waterline

waterstone INSOLVENCY

2021 EDITION 25

INSIDE:

Fatupaito and Bates; PG 2

Regulating Litigation Funding PG 5

The Ten Day Rule is back? PG 6

There is something happening Down South! PG 6

Gravity's Networking Event PG 8

Fatupaito and Bates; Looking back on a classic New Zealand case

Background

The case has cast a long shadow. It deals with two issues; the first is who can be a director and the other is on the legitimate risks a director can take.

Within the insolvency community Fatupaito v Bates is well known for holding a non-director to be liable for the losses of a company, but it is more often cited in judgements for the commentary on the demarcation between acceptable and unacceptable risk.

This case featured heavily in the recent Mainzeal and Debut Homes cases, so remains highly relevant today.

Legal Issues

Who can be defined as a director? Under section 126 of the Companies Act a director is defined widely; "A person occupying the position of director of the company by whatever name called…"

When can a person who is not formally a director be treated as one?

A second issue is what are the legitimate risks a director can undertake and how can the courts determine where that line is? The third issue discussed is what is the correct level of compensation that a director should be held to if they breach their duties?

Case Facts

The company, Metalsmiths Limited, was in some financial trouble. The director was Robert Moon. Metalsmiths was, as the name implies, in the business of metal work. It had acquired another operation, Aleete Wrought Iron. This hadn't helped resolve the firm's financial problems.

In November 1997 William John Bates appeared on the scene. He claimed to be a business advisor and provided accounting and advisory services to the company and to Mr Moon.

This advice didn't resolve the cash pressures. By early 1998 it was clear that the enterprise was in deep trouble. It was then that Bates came up with the idea of having himself appointed as a receiver. There was no legal basis for this. Bates had read the Receiverships Act and had formed a view that he could be appointed as a receiver.

This was incorrect. Only a creditor with a security over the company could place Metalsmiths into receivership. In any event the company went into receivership and Bates was the receiver; at least according to the Companies Office and the rest of the world.

At the time he was appointed the balance sheet looked like this;

Assets	$32,000
Liabilities	$47,000
Shortfall	$15,000

Bates made the decision to keep trading. This was a considered decision. There were some large debtors who wished to have their projects completed. Bates believed that if he completed their jobs he would take in more revenue than he would spend in completing them.

As it turned out, this was wrong. By July 1998 things had deteriorated and the decision was made, by Bates, to cease trading. The IRD appointed liquidators in February 1999.

The Liquidator's Claim

Bates fitted the description of a director and therefore he held duties to the company. He breached those duties. He should be held liable personally, as allowed for under the companies act.

Was Bates a Director?

Section 126 of the Companies Act covers what a director is. The key sections for our purposes in this case are;

> *In this Act, director, in relation to a company, includes …a person occupying the position of director of the company by whatever name called*
>
> *… a person to whom a power or duty of the board has been directly delegated by the board with that person's consent or acquiescence, or who exercises the power or duty with the consent or acquiescence of the board.*

This was a novel case for the New Zealand courts at the time. Bates was acting as a receiver, but it was agreed by all parties that he was not one. The question then became; was he a director?

The Court found that he was, because;

> *The appointment of a receiver by Mr Moon was clearly intended by him to hand over the powers which he had as the board of the company to Mr Bates. Mr Bates appeared to accept this. (Paragraph 48)*

Bates had control over the cheque book, he was not subject to oversight by the actual director and it was Bates who took the decision to continue trading and to eventually close the doors. The answer was a definitive yes.

However; there was an out for William Bates. Under section 126 there is an exception for professionals. The act says that the provisions;

> *…do not include a person to the extent that the person acts only in a professional capacity.*

Bates' lawyer argued that his client was captured by this exclusion as he was at all times acting as the firm's accountant. The Court did not agree.

Now that we know he was a director; did he trade recklessly?

There are two directors' duties that the Court looked at in this case;

> 135, Reckless trading, and 136,
> a duty in relation to obligations.

<u>Section 135</u>

With respect to Section 135 the liquidators claimed Bates was trading recklessly. The company was insolvent when he assumed office. The bank account had an unauthorised overdraft of $4k. Bates, as the accountant, was aware of these matters.

Perhaps the most significant aspect of the reckless trading claim was that Bates had concluded that if he completed the outstanding projects there would be sufficient margin to allow the business to trade its way out of trouble. However, the liquidators were able to convince the court that Bates had not done enough analysis. There were problems with the projects and a fair examination would show that there was no prospect of free cash emerging from the decision to finish the half-completed jobs.

Compounding the issues facing the firm, key personnel had been lost which added to the poor record of timeliness, workmanship and underpricing that had lead to the problems in the first place.

The case of Fatupatio and Bates brought shadow directors into the light.

There was a key line in the judgment that had an effect on many other director duties cases;

> *"It is always open to the directors of a company to cease trading even through the company has entered into pre-existing commitments and in some cases this will be the wise cause to take. Of course that would hurt those who have paid a 30% deposit and have not had their work done, but section 135 required an assessment of the position of creditors as a body rather than individual creditors."*

This is the difference between Section 136, which looks at individual creditors, and Section 135 that looks at all creditors. This interpretation of Section 135 prevailed in many cases, but was ultimately discarded by the Supreme Court in the Debut Homes case in 2020.

However, because Bates could have made the decision to cease trading, and this would have been the correct decision, he placed himself at risk of trading recklessly by agreeing to keep the doors open.

This is what occurred.

> *"I find that Mr Bates, in his capacity as a director, was in a position where he could have made a decision to cease trading at the time of his appointment or after a reasonable period during which he could have evaluated the financial position of the company. By not doing so, he allowed the company to carry on business."*

> *"…I therefore find that the position was such that Mr Bates was in breach of Section 135 by allowing the company to keep trading because this involved a serious risk of substantial loss for creditors of the company."*

Section 136

Section 136 is a duty not to incur an obligation without a reasonable belief that the company can meet the obligation.

The Court considers that, in order to not breach Section 136, the director must believe, subjectively, that the company could perform the obligation. However, that belief must be reasonable, on an objective basis.

Let's break this down.

> Subjective test;
> *What does the director believe?*
>
> Objective test;
> *What would a reasonable person believe?*

So; did Mr Bates actually believe, and on reasonable grounds, that Metalsmiths could meet the new debts he was incurring?

Here the judge concluded that while Bates did honestly think that the business could meet the newly created debts, a reasonable person in his position would not have done so.

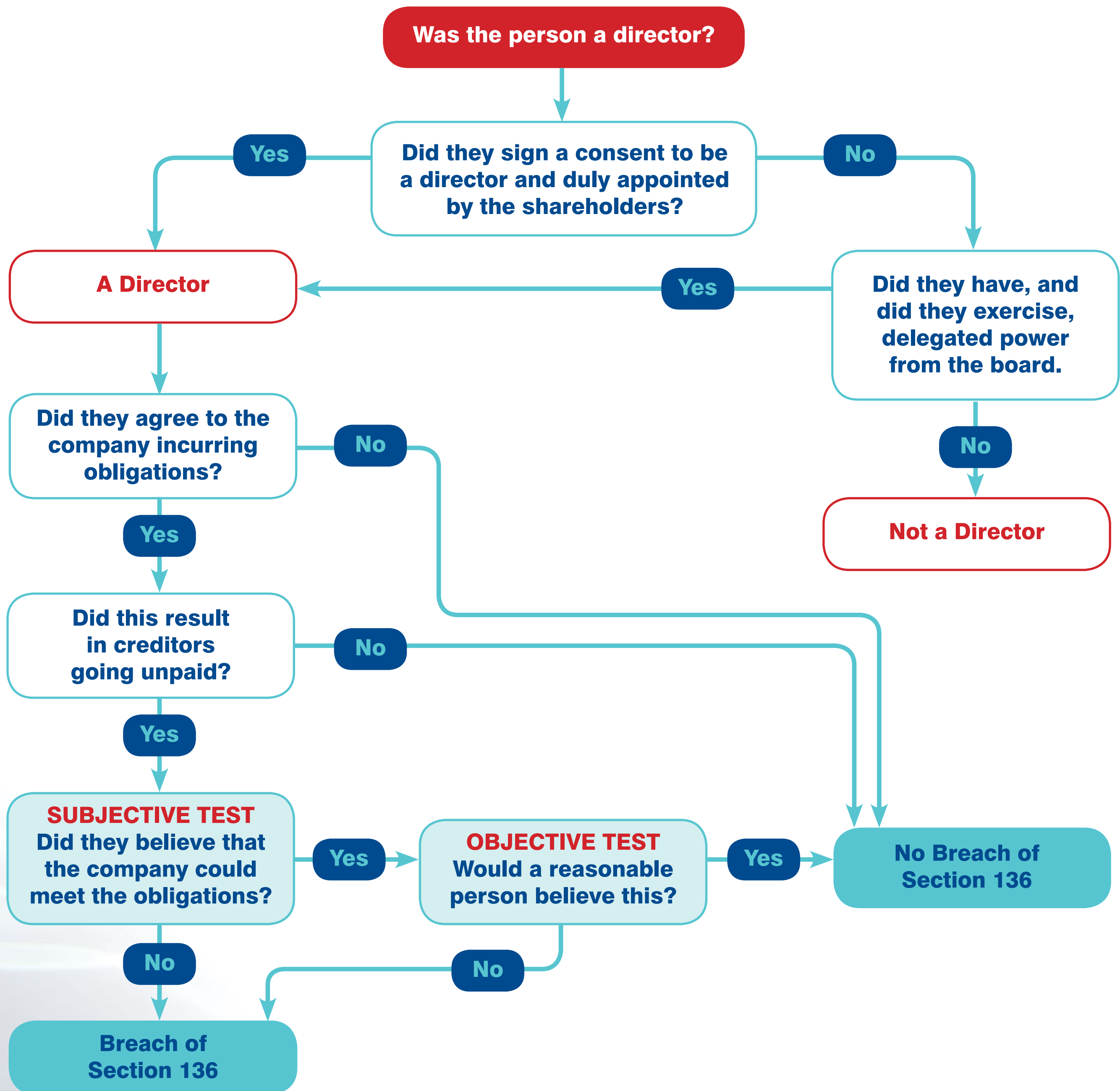
> *"In the circumstances, I find that Mr Bates was in breach of Section 136 from the beginning of March 1988 because he was, at that time aware that the company was in an insolvent position and that it was not reasonable for him to believe that from then on obligations incurred by the company would be able to be met as they fell due."*

Assessing Liability

The liquidator's claim was $59k; being the increase in liabilities due to Bate's decision, should be repaid by him personally. The court found that some of these costs were due to factors beyond his control, and assessed liability at $30,000.

According to the liquidators' reports, this was paid.

The Fatupaito and Bates Director and s136 Test



Section 136: A director of a company must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.

Regulating Litigation Funding

Fresh from the success and trouble-free regulation of the insolvency industry, parliament is turning its omniscient eye towards the field of litigation funding; with the Law Commission being asked to commission a report.

This interests us here at Waterstone, because our sister company, Tempest, does a small amount of litigation funding, although its main business is buying debt, including disputed debt.

You can imagine our excitement at, once again, having the state coming in to assist us in how we run our affairs.

Before we get into the detail; readers may want to know what has prompted this review, was there an outpouring of complaints about litigation funders? Has there been angry letters to Members of Parliament regarding the rapacious fees and behavior of litigation funding firms?

Well. No. None of that. There are, as it happens, just two litigation firms in New Zealand. Well. One and a quarter, given the very small amount of things that Tempest actually funds.

There are a small number of overseas firms who probably average one funded case every three years. So; this is a tiny market with massive barriers to entry. The main complaint we face is that there are too few cases being funded; justice is just too expensive in New Zealand. We'd love to fund more, but capital and resource constraints make this difficult; and let's not forget, litigation funding is not for the faint hearted; the profits can be large but so are the losses.

So, what is the Law Commission likely to recommend?

Mandatory Deed Provisions

The Commission seems likely to force litigation funders to insert clauses in their deeds designed to protect the plaintiff from losing control over their case. The concern is that the litigation funder will have too much control over the claim so the party who is bringing the claim needs protection.

Fair enough, but this will also have the effect in some claims where the litigation funder is concerned at the reasonableness of the plaintiff to elect not to fund their case. For a funder, you want to know that the plaintiff is going to agree with your advice to either proceed, or to settle.

Currently the deeds used in the industry give the funder considerable influence, but not direct control.

Regulation of Commission

Litigation funders take a share of any returns, and we price accordingly. For a small claim, we may want our legal costs and over half of any recovery, simply because the return is going to be too small to cover the costs and risks. In others we will be aware that there may be competition and price accordingly.

By placing a cap, this ensures that only excellent and relatively low-risk cases are funded.

Capital Adequacy of litigation funders

As far as the Law Commission is aware there has only ever been one case of a funder getting into trouble, with the funder of the large and complex Feltex case having their claim struck out for failing to stump up for a security of costs.

In most cases, the funder will be asked to provide a security for costs, to cover a negative costs award. If this cannot be provided, the case fails. This is fairly standard practice for all litigants. There is a real risk for a plaintiff, if their funder fails, they could be on the hook for a costs award.

In the normal course of commercial life, it is expected that a competent civil lawyer could advise the plaintiff of this risk.

From a practical perspective, litigation firms typically enter into agreements with high-net-worth individuals to fund their claims, rather than have access to their own capital reserves. Capital adequacy rules will complicate these arrangements substantially.

Outright Regulation

Several options are being considered for regulating the industry, from requiring funders to get a license from the FMA through to some form of self-regulation or forcing all agreements to be first approved by the relevant court.

Impact of regulation on the sector

Litigation funding is very young in New Zealand. Given the slow pace that our courts work and the high and growing cost of litigation it is both profitable and highly speculative. Regulation is certain to chill the development of this industry.

In one rare moment of clarity, the Commission writes;

> *"…there is a risk that increased regulation could hamper market entry and therefore competition. If regulation is too onerous, litigation funders may be deterred from funding litigation…"*

Despite this, is seems certain that the Law Commission will seek regulation and parliament will impose it. This will improve, marginally, the experience of sophisticated plaintiffs with excellent claims and ensure that many other potential claimants will get no representation but will be unaware of the reason why.

At Tempest we see the real need for litigation funding. We could take on twenty times the number of cases we currently do but the constraint isn't just financial, it is internal capacity. Managing litigation is time consuming and requires considerable management attention. The market could use a number of smaller new entrants.

Regulation is certain to hamper this development, which in our view is unfortunate for those without the financial resources to obtain access to the justice system.

The Ten Day Rule is back?

Bad law makes for uncertainty and few laws are as artlessly crafted as Section 241AA of the 1993 Companies Act.

This deals with when a shareholder can appoint a liquidator once the company has been served with a liquidation application.

Under the law that applied prior to September last year, the shareholders had ten working days to appoint their own liquidator or Voluntary Administrator once a creditor had served a liquidation application on the company.

The new law, at s241AA, says this;

1) This section applies if an application for the appointment of a liquidator under section 241(2)(c) has been filed and served on the company.

(2) A liquidator may be appointed under section 241(2)(a) or (b) only if—

(a) the liquidator is appointed within 10 working days after the application is served on the company; or

(b) if the application is made under section 241(2)(c)(iv), the creditor who filed the application consents to the appointment under section 241(2)(a) or (b).

Section 241(2)(c)(iv) is a creditor's application. There are many other people who can apply to liquidate a company, including the company itself, a director, the FMA, the Reserve Bank, etc.

Now, this is confusing, but here at Waterstone we believed that what this law is saying is that if a creditor has served a liquidation application then paragraph (b) applies, which means that the moment the company is served the shareholders require the petitioning creditor's consent. If a director, the FMA or anyone else made the application, then the company had ten working days to appoint their own liquidator.

We still believe that, but there is now a court ruling saying that we are wrong and there is a typically Shakespearean element to this drama.

Ten things I hate about you!

"Ten things I hate about you", is a terrible 1990s flick with Heath Ledger and Julia Stiles. It is relevant to this story only because it is based on the Shakespearian play "The Taming of the Shew", the writing of which seems a little like something that could get a chap cancelled these days but it was performed at the Pop Up Globe.

Sadly, the Pop-Up Globe Foundation hit troubled economic waters as a result of last year's pandemic and placed the company into liquidation. However, before this happened the Inland Revenue had served up a liquidation application.

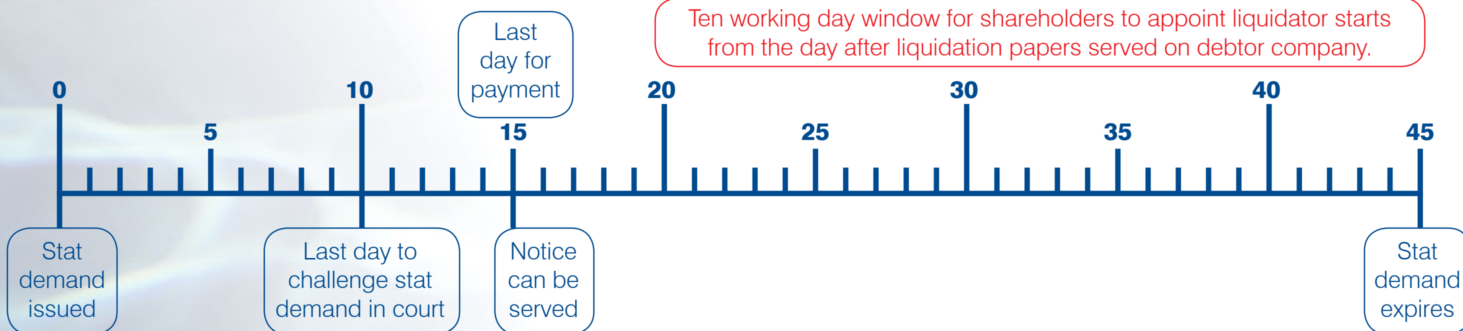
The issue landed in front of an associate judge who ruled that what Section 241AA means is that shareholders of a debtor company can appoint a liquidator within ten days of being served with a liquidation application, but if they wish to do so outside the ten days, they need the petitioning creditors' consent.

This seems, on the face of it, to be a misreading of the act. However, this would not be the first time we have been proven wrong, so given a choice of believing us or believing a Associate Judge of the High Court, we recommend not taking our advice.

So, until this ruling is challenged the law of the land is that the ten day rule is back. We expect that this will not be the last we hear on this subject, however, so caution and competent legal advice is always recommended.

Statutory demands:

- Must be challenged in court within 10 working days.
- Must be paid or settled in fifteen working days.
- Can be used as proof of insolvency to obtain a liquidation order.
- Liquidation application can be served on debtor company after fifteen days.
- Debtor company has ten working days, after service of liquidation application, to appoint liquidator.



There is something happening Down South!

Blenheim is a lovely place, full of vineyards and sunshine. However, around 2017 a local chartered accountant, who we shall refrain from naming, elected to take on a number of insolvency appointments. They got him into trouble with the Institute.

Section 280 of the Companies Act prevents those who have provided professional services to a company within the last two years from acting as liquidator or Voluntary Administrator of that company.

Our Blenheim accountant, unfortunately, accepted the appointment as a liquidator of two companies and a Voluntary Administrator of a third, in violation of this restriction.

There is another requirement on practitioners to state not only the name of the company when advertising its insolvency, but any name it has used in the past twelve months. Unfortunately for our Blenheim accountant, he failed to do this for two of the companies.

There is even another rule that practitioners must provide a list of creditors in the first report, as well as provide a state of affairs. Again, this did not happen.

Now, in fairness, this last rule is not always scrupulously followed, often through no fault of the practitioners; we simply do not always have the books and records for the company. In any event, these three problems were statutory breaches.

However, things did not end there. As the gentleman in question was a Chartered Accountant he was subject to oversight by the Institute. He failed to respond in a timely manner to the Inland Revenue and, once he had been replaced as liquidator, refused to co-operate with the new liquidator and even gave false and misleading information.

When required to attend an interview with the replacement liquidator the colorful Blenheim accountant demanded the very reasonable sum of $8,000 for his time and travel expenses. This was declined.

In short, the behaviour was remarkably unprofessional and certainly in violation of the restrictions in the Companies Act as to who can take appointments. The issue came before the Institute of Chartered Accountants who found against him and suspended his ability to practice as a Chartered Accountant for eighteen months.

Horoscope; By Prudence

Our mascot, prudence, has a very dark perspective. We asked her to prepare a horoscope. This is what resulted.

Aries ♈
This month will bring heartache as those closest to you will betray your trust in order to obtain favour with individuals of low consequence and minimal social standing.

Taurus ♉
Commercial problems will be exacerbated by poor decisions made by unworthy people in whom you have placed in positions of authority.

Gemini ♊
Longer term personal aspirations will be undermined by poor decisions taken in your youth resurfacing in unexpected and novel ways. Seek medical advice.

Cancer ♋
Feelings of despair, frustration and a sense of inconsequence will become overpowering and will be exacerbated by alcohol usage. Stay off social media during this difficult time.

Leo ♌
Intense stress will be placed on social and personal relationships as a consequence of sending a text intended for one person to another. Knowing this in advance will not prevent this occurring.

Virgo ♍
Good news in your professional life will be overshadowed by insecurity over your ability to capitalise on the new opportunities. These fears will prove self-fulfilling and would not have arisen had you not read this.

Libra ♎
The cooler weather will be accompanied by weight gain.

Scorpio ♏
A growing sense of antipathy towards your fellow man will become intensified during this month. A re-lapse into self-destructive patterns of behaviour is inevitable.

Sagittarius ♐
A growing sense of optimism that has been evolving over the first few months of this year will prove to have been unfounded.

Capricorn ♑
A chance encounter with a past romantic partner will trigger sensations of lost opportunities and deep regrets over paths not taken.

Aquarius ♒
The growing sense of ennui that has been developing over the past several months will validated by a series of disappointments.

Pisces ♓
A failure to master a simple skill or task will be evidence of either inherent inadequacy or the acceleration of the process of physical decline that has been obvious to others for some time.

Prudence, in Hong Kong, admiring the local fleet.

Gravity's Networking Event

Is being ethical good for your business? In the current environment, where firms are falling over themselves to be seen to ethical, regardless of whether they are or not, we decided to put this issue to the test.

Bruce Sheppard, OZNM, former board member of the FMA and founder of the Shareholder's Association, argued that being ethical was good for your business.

Damien Grant, Stuff columnist and fashion icon, took the negative.

Sheppard's position was that being ethical gave the business and its staff a reason for being bigger than the individuals and this would drive performance. He recalled the Pavlovsk Experimental Station, founded in 1926. Here the Soviets founded a gene bank of rare and lost species of seeds. Faced with the oncoming Nazi assault twelve of the scientists in charge of this remarkable repository were so committed to the project that they starved rather than see the precious seeds lost.

This, Sheppard claimed, was evidence of the power of ethics.

Fair enough, Grant responded. But, he made the point that those on the other side of the siege were soldiers driven to exceptional courage and devotion as well; only their ideology wasn't ethical; it was evil. Humans can be driven to achieve incredible things by ideas, but those ideas do not need to be ethical.

In Grant's view; acting ethically was something that should be done for its own sake and not in anticipation of some tangible reward. Acting ethically carried short term and possibly long-term cost but it is something that an individual should do in spite of this; being ethical was its own reward.

At the end of the discussion, Sheppard declared the result a draw.

Gravity Director Andrew Kingstone kicking off the debate.

Newsroom editor Jonathan Milne holding court.

Colin Theyers, Bruce Sheppard, Mike Alexander and Robert Walker; four of Auckland's finest.

Damien Grant explaining how large the problem with Sheppard's argument is.

Gravity; at the Hilton.

New Zealand based experts with many decades of experience managing Bad Debt and Receivables.

0800 GRAVITY (4728489)
gravitycredit.co.nz

Gravity
CREDIT MANAGEMENT