waterline

waterstone
INSOLVENCY

EDITION 9

INSIDE:

Finally: a win for the small investors

0800 CLOSED

When can a bank accelerate?

Banks borrow short and lend long. They cannot call up the full amount of your home loan if you remain within the terms of your agreement. A common feature of many loan contracts provides that in the event of a default the lender can call up the entire debt. This right is called an 'acceleration'. This right was challenged last year by high profile property developer Duong Ha.

Ha's company, 21st Century Investments had a loan with the ANZ National Bank. The loan had an acceleration clause and in October 2010 21st Century owed the ANZ $788,000, and was in arrears with its interest and other payments, but the amount of the arrears was disputed. This is the timeline:

OCTOBER 2010

1-10-2010	7-10-2010	12-10-2010	14-10-2010	15-10-2010	18-10-2010	29-10-2010
ANZ National Demands $20,000 of arrears. Due date 8-10-2010	*21st Century Seeks clarification on due debt by letter.*	*ANZ National responds, extends due date to the 14-10-2010.*	DEBT DUE	*ANZ National declares loan in default, activates 'acceleration', calls up $795k.*	*21st Century denies liability, concedes $4.5k owing. Pays $4.5k.*	*Statutory Demand issued for $795k:* *• $788 for the loan* *• $7k for the over drawn bank account*

The bank claimed that the company was in default and so exercised their acceleration clause. Even though, in the course of the court case it appeared that the undisputed default was minor, the court held that even a minimal default could justify an acceleration if that is what the parties had agreed. The bank issued a statutory demand based on the total, accelerated, debt.

Once a Statutory Demand is issued the company receiving it has three options:

- Pay the amount in fifteen working days
- Raise a dispute with the High Court as per Section 290 of the Companies Act
- Do not pay the amount and wait for the liquidation proceedings to arrive.

21st Century disputed the demand under Section 290.

21st Century Claim	Courts Answer
The bank did not give notice demanding repayment of the overdrawn bank amount of $7k. This was not a debt due.	Agreed. The Statutory Demand is reduced to $788k.
The bank demanded 20k to be repaid, but $15k of this is disputed, therefore the acceleration clause cannot be activated.	Rejected. As long as part of the demand was undisputed debt, the acceleration clause is valid.
Bank was unreasonable to use acceleration clause as all but $80 of the undisputed debt was paid three days after due date.	Rejected. When the acceleration clause was activated the loan was in breach. Repairing the breach does not undo the acceleration clause.
Because Statutory Demand incorrect, it should be set aside in totality.	Disagreed. The court can change the value of a statutory demand and leave the statutory demand intact for the balance.
The bank was unreasonable, giving just two days to pay the $20k	Disagreed. The court referred to earlier case law that stated the debtor had to be given enough time to retrieve the money it had at its disposal, not to go looking for new money

The issues were canvassed further in the Court of Appeal and upheld.

The Phoenix Failure

Back in 2007 Parliament bestowed on the grateful commercial community the Phoenix Company provisions of the companies act: Section 386.

The legislation has some tricky sections but the new laws were pretty specific. If you were the director of a company that goes into liquidation, and you then become the director of another company with the same or similar name, then you are personally liable for the debts of the new company and the courts can sentence you to a $50,000 fine or send you to prison for up to five years.

Five years in prison, seems a clear signal. Sadly, the courts have failed to take parliaments lead.

Three directors have been convicted and all enjoyed the same pro-forma sentence: convicted and discharged.

For completeness, they are:

Michael Donovan	Original Company: Phoenix Company: Consequences:	Site It Limited Site It Engineering 2008 Limited Convicted and Discharged
Sue Tierney	Original Company: Phoenix Company: Consequences:	Mortgages by Design (Changed name to Pin Limited) Mortgages by Design Convicted and Discharged
Ian Schuler	Original Company: Phoenix Company: Consequences:	Independent Livestock Agents Limited Independent Livestock 2010 Limited Convicted and Discharged

All three were selected by the National Enforcement Unit for prosecution because theirs were deliberate, considered attempts to establish a Phoenix company, not accidental errors or the result of procedural ignorance.

As an automatic consequence of their conviction all three are banned from being directors for a period of five years but otherwise suffered no consequences, other than some bad press, for their transgressions.

A Dandelion by any other name

Dandelion Limited fell into the gentle hands of John Managh, a liquidator from the Hawkes Bay. Prior to Mr Managh's arrival the company had suffered some misfortune at the hands of its lawyers who, it was alleged, and still is alleged, were negligent in their handling of a property transaction. The size of the loss was as much as a million dollars.

Dandelion, however, was unable to fund the litigation, so the director assigned the litigation rights from Dandelion to trusts connected to himself. The trusts were to fund the litigation and were to receive its legal costs back, plus the first $1.5m. Any residual would be split between the trusts and the company fifty fifty.

At the time of the assignment, the family trust was owed a paltry $4k compared to a third party debt of over $500k. This was, frankly, a rort by the director.

The liquidator went to sue the lawyers, as did the family trust. Mr Managh, who has featured in these pages before, is clearly not a liquidator to be trifled with and went to court to have the assignment set aside. He won.

A transaction is voidable if it was entered into when the company was insolvent and it:

> *"...enables another person to receive more towards satisfaction of a debt owed by the company than the person would receive, or would be likely to receive, in the company's liquidation."*

The court sided with Mr Managh declaring the transaction void. The key word was 'enables', because although the director's trusts had not received any money, the assignment enabled them to receive more, even if they did not actually receive more.

Trading Trusts: A Commercial Monstrosity

There are few trading entities more dishonest than a trading trust; they are the devils spawn: an unholy union between trust law and company law.

Professor Ford, an Australian authority on trust law, was quoted by the Law Commission as saying:

> *"The fruit of this union of the law of trusts and the law of limited liability companies is a commercial monstrosity."*

Many creditors we deal with were unaware that they were dealing with such an entity and are surprised and not a little annoyed at the lack of re-dress available to them. Many do not even know what a trading trust is.

We often forget that a trust is not, in itself, a legal entity. It is assets held by one person for another. The person holding the assets, the trustee, is the person who contracts on behalf of the trust.

The problem is that if you are that person you are personally liable for the debts of the trust. Smarter, someone thought, to make a limited liability company the trustee. Thus, the 'Corporate Trustee' was born.

When the trading trust fails, the trustee can appoint a friendly liquidator to the limited liability company and walk off into the sunset with the assets of the trust intact. And they do. All the time. The creditors are left with a one page liquidator's report and an acrid taste of sick at the back of their throat.

Back in 2002 the Law Commission looked at this issue. They canvassed an idea; that directors of Corporate Trustees should hold the same liability as trustees but this idea was dropped, partly because it was deemed that there were insufficient problems at that time.

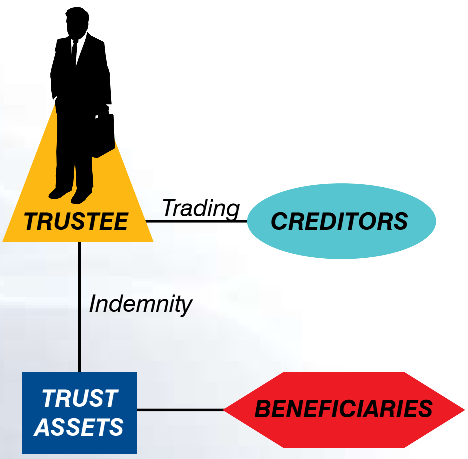
What is often forgotten by those who establish and advise on such schemes is that a director has a statutory obligation to act in the best interests of the company (Section 131 of the Companies Act.)

The Law Commission quotes the fearsome Justice Heath:

> *"A company is a company is a company. Whether a company is a trustee or operating on its own behalf, it remains a company subject to statutory, common law and equitable rules.*
>
> *A director is a director is a director. A director of a company owes the same duties to a company, whether the company is a trustee or operating on its own behalf."*

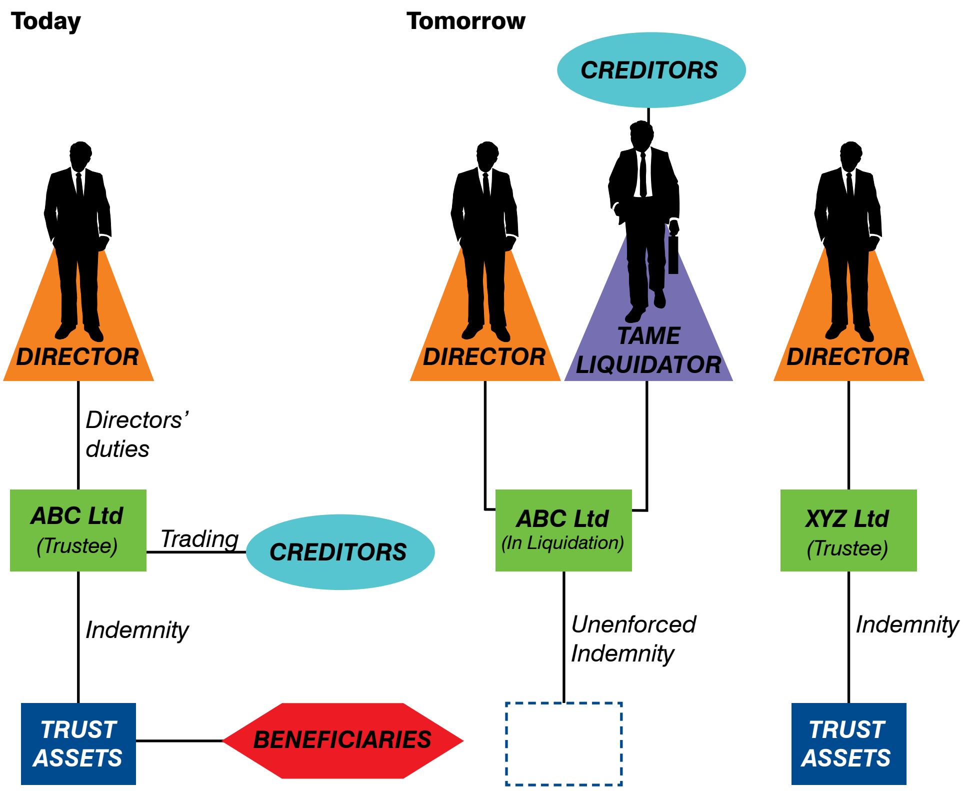
How the scam usually works:

HOW IT SHOULD WORK



The creditors contact the individual (usually the settler of the trust) and can sue him. The Trustee has an indemnity against the trust assets and can use them to pay creditors.

THE CORPORATE TRUSTEE TRICK



ABC Limited buys goods and services, improved net worth of Trust Assets. Obligation to pay sits with ABC Limited.

ABC Limited is liquidated. Tame liquidation fails to enforce indemnity or investigate director. Trust assets safely transferred to new corporate trustee.

A director must:

> *"..when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company." (Section 131. Companies Act)*

The very nature of almost all corporate trustee relationships violates this obligation. A corporate trustee has no beneficial interest in the profits of a successful trading trust but incurs all of its obligations. In fact, the entire arrangement is designed to leave the company holding the obligations of the failed trust, an obligation for which the company derives no benefit.

This is a one-way bet that the company cannot possibly benefit from.

There is only one case where a liquidator has challenged a director of a corporate trustee, Levin v Ikiua, although the very fact specific case here meant that the directors were not found fully liable.

Waterstone has the view, and indeed we are pursuing a case, to test just this point. A director who allows his company to be used as a vehicle to incur obligations with no prospect of a reward is not operating in the best interests of the company and opens themselves up to personal liability.

We think.

We have been pretty confident in the past and been proven to be wrong. We will report back.

Our mascot Prudence on the set of Friends at Universal Studios.

The Law Commission is having a large and comprehensive review of trusts and they have identified four key problems with trading trusts and have suggested some solutions:

1. Creditors unaware they are dealing with a trading trust, thinking that they are dealing with a normal limited liability company when in fact the assets are hived off into another entity.

Possible Solutions	Limitations
Force disclosure to creditors that the company is a corporate trustee.	Trust deeds not available for inspection, breaches of trust deed not always disclosed.
A registrar of corporate trustees could be established.	Creditor's rights may actually be less because they have been made aware of trust.

2. The trustee has an automatic indemnity against the assets of the trust and although some trust deeds limit this indemnity it is unlikely such a limitation has any legal force. The indemnity however can be compromised, usually without creditor's knowledge, because the trustee acted outside their authority in incurring the liability, or due to a counter claim by the trustee.

Possible Solutions	Limitations
Stature forbidding the impairment of the indemnity by the trust deed.	May restrict settlor's ability to vest assets as they wish.
Force disclosure of Trust Deed.	May place obligation to investigate breaches on creditors.

3. Although a trustee is liable because they are contracting in their own name; creditors must sue corporate trustees, and directors are not automatically liable to creditors who lose money to a limited liability company.

Possible Solutions	Limitations
A change to the Company's Act imposing the same liability on company directors of corporate trustees as if they were a trustee themselves.	Imposes greater burden on directors of corporate trustees than on normal companies.
Copy Australian legislation (Section 197 of the Corporations Act) making directors of Corporate Trustees personally liable for debts incurred if the Trust itself is not also liable for the debts.	Little practical effect of the Australian legislation.

4. Unsecured creditors of a corporate trustee do not have automatic access to a trust's assets; they must rely on the indemnity of the corporate trustee.

Possible Solutions	Limitations
Default position that Trustee has a charge over the trusts assets.	Impracticable and difficult to enforce.
Allowing direct recourse by creditors to trusts assets.	Resolving priority and logistical issues are complex.

Conflicted much? Big win for small investors

Nelson is a nice place. It weaves around a pretty bay, the weather is pleasant and the inner city is picturesque as green pastures roll into the very city itself. It was in this bucolic setting that some very dirty deeds were done.

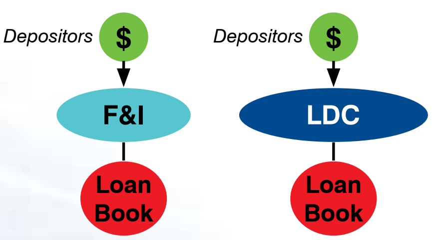
F&I was a small finance company trading quite happily, it had been doing so for several decades. F&I was a partnership and it raised money from the Nelson public, it operated like a bank. The enactment of the Securities Act in 1993 required businesses like F&I to get a prospectus, this was not done. No one seemed to notice or care.

LDC was a similar firm, also based in Nelson, who had likewise ignored the Securities Act, but in 2004 they decided to get compliant; got a prospectus and submitted themselves to the not very rigorous over lordship of Perpetual Trustees.

Both F&I and LDC lent money to a doomed finance firm called Halifax Finance. Halifax lent money in return to a Helicopter firm that spiralled into liquidation in May 2006, leaving a seven million collective hole in the balance sheets of F&I and LDC.

This meant that LDC were non-compliant with their prospectus. F&I, however, were happily ignoring the Securities Act altogether but had no money. In order to correct their balance sheet LDC and F&I did a deal in September 2006. A very dirty deal.

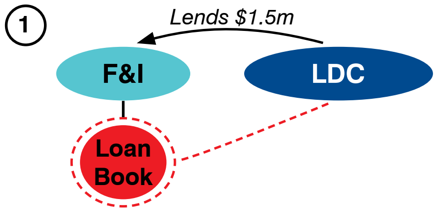
BEFORE ANY DEALS



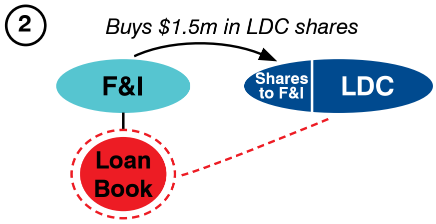
Now, at this point in time, before any deals with LDC were done, F&I was a finance company and it should have had a prospectus. It did not. Had the Securities Commission been alerted to this fact F&I would have been wound up, its assets collected and paid out to their depositors. The director of LDC, a Mr David Miller, should have known this and the High Court subsequently concluded that he did know this. No matter, it seemed, time was of the essence. Rules are for sissies. Fortune favours the brave and all that. A deal was done.

LDC lent F&I $1.5m. This helped LDC because now they had a performing loan on their books but, well, they were out of pocket $1.5m, so in return F&I conveniently brought $1.5m of LDC shares and LDC lent it another $500k.

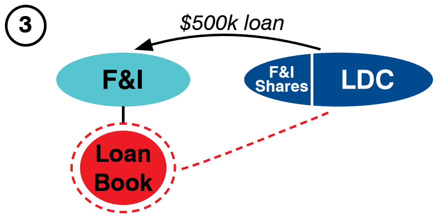
DEAL 1 - September 2006



F&I receives $1.5m loan from LDC: grants security over it's loan book.



F&I uses LDC money to purchase LDC shares.



LDC then advanced F&I $500k in cash

So, at the end of this piece of creative accounting LDC were down $500k in cash but their balance sheet looked $1.5m better, enough to keep the sleepy folks at Perpetual Trustees happy.

Better still for LDC they had taken a security over the receivables of F&I, placing themselves ahead of the depositions who had advanced money to F&I. Clever.

Sadly, shonky deals are like beer nuts, cocaine and tattoos. Moreish. Some months later, in December 2006, LDC turned to professional advisors PwC for help.

PwC partner Mr Noone, whilst in Nelson, dropped into the office of F&I in January 2007 and he noticed immediately something very interesting. F&I should have had a prospectus. He mentioned that to the F&I partners. He also told them, incorrectly, that this breach could see them going to prison.

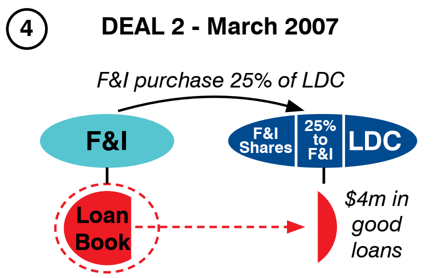
Just as Mr Miller was untroubled by breaches of the Securities law, it seemed Mr Noone was equally untroubled. It is also interesting that he had with him a Mr Malcolm Hollis during his travels in Nelson. This point becomes important later.

PwC write a report for LDC. This report details that LDC needs additional capital and that F&I is in trouble. A copy of this report was sent to Perpetual and an eyebrow is raised.

PwC do a second report, on F&I, for the LDC directors. This report details that LDC needs four million dollars and F&I is operating outside the Securities Act.

LDC spring into action, do a repeat of the earlier deal with F&I. At this point it appears no one has much cash so LDC takes over four million dollars of F&I's good receivables and in return F&I purchases 25% of LDC.

DEAL 2 - March 2007



F&I transferred $4m in good loans to LDC in return for 25% of shares in worthless LDC.

This second deal closes the four million hole that PwC identified in their second report. LDC drafts a new prospectus and gives a copy to John MacPherson of the Companies office who, the very same day, peppers LDC with questions, including a query if any of the finance companies LDC were dealing with were in breach of the Securities Act and, unhelpfully, for a copy of the PwC report on LDC. The report that says F&I were in breach of the Securities Act.

A second, edited, version of this PwC report was sent to John MacPherson. Key elements of it, including the fact that F&I were trading in breach of the Securities Act, was deleted. When all this went to court Justice Forgery had an opportunity to comment on this second report and he said this:

> *"I have no doubt that the modifications to the PwC report to Perpetual and known to be forwarded on to John MacPherson at the Companies Office were designed with the knowledge of the LDC directors to deflect Perpetual and the Companies Office from identifying the possibility that F&I were trading in breach of the Securities Act.*

Were Perpetual and/or the Companies Office to take an interest in this fact, such interest would generate an inquiry which at the very least would withhold approval by Perpetual to the amended prospectus, and so further impede LDC's return to trading."

In late 2007, with no more tricks up their sleeves, the defeated board of LDC went to their trustees and admitted defeat.

Helpfully, Perpetual appointed PwC as the receivers of LDC, including Mr Noone's travelling companion, Malcolm Hollis.

Upon arrival, PwC immediately applied themselves as receivers of F&I.

Because LDC has a security over the F&I receivables, as well as four million dollars of good F&I loans, PwC successfully collected eight million dollars. It was their intention to pay this to the LDC depositors and leave the F&I depositors with nothing.

The investors in F&I rallied. Assisted by the partners of F&I who gave up all their personal assets, and Stephen Eaton, formerly the CEO of Perpetual Trustees, the F&I depositors challenged PwC.

Their argument was that F&I held the depositor's money in trust and likewise the F&I loan book was also held in trust for the depositors. F&I were trading without a prospectus and if the Securities Commission was aware of this F&I would have been wound up and the depositors would have received some of their money back.

Because the LDC was aware of this issue their GSA over the F&I receivables ledger was declared invalid and PwC were ordered to hand the eight million dollars back to the F&I investors, about 70 cents in the dollar.

How much did all of this cost: Not including the last six months: PwC have charged just $750k, which is not unreasonable in a file of this size and complexity. However, there is $1.5m in legal, which is likely to be in excess of two million now.

What, however, is truly galling, is that Perpetual Trustees continue to receive money from this distressed asset; over $220k and rising.

As for PwC; well, maybe someone needs to explain to them the term *Conflict of Interest* does not mean banks discounting their mortgage rates.

What's your preference?

Fixed v Floating

Taking a security over fixed assets is straight forward. You can identify the asset and both the debtor and creditor agree. But how do you deal with more ethereal assets like money in the bank, inventory that comes and goes, and debtors whose amounts change daily?

An answer was developed around 1883, with a floating charge. Until the formal acts of bankruptcy, these non-fixed assets where available for the company to use at their leisure, but once bankruptcy occurred the floating charge fell onto the debtor and the security attached to whatever assets existed at the time.

Preferential Creditors Preference

The British Parliament was unimpressed by this innovation as it was designed to defeat the interests of preferential creditors, so in 1897 new legislation specified that such transitory assets be used to pay preferential creditors before being available to the secured creditor.

In New Zealand these ethereal assets were defined as those 'covered by a 'floating charge' and the Companies Act specified that they should be used to pay preferential creditors before going to a GSA holder.

The PPSA

The position was further clarified when the PPSA was introduced and the description redefined in the Companies Act as being "inventory and accounts receivable" with the term 'accounts receivable' having the same meaning as in the PPSA:

> *"..accounts receivable means a monetary obligation… whether or not it has been earned by performance."*

Such assets remained ring-fenced for the benefit of preferential creditors, but what, exactly, is an *accounts receivable*?

North Shore Taverns

The issue of what is an accounts receivable was first thrashed out in the High Court in the North Shore Taverns case. Here the eftpos receipts of various taverns had been held in an third party's account. The liquidators requested and received these funds.

The court was asked to determine if the liquidators should use the funds to pay the preferential or GSA creditors first. The court mulled the issue and decided that the key word was account, and accounts receivable were *trade debtors*. Specifically, where people owed the company money for invoices raised, this was an accounts receivable. Anything else was covered directly by a GSA and not available for preferential creditors.

This judgment was not widely appreciated within the insolvency community, with Professor Gedye, the guardian of PPSA purity, apologetic in angst ridden frustration.

Mr Burns and the Commissioner

In 2011 the issue was re-addressed.

The liquidators of Takapuna Procurement Limited, a property development firm, recovered 451k from the North Shore council being unused developer contributions. The receivers of Strategic Finance, which had a GSA over Takapuna Procurement Limited, and the Commissioner of Inland Revenue, both laid claim to the funds.

The court took another look and came up with a different view. Here the court took a much wider interpretation of accounts receivable, one much more consistent with the 1897 position.

Accounts receivable are not merely trade debtors, or book debts. It is exactly as the legislation says:

> ***"...accounts receivable means a monetary obligation"***

Thus, any money owing to the company is an account receivable. In one practically important sentence the court stated:

> *"…are no different in concept to funds held in a bank account or deposit account which fall within the definition of accounts receivable."*

Thus, money held in a bank account is an accounts receivable and must be used to pay preferential creditors.

Wider Impact

Although we now have two competing high court cases on the same issue the consensus is that the Burns case is the correct interpretation, certainty that is the view of Professor Gedye.

Bring out your dead!

A few years back a Doctor in the United Kingdom, Dr Harold Shipman, took it upon himself to relieve many of his patients of the burden of living, and in some instances Dr Shipman relieved them of the burden of their assets as well.

This unassuming serial killer was able to ply his trade for decades because doctors are the gate keepers of the dead: they determine if the deceased warrant an inquest or are to be promptly dispatched into the soil or the ether. The system of checks and balances failed because no one considered the possibility that the doctor would be the one doing the killing.

In the wake of Shipman's misdeeds the British re-evaluated their death certificate system and our Law Commission is turning its collective mind towards the problems that may exist in our regime as it mirrors the original British system and is looking at ways to ensure that those who kill are not those who issue death certificates.

This has nothing to do with insolvency, but it is interesting.

Dirty Little Liars

It would be nice to think that being honest pays an dividend but economic research indicates the opposite.

Cheats prosper, for three reasons. If you are ripped off it almost never makes financial sense to pursue the debt, it is uneconomic to vet thoroughly everyone we do business with and even if someone is known to have cheated in the past we often give second chances.

The New Zealand business landscape is filled with colourful characters who've demonstrated considerable character flaws and re-invented themselves; you'd be surprised how respectable a motivated ex-con can become.

It is, however, a common fallacy that most of us are honest and that only a few bad apples lurk in the commercial barrel. The truth is, almost all of us cheat, if only a little. A new academic discipline, Behavioral Economics, is coming up with some fascinating results into human behavior and one of the most curious is our attitudes to honesty.

When asked we self-describe ourselves as honest. However it is very easy to manipulate almost all of us into small acts of dishonesty; the most effective is to have a member of our group to validate the dishonesty. Conversely, if any member of the group makes a point of acting honestly the rest of us toe the line.

Dan Ariley, himself a colorful character and author, is the leading proponent of this developing field and, with others, has developed the concept of ethical dissonance; the gap between a person's actual dishonest behavior and their self-image as an honest person.

We use three strategies to maintain both dishonest activities and a positive self-image.

The most important is to act within the social norms of what is acceptable; "Fudging my expenses a little" is acceptable, "everyone does it". "Stealing from my employer" is not.

If the dishonesty is larger some moral cleansing maybe needed. Catholics make good use of the confessional, secular sinners confess to their wives if not their auditors.

For those engaged in on-going dishonesty they need to engage in moral licensing, doing some good works to negate the negative; Madoff was a significant philanthropist.

Most interesting are the methods Ariley uses to encourage honest behavior. Students asked to recall the Ten Commandments before a test were shown to cheat less, no matter their religion; being reminded of social norms is enough.

For those in business it is important to understand these motivations and the effect of even a single member of staff. A sales rep fiddling their mileage grants license to his colleagues just as an office worker who keeps punctual hours and high work rate instills similar patterns in others.

And of course, leadership flows from the top. If the business owner or manager sets a high standard their staff *may* follow, if they show indications of dishonesty, disregard for the rules and indifference to ethical standards their staff *will* follow.