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Welcome to the Spring issue of Commercial e.Speaking. We hope you find the articles both useful and of interest to you. If you have any specific business or commercial topics that you would like to see covered in future issues, please get in touch with us.

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Director Personally Liable for Company Debts - Court of Appeal upholds High Court decision

This article postscrips our commentary in Commercial e.Speaking (July 2004, No 2) on the High Court finding Mr Lower liable for reckless trading.

Mr Lower appealed to the Court of Appeal challenging the High Court decision on a number of grounds - all of which failed. The Court of Appeal affirmed the High Court decision.

To recap, Mr Lower, of South Pacific Shipping Limited, was found personally liable for \$8.4million of the company's debts due to his involvement in the company conducting its business in a reckless manner.

This case illustrates the courts' willingness to find company directors personally liable for reckless trading where 'appropriate'. The question of what is appropriate is unclear from the decision, but the facts of the present case that amounted to recklessness are:

1. Trading when the company was insolvent for six years where there was no reasonable prospect of recovery;
2. A hostile business environment;
3. Mr Lower was unwilling and/or unable to implement orthodox government practices;
4. Unreliable management reporting; and
5. Mr Lower was unwilling to risk his own money for business purposes, but prepared to risk creditors' money.

The court recognised that in the course of business there is always risk taking, which is to be expected. However, illegitimate risk taking will not be tolerated.

Directors should be aware that a liquidator, creditor or shareholder, can sue a director for conducting their business in a reckless manner.

Second case

A second significant recent case is *Mountford v Tasman Pacific Airlines of NZ Ltd*. This case further indicated the line courts are taking with directors. In this case the court found that the limited liability protection a company gives to a director only applies as long as the company is solvent. This decision has been the subject of some criticism but indicates the current thinking of the courts.

Be careful

These cases illustrate that directors are becoming more vulnerable to personal liability for company debts if they recklessly allow their companies to trade.

Our advice to directors is:

- Be careful when making decisions when the business is insolvent or where there is a real chance that it may become insolvent, as there is a fine line between legitimate and illegitimate risk; and
- Seek professional advice if you are unsure of your actions to help protect yourself from personal liability.

GST and Nominees

- Early advice essential

Agreements for Sale & Purchase of business properties are frequently signed up in the name of the purchaser 'or nominee'. Where this is coupled with a 'going concern' provision in the Agreement for GST purposes, failure to appreciate the resulting GST time of supply issues can have serious consequences.

Often a business property, such as a commercial building, orchard or farm, is bought in the name of a company or trust that has not yet been incorporated or formed. Purchasers frequently take the view that they will obtain the appropriate legal and accounting advice once they have signed up for the property. Often this approach is taken in the belief that there is no point in incurring the expense of that professional advice sooner than is necessary.

Where the sale of the property is a going concern for GST purposes, the parties often attempt to treat the transaction as zero rated. However, in order to meet the zero rating test, the sale needs to satisfy all the following criteria:

1. '... supply to a registered person ...'
2. '... a going concern at the time of the supply...'
3. '... agreed by the supplier and the recipient in writing to be the supply of a going concern...'

'Supply'

The first area of difficulty is the time of supply. Unfortunately, buyers often defer obtaining the necessary legal and accounting advice until after the time of supply has occurred.

Where the supplier and recipient are not associated persons, the GST Act deems the time of supply to have occurred at the earlier of:

- An invoice being issued by the vendor to the recipient; or
- Any payment is received by the vendor/supplier.

'Invoice' is defined in the GST Act as a document notifying an obligation to make a payment. Where the sale is unconditional, the Agreement for Sale & Purchase becomes an invoice because it is a document notifying an obligation to make a payment. If the Agreement is unconditional from the outset, time of supply occurs the moment the Agreement is signed by both parties.

'Going concern'

There is also a difficulty in satisfying the going concern test in this situation. The sale cannot be a supply of a going concern because the time of supply occurs at the time that the contract is signed, and the ultimate purchaser (the company or trust that is nominated) may not have been in existence or may not have been registered for GST at the time the contract was signed.

Even where a nominated company or trust was in existence and was GST registered when the supply occurred, there is still doubt whether the supply is a going concern because the vendor and the nominee have not agreed in writing that it is the supply of a going concern. Whilst the vendor and the original named purchaser may have included a clause to that effect in the Agreement, the nominee is not a signatory to the Agreement.

This requirement can, however, easily be remedied with a Deed of Nomination, provided the original named vendor is also a signatory to it and not just the original named buyer and the nominee.

As always, the moral of the story is to obtain comprehensive advice before signing anything. It is money well spent in the long run.

Fast Moves as the Boat Goes Down

- How the voidable transaction regime in the Companies Act treats set-offs - the Trans Otway case

When a company struggles to pay its debts and insolvency looms, knowledgeable and resourceful creditors seek out stratagems to avoid being disappointed as unsecured creditors. They might try and become secured creditors. They might devise arrangements (such as buying an asset from the struggling debtor company for the debt) which appear to satisfy the debt. This article looks at how a recent scenario was treated by the Court of Appeal.

In an attempt to level the playing field in the above situation legal systems have 'voidable transaction' (sometimes called 'voidable preference') regimes. For New Zealand companies this is found in sections 292-296 of the Companies Act 1993.

Section 292 allows a liquidator to void a transaction made within the specified period if at the time of the transaction the debtor company was unable to pay its debts and the transaction allowed a creditor to receive more towards satisfaction of a debt than the creditor would otherwise be likely to receive in the liquidation unless the transaction took place in the ordinary course of business.

Transaction is defined widely to include transfers of property, payments of money and the incurring of obligations by the debtor company. The specified period is based on the two year period before liquidation commences (but there are special presumptions in the last six months [the restricted period] that the company is unable to pay its debts and that payments are made other than in the ordinary course of business).

The recent Court of Appeal decision in *Trans Otway Ltd v Shephard* set aside an attempt to circumvent the voidable transaction regime by way of set-off. Trans Otway carried out line-hall freighting for Newman. Newman had done freighting for Trans Otway in the lower North Island. In early 2003 Newman owed Trans Otway \$95,000. On 20 March 2003 Trans Otway served a statutory demand on Newman.

In late March an agreement was reached for Trans Otway to buy Newman's business. The agreement provided:

- Assets in a First Schedule were to be sold for \$371,000 plus GST;
- Trans Otway purchased Newman's client list for \$95,000 including GST;
- Settlement was to be made by payment of \$371,000 plus GST less payments by Trans Otway to holders of any securities over or leases of the assets; and
- The payment for the client list (\$95,000) to be made by Trans Otway acknowledging that Newman had made full payment of all sums previously owing to Trans Otway.

The settlement took place on 1 April 2003. In mid-May 2003 Newman was put into liquidation. Newman's liquidators served a notice under s294 of the Companies Act on Trans Otway to set aside the \$95,000 payment which had been made by set-off.

The Court of Appeal decided that while no physical cash was exchanged and while there was not a cheque swap, payments were nonetheless made at law and were within the s292 definition of transaction. Trans Otway was required to repay the \$95,000 and stand as an unsecured creditor in the liquidation for this sum.

Not all set-offs are doomed. If there was a prior agreement permitting the creditor to act unilaterally to set-off mutual money obligations between it and the debtor, then the set-off would be in the ordinary course of business. However, last minute set-offs such as that attempted by Trans Otway are most likely to be tipped up by a liquidator.



Business Briefs

Unsolicited Electronic Messages Bill

Introduced on 28 July 2005, this legislation is aimed at regulating unsolicited electronic messages (ie: 'spam'). The Bill provides maximum penalties of \$500,000 for organisations and \$200,000 for individuals. The regulatory impact and cost compliance statement that was issued concurrently with the Bill suggests that spam accounts for between 40% and 75% of all email traffic. The legislation will be administered by the Department of Internal Affairs.

Small and Medium Enterprises

The Ministry of Economic Development has released a report entitled 'SMEs in New Zealand: Structure and Dynamics Report'. The report defines an 'SME' as an enterprise employing 19 or fewer employees.

The report advises that SMEs account for 96% of all enterprises in New Zealand, for 29% of all employees and, in 2003, accounted for 37% of total national output, amounting to just under \$27 million. To read more about SMEs, look at www.med.govt.nz/irdev/ind_dev/smes/2005/index.html

Penalties of Liquidated Damages: Steelbro New Zealand Limited v Marshall & Ors

Steelbro New Zealand Limited sought summary judgment against Marshall as guarantor for unpaid rental that had accrued under two lease agreements for transport trailers. The amount sought was the unpaid rental due until the date that the trailers were repossessed, in addition to all future rental payments (for a further four and a half years) following cancellation. The High Court allowed the claim for unpaid rental due prior to repossession, but turned down the claim for future rental, although a provision in the agreement enabled Steelbro to claim payment of all future rental without allowing any discount for early repayment, as the High Court viewed such provisions as constituting a penal provision, rather than liquidated damages.

The case illustrated the principle that parties to a contract can agree on the payment of liquidated damages. However the quantum of liquidated damages must be realistic, and charging unrealistic liquidated damages may result in a claim for liquidated damages being unenforceable.

Incorrect Information on Websites: Police v Tony's Vineyard Restaurant

The Commerce Commission successfully prosecuted the owner of Tony's Vineyard Restaurant for permitting incorrect information to remain on its website. The website included menus and prices. A customer complained when he visited the restaurant and found that not only were many of the menu items not available, but also the prices of the menu items that were available were higher than advertised. The owner was fined \$3,000 plus \$260 in court costs. Check your website now!

Copyright Infringement: Callista Group Limited v Zhang & Ors

Callista Group Limited initiated a claim against Zhang who was previously employed by the company. The High Court held that Zhang infringed copyright held by Callista Group Limited in respect of certain of its programs and materials. The court granted Callista Group Limited an injunction against Zhang, together with orders requiring the delivery or destruction of the copyrighted information, and awarded \$150,000 in damages.