

Meltzer Mason Heath

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UPDATE + NEWS + REVIEW

September 2006

"Spring is a heart full of hope and a shoe full of rain." - **Unknown**

"September comes like an idiot, babbling and strewing flowers." - **Edna St Vincent Millay**

"Sleeping Directors" Beware

Rachel Mason

A Court of Appeal decision earlier this year highlights the risks directors take if they do not keep themselves informed and involved in their companies. In *Mason v Lewis* (CA 267-04) the Court said that:

"Directors must take reasonable steps to put themselves in a position not only to guide but to monitor the management of a company. The days of sleeping directors with merely an investment interest are long gone: the limitation of liability given by incorporation is conditional on proper compliance with the [Companies Act]."

This was an action under section 135, Companies Act, for reckless trading by a company's directors. Two of the directors (Mr and Mrs L) had effectively left the company in the control of a manager (Mr G), who turned out to be a rogue. Mr G's dishonest trading of the company, over a period of three years, consisted of activities ranging from false invoicing, to failure to pay tax, to lying about the state of potential clients. Mr & Mrs L knew that the company had lost its major customer within a few months of commencing business. They knew that the company did not maintain adequate (or any) books and records. They eventually became aware of a large debt outstanding to the IRD. They took no active role in directing the company and accepted the assurances of Mr G without adequate inquiry. But it was not until nearly a year after receiving an IRD letter as to the outstanding tax that Mr and Mrs L finally took steps to cease trading, and place the company in liquidation.

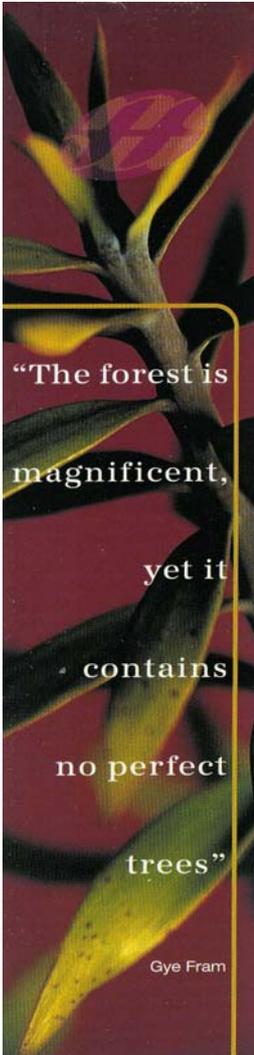
The directors claimed that they did their best to ascertain the company's position, and they had the belief that competent parties were looking after the company. However, the Court's view was that any reasonable and prudent director would have known (at an earlier stage) that the company was in deep trouble, that even radical surgery might not save it, and that cessation of trading had to be contemplated. It was the directors' underlying failure to see the company properly set up, with adequate, ongoing, and monitored books of account which created the very context in which the rogue manager's unauthorised steps, expenditure, and dishonesty could thrive. The Court considered that this neglect of their duties could be fairly described as reckless. In the circumstances of this case, the directors' culpability was significant in creating a substantial risk of serious loss to the creditors of the company.

Therefore it is very important for directors to be involved in the operation of a company, and to ensure that they fulfil their duties as charged under the Companies Act – specifically to act in good faith, in the best interests of the company, and with a duty of care towards the company, its creditors and shareholders. They must also ensure adequate books and records are maintained, or risk being liable for the amount of the loss to the creditors (for the period of inadequate book-keeping).

Lien Over Documents—Section 263, Companies Act 1993

Arron Heath

Practitioners may be interested to note that the Insolvency Law Reform Bill proposes increasing the amount that can be claimed preferentially against a company in liquidation from the present \$500 to "10% of the total value of the debt, up to a maximum of \$2,000".



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Persons Prohibited From Managing Companies

Mike Lamacraft

Most directors these days are aware of such terms as “voidable transactions”, “overdrawn current account” or “reckless trading” and appreciate that the conduct of a director of a company which is placed into liquidation will be subject to scrutiny. It is also generally known that the legal costs in pursuing directors can be high. Where there are only limited funds in a liquidation estate a Liquidator is unlikely to be able to commence proceedings. Directors may therefore escape any financial penalty.

However, the Companies Office National Enforcement Unit (“NEU”) on behalf of the Registrar of Companies can prohibit a person, including a director, from being concerned in, or taking part, in the management of a company. The NEU will review the company’s affairs and the person’s conduct and if appropriate a report is filed with the Registrar and a notice issued to the person pursuant to Section 385(3) of the Companies Act 1993. If the Registrar is satisfied that the person’s mismanagement of a company’s affairs was directly responsible for the company’s failure, that person may be barred from managing a company for a number of years.

Two of the main areas which can lead to disqualification are:

- Retention of Crown Funds – i.e. non-payment of GST and/or PAYE.
- Excessive drawings –i.e. an overdrawn current account which cannot be repaid.

Coupled with the IRD’s new proactive approach to pursuing directors for company PAYE debt (as reported in our last newsletter) directors must react swiftly to recognise when the company starts to struggle to meet its commitments and should seek advice sooner rather than later to protect their own position.

Insolvency Law Reform Bill Update

Arron Heath

On 10 August 2006, the Commerce Committee reported back to Parliament recommending that the Bill be passed. The second reading of the Bill concluded on 13 September 2006 and the Bill has been referred back to the Committee for further consideration.

Despite submissions to the contrary from among others, the Law Commission, Ministry of Economic Development, Institute of Chartered Accountants and the Law Society, the Committee opted to retain the Crown’s GST and PAYE preference in receivership and liquidation situations. It is believed that the Crown only receives about \$5.0 million a year in preferential distributions but agreement to an alternative appears to have been a major sticking point.

The impact of retaining the Crown preference on the proposed Voluntary Administration regime will be interesting as both Australia and the United Kingdom abolished Crown preference when introducing their voluntary administration regimes.

It is likely that the Bill will have its third reading and be passed before Christmas 2006, but will not be operational for some time after in order for regulations to be enacted and administrative requirements to be put in place.

Between the professional staff at Meltzer Mason Heath there is over 100 years insolvency experience. This means that any problems or uncertainties facing your clients are likely to have been seen by us before. Please call us, and as always we will offer you and/or your clients a free one hour consultation.

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