waterline

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INSOLVENCY

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INSIDE:

Calculating Interest on Debt

Inflation is back! For three decades we have enjoyed price stability. A dollar today used to be worth about 98c a year from now; in nominal terms at least. However, we are now seeing prices rise at over five percent a year.

A dollar today is worth 94c a year from now; all going well, and things are not going well.

Up until recently, interest was merely the price charged for the Time Value of Money and risk. Now, interest needs to compensate for the declining value of our currency over time.

There are four aspects to considering the charging and collecting interest in the current environment;

- Commercially negotiated rates
- Court claims and what can be claimed after judgement
- Statutory limitations on charging interest
- How debts are handled in insolvency.

Commercially Charged Rates

Private firms can charge whatever rates they wish, subject only to some statutory limits, see below. There are two basic types of credit where interest is applied. The first is on loans, and the second is where credit is provided for goods and services.

With private commercial arrangements, it is common for firms to include a provision for charging interest where the invoice is not paid on time. However, in recent times, given the low rate of inflation, these have sometimes been dropped or no rate is specified. For larger commercial firms, however, the rate is defined as a rate a percentage or two above some defined rate; such as the five year mortgage rate for a specified trading bank.

Critically, this amount can be cumulative, but this must be specified in the contract. A 1,000 debt with a five percent annual interest rate grows by $4.17 in the first month; using 5% divided by 12 to work out the monthly interest amount.

In the second month, this rate is applied to the new debt of $1,004.17. Admittingly, this only increases the interest amount by a single cent in this example, but by the end of the first year the monthly interest rate has grown to $4.36 within a year, and builds quickly.

Most private firms have default rates around ten to twenty percent, so the cumulative impact of these outstanding amounts can be significant. A debt with a fifteen percent cumulative default rate will double in 56 months.

Where credit is provided as part of a loan, there is usually two rates; those for where the loan is not in default, and when it is.

Both of these interest costs are those that can be claimed in the various courts and tribunals in New Zealand and it is a debt that can be enforced.

After Judgement

Under the Interest on Money Claims Act 2016, the court will apply to successful plaintiffs the amount a rate of interest set by the Reserve Bank's six-month term deposit rate plus a nominal penalty rate of 0.15% above that rate.

This rate will apply from the time that the obligation was due to be paid until the date it is paid; and it is compounding. This is a large change to the ad-hoc system that preceded it. The act provides that the MBIE provide an online calculator, which can be found by searching "Interest of Money Claims Calculator".

This new regime is far more favorable to creditor plaintiffs than the previous regime.

However, if the contract provided for an interest rate, that is the rate that will be provided. The Act itself is full of helpful examples that will leave all but the most academically inclined accountant with a migraine. However, as far as this author can determine, if the contract provides for an interest rate, that rate will be applied rather than the rate detailed in the legislation.

Statutory Limit on Charging Interest

Changes to the Credit Contract and Consumer Finance Act came into force in December last year. One of the impacts of this legislation is a cap on the rates of interest that can be charged as well as restrictions on the way interest can be calculated.

A lender cannot require a borrower to pay back more than twice the amount borrowed if the loan is defined as being a high-cost consumer credit contract. This is one that has an annual interest rate of over 50%. This calculation includes the default rate. So; if the standard annual rate was 45%, and the default rate was the standard rate plus 10%, then the loan contract is considered to be a high-cost consumer credit contract.

Beyond this, there are a number of restrictions around unreasonable fees and disclosure and these restrictions do not apply to pawn brokers. Importantly, these restrictions only apply if the debtor is a person. It does not apply to contracts between companies or other such entities.

Interest in an Insolvency

Once a company falls into liquidation, or receivership, creditors divide into two camps. Secured creditors retain their right to charge interest at the contracted rate, but only up to the value of the security they have a claim over.

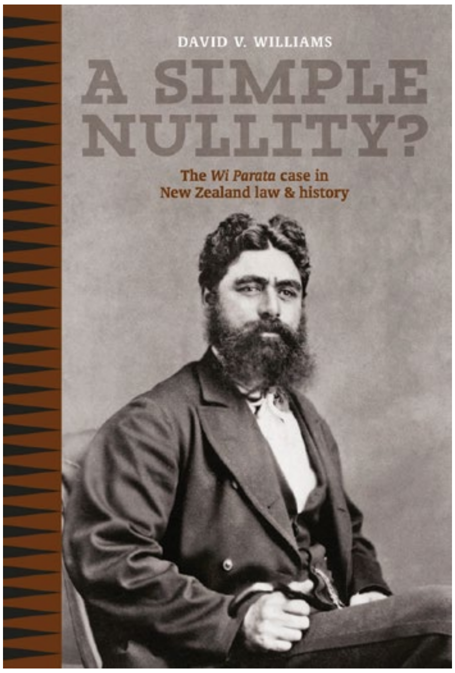
So; if a finance company has a security over a van, they can charge interest after the appointment of a liquidator or receiver. However, once the value of their debt exceeds the value of their asset, anything left over is an unsecured claim.

If the secured creditor has a General Security Agreement, the calculation remains the same, except the security extends to all of the assets of the company.

Unsecured creditors have a right to have interest added to the value of their unsecured debts in the insolvency, but when it comes to doing a distribution to the creditors, the insolvency practitioner will take the face value of all debts, including interest, that was owing at the time of the company went into liquidation or receivership.

Any distribution will be based on each creditor's percentage of the total pool of creditors. Only if all of these claims are paid does the law allow for the unsecured creditors to receive their interest.

Book Review: A Simple Nullity



It comes highly recommended.

Back in 1877 the Chief Justice of the Supreme Court, the equivalent of today's High Court, handed down a judgement on a long running dispute between the Ngati Toa and the Anglican Bishop of Wellington.

It was this judgement that delivered a verdict on the Treaty of Waitangi; declaring it a 'Simple Nullity'. The story behind the case has been overlooked while that line has taken on a life of its own.

Inspired by the back story, Auckland Rhodes Scholar and academic Dr David Williams devoted an entire book to the case. It is a remarkable bit of legal forensics and a window into our early colonial past and the wild-west nature of our early legal fraternity.

At issue was 300 hectares of land known as Whitireia, a peninsular near Porirua. The Ngati Toa wanted a school and the Anglicans promised to build one in return for the gift of land.

At the time the Crown had the exclusive right to acquire native land, so the arrangement was that the land was ceded to the Crown who gifted it to the Anglican Bishop of Wellington in 1848, on the condition that he build a school.

The school was to be built on the same model as the Saint Johns College in Auckland, founded by the impressively named George Augustus Selwyn, Bishop of Auckland, who was involved in the idea of a school, along with Octavius Hadfield, the Archdeacon of Kapiti and Bishop of Wellington, who took on the gift on behalf of the church.

These gentlemen's parents clearly had a fondness for the foundations of Empire.

It will come as no surprise to contemporary readers that no school was provided and the local people wanted the land back.

Here is where things began to get interesting, and a cavalcade of remarkable characters wandered onto the scene.

The first was Wiremu Parata, who filed a case in the Supreme Court. Parata was of mixed descent and moved between the native and colonial words. He was elected to the House of Representatives and served as a Minister of the Crown and even the Executive Council.

After he left office he petitioned parliament for the land to be returned, but was rebuffed. He took his case to court.

The next character in this drama was George Elliot Barton, Parata's lawyer. Barton was the Evgeny Orlov of his day and clashed acerbically with the Wellington judiciary and these spats dominated the colonial papers. Why Parata choose Barton is a mystery but he did.

Barton was admitted to the Bar in his native Ireland and spent some time prospecting in the Victorian goldfields where, as it happens, he spent time with James Prendergast, who would decide the Parata case.

In one reported clash, Barton challenged the integrity of Prendergast, claiming that he could not see the spirit and intent of the court. This appears to be implying he thought the judges were not exercising judicial impartiality.

The Chief Justice asked Barton to clarify his meaning, whereby Barton replied, in essence; I said what I said.

Whilst the Parata case was being heard, Barton had a complaint in with the Attorney General, asking that Prendergast be removed from office on the grounds of bias and the matter was even debated in the House.

It was wild but the best was to come. The year after the Parata judgement, Barton was sent to gaol for a month over his contempt. Whilst locked up, Barton put his name forward for a by-election for the seat of Wellington, and was elected, whilst incarcerated!

He went from one stone building to another.

Sitting with Prendergast on the bench to hear the case was William Richmond, who had enjoyed political success, being a member of Parliament and holding office as both the Colonial Secretary and Treasurer at different times. He had even been the colonies first Minster of Native Affairs, which makes his sitting on this case especially poignant.

Prendergast is credited with writing the judgement, but Williams research indicated that the authorship belongs to Richmond. Prendergast was the chief justice, and so gets the credit, but he wasn't the author.

Williams looks at that now infamous comment in its full historical context. He notes that other justices at the time took a very different approach to the Treaty and goes further in pointing out that Prendergast and Richmond did not claim that native title did not exist.

A reading of the judgment, although the language is confronting to modern readers, makes it clear that the justices held the firm belief that the owners of the land had rights that were not extinguished by the Treaty.

The case lives on. Some of the land was developed and some was handed back and has become a park, and as part of the long settlement process resulted in the establishment of the Whitireia Polytechnic as the Crown sought to correct the mistakes of the past.

This isn't strictly an academic book as Williams goes into detours to explain the background to the case and the lives of the protagonists. The author places this remarkable case into its wider historical context and both entertains and informs readers.

The Rights of Surviving Shareholders to Vote

There was a curious case from the Waikato that came across our desk last month. It involves a small firm, Osborne Building 2000 Limited, that was placed into liquidation in June 2016. Kelera Nayacakalou was appointed as liquidator.

A bit of background.

Mr Osborne was running his eponymous building firm but got into some financial trouble. He appointed Ms Nayacakalou as liquidator in 2016.

A dispute arose between the Ministry of Education, who claimed to be a creditor, and the liquidator.

Osborne Building 2000 Limited had been contracted to do work on a Ministry building. The building work, the Ministry claimed, was defective, and they had a remedial claim against the company for circa $324k.

This was a claim for damages, not an unpaid bill for work completed. It was the Ministries estimate of the damages. The liquidator is not, and is not expected to be, an expert in construction issues, nor the law of torts.

When must a liquidator adjudicate a claim?

The ministry, on the basis that they were a large creditor in the liquidation, requested a creditors' meeting, presumably to seek a fresh liquidator. The incumbent declined, on the basis that she believed that the claim was contingent, and until the quantum of the claim had been determined by a court or tribunal, there was no debt owing.

The parties could not resolve the impasse, so the liquidator exercised her rights under Section 284 of the Companies Act to seek directions.

She sought directions that she be relieved from her obligation to call a creditors meeting on the basis that the Ministry was not a creditor, and that the Ministry provide her with further and better information to allow her to determine the claim value. Specifically, she wanted the Ministry to provide an independent report at their cost.

The Court went in another direction

Section 303 of the Act has a very wide interpretation of what constitutes a creditor, and declares that admissible claims are:

> *"…a debt or liability, present or future, certain or contingent, whether it is an ascertained debt or a liability for damages, may be admitted as a claim against a company in liquidation."*

Given this wide remit, the court believed that the Ministry was well within it, and the liquidator was required to call a creditors' meeting.

Section 307 of the Companies Act provides for claims that are not for a prescribed amount, and allows a liquidator to seek the guidance of a court or tribunal, or estimate the value of the claim. A liquidator cannot do nothing.

Either way, a contingent claim for damages is still a creditor, and is entitled to call a creditors' meeting.

The court ruled that the liquidator must accept or reject the claim, and where the claim is uncertain, admit that creditor for the purposes of voting.

The burden on a liquidator to make a determination exists regardless of the funds in the estate. The judge riled:

> *"The Act places positive obligations on liquidators regardless of whether or not the company in liquidation has funds. Liquidators can be required to incur expenditure in order to discharge their duties which the act imposes on them. If Ms Nayacakalou requires yet another report, then that cost will fall on her."*

The court ordered that the liquidator accept or reject the Ministries claim, make an estimate of the amount of that claim or seek direction from the court, and call a creditors' meeting.

When is a shareholder not a shareholder?

That case was heard and decided in 2017. This did not end matters. The liquidator experienced some misfortune and the affairs of this file fell into abeyance.

The liquidator did not perform the tasks required by the 2017 judgement and reasonably offered to resign in favour of liquidators put forward by the Ministry.

However. There was a problem. There were three shareholders in Osborne Building Limited. Mr Osborne, with 49%, Mrs Osborne with 50%, and one percent by Fraser Osborne.

Sadly, Mrs Osborne had passed away in 2010. She had left her shares in the business to her husband in her will, and Mr Osborne signed the shareholder's resolution on her behalf, believing he was entitled to do so.

The problem then became, if he was not entitled to do so, the appointment of Ms Nayacakalou was invalid and she was unable to resign her office if she was invalidity appointed to it.

The issue fell down to; who is a shareholder? This is defined under Section 96 of the Act, and a shareholder is a person whose name is entered into the share register. This is not the same as being registered on the Companies Office; all companies have an obligation to hold a share register. This is an obligation that, this author suspects, close to no small companies do unless this task is performed by their external accountants or similar.

In any event; no such registry was updated. Although Mr Osborne could have entered this detail in the share registry, even if he had to have created one by printing it out and writing *Share Registry* at the top, he did not.

He was not entitled to vote his late wife's shares. The appointment of Ms Nayacakalou was invalid.

However, despite the fact that her appointment was invalid, does not mean that the company was not in liquidation nor that her actions as liquidator were invalid.

The Court held that the company was in liquidation from the date of her appointment, and new liquidators were installed in her place.

Waterstone Mascot, Prudence, watching a military parade in Taipei.

Objectifying Directors' Duties

The terms *subjective* and *objective* bounce around in insolvency law when dealing with directors' duties, so it helps to be clear as to their meaning, at least in the arcane area of how the courts interpret them when dealing with directors.

Something is subjective when it is based on the opinion or perspective of the individual. Objective is what the thing actually is when viewed without personal feelings or opinions.

Is Waikeria a good prison? The answer to this question will depend on the personal experiences of those who have visited, in whatever capacity, and the views each individual has about the institution and even how they define *good*. It is, perhaps, a question that cannot be answered objectively unless you design some matrix to measure liveable.

"Robert Pattinson is a brilliant actor" is a subjective statement. It is based on the individuals reactions to his performances.

"Robert Pattinson is a well known actor" is an objective statement. He is, whether you like his acting or not.

When applied to Insolvency Law, the terms have extra significance.

A Subjective Test can be summarised as:

> What did that specific director believe, based on what they knew at the time?

An Objective Test can be summarised as:

> What should a reasonable director have believed, based on what they knew, or should have known, at the time?

Some directors' duties are subjective, such as the obligation to act in good faith. Others, such as the prohibition on trading recklessly, are objective.

It is possible for a director to have honestly believed they were acting in the best interests of the company but, when viewed objectively, their actions were reckless. This has occurred, and the courts have ruled that they were acting in good faith but trading recklessly.

However, there are always caveats. It is not enough to simply assert that you thought your actions were in the best interests of the company. If you cannot prove that you considered the interests of the creditors, or your actions were irrational, the court will not look sympathetically at your case.

Most director's duties are objective. Section 135, Reckless Trading, prohibits a director from trading a business in a way likely to create a substantial risk of serious loss to creditors. It does not matter what the director felt, or believed. It matters what the director did.

The same applies to Section 136; incurring an obligation without a reasonable belief that the obligation could be performed. There is no room for a post-modern assessment here. Either the director did a thing, or they did not. The court is not going to care about the director's feelings.

However. Feelings, or at least the directors belief, does matter when it comes to Section 131; Acting in good faith.

Here the test is subjective. What did the director thing they were doing? Not, what was the director doing?

A director who believed that they were acting in the best interests of the company will be deemed by the courts to be acting in the best interests of the company, even if they objectively were not.

There has been some judicial re-thinking on this issue. In Sojourner and Robb, the High Court felt that the test was objective. The judge wrote:

> *As a result, Mr and Mrs Robb were not acting in good faith when selling the old company's business to the new company. The fact that they personally thought they were acting in the interests of the company is irrelevant in this context.*

However, the Supreme Court in Debut Homes went another way. Referring to Section 131 and the High Court's decision in Sojourner and Robb the judges declared;

> *The test is subjective. This follows from the wording of s 131 (expressed subjectively) and the legislative history... This aligns with the common law test and policy considerations. Courts are not well equipped, even with the benefit of expert evidence, to second-guess the business decisions made by directors in what they honestly believed to be in the best interests of the company.*

So. A director can act in the honest belief that their actions benefit the company, even if they are not, and not breach the good faith duty as written in Section 131 of the Companies Act.

However, the court also laid out exceptions and qualifications. If the director did not even consider the interest of the company or creditors, was acting irrationally or where there was a conflict of interest, then the director was going to struggle to get the court to believe that they were acting in good faith.

Mako Holdings and Messrs Crimp, Carswell and Smith

Sometimes, at Waterstone, we like to go back and look at some old insolvency cases. It isn't something we are proud of, but as far as vices go, there are worse things you can do with your limited time on this planet.

Mako is a great case from back in 2000, involving an Invercargill property development company and a nasty shareholders' dispute.

The Facts

Mako Holdings had three shareholders; Mr Crimp, Mr Carswell and Mr Smith. The company was established to complete a housing development of a single property.

Mr Crimp had a construction firm, Andrew Housing, that was contracted to do the actual building work, while Mako Holdings was to pay Andrew Housing for the work. There was a dispute regarding whether Andrew Housing should do this work at a ten percent profit margin or if it should have been done at cost.

In any event, a dispute arose, and the development was not going well.

Mr Crimp took legal action against the company that he was a minority shareholder in, and the other two directors engaged a law firm, French Burt Partners, to defend the claim.

Despite this dispute, the directors agreed to sell the building to Mr Crimp for an agreed price. From the proceeds, Andrew Housing was paid $92k, and the balance of $161k was deposited with a local chartered accountant.

This left, according to Mr Crimp, $116k still owing to Andrew Housing, as well as debts owing to French Burt lawyers, a quantity surveyor and a few other smaller creditors.

Meanwhile, the litigation by Andrew Housing was progressing, and it was not looking good for Mako Holdings. Despite his strong legal position, Mr Crimp then took an unorthodox approach to resolving matters.

He called a directors' meeting, but didn't tell Mr Smith. At the meeting with just himself and Mr Carswell, the board voted to fire French Burt lawyers, and hire new lawyers to end the litigation against Andrew Holdings on favourable terms to Andrew Housing.

The balance of the funds held by the accountant, being $113k, was to be paid to Andrew Housing.

On the same day as the board meeting, Mr Carswell agreed to sell his shares to Mr Crimp for $15k. It was a matter for debate as to which event occurred first. The judge, however, was of the view that the sale of the shares was settled before the board vote was held.

Mr Carswell effectively sold his vote for the $15k, changing his support from Mr Smith to Mr Crimp.

The lawyers applied to court and had a liquidator appointed. The liquidator took Mr Crimp and Mr Carswell to court for breaching their directors' duties.

The Legal Case

In terms of legal cases, this is one of the more interesting ones you will read. At one point the judgment reads:

> *I might add that he (Crimp) seems to have something of a grudge against French Burt Partners arising out of something which involved Mr John French's fathers and which happened thirty years ago.*

Sadly, no further details are provided. In discussing Mr Crimp, the judge finds;

> *I think what happened here is perfectly clear. Mr Crimp, in an exercise of bloody-mindedness, sought to ensure that French Burt Partners and Chas E George and Sons (the quantity surveyors) were not paid.*

The liquidators brought two breach of duties claims against both Mr Crimp and Mr Carswell; one being section 135 (reckless trading), and the other was section 137 (failure to use appropriate skill).

The judge took little convincing that there was a breach of section 137. The two delinquent directors knew what they were doing. They had engineered a position where Andrew Holdings would get paid, as would Mr Carswell, and the other third-party creditors would be left with nothing.

> *In any event, it was not open to directors, acting properly, to pay all the funds of the company out to one disputed creditor in circumstances where the other undisputed creditors were left unpaid….*

This breach dated from the disputed board meeting. The court then turned their mind to the appropriate degree of compensation that the director should pay to the company.

The court believed that had the directors acted in accordance with their duties under section 137, the third-party creditors would have been paid and the balance could be used to pay Andrew Housing, or whatever other arrangements the directors and shareholders wished to take.

Mr Crimp claimed that French Burt lawyers was merely a stooge for the other two directors, especially Mr Smith. The court felt that his claim may well have been correct. However, the lawyers were entitled to enter into an agreement with the management of the company, being the two directors who engaged them.

If Mr Crimp was unhappy with the management of his fellow directors, he could have taken a claim as a shareholder and disputed their action. He did not. The Directors...

> *...should have ensured that other creditors were not out of pocket. I regard this as a baseline against which compensation should be assessed. If they had acted on that basis there would have been no creditors' liquidation and all the other creditors would have been paid. This means that the compensation awarded must extend to all expenses of the liquidation and I am of the view that this include the expenses associated with this case.*

Because the decisions led to the liquidation, the directors should be liable for all of the costs that occurred as a consequence.

> *I see this case being entirely the fault of Crimp and Carswell. There was an element of malevolence in Mr Crimp's attitude to the solicitor and quantity surveyors. There was greed on the part of Mr Carswell who could hardly honestly believe that he was entitled to $15,000 ahead of his professional firms he had commissioned to act on behalf of Mako Holdings.*

The judicial language was delightful and this case is fun to read in full. Well. If you like that sort of thing.

The directors Crimp and Carswell were ordered to pay an amount equal to all of the creditors, the cost of the liquidation, including the legal costs on a full solicitor-client basis.

We Did This

As we enter into turbulent economic times, the focus on director's duties is going to come into sharp focus.

We have prepared a small publication on director's duties and we review seventeen cases on how they have been applied. It is designed for a lay reader. If you would like a copy, please get in touch. At this stage, it is not available to the general public. We expect to do a larger run later in the year; preferably after the Mainzeal Supreme Court case has been delivered.

This publication isn't a thick legal text. There isn't any shortage of those on the market. This is a booklet designed for directors and includes a brief outline of the key duties of a director and then runs through seventeen key cases in New Zealand insolvency law. Peace and Glory, Goatlands, Fatupaito and Bates are all covered in non-technical language.

Our aim is to help directors, and potential directors, understand how the courts look at directors who trade once their firms slip into the twilight of insolvency and give them some understanding of how the law is likely to apply to their specific cases. The legal and regulatory environment for directors continues to become more complex, and the fact that the High Court and Supreme Court took one view on Debut Homes, while the Court of Appeal took another, highlights that even if our most esteem judges cannot achieve unanimity on this issue, the challenge for directors is real.

And then there were three

Adam Botterill; #143

As regular readers will be aware, becoming a licensed insolvency practitioner isn't always a straightforward process. There are tests, assessments, an extensive examination of an individual's background, past life, social media posts and all media commentary going back as long as the internet will allow.

So. It is with delight that Waterstone can announce that, in addition to the conservative and respectable Greg Sherriff (#52) and the controversial and colourful Damien Grant (#131), Waterstone now welcomes Adam Botterill to the ranks of licensed insolvency practitioners.

Adam is also a practicing lawyer and has successfully taken a number of cases for Waterstone in the five years he has been part of the practice. He became a director of Waterstone Insolvency Limited last year.

Waterstone continues to grow, building capacity and experience to tackle the challenges of a fast-changing insolvency environment.

And in other news...

Kelly Cocks

Kelly Cocks became a real lawyer last month, when she appeared for the first time in front of the High Court, alongside Adam Botterill and her learned friend, James Caird, on a matter in the iconic Number One court room at Auckland.

Kelly has a great legal future ahead of her.

But wait, there is more...

Stan Denisenkov

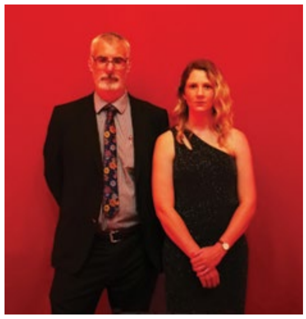
Stan Denisenkov joined Waterstone as part of our insolvency team. He has a finance, IT and management background. Stan is part of Waterstone's program of expanding our technical and analytical skills as we have been asked to handle larger and more complex files in recent years.

Waterstone Annual Ball

Waterstone, and our related entities, combined to host our annual year-end function. We hired St Matthews in the City and re-branded it for our event. It was a spectacular evening.

Waterstone

Waterstone; expanded edition



Kelly Cocks and a visitor from the Hawkes Bay

A rousing evening

Damien Grant and a known associate

Mrs Grant settling scores

The Chateau Retreat

Each year Waterstone and her sister companies takes a few days to celebrate lasting another 12 months. Last December we went to the Chateau with partners and children.