# waterline

waterstone
INSOLVENCY

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INSIDE:



## Supreme Court gives directors a lecture

0800 CLOSED

# Debut Homes; Building Precedent

Debut Homes Limited was a 'spec' property developer. It had one director, Leonard Cooper.

The business got into trouble and in late 2012 Mr Cooper went to talk to his accountant. They had a frank discussion. The business owed substantial debts to the BNZ and a smaller secured lender called JT Jamieson and Co.

There were a number of partially completed houses. The accountant explained to Cooper that his business was insolvent but that if he competed the houses they would be worth more than if they were sold as they were now; partially completed.

Mr Cooper had three choices.

One: He could end his involvement by liquidating or asking his secured lenders to appoint a receiver.

Two: He could do a deal with his creditors, either through a Part Fourteen Compromise with Creditors, a Voluntary Administration, or some form of informal deal.

Three: He could box on, putting in some of his own money and finish the houses.

The problem with option one was that the sale of the properties by a liquidator or receiver would not result in the secured lenders, BNZ and Jamieson, being paid out in full. Cooper had a personal liability to these lenders. The problem with option three was that there was not going to be enough from the sale of the houses to pay the secured lenders, all of the trade creditors, and the IRD.

**Here is what Mr Cooper did.**

He went for option three. He secured a further $200,000 from Jamieson. He also put in $377,000 of his own money, through a family trust, into the Company and took a GSA over the assets of Debut.

He used this cash to complete the remaining four houses. Once completed he sold the houses and repaid the BNZ, Jamieson, and a large part of the debt to the family trust.

In 2014 the IRD appointed Deloitte as liquidator over the company. Debut still owed Mr Cooper's trust $200,000 of the $377,000 that he advanced to the business in order to complete the developments.

The Deloitte liquidators took Cooper to court for breaching his duties as a director. They won in the High Court. Lost in the Court of Appeal. This article is about the Supreme Court decision that was released in September last year.

### The Case

The liquidators claimed that Cooper breached his duties and wanted him to be personally liable for the losses. An interesting aspect to this court hearing was that the Crown made direct submissions; with the Attorney General given leave to appear.

An important aspect of this case was the treatment of GST. Had Debut been placed into receivership or liquidation, or the properties been sold by the secured creditors by way of mortgagee sale, then the IRD would have been paid and the secured creditors would have missed out.

This is because both insolvency practitioners and mortgagees are obligated by tax and security law to account for GST on assets that they sell. Company directors, however, while they should pay the tax, the mechanics of selling property means that they can elect to not pay GST, creating a liability for their companies to be settled at a later date.

### Section 135; Reckless Trading

The liquidators claimed that by trading the business on, after his discussions with his accountant, the director caused Debut to run a substantial risk of an inability to pay GST.

Mr Cooper's lawyers responded that his decision to trade on was a legitimate business decision and that the court should look at the total position of all the creditors. Yes; Mr Cooper argued, the IRD was likely to miss out on its GST but the total body of creditors were better off. His reasoning was that the increase in value of the properties as a result of Debut continuing to trade and completing the houses was greater than the costs of not doing so. The fact that one group of creditors got paid and one missed out should be irrelevant.

The Attorney General agreed with the liquidators and so did the Supreme Court.

*"…Mr Cooper did not consider that Debut's financial position was salvageable. He knew…that completing the properties would lead to a GST shortfall…To continue trading in such circumstances must be a breach of Section 135."*

### Section 136; Incurring Obligations

Section 136 focuses on specific obligations, rather than the body of creditors. In this case the obligation in question was the unpaid GST on the properties that were to be completed.

The liquidators submitted that by trading on the business Cooper did reduce the liability to the secured creditors, but he did so by at the expense of the Inland Revenue. His decision resulted in an obligation for the company to pay GST and, at the time he made that decision, he had no reasonable expectation that his company could meet that obligation.

Here the liquidators invoke the concept of *'robbing Peter to pay Paul',* where Peter was the IRD and Paul was the secured creditors.

Mr Cooper made the claim that he never agreed to anything with the IRD. He claimed that as GST is a statutory obligation, that a director cannot agree to incur such an obligation. He relied on a semantic wrinkle in the language of Section 136, where it says a director *'…must not agree to a company incurring an obligation…'.*

Cooper claimed that as he did not 'agree' with the IRD, he formed no contract with them, that Section 136 cannot apply.

The Attorney General disagreed that Section 136 required a specific agreement and that removing tax obligations from the remit of Section 136 would have negative public policy implications.

The Supreme Court agreed with the liquidators. They found that Cooper knew that by choosing the course of action that he did, that there would be a GST shortfall and that as a consequence he had agreed to Debut incurring an obligation without a reasonable expectation that this could ever be fulfilled.

### Section 131; Acting in good faith

A company director has an obligation to act in good faith and in the best interests of the company. Did Mr Cooper's actions breach this obligation?

The liquidators point to the fact that he was incurring obligations that he knew the company could not perform and that the creditors who would benefit from this arrangement were those to which he had a personal obligation to; namely the secured creditors.

Mr Cooper responded that his actions benefitted the total body of creditors. He claimed that it was wrong to look at the position of only one creditor; the IRD. In his view the court should look at the total financial position of the company, which he claimed was improved by his decision to trade on.

Again; the Supreme Court sided with the liquidators, but not before going on a diversion.

The question was; is Section 131 a subjective, or objective test?

If it was subjective, then what matters is what did the director think at the time he made the decision? If it was an objective test, then the question is was his decision in the best interests of the company? If the test is objective, then Mr Cooper can have thought he was doing the right thing but have miscalculated and as a consequence have breached his duty to act in good faith.

The prevailing case law had been that the test was objective. This Supreme Court dissented. It was unreasonable for liquidators and judges to second guess directors who, faced with uncertainty, make decisions. If they believe, and with good reason, that their decisions are in the best interests of the company, then they will not have breached their duties as a director; even if events prove them wrong.

However; if, as in the case of Mr Cooper, they do not consider the interests of the creditors at all; which when it came to the IRD he did not, then they breached the good faith obligation. Mr Cooper also placed his own interest ahead those of the creditors and the company, which compounded his breach.

## Did Mr Cooper have a Section 138 defence?

Section 138 of the Companies Act allows a director to rely on the advice and information from advisors when making a decision. Before the director can avail themselves of this defence they must act in good faith, make proper enquiry where necessary and have no knowledge that the advice or reports are unwarranted.

There are two aspects to Section 138. One line of thinking is that if a director takes and relies on such advice, then they have not breached their duties as a director if their subsequent decisions prove poor. The other is that the breach still occurs but that no liability should befall a director who relies on advice when they have good reason to rely on such advice.

In this case, the advice was that of the accountant. The facts were that the accountant gave Mr Cooper options and advice on what would happen under various scenarios. The accountant did not make any statement that if Mr Cooper traded on he was acting in the best interests of the company, or anything similar.

The standard of advice required to rely on Section 138 is high. Mr Cooper did not get anywhere near it.

## What did he have to pay?

A director is not automatically liable for the debts of their company; personal guarantees aide. However, if the court finds that they breach their duties as a director, then the court can hold them fully or partially liable for the losses that the company faces.

The Supreme Court reverted to the decision of the High Court. Here the judge considered the liquidators' request that the director be liable for all of the creditors of Debut Homes; a total of $499k; almost all of which was unpaid GST and associated interest and penalties.

The director maintained that the court should look at the total losses had the company been placed into liquidation at the time the breach of duties occurred and the total losses at the eventual liquidation. The starting point for any liability claim should be limited to any increase. He also claimed that there had been no increase, although the liquidators disagreed with his maths.

The liquidators saw no reason to run with this 'increase in liabilities' analysis. As far as they were concerned, especially when dealing with Section 136; the incurring of obligations duty, that the director should be personally liable for the new debts incurred.

The Court took into account the fact that the director's trust was left out of pocket for $200k and that the director worked for eighteen months without pay.

He took the total new debts incurred since the breach, being the decision to trade on; $316k. He made an allowance of $80k for the trust debt and the director's labour, weighted some other case specific details and settled on $280k.

## Other Debut matters

The Debut Homes case also made significant case law on dealing with shareholder GSAs. However, as this article is already over two thousand words; we shall leave the discussion of this matter for another Waterline.

# Waterstone;
# YEAR IN REVIEW

**At the end of last year Waterstone took the time to thank our supporters and clients who have stood by us during what has been a challenging twelve months by hosting what will become an annual event; our 'YEAR IN REVIEW', with Simon Bridges as our guest speaker.**

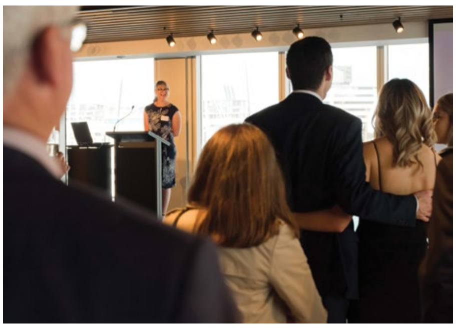
*Damien Grant and Adam Botterill lead the staff into the venue.*

*Andrew Kingstone testing the champagne.*

*To the theme music of Darth Vader.*

*Val Berry and a visitor from the Hawkes Bay.*

*Assembled dignitaries.*



*Rebecca Grant gave the best speech of the evening.*

*Juliet Moses and Mark Jennings.*

*Brent Norling and Lawrence Pope.*

*Damien Grant read a prepared speech that wasn't anywhere near as good as that given by his wife.*

*Dan Henderson, Nola McGowan, Tony Vlatkovich, Dr Don Brash, Ping Chen and Jeff Ussher.*

The Hon Simon Bridges showed he's lost none of this enthusiasm and is surely a contender to be New Zealand's John Howard.

Rebecca's speech was interactive.

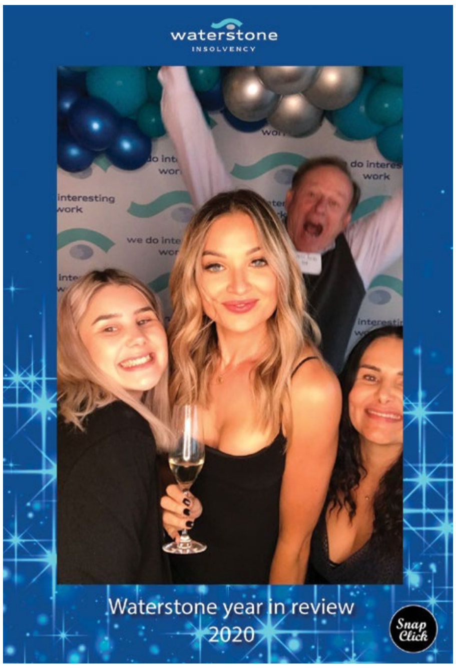
A group of millennials is known as a clutch. They can be seen here in their natural environment.

Xavier Grant and some old guy in a suit.

Damien Grant, Adam Botterill, Greg Sherriff, Yen Teh, Michael Turner, William van Roosmalen-Werie, William Robertson, Andrew Kingstone and Rebecca Wong.

Lucia Krajancic, Connor Cowley and Charlie Lin.


John Chow and Damien Grant failing to look at the camera.




Kevyn Botes being Kevyn Botes. With Isabella Burns, Georgia Brodie and Ingrid Uddenberg.


Darth Vader with Tom Wilson and Tegan Goldsworthy.

# Are we getting Deposit Insurance?

**After its election in 2017 the Labour led government undertook a review of the Reserve Bank Act 1989. Most of the proposed changes are technical. The fundamental statutory independence of the Bank isn't being compromised and there will be further prudential oversight of the banking sector.**

However, one change is significant.

New Zealand is almost unique amongst modern OECD nations in not having state backing for bank deposits. Only Israel and ourselves have not implemented one, although Chile's is set at a nominal rate.

Once introduced depositors will be insured up to $50,000. It appears that this will be $50,000 per individual per Deposit Taker, being a bank, cooperative or finance company. At this stage it appears it will include businesses as well as individuals, although the draft legislation has yet to be published.

This will be paid for by depositors from a levy raised against their account. Given that current interest rates are lower than the rate of inflation, even a trivial levy is unlikely to be popular.

The government is also looking at changes to the statutory preference for bank depositors in the event of a bank failure. Currently depositors are unsecured creditors. The proposed changes will make a new class of preferential creditors in Schedule Seven of the Companies Act; ranking them ahead of unsecured creditors.

This will possibly have little practical effect in an insolvency. The non-deposit unsecured creditors of a bank will be suppliers such as landlords, stationary suppliers, advertising firms and the like.

However, the unsecured creditors of banks who are not depositors are a small portion of the total unsecured pool. As an example, from the annual report of one of the large four New Zealand Banks shows 1.2 billion in deposits against just over a million in other unsecured creditors.

Based on these sorts of numbers changing the priority of unsecured creditors in a banking failure will make no real difference but in the event that a bank did fail, it is possible that the non-depositor creditors could be higher. However, the most likely cause of a bank failure would be a large-scale default on their loan book.

*A government run insurance scheme for NZ Banks and finance companies is planned.*

# ICMS Credit Systems becomes Gravity Credit Management

Gravity
CREDIT MANAGEMENT

**ICMS, a Waterstone company, is a debt collection and credit reporting business that has a history dating back to the 1930s and was once known as Creditman Duns. It was re-branded last year to Gravity Credit Management at an event at the North Shore Stadium. David Seymour was the guest speaker.**

Gravity has a strong track record of collecting receivables and has a number of large corporate clients as well as many smaller firms who have come to rely on us for their credit management.

For details, email the director, Andrew Kingstone, at andrew@gravitycredit.co.nz.

# Where is the Recession?

**For those working in or around the insolvency sector 2020 was a surprising year. Most economists had been predicting that we were overdue for a recession and that the indicators were that 2020 would be one where the slumbering bears would come out of hibernation.**

Then, when the pandemic and the government's response both here and overseas of locking down economies hit there was an expectation of severe economic hardship. Insolvency firms braced for an influx of work that never arrived.

**What happened; and have we dodged or delayed a bullet?**

This isn't the format to re-litigate all of the economic arguments about the effectiveness of fiscal stimulus, monetary policy and whether the trade-off between saving lives or saving the economy. We all now the arguments.

From our small corner of the world we can observe two factors that we believe has contributed to fewer insolvencies in 2020 that we saw in 2019.

The first is the wage subsidy. A staggering amount of cash flowed directly into the bank accounts of every affected business in the country. Many firms that were in trouble even without Covid19 were given a fresh source of capital. In addition, the government loans of $10,000 per Limited Liability Company with an extra $1,800 per employee was another massive liquidity boost.

The other is the relative inactivity of the enforcement arm of the Inland Revenue Department. We have seen a dramatic decline in the level of liquidation applications being made by the Revenue in 2020 relative to other years. There is also anecdotal evidence that the Revenue is being far more accommodating when it comes to entering into arrangements.

These two issues matter. There are many drivers of insolvency but the two key decision points are an inability to make the payroll and litigation from the IRD. The wage subsidy and a lack of enforcement by the Commissioner of Inland Revenue has contributed to a fall in the level of formal insolvency appointments.


*Our mascot, prudence, exploring Ayres Rock.*

# Waterstone Retreat

**Since 2008 Waterstone has taken staff on an annual three-day retreat. This year we visited Rotorua, to take a break from what has been a remarkable year.**


# What is Quantitative Easing?

**Ever since the GFC we have been hearing the term 'Quantitative Easing', and there are always some nice words to explain it. But most of us who don't live in the narrow world of finance and the words don't tell a story. Let's try something different.**

### What is Printing Money?

To get to grips with this let's use an example. The numbers quoted below are roughly right, but don't worry about the details. It is an example for illustrative purpose.

At the moment the total amount of money in the New Zealand economy is 350 billion dollars. Our GDP is 320 billion dollars. The government spends one hundred billion dollars and is taking in seventy billion at the moment.

How to cover the thirty billion dollars? Two options. Borrow the money or print it. Lets look at what happens when they borrow ten billion and print twenty billion;

In the first scenario the Reserve Bank simply creates the cash. It prints it, literally or digitally. As the Reserve Bank is responsible for the creation of money, it can create as much as it wants. However, where the amount of goods and services in the economy isn't changing, the risks are that this will create inflation as we have more dollars chasing the same number of goods and services.

This happened in the 1970s and 1980s. To correct for this, Quantitative Easing takes a slightly different approach. Now let's look at the same process, but with Quantitative Easing, rather than printing money.

In the second scenario the only change is that the Reserve Bank now has a claim on the Treasury for Twenty Billion dollars. This is why, when we hear commentators talking about an 'increase in the Fed's balance sheet', they are referring to the Federal Reserve in the United States where they have been buying assets, including Federal Treasury bonds. These are now assets held by the Federal Reserve and this money must be repaid by the taxpayers. At least in theory.

However. Quantitative Easing isn't limited to the central bank buying government bonds. Central Banks have been buying bonds issued by private banks and even listed private companies. Firms are going to the market to raise money and the central bank is fronting up with freshly created digital money and buying them. Now the private firms owes the central bank the money. This is conceptually very different from the central bank giving money to the government to spend.

In New Zealand the Reserve Bank does not purchase debts from our Treasury directly. There is a small list of approved private banks who must bid for the bonds issued by Treasury. Those who bid the highest price get to pay Treasury in order to obtain the bond. The Reserve Bank will then purchase the bond from the private firm.

*Scenario 1: Printing Money*


*Scenario 2: Quantitative Easing*