Fineprint | ISSUE 83 Summer 2020

Directorships mean significant obligations

Hefty consequences for getting it wrong when company was in financial distress

In September 2020, the Supreme Court released its keenly anticipated decision in the *Debut Homes* case[1]. This decision illustrates the risks for directors where a company is experiencing irrecoverable financial distress.

In the *Debut Homes* decision, the court clearly spelt out that in insolvency, or near-insolvency situations, it is not acceptable to simply try to 'trade through' in the belief that this will improve the company's financial position. Instead, directors must ensure they use the formal (or informal) mechanisms provided in the Companies Act 1993 to address the company's financial predicament.

If directors fail to meet their duties, they face a very real risk of incurring personal liability — as occurred in the *Debut Homes* case.

The law

Before we look at the implications of the *Debut Homes* case, it is helpful to summarise the legal duties of company directors. Directors have a range of specific legal duties, including to:

- Act in good faith and in what they believe to be the best interests of the company (which includes an obligation to consider the interests of creditors in near-insolvency situations)
- Use their powers for a proper purpose
- Follow the Companies Act 1993 and the company's constitution
- Only allow the company to make commitments that they believe, on reasonable grounds, that the company can perform when required to do so
- Trade in a manner that is not likely to put creditors at a substantial risk of serious loss, i.e. trading recklessly, and
- Use company information appropriately.

As these duties are active, rather than passive, it is impossible to be a 'silent' or 'sleeping' director. All directors are responsible for fulfilling these duties, which means that you cannot simply default your duties to your fellow directors.

Why is it important to fulfil your director duties? If you breach your duties as a director and the company is placed into liquidation, you risk being held personally liable to repay or restore funds, or to contribute a sum of money to the assets of the company (as the court thinks just).

Setting the scene

Debut Homes Limited operated a residential property development business; Mr Cooper was its sole director. In October 2012, the company was in financial difficulty and, in November 2012, Mr Cooper decided to wind down Debut's operations. Mr Cooper made the decision to not take on any further work, but to complete and sell the company's existing projects. At the time of this decision, it was forecast the

1 *Vivien Judith Madsen-Ries and Henry David Levin as Liquidators of Debut Homes Limited (In Liquidation) v Leonard Wayne Cooper* [2020] NZSC 100.

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company would be unable to meet its GST obligations of over $300,000 once the wind-down was complete.

The company was not salvageable in the sense that even after continued trading it would still be insolvent. Mr Cooper, however, believed that completing the company's existing projects, rather than selling them half-finished, would provide a higher overall return to creditors. Mr Cooper did not, however, consider the interests of all creditors, namely Inland Revenue.

Mr Cooper ran the company (without drawing any salary) until February 2014, when the company's last project was completed and sold. In finalising these projects, Debut Homes had incurred further debt of approximately $28,000. In March 2014, Debut Homes was placed into liquidation by the IRD. At this point, the company owed more than $450,000 to the IRD. The liquidators brought proceedings against Mr Cooper for (amongst other things) breach of his director duties under the Companies Act, and sought an order under s 301 for compensation against him personally.

The High Court and Court of Appeal decisions

The key issue was whether Mr Cooper had breached his director duties by continuing to trade when the company was insolvent (or nearly insolvent). The particular director duties in question were the duties to:

- Act in good faith and in the best interests of the company (s 131 of the Act)
- Not allow the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors, commonly known as 'reckless trading' (s 135), and
- 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 due (s 136).

The High Court found that Mr Cooper had breached his director duties and he was ordered to pay $280,000 to the liquidators. Mr Cooper appealed.

The Court of Appeal overturned the High Court's decision, on the basis that Mr Cooper's decision to complete the existing developments was a sensible business decision. The court noted that if Debut Homes had sold its projects while incomplete, then the losses to creditors would have been even greater. The liquidators appealed.

To the Supreme Court

The Supreme Court considered whether it was a defence for Mr Cooper to assert that completing the company's existing projects was a justifiable decision, given this would provide higher returns than immediate liquidation would have.

The court held that if a company reaches the point where continued trading will result in a shortfall to creditors and the company is not salvageable, then continued trading will be reckless and a breach of director duties.

It was *not* a defence for Debut Homes to assert that completing the properties was a sensible business decision. Mr Cooper knew that continued trading would still result in a shortfall, and accordingly he had breached s 135 of the Act, regardless of the fact some creditors would be better off and despite the overall deficit to all creditors being reduced.

Where there are no prospects of a company returning to solvency, it makes no difference that a director honestly thinks some of the creditors will be better off by continuing trading. Directors should not enter into a course of action that may result in some creditors receiving a higher return at the expense of incurring new liabilities which will not be paid. In this case, by continuing to trade, some creditors received more at the expense of the IRD. As the court put it, it is not legitimate 'to rob Peter to pay Paul.'

The result

The Supreme Court reinstated the decision of the High Court and Mr Cooper was ordered to personally pay compensation of $280,000 to the company. The compensation sum could have been more, but the Supreme Court agreed with the High Court that a discount was warranted on the basis that Mr Cooper had worked for 18 months without pay to complete Debut Home's projects. Mr Cooper was also ordered to pay the liquidators' legal costs.

Options for directors

The *Debut Homes* case highlights that directors must be aware of the various mechanisms that are available if a company is facing insolvency or near-insolvency. The key mechanisms are:

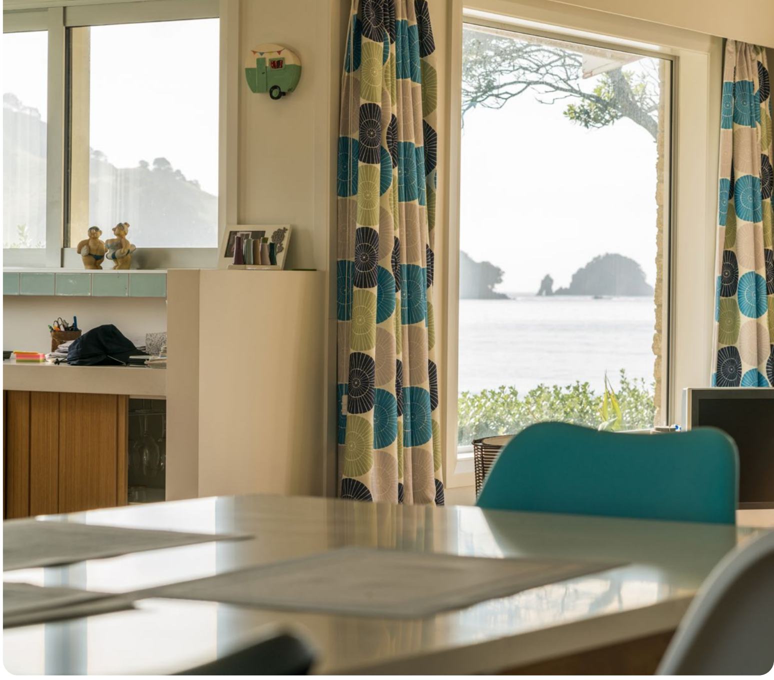
- **Liquidation**: winding up the company
- **Creditors' compromise**: this usually involves part of a company's debts being forgiven. It must be approved by a majority of creditors, representing at least 75% of the debt owed to each class of creditor
- **Court-approved creditors' compromise**: where the court agrees that a compromise is fair and reasonable to creditors, and
- **Voluntary administration**: an administrator is appointed to increase the prospects of a company surviving. This must be approved by a majority of creditors, representing at least 75% of the debt owed to each class of creditor.

Directors must take care

The decision in the *Debut Homes* case is relevant to directors of all New Zealand companies. The case highlights the risks for directors who continue trading when the company faces actual, or near, insolvency. If, as a director, you allow your insolvent company to continue trading without using one of the available formal or informal mechanisms, then you will breach your director duties and you are likely to incur personal liability.

A critical decision for directors is whether or not to continue trading. If you are a director of a company in financial distress, it is essential that you deal promptly with the situation and seek both legal and accounting advice as to your options. This should include considering the mechanisms available through the Companies Act 1993, such as liquidation, voluntary administration or a creditors' compromise. ✱

Holiday houses



Rules for both owners and renters

With New Zealand's borders closed and overseas travel restricted for the foreseeable future, many Kiwis will be looking to rent a holiday home for the traditional summer holiday this year.

There are plenty of options on sites such as Bookabach, Holiday Houses and Airbnb as well as renting a holiday house privately. Whether you own a holiday home and are looking for some extra income, or you want to rent a place for the whānau Christmas, there are a few things to remember.

Property owners

Houses should be presented in a clean and tidy way.

Paying the rent: The expectations about payment arrangements need to be clear from the outset. Property owners can ask for a deposit for a holiday house rental but, to avoid confusion, it's important to be clear about this requirement in the fine print in any agreement. In some cases, the property owner may require that the full cost may be retained if the booking is cancelled. In other situations, however, a partial refund could be made to the renter depending on the timing of the cancellation (for example a 50% refund could be given if the booking is cancelled not less than two weeks prior to the booking). Any refund arrangements not covered by the agreement are made at the discretion of the property owner. It is, however, advisable to make sure that any arrangements are fair and reasonable.

Health and safety: Property owners are generally subject to the duties and obligations in the Health and Safety at Work Act 2015. Under the Act, a host renting rooms could be prosecuted if he or she is negligent, resulting in a guest being injured (or even killed) as a result of that negligence. Although insurance cover may help with an owner's liability, the legislation makes it illegal to insure against fines imposed by the courts. If you are unsure about your obligations under the Act, please don't hesitate to contact us.

Hazards: Property owners should ensure the house and garden are free of any hazards that could cause an accident or injury, as well as being free of pests and vermin.

Residential Tenancies Act 1986: As a general rule, this legislation does not apply where the house is let for the tenant's holiday purposes. However, the question may be asked — how long is a holiday? If the Residential Tenancies Act does apply, both owner and the holidaymaker (or tenant) must comply with the duties and obligations set out in the legislation. With the country experiencing a shortage of rental accommodation in some areas, those owning holiday homes may encounter those wishing to rent a holiday house for the longer term. This arrangement would then become a formal tenancy subject to the requirements of the Residential Tenancies Act.

GST and income tax: If the gross rental income is more than $60,000 over a 12-month period, property owners must be registered for GST. Property owners will also have to declare any income from a holiday house in their annual tax return.

Local authority: Depending where you are in the country, you may also need to register with the local authority and, in some cases, obtain resource consent. Do check with the relevant local authority on its specific requirements for the area in which the holiday house is located.

Insurance: It's important to ensure you have the right type of insurance policy in place for a holiday house rental scenario, and that the insurer is notified that the property is being tenanted.

Renters

General: If you're renting a house for the holidays, it's important to read the owner's terms for rental before you make a booking.

Payment arrangements: Owners can usually choose to require full payment, or just a deposit, to be paid at the time of booking. If only a deposit is charged initially, full payment is often required 10 days before the rental begins.

The rules can vary but if you cancel at short notice, you are likely to be liable for some (or all) of the rental fee.

Damage to the property: You will be liable for damage caused by you or any other guests staying with you, including someone visiting the property.

No sub-letting: People renting holiday houses cannot sub-let and/or let extra rooms to third parties. In a recent decision[2], the Tenancy Tribunal ordered Mr Kennedy to pay $12,500 to the landlord for various things including cleaning, property damage and sub-letting the property on Airbnb without the landlord's permission.

While the Kennedy case related to a residential tenancy, a similar approach and monetary penalty could potentially be applied in any tribunal dealing with a holiday house situation.

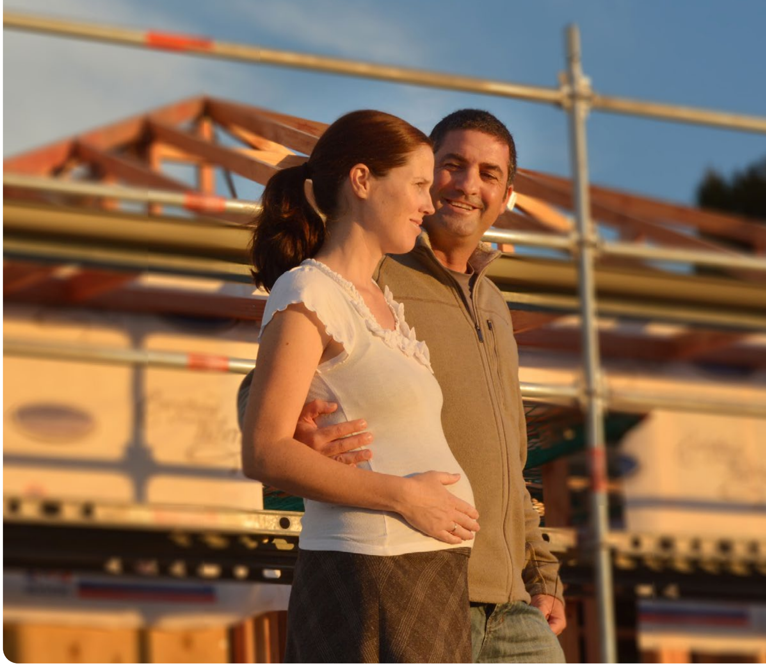
Online feedback

Holiday house websites have feedback platforms. Any difficult homeowner or troublesome renters may find themselves the subject of a damaging review that would not help their future chances of renting out their house or making a booking.

It is important to be clear on your obligations before you pack the car and surfboards to head away for Christmas. No one wants to start the New Year with a legal dispute on the horizon. ✱

2 *Harris and Others v Sean Robin Kennedy* [2020] NZTT Auckland 4263775.

We're buying a house together



Time for a contracting out agreement?

You have had years of saving up for the overseas experience many New Zealanders dream of — then a pandemic hits. The London job you thought you had in the bag is no longer an option, and you and your partner are faced with extending the lease on your flat here — that you were eagerly awaiting to escape. What do you do now?

In 2020, many couples have found themselves cashing out what would have been their big OE savings stash and using it for a house deposit. Others have leapt at the banks' lower interest rates to extend their borrowing and have bought properties that were unattainable only a year ago. All over the country, and particularly in Auckland, the property market is flooded with returning expats who are establishing roots back here — often earlier than anticipated.

We have seen an exponential uptake of investment in property, among young couples in particular. Part and parcel of getting a deposit together is that, quite often, many couples' initial cash contributions to fund the deposit are different. This may not be an issue at the time of purchase, but if you and your partner or spouse break up, this difference could become a major sticking point.

Get a contracting out agreement

In order to protect your contribution to your property purchase, you should enter into a contracting out agreement (more commonly referred to as 'a pre-nup' or 'pre-nuptial', even if you are not married).

Through this agreement, couples can stipulate their own rules for the classification and division of their assets in case they separate or one of them dies. Without a binding contracting out agreement, the Property (Relationships) Act 1976 (PRA) will determine how your assets are split if you separate. Under this legislation, the home you live in as a couple is generally deemed to be 'relationship property' — meaning it is an asset that is likely to be divided equally between you both, even if one party contributed more towards the purchase.

A contracting out agreement can be entered into at any time. It is recommended, however, that couples enter into a contracting out agreement before they have been in a relationship for three years (which is generally when the equal sharing principles of the PRA apply).

How it works

Let's look at the example of Emma and Tane. Emma has $10,000 of cash savings and a further $20,000 from her KiwiSaver that is available for withdrawal. Meanwhile, Tane has been in the workforce longer and has cash savings of $30,000, he has $55,000 in available KiwiSaver funds and Tane's parents are gifting him $40,000 to assist in his first home purchase.

With $155,000 as a deposit, Emma is contributing $30,000 and Tane $125,000 to the purchase price of what will be their family home and relationship property. Without a contracting out agreement, if their relationship ends, the equity in the family home is likely to be divided 50:50.

In this situation, it is prudent for Emma and Tane to enter into a contracting out agreement to effectively ring-fence these initial contributions. An agreement could stipulate that, in the event the house is sold or Emma and Tane separate, Emma would receive $30,000, Tane would receive $125,000, any mortgage and costs of sale are repaid in full, and the balance is split equally between Emma and Tane. A mechanism such as this protects initial contributions from Emma and Tane, while acknowledging their contributions to their home through equally sharing in any equity increase.

Although there are other options for Emma and Tane — such as owning their home in unequal shares to acknowledge their unequal initial contributions — a contracting out agreement is still needed to establish the unique rules for Emma and Tane's relationship property. Without an agreement, if Tane and Emma separate after three or more years together, the PRA would apply and the proceeds of the sale of the family home are likely to be shared equally, which Tane may consider to be unfair.

Couples should be aware that it is not just their home that comes under the rules of the PRA. Incomes, KiwiSaver, company shares, chattels and most assets acquired during the relationship also come into play under the legislation. A contracting out agreement can dictate and pre-empt how all assets will be classified and divided.

When you may not need an agreement

If a couple contributes relatively similar amounts to the purchase of their property — all those OE travel savings have added up to similar-sized piggy banks — a contracting out agreement is perhaps not necessary.

Buying your first home is an exciting chapter for any couple. If 2020 has taught us anything, however, it is to expect the unexpected. It may feel inconceivable that you and your partner may separate, but none of us know what the future may hold. Should your relationship go pear-shaped, your contracting out agreement may become your greatest friend to guide your separation and set up your new life. ✱

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Building a fence in town

As the daylight hours extend, so too does the list of summer jobs that have been building up over the past year. On that list for many will be replacing those rickety old boundary fences that surround your house. Before you rip them all down, we have a case study that clarifies why it's so important not to rush.

John's fence

John believes that his boundary fences should be rebuilt; he approaches his three neighbours to discuss this.

His first neighbour, Julia, disagrees with John and thinks the fence is doing an adequate job, but admits the fence is not aesthetically pleasing. She is not willing to pay for half of a new fence and wants to hear no more of the matter.

Toby and Mikayla are John's second neighbours. They agree that a new fence is required, but want to put up a tall fence made from expensive materials.

John's third neighbour, Brent, is a builder. Last year, he built a lean-to shed attached to the boundary fence without seeking John's permission, breaking the existing fence in the process.

The Fencing Act 1978

The law that governs all fences, whether they be urban or rural, is the Fencing Act 1978. The key points concerning boundary fences covered under the Act are:

- That boundary fences need to be adequate
- If boundary fences are not adequate, adjoining occupiers are obliged to contribute equally to the cost of an adequate fence
- Alterations to an adequate fence cannot be completed without the consent of the adjoining neighbour
- Any damage is to be borne by the neighbour who caused the damage, and
- When neighbours refuse to contribute and cannot agree on any of the above, there is a specific disputes process laid out in the Act.

What can John do about his boundary fencing issues?

Adequate fence

An 'adequate' fence is defined in the Act, but how it is replaced will ultimately come down to whether the fence is fulfilling its purpose. If the fence between John and Julia's properties meets the minimum standards, John cannot reasonably ask Julia to pay half just because it is an eyesore; it would need to be in a state of disrepair, dangerous or failing to provide adequate privacy before the Act would apply.

John's options for this fence will be to either pay for the entire fence himself, after getting Julia's consent, or he could follow the procedure in the Act by issuing Julia with a Fencing Notice outlining the fence he requires and giving her 21 days' notice to respond. Julia could then give a cross-notice objecting to John's proposal. If John and Julia cannot agree, they may need to apply to the Disputes Tribunal for a hearing to decide the matter.

More than adequate

Toby and Mikayla want to go above and beyond an adequate fence when rebuilding. John does not have to pay for anything more than an adequate fence under the Act, but both parties can reach a mutually beneficial agreement. Equal cost does not have to be financial so if neighbours can agree, one party can pay for the materials and the other can contribute to the labour costs.

Damage

Under the Act, the cost of repairing a damaged fence lies with the party who caused the damage; Brent must repair the fence. If Brent disagrees, John may need to go to the Disputes Tribunal.

Communicate!

Communication is key when dealing with boundary fence issues. Neighbours are generally cooperative and you can usually reach a sensible agreement if you talk with them first. If no agreement can be reached, however, you can turn to the Fencing Act to see what your next steps could be. *

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Postscript

Privacy Act 2020 comes into force on 1 December 2020

The new privacy legislation comes into force as this edition of *Fineprint* is published; it updates the law to reflect the needs of the digital age. Although we published an article on this topic in the Winter edition (page 5), we remind you that the key changes relate to:

- Reporting data breaches
- Compliance notices
- Decisions on access requests
- Strengthening overseas connections, and
- New criminal offences.

Data breaches: Under the new Privacy Act, it is mandatory for organisations to notify the Office of the Privacy Commissioner (OPC) if a privacy breach has caused, or is likely to cause, serious harm. Organisations that fail to report a notifiable privacy breach to the OPC could be fined up to $10,000.

To help organisations work out if a privacy break is notifiable, the OPC has launched an online tool, NotifyUs. Organisations are encouraged to access NotifyUs and use the self-assessment tool before the new Privacy Act comes into effect on 1 December 2020.

For more information about the new legislation and NotifyUs, go to the Office of the Privacy Commissioner's website at **www.privacy.org.nz** ✱

Stay safe this summer

We are all very much looking forward to a warm sunny summer, with sufficient rain for the rural sector but not so much that it floods campsites or causes harm.

If you are boating, driving, swimming and enjoying our backyard in this post-COVID Christmas, please stay safe, look out for others, relax and enjoy yourselves.

Merry Christmas and Happy New Year

We wish you all a very Merry Christmas and a happy, safe and healthy 2021.

Meri Kirihimete me te Hape Nū Ia. ✱

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