

## CASE SUMMARY

# Debut Homes Ltd (in liquidation) v Cooper

Decision date: 24-09-2020

CSUM 20/12

## CASE

**Vivien Judith Madsen-Reis and Henry David Levin as Liquidators of Debut Homes Limited (in Liquidation) and Debut Homes Limited (in Liquidation) v Leonard Wayne Cooper and Leonard Wayne Cooper and Tracey Cooper as Trustees of the L & T Cooper Family Trust [2020] NZSC 100**

## LEGISLATIVE REFERENCES

Ss 131, 135, 136, 301 Companies Act 1993

## LEGAL TERMS

Directors duties, solvency, reckless trading, best interests of the company, incurring obligations, breach of duty, interest of creditors, compensation, "rob Peter to pay Paul".

## Summary

This Judgment sets out the scheme of the Companies Act 1993 and the underlying principles for assessing whether a director has breached their duties under ss 131 (duty to act in the best interests of the company), 135 (reckless trading), 136 (duty not to incur obligations without reasonable grounds to believe the company can meet them when they fall due) and the correct approach to determining the compensation to be ordered under s 301. The Appeal was allowed.

## Impact

This has a significant impact on clarifying when the actions of will be in breach of their duties under the Companies Act. In particular, directors must consider the interests of creditors in cases of near insolvency. It also confirmed that s 136 applies in respect of all debts incurred, not only contractual debts, otherwise the situation would allow Peter to be robbed to pay Paul. The effect of this decision is that if the director incurred GST when they knew that it could not be paid, this was a breach of duty under s 136. The approach to the calculation of compensation under s 301 was confirmed as a two step approach.

## Facts

Debut Homes Ltd (Debut) was a property development company and had been balance sheet insolvent since 2009 but by October 2012 was in serious financial difficulty and unable to pay its debts. In November 2012 its director, Mr Cooper, sought advice from his accountant and it was clear that the company debt was insurmountable. A GST debt to Inland Revenue was expected to be \$300,000 at that stage. Debut still owned six properties, all at various stages of completion. Mr Cooper made the decision to complete these properties on the belief that they would sell for a higher price once they were completed rather than if they were sold incomplete. Mr Cooper obtained further finance to complete the building projects which he personally guaranteed and also obtained a loan from his family trust, subject a general security agreement. The properties were sold and the sale proceeds used to pay secured creditors but no GST was paid on any of the property sales. Inland Revenue applied to liquidate the company and in 2014 and at the time of the liquidation Debut owed approx. \$499,000 to its creditors, of which approx. \$450,000 was owed to Inland Revenue for unpaid GST on property sales.

## Issues

Whether the Court of Appeal decision was in error. Specific issues included:

Whether continuing to trade to complete the unfinished properties and incur further debts was a breach of duty under ss 131, 35 and 136.

Whether creditors interests had to be considered by directors in cases of near insolvency

Whether incurring GST was the type of debt that was captured under s 136

The correct approach to calculating compensation

## Decision

The appeal was allowed.

The full court made the following observations about the scheme of the Companies Act in general:

- Under the scheme of the Companies Act, maintaining solvency is the key value in the Act and vital to the best interests of the company.
- In cases of near solvency the interests of creditors must be considered.
- The formal mechanisms within the Act and the informal mechanisms of maintaining solvency all involve consultation and agreement with creditors.
- Directors may be compromised and where they have an interest (e.g. a security) in resolving the company debt.

### *Section 135:*

The Court to the view that contrary to the Court of Appeal's decision, it cannot sensibly be said that completing the properties benefitted Inland Revenue because higher sale prices would increase the GST payable, given that it was clear there was no intention or ability to pay GST on the sales of the properties.

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 in breach of s 135 of the Act. Subject to the use of the formal or informal mechanisms elsewhere discussed, this applies whether or not continued trading is projected to result in higher returns to some of the creditors than would be the case if the company had been immediately placed into liquidation, and whether or not any overall deficit was projected to be reduced. Refer to paragraphs

### *Section 136*

The Court held that as GST is payable at the time of supply, the obligation did not arise at the time the properties were purchased, there is no debt to Inland revenue until the time they are sold.

It is not legitimate to take a course of action where some creditors have a higher return than others at the expense of new creditors not being paid, that it is not legitimate to “rob Peter to Pay Paul”

If directors agree to debts being incurred where they do not believe on reasonable grounds that the company will be able to perform the obligations when they fall due, then there will be a breach of s 136 of the Act. Such obligations do not need to arise from direct contractual arrangements between the company and the creditor.

### *Section 131*

In cases of near insolvency a director must consider the interests of creditors.

There will be no breach of s 131 if a director honestly believed they were acting in the best interests of the company. There will, however, be a breach of s 131 if directors, in an insolvency or near-insolvency situation, fail to consider the interests of all creditors. Such a breach may be exacerbated by a conflict of interest.

Where there are no prospects of a company returning to solvency, it makes no difference that a director honestly thought some of the creditors would be better off by continuing trading. There are alternatives other than liquidation open to directors where continued trading is projected to result in a shortfall. The formal mechanisms available include those in Parts 14 and 15A of the Act.

### *Section 301*

Where there have been breaches of duties, any relief ordered under s 301 must respond to and provide redress for the particular duty or combination of duties breached. Relief can be compensatory or restitutionary in nature and must take account of all of the circumstances, including the nature of the breach or breaches, the level of culpability of the director, causation, duration of the breach, holding the director to account and reversing the harm to the company.

For breaches of s 135 the starting point is the net deterioration in the company’s financial position between the date it should have stopped trading and the date of actual liquidation.

For breaches of s 136 the net deterioration method will not necessarily respond adequately to the breach, especially where new obligations are incurred and “Peter has been robbed to pay Paul”. There the net deterioration will not reflect the harm. Any relief should therefore be restitutionary.

#### *Other findings*

The court Considered that the GSA should be set aside as the GSA would frustrate the purpose of the judgment if it would enable to family trust to claim the benefit of the judgment by returning any compensation paid by Debut to Mr Coopers as a beneficiary of the trust.

Mr Cooper could not rely on s 138 as the accountant’s advice was too general and the forecast of \$300,000 GST debt was unsurmountable.

Costs were awarded to the appellant (note that as Intervener our costs lie where they fall).

## About this document

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