutes an on-going business relationship and to date this issue hasn't been tested. However, Robertson's firm, Isolve, was doing the books for Hukatere and a little trolling on the companies office reveals at least one company linked to Brown were using Isolve as its registered office.

Danger lurks in the shallows.

While this was proceeding and the Commissioner was trying to get Robertson replaced, there was the issue of some unpaid GST. In his first liquidator's report Robertson listed an unpaid GST return as the only asset of the company. By contrast, the IRD felt they were a creditor.

There was more back and forth when someone at the Revenue had a fat-fingered-moment and sent out GST returns for 160k to Robertson for Hukatere. We don't need to speculate what happened next. The cheque was banked.

Robertson maintained that Hukatere was a corporate trustee and he'd passed the cash over to the new trustee, although later evidence unhelpfully contradicted this assertion.

The issue here is that the IRD has a right, under Section 310 of the Companies Act, to net-off debts owing. If you owe a company in liquidation money, and that debt is over six months old, you can net this off any debt the liquidator seeks to recover from you. The Commissioner had a right to exercise this net-off. They told Robertson they were going to do this. But they sent the GST refund anyway.

Curiously, Robertson's next liquidators' report failed to mention this payment. More legal jousting ensued and Robertson was finally declared disqualified under the Companies Act from being the liquidator for Hukatere and replaced.

Robertson was less than forthcoming to the replacement liquidators about where the money went and the IRD applied to court. Once in front of a judge, Robertson conceded he was wrong to have distributed the cash but disputed that he was personally liable to repay it.

The IRD was relying on Section 301 of the Companies Act that specifies if a person misapplies or retains property of a company that is in liquidation, including a liquidator, then the court can demand it be repaid. Robertson said that more than mere negligence on his part was needed for an order of repayment.

The court took a different view. Merely misapplying the funds, as Robertson had done was enough, and he was ordered to re-pay the 160k that he maintained he paid to the new trustee.

This isn't the first time a liquidator has been caught for intermingling their own money with that of the estates they manage but it's a helpful reminder of the importance of maintaining accurate trust records, and for this we thank Mr Robertson.

Red Carding Directors

One of the benefits of doing business in New Zealand is the light-handed regulatory environment. A company can be set up in a few hours and anyone over the age of 18 who has not been convicted of a crime of dishonesty or one of the handful of offences in the Companies Act can be a director.

As a precaution, the Companies Act allows the Registrar of Companies to issue a red-card to directors who, in the opinion of the Registrar, warrants it. The Act, remarkably, provides no guidance to the Registrar as to what sort of behaviour merits a ban.

So long as the person in question was responsible, even in part, for the failure of a company, they are eligible. The scope, under Section 385, is pretty wide, and the ban can extend out to ten years and in recent years this power has been extended to the Financial Markets Authority.

With over half a million companies and several thousand insolvencies, it is surprising how few directors are banned by either organisation, around forty a year.

In addition Section 382 of the Companies Act precludes anyone who has been convicted of an offence under the Companies Act where the maximum sentence was more than three years in prison.

These offences include things like disseminating seriously misleading accounting records or fraudulently destroying company records. While these activities are doubtlessly numerous, they are very rarely prosecuted.

The Companies Office, reasonably enough, prefer to focus their enforcement efforts on directors who commit more serious criminal breaches.

Mr Grant Goes to Wellington

Waterstone principal and occasional columnist, Damien Grant, headed down to Wellington to make a submission to the Select Committee tasked with reviewing the Insolvency Practitioners Bill.

This piece of legislation seeks to regulate who can practice insolvency and the preferred option, proposed by the industry, is a form of co-regulation, where an industry body will, effectively, be granted state power to regulate the industry.

At Waterstone we're not opposed to regulation, but we feel that the industry is too small to effectively police itself and we'd prefer to have the Companies Office policing the industry. Perhaps they could issue red-cards to rogue practitioners as they do to directors as per the story above.

This simple proposal was outlined in an earlier version of the law, but was superseded by the co-regulation model.

Waterstone also proposed that the requirements for replacing a liquidator be lowered. Currently a motion at a creditor's meeting to replace a liquidator requires both a majority of creditors by number and by dollar value. This is a very high bar and it is rarely achieved.

Oppression

Shareholder disputes, when you get into them, can be exceptionally nasty, rivalled only by acrimonious relationship dissolutions. The parties often descend into a rabbit hole of misery where the costs of litigation easily exceed the merits of the case.

There is, for those who find themselves in the middle of one, a small but very powerful section of the Companies Act; Section 174. This short stand-alone section grants the Courts wide and discretionary powers to resolve matters where the parties cannot untangle the affairs themselves.

Commentary around this section often makes reference to minority shareholders, but the legislation itself is silent on the shareholding percentage and merely grants the court power to address oppressive behaviour.

Liquidators, naturally, believe any shareholder dispute should be rectified by liquidation under the grounds that it would be 'just and equitable' to do so; specifically the power of the High Court to place a company into liquidation (even if it is solvent) if the company has become deadlocked by a shareholder dispute.

In Latimer Holdings Ltd v SEA Holdings NZ Ltd [2005], this issue was canvassed and the Court of Appeal held that Section 174 was an appropriate alternative to liquidation to resolving disputes. Winding up was seen as a drastic solution and it was preferable to use the court's discretion if possible.

In Latimer Holdings the Court drew on the foundation case, Thomas v HW Thomas, where a minority shareholder was removed as a director. The test for what constituted oppressive behaviour was an "unjust detriment to the interests of a member of the company". It does not matter if the oppressive party acted within the confines of the law and even the company's constitution. If the action created a prejudice then a remedy was available to the oppressed party.

However, there were three principles that the Court of Appeal outlined that should constrain the use of Section 174;

1) Errors of business judgement cannot count as oppressive

2) Judges should exercise restraint when assessing business strategies

3) The court should not facilitate a party's exit over a disagreement over strategy

To invoke Section 174, the applicant must show that the other side is misusing their power to prejudice them and is outside the reasonable expectations of the oppressed shareholder.

The court has very wide powers to address the grievances of an oppressed shareholder, including ordering that the shares are sold. Importantly, the court can go back to the time that the oppression occurred.

This means that if a majority shareholder acts in a way that destroys value the oppressed shareholder can ask the court to value the business at the time before the oppression occurred, imposing the cost of the oppression on the offending shareholder.

These remedies are exceptionally powerful but rarely used, possibly due to the litigation cost and reputational damage caused by an ongoing dispute.

Waterstone

We do interesting work.

Island City on Gulf Coast of Texas

Not all liquidations are exciting. We don't like to admit that, but some liquidations are about as eventful as 11 April 1954. And that's fine. Galveston Nominees (2003) Limited was one of these stories. Liquidated on 12 November 2013, removed from the Register on 21 May 2014. No assets, no recoveries, life goes on.

But life, uh, finds a way. On 13 December 2017, an application was made to restore Galveston to the Register. It appears that there was an on-going dispute between the previous director of Galveston and a previous employee ***(Ms Pillay)*** over purported shareholdings. As part of this dispute, Ms Pillay wanted to ascertain the value of Galveston's shares and its profit, and sought non-party discovery against the IRD for Galveston's GST and PAYE returns. But taxation is theft, and the thieves use "Section 81 of the Tax Administration Act 1994" to guard their houses. So Ms Pillay can't seek the documents, but Galveston can, if it was still alive. And hence, Ms Pillay sought the High Court to inject life back into Galveston.

Not all court proceedings are exciting. We don't like to admit that. But when Alden Ho, former Waterstone alumni, serves you with an originating application, it turns into something like an invitation to a high school reunion. Minus the alcohol and the fanfare when someone reveals they're pregnant. Plus litigation and stacks of paper bound to be recycled.

So naturally we accepted the invitation and opposed the reinstatement.

Condensed Submissions

We opposed on 2 well-established grounds. First, a company cannot be restored to the Register if the liquidator's final report is unable to be reversed. Second, Ms Pillay does not have the ability to reverse the liquidator's final report.

The reversal of the report is crucial and runs in parallel with Section 329 of the Companies Act. Technically, when a liquidated company is applied to be removed, there is an interim period where the company is no longer in liquidation, but exists solely pending its removal. If you don't reverse the report and it's reinstated, the company may end up being liquidated twice. It will also find itself stuck in a loop where it gets removed again, like Dormammu when he had to surrender to Dr Strange.

Section 284 of the Companies Act states that only a certain class of individuals (outside the liquidator) can apply to the Court to confirm/reverse/modify an act or decision of the liquidator, which includes reversing the final report. The class of individuals includes a creditor, shareholder or director, which nope, nope, nope, Ms Pillay was not.

Bell's Decision

But Associate Judge Bell had different ideas. He referred to s329(4), which states that the Court is given the power to give such directions and make orders as may be necessary or desirable for the purpose of placing the company and any other persons as nearly as possible in the same position as if the company had not been removed from the Register.

At the end of the day, Bell likened Ms Pillay's course of action to crossing the Himalayas to find a river. But alas, Ms Pilay's hopes are found in a "very modest trickle which does not make the effort worthwhile". Based on this disproportionality, Bell regarded the circumstances of this case to be disproportionate to the requirements of the substantive proceeding.

Let it therefore be known that Bell denied Ms Pillay's application to restore Galveston Nominees (2003) Limited to the Register, and Waterstone picks up another victory in the High Court, as it finds its place in the records as [2018] NZHC 842.

But wait, there's more

As per custom, costs were awarded against Ms Pillay. But Mr Ho was sharp. He knew that there has been a recent decision denying costs against in-house counsel *(CIR v New Orleans Hotel (2003) Limited)* and cited this in order to recall Bell's decision regarding awarding 2B costs to the liquidators.

But Bell, once again, had different plans. Bell had found that in these circumstances, we were like a non-party successful in resisting an application for non-party discovery, and are therefore entitled to recover actual costs, including the costs of in-house counsel. Bell had found that there was no way for us (as former liquidators of removed companies) to recover costs, unless the Court orders it. Taking into account that our presence was required at this proceeding, Bell thought it appropriate to have the costs of in-house counsel to be reasonable remuneration for our work opposing this application.

Let it therefore be known that Bell ordered Ms Pillay to pay Waterstone costs of their in-house counsel for their work, as it finds its place in the records as [2018] NZHC 1179.

Our mascot Prudence enjoying the snow on Mauna Kea, the Big Island, Hawaii.

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The true cost of a Capital Gains Tax

The Right Honourable Sir Dr Michael Cullen has sprung back onto centre stage. He seems to be enjoying the role and has a new toy; a Capital Gains Tax.

Many Kiwis have enjoyed a growth in capital gains over the last twenty years off the back of an increase in the value of their houses, but Cullen et al have made it clear that there will be no tax on this unearned windfall.

Instead, there is a desire to tax the growth in capital gains on all other capital assets, including shares, investment properties and Bitcoin.

There are a lot of problems with a Capital Gains Tax. An obvious one is that the increase in asset prices over the last few years has been driven by record low interest rates that has driven capital away from cash and towards assets. There is a direct relationship between the level of the OCR and asset prices.

While a few millionaires inherit their wealth, the wealthiest people tend to be self-made. If parliament wanted to punish people for inheriting wealth they can always introduce a death tax, which Dr Cullen's group specifically asked not to consider.

Consequently, most Kiwis with wealth made it themselves and, as the forth law of entropy makes clear;

"Children who inherit vast wealth squander it and die penniless."

In order to acquire capital you must first earn money, which is taxed. An income of a $100,000 nets only $75,000. From this the employee must pay rent, food and their Netflix subscription. What's left is their savings from which they can then buy an asset.

Once this is achieved the lucky capital owner will find that the bank pays them nickels on the pound, thanks to the Reserve Bank keeping interest rates low. So they go looking for an asset with a better return, but sadly so is everyone else, so these assets becomes expensive and, in effect, return a very low yield as a result. *(Diagram A)*

It is important to remember that returns from capital assets are taxed. A perfect example is a rental income. If your property returns $50,000 per annum, the IRD will take a third, more if GST is payable. This means an investor looking at your asset will value it as an asset returning $35,000, which means the value of capital assets in New Zealand are a full third below what they would otherwise be if it wasn't for the tax on incomes derived from capital.

So; in order to obtain an asset paying a return, our Kiwi Investor must save from the post-tax portion of their income they can afford and buy an asset at inflated prices with low returns.

If, after all this, they manage to increase the value of this asset, the Crown now is looking to take a percentage of this return.

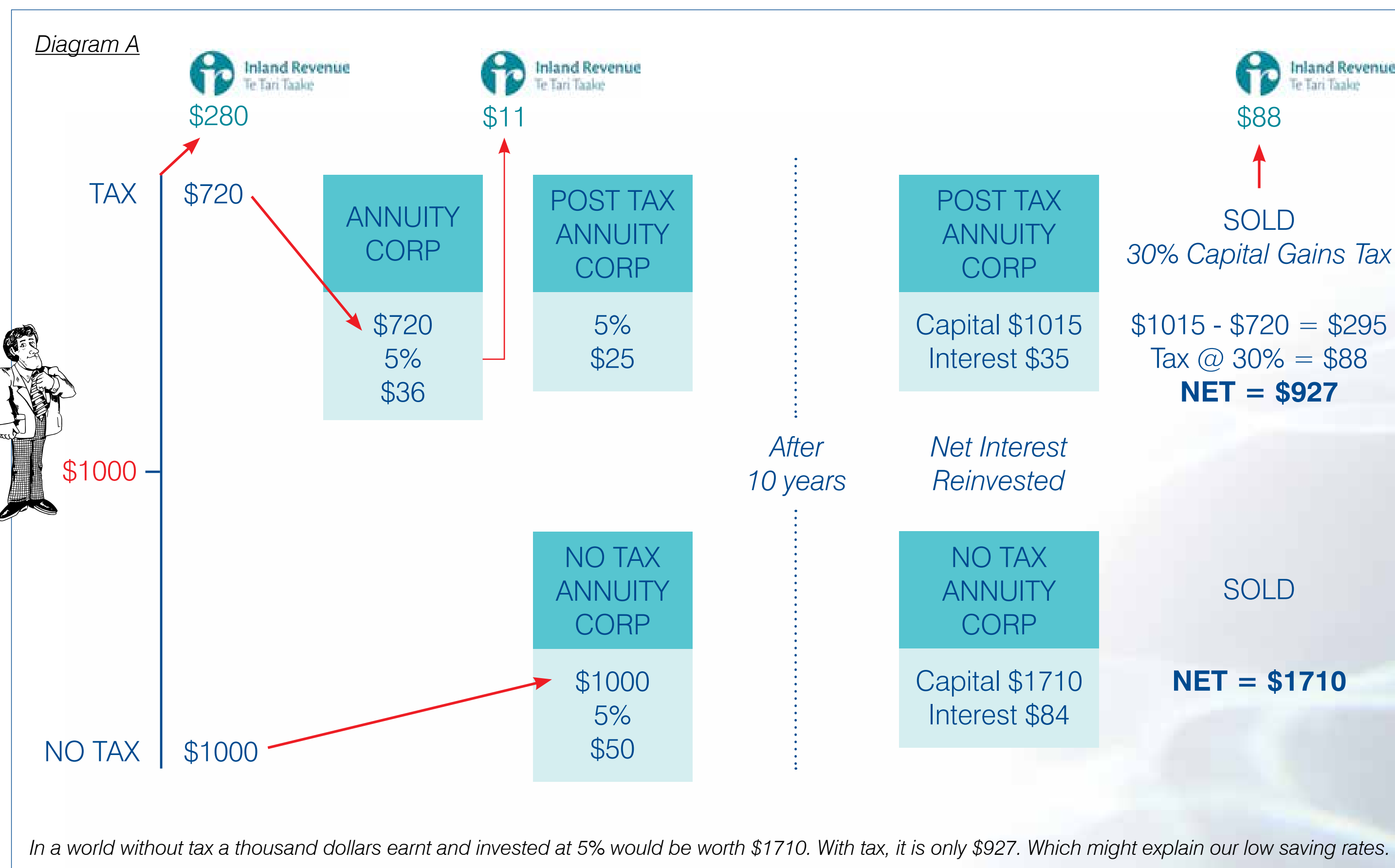
Given this environment, many Kiwis throw in the towel and spend their disposal incomes on smashed avocado. This isn't irrational. Why save for tomorrow when;

a) You might not live until tomorrow
b) The returns on forgone consumption are low
c) The state promises to look after you
d) You don't want to leave anything to your kids

Unsurprisingly then, New Zealand has a problem with retirement savings, which the government seeks to correct with KiwiSaver.

Despite what Jessie Mulligan may claim; a Capital Gains Tax will reduce savings even further, reduce the capital accumulation and increase the reliance on the state.

It is a bad idea whose time has come. Expect it to become law.



In a world without tax a thousand dollars earnt and invested at 5% would be worth $1710. With tax, it is only $927. Which might explain our low saving rates.

A West Auckland Phoenix

Earlier this year Waterstone was called into a West Auckland contracting business. They had around twenty staff, a small mountain of IRD debt and a shareholder's dispute wider than the Atlantic.

The business, though, was actually profitable. This happens more often than you might imagine. The problem for this company was that its supplier had indicated a certain level of work which had failed to materialise.

The company, who we shall call Fibre Solutions, had scaled up to cope with the expected work level and got into trouble.

The directors' expectation was that they had to walk away and deal with a raft of personal guarantees.

We met this company for the first time on a Friday. We worked over the weekend and by the Monday we had a plan. The shareholders took a risk and the company went into liquidation.

There was a secured creditor who needed to be re-assured and a large supplier who was naturally nervous.

However, once the company was in liquidation we were able to sell the assets of the business back to those shareholders who wished to continue with the operation. The others walked away.

This deal was done by Wednesday, with the secured creditor's consent, although it took a few more days for the main supplier to come around.

The company, and twenty jobs, were saved. Sadly there wasn't anything for the unsecured creditors but the secured creditor was placed in a better position than they would have otherwise and there was some distribution to preferential creditors.

Insolvency Law allows for this type of restructure and, if you will excuse some self-promotion, Waterstone was able to deliver this only because we have an in-house team of lawyers who were able to draft a Sale and Purchase agreement, new security arrangements and related contracts on-site, in real time, and at a minimal cost.

Waterstone; we are that good.

Waterstone staff Sarona Chambers and Jai Merrick on site at 'Fibre Solutions'.