IN THE SUPREME COURT OF NEW ZEALAND

I TE KŌTI MANA NUI

SC 29/2019
[2020] NZSC 100

BETWEEN	VIVIEN JUDITH MADSEN-RIES AND HENRY DAVID LEVIN AS LIQUIDATORS OF DEBUT HOMES LIMITED (IN LIQUIDATION) First Appellants
	DEBUT HOMES LIMITED (IN LIQUIDATION) Second Appellant
AND	LEONARD WAYNE COOPER First Respondent
	LEONARD WAYNE COOPER AND TRACEY COOPER AS TRUSTEES OF THE L & T COOPER FAMILY TRUST Second Respondents

Hearing:	1 October 2019 (further submissions received 12 November 2019)
Court:	Winkelmann CJ, Glazebrook, O'Regan, Ellen France and Williams JJ
Counsel:	N H Malarao and P V Shackleton for Appellants R B Hucker and R F Selby for First Respondent H W Ebersohn and C L White for Attorney-General as Intervener
Judgment:	24 September 2020

JUDGMENT OF THE COURT

A The appeal is allowed.

B The High Court orders outlined at [4(a)], (b) and (c) of this Court's judgment are restored.

C The respondents must pay the appellants costs of $25,000 plus usual disbursements. Costs in the Courts below are to be determined in accordance with this judgment.

REASONS

(Given by Glazebrook J)

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Introduction

[1] Debut Homes Ltd (Debut) was a residential property developer. The first respondent, Mr Cooper, is its sole director. At the end of 2012 Mr Cooper decided to wind down Debut's operations. Existing developments would be completed but no new developments undertaken. At the time this decision was made, it was forecasted that there would be a deficit of over $300,000 in goods and services tax (GST) once wind-down was completed.

[2] Debut was placed into liquidation on 7 March 2014 on the application of Inland Revenue/Te Tari Taake (Inland Revenue). The first appellants are Debut's liquidators.

[3] The main issue in this appeal is whether Mr Cooper was in breach of his directors' duties under the Companies Act 1993 (the Act). The other issues in the appeal are:

(a) whether Mr Cooper has a defence under s 138 of the Act;

(b) whether a general security arrangement (GSA) securing advances by the L & T Cooper Family Trust (the Trust) should be partially set aside under s 299 of the Act; and

(c) if there was a breach of directors' duties, what level of relief should be ordered under s 301 of the Act.

[4] In the High Court, Hinton J held that Mr Cooper had breached his duties under ss 131(1), 135(b), and 136 of the Act.[1] The Court rejected a defence under s 138 of reliance on professional advice.[2] The Court made the following orders:[3]

(a) Under s 301(1)(b)(ii) of the Act, Mr Cooper was ordered to make a contribution of $280,000 towards the assets of Debut.

(b) Under s 299(1) of the Act, the GSA entered into between Debut and the Trust, dated 22 March 2013, was set aside as against the second respondents, only to the extent of the awards made against Mr Cooper in the judgment.

(c) Leave was granted to the liquidators to re-apply to the Court for an increase in compensation if the trustees of the Trust succeed in proving in the liquidation as unsecured creditors.

[5] The Court of Appeal allowed Mr Cooper's appeal against the findings of breach of ss 131, 135 and 136 of the Act and quashed the above orders.[4]

[6] The liquidators' application for leave to appeal was granted by this Court on 21 June 2019.[5]

[7] Before turning to the issues in the appeal, we elaborate on the factual background and make some general comments about the scheme of the Act and on GST. We then consider the relevant directors' duties before discussing s 138, the GSA and compensation.

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1 *Debut Homes Ltd (in liq) v Cooper* [2018] NZHC 453, (2018) 12 NZCLC ¶98-059 [HC judgment] at [37] and [42]–[43].

2 At [66].

3 At [143]. The High Court also made an order that payments made by Debut to Mr Cooper totalling $34,129.54 be set aside as voidable transactions under ss 292 and 294(5) of the Companies Act 1993. Mr Cooper was required to repay that amount to the liquidators. This order is not under appeal in this Court.

4 *Cooper v Debut Homes Ltd (in liq)* [2019] NZCA 39, [2019] 3 NZLR 57 (Miller, Asher and Gilbert JJ) [CA judgment] at [96].

5 *Madsen-Ries v Cooper* [2019] NZSC 59 (Glazebrook, O'Regan and Ellen France JJ) [Leave judgment]. The approved question was whether the Court of Appeal was correct to allow the appeal.

Factual background[6]

[8] Debut was incorporated in 2005. As noted above, Mr Cooper was the sole director and he and his wife owned all the shares. Debut's assets had been less than its liabilities (balance sheet insolvency) since March 2009 but it had been supported by shareholder advances and, up until the end of October 2012, had paid all its debts as they fell due. It had, however, been experiencing cost overruns and increasing debt and, by the end of October 2012, was in real financial difficulty.

[9] Debut had two outside financiers: the Bank of New Zealand (BNZ) and a second-tier lender, JT Jamieson & Co Ltd (Jamieson). The loans were secured by mortgage and Mr Cooper had given personal guarantees.

[10] In early September 2012, Debut had entered into agreements to sell two properties (2 and 7 Karika Place). Settlement took place in mid-October 2012 but the GST output tax on the sale of these properties was not due to be accounted for until 30 November 2012. The majority of the proceeds from the sale of those properties had been used to reduce the Jamieson debt. Some of the funds had, however, been retained by Debut.[7] No portion of the GST owing was paid on 30 November or thereafter.[8]

[11] On 23 October 2012, Jamieson emailed Mr Cooper to advise that no further funds would be advanced to complete the remaining building projects.

[12] Mr Cooper met with Debut's accountant, Mr Furlong, on 6 November 2012. Mr Cooper prepared costings for that meeting, including forecast expenditure to complete the remaining properties and estimated sale prices of these properties based on real estate agents' advice. These costings showed a surplus of nearly $170,000 but no provision was made for interest costs or for the GST payable on the sales, including that due on 30 November. The costings were designed to secure further funding from

[6] This background is largely taken from the HC judgment, above n 1, at [5]–[31].

[7] The sum of $121,600 was retained out of a total (GST inclusive) sale price for the two properties of $826,000.

[8] The GST payable on the sales of 2 and 7 Karika Place was $104,799.46. GST input tax credits reduced the amount payable to $88,620.15. When considering relief under s 301, the High Court used an approximation of $100,000 for the GST debt from these sales: HC judgment, above n 1, at [83].

Jamieson and were prepared in the form they were on Mr Furlong's instruction. At that meeting, Mr Furlong told Mr Cooper that the GST deficit would be over $300,000.[9]

[13] After the 6 November meeting, Mr Cooper decided that Debut should cease trading after completing the remaining unfinished properties and should sell all of its properties as soon as possible. On 7 November further funding was secured from Jamieson, with Mrs Cooper giving security over a $200,000 deposit she had with Jamieson.

[14] As at early November, Debut had four properties to complete. One, at 4 Karika Place, was close to completion. Another two at 28 Coby Sydney Drive (divided into two titles) and a house at 78 Pemberton Avenue were still in the middle of construction. Two other houses at Penrod Drive were already completed and were rented out but had not yet been sold and, as mentioned above, 2 and 7 Karika Place had been completed and sold.

[15] On 9 November 2012, Debut sold 4 Karika Place for $589,000 (GST inclusive), settling on 7 December. All proceeds from that sale were paid to Jamieson.[10]

[16] On 20 November, Debut sold 48 Penrod Drive for $408,000 (GST inclusive), settling on 23 January 2013. Debut retained nearly $82,000 and the balance was paid to BNZ, the mortgagee of that property.

[17] On 5 February 2013, 27A Penrod Drive was sold for close to $317,000 (GST inclusive), settling on 8 March 2013. The mortgagee of that property, BNZ, received $272,400 and the balance of over $44,000 was retained by Debut.

[18] On 20 February 2013, Mr and Mrs Cooper as trustees of the Trust agreed to lend up to $380,000 to Debut as working capital. Mr and Mrs Cooper were the settlors

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9 Mr Cooper disputed this evidence at trial but this was the High Court's finding: HC judgment, above n 1, at [13]. In any event, the High Court found that Mr Cooper was aware there was a GST liability on the sales and that he would have worked out the amount: at [13]–[14] and [61].

10 HC judgment, above n 1, at [18].

and primary beneficiaries of the Trust. A GSA was signed in March 2013 between Debut and the Trust. Advances of nearly $377,000 were made by the Trust to Debut between March 2013 and February 2014. Before the Trust started to make its advances in March 2013, Mrs Cooper's $200,000 deposit was returned to her and the security released.

[19] In April 2013, 78 Pemberton Road was sold for $825,000 (GST inclusive), settling on 12 April 2013. The full proceeds were paid to Jamieson.

[20] By mid-2013, almost all of the residual Jamieson debt had been refinanced through the BNZ, the Trust agreeing to guarantee the BNZ debt of about $435,000, in addition to the existing personal guarantee of Mr Cooper.

[21] On 13 September 2013, Inland Revenue served a statutory demand and after that issued a liquidation proceeding. In mid-November 2013, after the demand period had expired, a settlement proposal was put to Inland Revenue and rejected.

[22] On 12 November 2013, 28C Coby Sydney Drive was sold for $140,000 (GST inclusive). The sale settled on 20 December 2013. Of these proceeds, $17,400 was paid to the Trust and the balance to BNZ.

[23] On 21 January 2014, 28B Coby Sydney Drive sold for $485,000 (GST inclusive), settling on 28 February 2014. Of the proceeds, $147,000 went to the Trust and $322,000 to BNZ.

[24] On 7 March 2014, Debut was placed into liquidation on Inland Revenue's application.

[25] For a period of approximately 18 months leading up to completion of the development work on the properties, Mr Cooper worked full-time for Debut and received no salary.

[26] On the liquidation date, Debut still owed Mr and Mrs Cooper a current debt of approximately $210,000, and over $200,000 of the $377,000 Trust loan was outstanding. In addition, trade creditors were owed at least $28,700 from trade debts

incurred after 31 October 2012.[11] On the liquidation date, there was GST owing of $450,099. This sum included interest and penalties of some $84,000.[12]

Scheme of the Act

[27] Before we consider the specific directors' duties Mr Cooper is alleged to have breached, we make some general points about the scheme of the Act because the nature, extent and content of directors' duties must be interpreted in light of that scheme. We then turn to consider formal and informal mechanisms for dealing with insolvency and near-insolvency situations.

General scheme of the Act

[28] It is the duty of directors to act in the best interests of the company.[13] The traditional view is that this requirement is fulfilled by directors acting in the best interests of the shareholders as a whole.[14] This is known as the shareholder primacy model.

[29] The main competing model of corporate governance is the stakeholder model, whereby the interests of those with some stake in the company and its business (such as employees, creditors and the wider public) should be taken into account by the directors, alongside the interests of shareholders. Wider considerations beyond

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11 The liquidators say the trade creditor debt was $44,723.74 but Mr Cooper disputes that figure on the basis that the debt of a trade creditor, Love Earthmovers, had been settled. He says that the proper figure is $28,712.34. We have no means of resolving the dispute over this figure. The High Court made no finding on it.

12 HC judgment, above n 1, at [3].

13 Companies Act, s 131. This provision did not exist in the predecessor legislation (Companies Act 1955). Previously common law duties, directors' duties became statutory after the implementation of company law reform recommended by the Law Commission: Law Commission *Company Law: Reform and Restatement* (NZLC R9, 1989) at [186].

14 John Farrar and Susan Watson (eds) *Company and Securities Law in New Zealand* (2nd ed, Thomson Reuters, Wellington, 2013) at [15.2.4], 369; Peter Watts *Directors' Powers and Duties* (2nd ed, LexisNexis, Wellington, 2015) at [5.3.1], 126 and [5.4], 132–135; and Linda Howes and Stephen Revill (eds) *Company Law* (looseleaf ed, Thomson Reuters) at [CA131.08]. Note though that s 169(3)(d)–(i) makes it clear that ss 131, 133, 135–137 and 145 are duties owed to the company and not to shareholders.

maximising profits might therefore be acceptable for directors under the stakeholder model.[15]

[30] A third view is that the concentration should be on the company itself. This approach arguably allows other interests to be taken into account more explicitly than under the traditional approach, as long as it is in the best interests of the company to do so.[16]

[31] We do not for the purposes of this appeal need to decide which of the competing models of corporate governance is correct. Even under the traditional approach, it is accepted that the interests of creditors have to be considered where the company is insolvent or nearly insolvent.[17]

[32] Further, no matter which view is taken on the best interests of the company, maintaining solvency is vital. It cannot be in the best interests of the shareholders as a whole for a company to become insolvent as they would not only lose possible future income from the company, but also their investment in it. Equally, it cannot be in the best interests of the company itself to become insolvent, given it would cease to exist in the event of liquidation. Similar considerations apply to other stakeholders.

[33] The importance of solvency is highlighted in the Companies Act itself, outside of the context of directors' duties. The 1993 Act introduced an expanded solvency test, which the Law Commission in its 1989 report considered to be "one of the pivotal

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15 See generally Susan Watson and Lynne Taylor (eds) *Corporate Law in New Zealand* (Thomson Reuters, Wellington, 2018) at [3.2], 53–54; and Edward Rock *For Whom is the Corporation Managed in 2020?: The Debate Over Corporate Purpose* (New York University and European Corporate Governance Institute, Law Working Paper 515/2020, May 2020).

16 See Susan Watson "What More can a Poor Board Do? Entity Primacy in the 21st Century" (2017) 23 NZBLQ 142; and Watson and Taylor, above n 15, at [3.3], 58–60. This was effectively the approach taken by the Law Commission in the late 1980s in the sense that it recommended a hierarchy of directors' duties, with duties to others subject to the fundamental duty to act in the best interests of the company: Law Commission, above n 13, at [194].

17 *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 (CA) at 250 per Cooke J and 255 per Somers J; and *Sojourner v Robb* [2006] 3 NZLR 808 (HC) (Fogarty J) [*Sojourner* (HC)] at [102] (upheld in *Sojourner v Robb* [2007] NZCA 493, [2008] 1 NZLR 751 [*Sojourner* (CA)]). Note, however, that this is not considered to amount to a duty to creditors. Rather, creditors' interests are to be considered since those are the interests that may be prejudiced in the event a company becomes insolvent. For a detailed discussion on the scope of the duty (and to whom it is owed), see Paul Heath and Michael Whale (eds) *Heath and Whale on Insolvency* (looseleaf ed, LexisNexis) at [32.11]–[32.15]; Watts, above n 14, at [10.1], 261–268; Matthew Berkahn "Directors' Duties to 'the Company' and to Creditors" [2002] CSLB 31 at 34–36; and Law Commission, above n 13, at [214] and [217].

provisions in the Act … designed as a substantial protection for creditors".[18] The Act requires the solvency test to be met when certain transactions are entered into by a company.[19]

[34] The solvency test, detailed in s 4 of the Act, has two limbs that both must be satisfied: the liquidity limb (s 4(1)(a)) and the balance sheet limb (s 4(1)(b)). The focus of the liquidity limb is that the company is able to pay its debts as they fall due, in the normal course of business.[20] The balance sheet limb was introduced into New Zealand company legislation in 1993.[21] This limb is satisfied if the value of a company's assets is greater than the value of its liabilities, including contingent liabilities.

[35] In addition to the solvency test, the Companies Act has other provisions dealing with insolvency and near-insolvency situations.

Formal mechanisms

[36] Part 14 of the Act provides a procedure for proposing a "compromise" to creditors. A "compromise" is defined as a compromise between a company and its creditors and includes a compromise cancelling all or part of a debt of a company and one that varies the rights of creditors or the terms of a debt.[22] Such a compromise is binding on all affected creditors if passed by a simple majority in number of creditors, where that majority also represents at least 75 per cent of the value of the affected debt in relation to each class of creditor.[23]

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18 Law Commission, above n 13, at [214].

19 For example, when distributions are made by a company (s 52), when a discount scheme is approved by a company (s 55), when a company redeems shares (s 70), and when a company gives financial assistance under s 76 (s 77).

20 An earlier version of the liquidity limb appeared in ss 217–218 and 319–320 of the Companies Act 1955.

21 The concept of "balance sheet insolvency" had previously been referred to in *Hilton International Ltd v Hilton* [1989] 1 NZLR 442 (HC). See Howes and Revill, above n 14, at [CA4.03].

22 See s 227 of the Companies Act for the definitions of "compromise" and "creditor". See also Heath and Whale, above n 17, at [16.12].

23 Section 230(1) and sch 5 cl 5(2). The Court is able to give directions in relation to, or waive or vary, any procedural requirements of Part 14: s 232(1)(a). See Heath and Whale, above n 17, at [16.11] and [16.15].

[37] Part 15 provides for compromises to be approved by the High Court.[24] The discretion under Part 15 is broad but the court would consider the interests of all creditors and whether any compromise is fair and equitable.[25] The court is able to, and usually would, direct a meeting of all creditors or the affected class of creditors.[26]

[38] Part 15A provides for voluntary administration.[27] The purpose of Part 15A is set out in s 239A: to provide for a company to be administered in a way that maximises its chances of survival or, if the company cannot survive, "results in a better return for the company's creditors and shareholders than would result from an immediate liquidation of the company". Once an administrator is appointed, with limited exceptions, there is a moratorium on enforcement of debts during the period of administration.[28] The administrator must call at least two meetings of creditors: the first creditors' meeting and the watershed meeting.[29] The latter is where the creditors decide the future of the company.[30] Creditors vote by class and the majority required is the same as for approval of a compromise under Part 14 of the Act.[31] Unlike in Part 14, however, the administrator has a casting vote.[32] The outcome of a watershed

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24 Part 15 allows for the court to make certain arrangements, amalgamations and compromises binding on the company and other persons or classes of person: ss 236 and 238(b). The Court may also approve a compromise under s 236 where the required creditor consent under Part 14 is not obtainable for some reason: *Bank of Tokyo-Mitsubishi UFJ Ltd v Solid Energy New Zealand Ltd* [2013] NZHC 3458 at [85].

25 *Weatherston v Waltus Property Investments Ltd* [2001] 2 NZLR 103 (CA) at [32]–[33] and [35] (a case about an amalgamation); and *Suspended Ceilings (Wellington) Ltd v Commissioner of Inland Revenue* (1997) 8 NZCLC ¶96-726 (CA) (a case about a compromise).

26 Section 236(2)(b). The general principles in *Weatherston*, above n 25, in relation to s 236 applications were affirmed by the Court of Appeal in *Dominion Income Property Fund Ltd v Takeovers Panel* (2006) 3 NZCCLR 946 (CA) at [22].

27 An administrator can be appointed by the company, a liquidator or interim liquidator, a secured creditor or the court: s 239H.

28 Sections 239ABC–239ABJ. See also Heath and Whale, above n 17, at [17.6]; and Watson and Taylor, above n 15, at [35.4.3(1)], 1074–1078.

29 Section 239AJ(a) and (b). The first creditors' meeting is for the appointment (if any) of a committee of creditors. The administrator must call other creditors' meetings as required: s 239AJ(c).

30 Section 239AS defines a watershed meeting to mean a "meeting of creditors called by the administrator to decide the future of the company and, in particular, whether the company and the deed administrator should execute a deed of company arrangement". The watershed meeting must be held within 20 working days of the appointment of the administrator, although that period can be extended: s 239AT.

31 Section 239AK. That is, a majority in number also representing 75 per cent of the value of the debt of the creditors or class of creditors voting. For voting under Part 14, see s 230(1).

32 Section 239AK(3); compare sch 5 cl 5(3). The administrator's casting vote must be exercised honestly and in accordance with what appears to be the best interests of the company's creditors as a whole and in furtherance of the objects of voluntary administration: see the discussion in Heath and Whale, above n 17, at [17.12].

meeting may be to end the administration, to appoint a liquidator or to enter into a deed of company arrangement.[33]

[39] Part 16 of the Act deals with liquidation. Liquidation may be the only option consistent with directors' duties if the other formal and informal mechanisms are not suitable. Indeed, it has been described as "the most frequently used of all of the collective corporate insolvency procedures in the Act".[34] Once the company is placed into liquidation, control and custody of the company's assets pass to the liquidator.[35]

[40] The assets or the proceeds from realisation of the assets must be distributed by the liquidator in accordance with the prescribed statutory priorities.[36] First, preferential claims must be satisfied.[37] The remainder of the assets are then distributed to satisfy all other claims on a pari passu basis of equal sharing.[38] Other provisions support the objective of equitable distribution.[39]

[41] Finally, another option for a company in distress is for a receiver to be appointed. The powers and duties of receivers are governed by the Receiverships Act 1993.[40]

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33 Section 239ABA.

34 Watson and Taylor, above n 15, at [35.2], 991.

35 Section 248(1)(a). Secured creditors retain the right to take possession of, and realise or otherwise deal with, company property over which that creditor has a charge: s 248(2). This right is subject to s 305. Section 305(1) allows creditors to realise property subject to a charge, to value property subject to a charge and claim in the liquidation as an unsecured creditor for the balance due, or to surrender the charge to the liquidator for the general benefit of creditors and claim in the liquidation as an unsecured creditor for the whole debt.

36 Other than secured assets, as noted in n 35 above.

37 Section 312 provides that the liquidator must pay out of the assets of the company the expenses, fees and claims set out in sch 7 to the extent and in the order of priority in that schedule. "Assets" in this context does not include assets subject to a charge unless the charge is surrendered under s 305: s 312(2).

38 Section 313. On the pari passu principle, see for example Lynne Taylor and Grant Slevin *The Law of Insolvency in New Zealand* (Thomson Reuters, Wellington, 2016) at [29.1], 787–788; and Watson and Taylor, above n 15, at [35.28], 1059.

39 Sections 292 (insolvent transactions) and 293 (voidable charges): see *Allied Concrete Ltd v Meltzer* [2015] NZSC 7, [2016] 1 NZLR 141 at [1] per McGrath, Glazebrook and Arnold JJ.

40 For completeness, we also note the statutory management regime under the Corporations (Investigation and Management) Act 1989.

Features of formal mechanisms

[42] A feature of Parts 15 (court approval of arrangements, amalgamations and compromises), 15A (voluntary administration) and 16 (liquidation) is that they require persons independent of the directors to run the processes. The same is true of receiverships. While the Part 14 process (creditor compromises) is run by directors, the decision-making is by creditors and there is the possibility of court intervention on the application of a creditor who voted against the proposal.[41] Further, the interests of directors in a proposed compromise under Part 14 must be disclosed.[42]

[43] The removal of decision-making powers from directors in such circumstances is a recognition that directors are not the appropriate decision-makers in times of insolvency or near-insolvency. This is because their decisions may be compromised by conflicting interests and, even where that is not the case, they may be too close to the company and its business to be able to take a realistic and impartial view of the company's situation.

[44] Another feature of the formal mechanisms is that both Parts 14 and 15A require the involvement of all creditors, and voting is by class and value. As discussed above, under Part 15, while not mandatory, involvement of all creditors is likely to be ordered and the interests of all creditors will be considered. In terms of Part 16, there is provision for meetings of creditors.[43] Under both Parts 14 and 16, meetings of creditors and voting are to be in accordance with sch 5.[44] Further, in a liquidation, assets and proceeds from the realisation of assets must be distributed in line with the set statutory priorities discussed above. It is worth noting too that receivers must exercise their powers with reasonable regard to the interests of the company and other creditors, to the extent that doing so is consistent with acting in good faith and for a

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41 Section 232(3). See *Trends Publishing International Ltd v Advicewise People Ltd* [2018] NZSC 62, [2018] 1 NZLR 903 in which this Court upheld the setting aside of a compromise pursuant to s 232(3). See also the discussion in Heath and Whale, above n 17, at [16.18].

42 Section 229(2)(b)(v).

43 Sections 243 and 258.

44 Section 230(1) (under Part 14) and s 243(5) (under Part 16). But see the different voting thresholds as applicable to Part 14 compromises (sch 5 cl 5(2) – a resolution passes if a majority in number representing 75 per cent in value of the creditors or class of creditors vote in favour of the resolution) as compared to Part 16 meetings of creditors (sch 5 cl 5(1) – a resolution passes if a majority in number and value of the creditors or class of creditors vote in favour of the resolution).

proper purpose and in the best interests of the person in whose interest they were appointed.[45]

[45] The third point is that Part 15A is the formal mechanism specifically designed to save a failing business or, if that is not possible, to maximise returns to all creditors.[46] Part 15A was inserted into the Companies Act in 2006 in order to fill a perceived gap in the other mechanisms available for corporate recovery,[47] and to bring New Zealand's corporate insolvency scheme into line with other comparable jurisdictions, notably Australia.[48]

[46] Finally, we note that administrators under Part 15A are liable for debts incurred in fulfilling their duties.[49] Receivers are also personally liable for any contract entered into by them in the exercise of any of their powers.[50] Liquidators are agents of the company.[51] Fees and expenses properly incurred by liquidators in carrying out their duties and exercising their powers rank first in preferential claims.[52] The responsibilities of liquidators and receivers in relation to GST are dealt with below.[53]

Informal mechanisms

[47] There are also informal mechanisms available to directors, including informal arrangements with creditors,[54] but we stress that these must accord with directors' duties and take into account the scheme of the Act, including the importance it places on maintaining solvency.

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45 Receiverships Act 1993, s 18.
46 Companies Act, s 239A. By contrast, liquidation is a terminal procedure: see s 253.
47 The main perceived gaps were the lack of a moratorium under Part 14, the time and expense of an application to the High Court under Part 15 and the infrequent use of the Part 14 compromise regime. See Taylor and Slevin, above n 38, at [32.1], 845–846; Heath and Whale, above n 17, at [17.4(c)]; and Watson and Taylor, above n 15, at [35.4.3(1)], 1074–1078.
48 Insolvency Law Reform Bill 2005 (14-1) (explanatory note) at 5; and Corporations Act 2001 (Cth), Part 5.3A.
49 Section 239ADH. The administrator may also be liable under employment contracts where the contracts existed at the start of the administration (s 239Y) and for rent and other payments under leases existing at the start of the administration (ss 239ADI–239ADK).
50 Receiverships Act, s 32.
51 *Dunphy v Sleepyhead Manufacturing Co Ltd* [2007] NZCA 241, [2007] 3 NZLR 602 at [22].
52 Companies Act, sch 7 cl 1(1). This applies also to the liquidators' remuneration.
53 At [50]–[53].
54 See discussion in Taylor and Slevin, above n 38, at [1.3.1], 10–12.

[48] They must also align with the available formal mechanisms. This would suggest the need to ensure the agreement of all creditors, including those who would be involved in and affected by the period of continued trading.[55] If all such creditors are not consulted, any informal scheme would have to ensure that those creditors who were not consulted would be paid in full. This also follows from the directors' duties in ss 135 and 136 discussed below.

Summary

[49] Solvency is a key value in the Act. Where a company becomes insolvent, there are statutory priorities for the distribution of funds to creditors and mechanisms to ensure these are not circumvented. There are also a number of formal mechanisms in the Act, apart from liquidation, for companies experiencing financial difficulties. All of the formal mechanisms have carefully worked out processes for decision-making and involve either an independent person or consultation with all affected creditors. None of these formal regimes involve continued unfettered decision-making by directors. Directors can choose to employ informal mechanisms but these must align with formal mechanisms. At all times, including where a company is insolvent, directors must comply with their duties under the Act.

Goods and Services Tax

[50] It is worth summarising the position in relation to GST because Inland Revenue was the major unpaid creditor in this case.

[51] As Debut was a property developer, any GST paid by Debut for the principal purpose of making taxable supplies would be claimed by it as input tax.[56] Debut would then have to account for GST on any of its property sales as output tax.[57] If Debut had sold an unfinished development to another registered person as a going concern, the supply would have been zero-rated.[58]

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55 As there is no statutory authority for majority voting by class in informal mechanisms, any decision would in practice need the unanimous agreement of those who would be affected by the continued trading. Compare ss 230(1) and 239AK.

56 Goods and Services Tax Act 1985 (GST Act), s 20(3)(b) as Debut was registered on a payments basis. See also s 3A(1) definition of "input tax".

57 GST Act, s 8(1). See also s 2 definition of "output tax". The current rate of GST is 15 per cent.

58 GST Act, ss 5(12) and 11(1)(m).

[52] Had Debut been placed in liquidation or receivership, any liquidator or receiver who conducted Debut's taxable activity on its behalf would have been deemed to be GST registered and thus personally liable for GST in relation to supplies made during the period of appointment.[59]

[53] With regard to GST owing on supplies made before any period of liquidation or receivership, the liquidator or receiver would not be personally liable.[60] Inland Revenue would on liquidation have become a preferential creditor with the ranking in sch 7 of the Companies Act.[61]

Did Mr Cooper breach s 135 of the Act?

[54] We discuss s 135 first as it (as well as s 136) contains the duties of particular relevance to insolvency situations.

[55] Section 135 provides:

> **135 Reckless trading**
>
> A director of a company must not—
>
> (a) agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or
>
> (b) cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

High Court decision

[56] The High Court held that, in allowing the business of Debut to be carried on after 1 November 2012, Mr Cooper was in breach of s 135(b), given the substantial risk of serious loss to Debut's creditors and in particular to Inland Revenue.[62]

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59 GST Act, s 58(1A).
60 GST Act, s 58(1D).
61 GST Act, s 42(2)(b); and Companies Act, sch 7 cl 1(5)(a). The claims of preferential creditors rank ahead of the claims of unsecured creditors and holders of some security interests in accounts receivable and inventory: sch 7 cl 2(1). See also *Stiassny v Commissioner of Inland Revenue* [2012] NZSC 106, [2013] 1 NZLR 453; and the analogous scheme in relation to PAYE as discussed in *Jennings Roadfreight Ltd (in liq) v Commissioner of Inland Revenue* [2014] NZSC 160, [2015] 1 NZLR 573.
62 HC judgment, above n 1, at [54]–[56] and [142].

Court of Appeal decision

[57] The Court of Appeal concluded that there was no breach of s 135. It considered that the decision to complete the houses was a "perfectly sensible business decision", and one that was "[o]verall … likely to improve the return rather than cause loss to [Debut's] creditors".[63] While the Court recognised that Inland Revenue would be more at risk than the secured creditors, it said that Mr Cooper had a sincere belief that significant surpluses (excluding GST) were expected and that in due course the GST issues would be resolvable with Inland Revenue.[64]

[58] The Court considered that Inland Revenue "was at serious risk of getting no GST before the complained of conduct" and that "[t]he risk taken [by Debut] was legitimate".[65] Although it was not possible to be definitive on the basis of the material before it, the Court considered that it was not clear that Inland Revenue was worse off in a net cash sense than it would have been if Debut had stopped trading in November 2012.[66] Rather, Mr Cooper's actions in completing the properties had the effect of increasing the amount of GST that would be payable because of the higher sale prices.[67]

[59] The Court of Appeal noted that Inland Revenue was not a preferential creditor when the decision to complete and sell the existing properties was made in November 2012 and indeed was not a creditor at all in relation to the existing properties because liability to pay GST only arises on supply.[68] As Debut was registered on a payments basis, liability to pay accrued when the payment was received and, even then, Inland Revenue's GST debt would not have priority over the secured debts.[69]

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63 CA judgment, above n 4, at [61].
64 At [61].
65 At [61].
66 At [45].
67 At [47].
68 Rather, it only became a preferential creditor on the settlement of sales when GST became payable: at [38]. See also GST Act, s 8(1).
69 At [38]. But see above at [52] in relation to a sale by a receiver or liquidator. The Commissioner is a preferential creditor in relation to GST under sch 7 cl 1(5)(a) of the Companies Act.

[60] The Court of Appeal considered that the High Court had erred by assessing risk largely from the point of view of the risk of non-payment of the GST. That point of view failed to take sufficient account of the certain benefits to other creditors from obtaining higher prices for the properties and failed to acknowledge Mr Cooper's personal input of unpaid work and funds, which were to the "great advantage" of Debut and its creditors.[70]

Liquidators' submissions

[61] The liquidators submit, adapting the words of s 135(b), that Mr Cooper caused the business of Debut to be carried on, knowing there was more than a substantial risk of a GST shortfall.

[62] The liquidators point out Mr Cooper had options open to him other than liquidation. He could have tried to make appropriate arrangements with Debut's secured creditors for the payment of GST and all of the other fresh obligations incurred in completing the properties. He could have tried to negotiate a position with Inland Revenue prior to entering into the sale and purchase agreements. He could have ensured the sales were to GST registered entities and that the sales would be zero-rated for GST. He could have used the mechanisms in Parts 14, 15 or 15A of the Act for companies in financial difficulties. Mr Cooper did not explore any of these options.

Intervener's submissions

[63] The Attorney-General accepts that, if a failing property development company or its liquidator sells properties in their incomplete form, there is a risk that the net proceeds from those sales will be lower than if the properties were completed before sale. It is submitted, however, that if completion of properties will result in the company incurring new debts in circumstances where a portion of these new debts will not be paid, directors' duties under ss 131, 135 and 136 will be engaged.

[70] At [63].

Mr Cooper's submissions

[64] Mr Cooper submits that s 135 does not prohibit all conduct that may lead to insolvency. Section 135 only imposes liability where the directors have "unreasonably" risked insolvency.[71] Continuing to trade in circumstances of insolvency can be a legitimate business risk (and thus not a breach of s 135) if there is a probability of improving the position of most of the creditors, as there was in this case. He submits that the reasonableness of such actions must be assessed in terms of the benefit to the company as a whole and not by reference to any detriment to individual creditors.

History of s 135

[65] Section 135 had its genesis in s 320(1)(b) of the Companies Act 1955.[72] From 1980, this provided that company officers could be held personally liable for part or all of a company's debt if, during the winding up of a company, the officer was knowingly a party to the carrying on of any business of the company in a reckless manner.[73]

[66] The Law Commission considered that re-enacting s 320(1)(b) would "go too far in undermining the position of the company as a vehicle for the taking of business risk".[74] The Commission recommended a replacement section in the following form:[75]

> **105 Solvency**
>
> (1) A director of a company must not agree to the company entering into a contract or arrangement or acting in any other manner unless he or she believes at that time on reasonable grounds that the act concerned does not involve an unreasonable risk of causing the company to fail to satisfy the solvency test.

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71 Relying on Law Commission, above n 13, at [516].

72 Companies Amendment Act 1980, s 32. Section 320(1) of the Companies Act 1955 as amended also provided for liability of company officers where the company officer contracted a debt at a time they did not honestly believe on reasonable grounds that the company would be able to pay the debt as it fell due, and where the company officer carried on business with an intent to defraud creditors. On the law reform, see *Final Report of the Special Committee to Review the Companies Act* (March 1973) at [324]–[327].

73 The leading case on s 320(1)(b) recklessness was *Thompson v Innes* (1985) 2 NZCLC ¶96-064 (HC) (Bisson J).

74 Law Commission, above n 13, at [214].

75 Law Commission, above n 13, at 241.

…

[67] The Law Commission's draft section was not enacted. Section 135, as originally introduced, prohibited a director agreeing to the business of a company being carried on recklessly and extended the prohibition to causing or allowing that result.[76] According to the explanatory note, this reframed duty was based on s 320(1)(b) of the 1955 Act.[77]

[68] The current form of the section was recommended by the select committee based on feedback that the meaning of reckless trading was unclear.[78] The term "reckless" in s 135 as it was ultimately enacted is limited to the section heading, but the wording of the redrafted section is still generally thought to bear more resemblance to the old s 320(1)(b) than to the Law Commission draft.[79] The select committee described the current wording as "broadly reflecting judicial interpretation".[80]

[69] There has been much criticism of the current wording of s 135 and its deviation from the wording recommended by the Law Commission.[81] One of the main concerns is the extent to which s 135 may inhibit taking ordinary and legitimate business risks. This is particularly acute for businesses that might be high risk but have the potential for high return commensurate with the risk.[82] Another issue arises with regard to companies that might be having temporary financial difficulties and whether in such circumstances it is legitimate to continue trading and, if so, for how long.[83] We do not

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76 Companies Bill 1990 (50-1), cl 113.

77 Companies Bill 1990 (50-1) (explanatory note) at vii.

78 Companies Bill 1990 (50-2) (select committee report) at 6.

79 Watson and Taylor, above n 15, at [22.2.1], 615–616 and 618. See also Howes and Revill, above n 14, at [CA135.02] for a textual comparison between the old s 320 and s 135.

80 Companies Bill 1990 (50-2) (select committee report) at 6.

81 See generally Roderick Deane "'Besieged by Duties': Will the new Companies Act work for directors?" (paper presented to the Company Law Conference, February 1994); Hugh Rennie and Peter Watts "Directors' Duties and Shareholders' Rights" (New Zealand Law Society seminar, 1996) at 34–36; Brian JD Gould "Directors' Personal Liability" [1996] NZLJ 437; Sian Elias "Company law after ten years of reform" (paper presented to the Company Law Conference, April 1997) 1; and Roswell B Perkins "Corporate governance and the Companies Act of 1993" (paper presented to the Company Law Conference, April 1997) 81.

82 See for example Watts, above n 14, at [10.2.2], 272–274; and Watson and Taylor, above n 15, at [22.2], 611.

83 See for example, with regard to s 320(1)(b) of the 1955 Act, *Re South Pacific Shipping Ltd (in liq)* (2004) 9 NZCLC ¶96-964 (HC) at [125(3)]. In that case William Young J suggested that continued trading in the hope of salvage should last a matter of months only. We do not need to decide whether William Young J's approach applies to s 135 as it is common ground that Debut was not salvageable.

need to engage with these controversies for the purposes of this appeal as they do not arise on the facts.

Our assessment

[70] In this case Mr Cooper did not consider that Debut's financial position was salvageable. He knew at the beginning of November 2012 that completing the properties would lead to a GST shortfall of at least $300,000. To continue trading in such circumstances must be a breach of s 135. Loss to creditors in this case was not merely a "substantial risk". It was a certainty. And $300,000 must be a "serious loss".

[71] That the GST on future sales was not a current obligation at the end of October 2012 is beside the point, contrary to the view of the Court of Appeal.[84] Section 135 is necessarily forward-looking.

[72] It is also not an answer to s 135 that completing the properties was a sensible business decision in that it had the potential to benefit some of the creditors by providing higher returns than immediate liquidation would have done. It is not possible to compartmentalise creditors in this fashion. If continued trading would result in a shortfall, as Mr Cooper knew it would, then there was a breach of s 135, whether or not some creditors would be better off and whether or not any overall deficit was projected to be reduced.

[73] There is nothing in the wording of s 135 that envisages a comparative exercise between immediate liquidation and continued trading, where continued trading would still result in a deficit. This is particularly the case where continued trading is undertaken in a manner that means creditors will not be paid in accordance with the statutory priorities that would arise in liquidation. In this case, as the High Court found, there was a deliberate strategy to put the whole risk of loss on Inland Revenue.[85] This was despite the fact that GST on sales made by Debut would have, if Debut had been liquidated, ranked above unsecured trade debts.

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84 CA judgment, above n 4, at [38].

85 HC judgment, above n 1, at [40]. In the event, the loss was also borne by some new trade creditors (and the Trust).

[74] Contrary to the view of the Court of Appeal,[86] 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. We accept that Mr Cooper may have considered that issues with GST would be able to be resolved later but this is not sufficient to absolve him from responsibility.[87] We note in any event that Inland Revenue refused a compromise that was proposed in mid-November 2013.

[75] The duty under s 135 must also be assessed in light of the scheme of the Act and in particular Part 15A, which is the formal mechanism specifically designed to be used in an insolvency situation for increasing returns to creditors.[88] Under Part 15A, all creditors are consulted and voting is by value and class.[89] The same applies to compromises under Part 14.[90] In this case Inland Revenue was not consulted, even though Mr Cooper's intention when he decided to continue trading was that it would bear all the loss.

[76] Finally, we accept the liquidators' submission that there were a number of formal and informal options, other than immediate liquidation, that Mr Cooper could have explored to avoid breaching s 135. If those other options proved impossible to implement, however, then the only proper course would have been liquidation.

[77] It is also significant that Mr Cooper never deviated from the strategy decided in November 2012, despite Debut's continued difficulties. There was no material improvement in the position of the company after November 2012. Indeed, overall the trading performance was worse than Mr Cooper's costings in the November 2012 report. And, by the time of liquidation, leaving aside the GST, there was at least $28,712.34 in new trade debts left unpaid.[91]

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86 CA judgment, above n 4, at [47].
87 Contrary to the view of the Court of Appeal: CA judgment, above n 4, at [61].
88 Section 239A.
89 Section 239AK(2).
90 As noted above at [36] and [44]; and see s 230(1) and sch 5 cl 5(2).
91 See above at n 11 (where we note the liquidators contest this figure). There was also an outstanding debt of over $200,000 to the Trust.

Did Mr Cooper breach s 136 of the Act?

[78] Section 136 provides:

> **136 Duty in relation to obligations**
>
> A director of a company must 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 it is required to do so.

High Court decision

[79] The High Court held that, after the meeting with Mr Furlong on 6 November 2012, Mr Cooper could not reasonably have believed that Debut would be able to meet its GST obligations or other debts incurred after 31 October 2012 when they fell due.[92] There was therefore a breach of s 136.

Court of Appeal decision

[80] The Court noted that s 136, unlike s 135, focusses on the incurring of a particular obligation rather than on the carrying on of the business as a whole.[93] In this case, there were no agreements apart from the sale and purchase agreements. Certainly there was no agreement with Inland Revenue. The Court considered that the fact that an incidental GST liability would arise on particular sales did not make the agreements the sort of transactions that are the object of s 136.[94]

[81] The Court of Appeal also said that the obligation "to pay GST on the properties had its origins in the original purchase of these properties years earlier, when there is no question about the company's solvency".[95] Signing the agreement for sale and purchase was "a trigger, rather than the incurring of an obligation".[96] In these circumstances the Court did not consider that a particular sale transaction was the sort of mischief that s 136 is aimed to prevent. There was thus no breach of s 136.[97]

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92 HC judgment, above n 1, at [36]–[38]. The High Court found s 136 to be most directly relevant and dealt with it first for this reason and because the liquidators placed most emphasis on it: at [33].
93 CA judgment, above n 4, at [67].
94 At [68].
95 At [68].
96 At [68].
97 At [68].

Liquidators' submissions

[82] The liquidators accept that, by continuing to trade, Mr Cooper may have reduced Debut's obligations to secured creditors. However, doing so also caused Debut to incur new debt to Inland Revenue, an involuntary creditor. There were also ten new unsecured creditors whose products and/or services assisted in the completion of the remaining properties. Mr Cooper knew that these obligations, or at least the GST obligations, would not be met. It is submitted that Mr Cooper therefore breached s 136.

[83] Contrary to the view of the Court of Appeal,[98] the liquidators submit that there is no requirement for a direct agreement to incur an obligation between a company and a creditor (voluntary or otherwise). There is no policy reason for such a gloss to be put on the plain wording of the section. Mr Cooper was aware Debut would be required to account for GST on each sale when signing the sale and purchase agreements. In executing the sale and purchase agreements, he "agreed" to Debut incurring the obligation to pay GST. The liquidators submit further that the Court of Appeal's assessment of Mr Cooper's actions and its interpretation of s 136 wrongly legitimises the "robbing of Peter to pay Paul".

Intervener's submissions

[84] The Attorney-General submits that s 136 does not require an agreement between a company and the creditor. It is pointed out that the same wording is used in s 135 in a context that can only refer to the manner in which the business of the company is carried on. Further, removing statutory charges, tax or other non-contractual obligations from the ambit of s 136 (as the Court of Appeal's reasoning does) would remove the protection provided by that section, which cannot have been Parliament's intent. Section 136 was designed to remove any incentive to "rob Peter to pay Paul".

[85] The Attorney-General submits that the Court of Appeal was wrong to limit the scope of the duty in the circumstances of this case because of any latent liability to

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98 CA judgment, above n 4, at [67].

pay GST arising from the original purchase or otherwise. Culpability and the extent to which the conduct caused the loss should be taken into account when considering relief under s 301. It should not limit the scope of the duty.

[86] The Attorney-General also points out that, had Debut been placed in liquidation at the end of October 2012, the GST on any subsequent sales would have been paid in full as part of the cost of liquidation. The same would apply with regard to a mortgagee sale. Further, in many cases there could be an issue of input tax having been claimed with regard to the costs incurred for goods and services in completing properties in circumstances where it is known (or where the director has reasonable grounds for believing) that the output tax (included in the sale price of the properties) will not be paid.[99]

Mr Cooper's submissions

[87] Mr Cooper submits that s 136 is directed towards contractual obligations incurred with the agreement of the director, rather than to tax debts.[100] He supports the finding of the Court of Appeal that entering into the sale and purchase agreements did not mean a contractual obligation to pay GST.[101]

[88] It is also pointed out that s 135 uses the words "cause or allow" as well as "agree", whereas s 136 uses only "agree". Mr Cooper submits that the word "agree" in s 135(a) must mean something other than "cause or allow" in s 135(b). In his submission, ss 135(a) and 136 must be read consistently. The word "agree" therefore in s 136 must mean something other than cause or allow.

[89] Further, the focus in s 136, as with s 135, should be on the duty to the company and to the creditors as a whole rather than on any individual creditor. The general question remains whether Mr Cooper and Debut exposed creditors as a whole to illegitimate risk.

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99 The Attorney-General accepts that in this case no GST refunds were paid to Debut and that, if refunds had been claimed, they would have been offset against the output tax that had not been paid from earlier periods.
100 Citing *Grant v Johnston* [2015] NZHC 611 at [134]–[135].
101 Referring to CA judgment, above n 4, at [67]–[68].

[90] In any event, under s 136, the time to assess the liability to pay GST is at the time the properties were first acquired.[102] Given that the properties in this case were acquired in the course of a taxable activity, a contingent or prospective liability to pay GST arose at that time.

Our assessment

[91] Section 136 is directed to the incurring of obligations without a reasonable belief that the company will be able to perform the obligations when they fall due. We do not accept that the section is limited to direct contractual obligations.[103] The word "agree" is used in s 135 as well as in s 136. We do not accept Mr Cooper's submission that the term in s 136 is limited to agreeing to a contractual obligation. We accept the liquidators' submission that there is no policy reason why there should be such a gloss placed on the section.[104]

[92] As Mr Cooper points out, the words "cause or allow" are used in s 135 as well as the word "agree".[105] It may be that "agreeing" to an action connotes a more active role than "allowing", and a more direct relationship to the particular decision than "causing".[106] This is not the place, however, to decide any nuances in the meaning of those words. In this case Mr Cooper made the decision as director that Debut would enter into the sale and purchase agreements, knowing that as a result Debut would incur the GST obligation on the sale prices charged. He had an active and direct role in those sales and was thus agreeing to Debut incurring the GST obligation.

[93] We do not accept Mr Cooper's submission that the time to assess the liability to pay GST is at the time the properties were first acquired. GST is not payable until

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102 Referring to CA judgment, above n 4, at [68]: the Court of Appeal said that GST arose at the time when the properties were originally purchased and so Mr Cooper, when Debut became insolvent, could not later be characterised as "agreeing" with Inland Revenue to incur GST as an obligation.

103 In any event, it would be the company that was the party to any contract and not the director.

104 It has been suggested that s 136 applies only to debts on capital account and not on revenue account: *Peace and Glory Society Ltd v Samsa* [2009] NZCA 396, [2010] 2 NZLR 57 at [44]; and *Grant v Johnston* [2016] NZCA 157 at [43]. That position was not argued in this case and so we do not address it. We comment, however, that it does not seem to have any basis in the statutory wording.

105 Section 135(a) uses "agree" and s 135(b) uses "cause or allow".

106 See *FXHT Fund Managers Ltd (in liq) v Oberholster* (2009) 10 NZCLC ¶97-053 (HC) at [40]; and *Ulsterman Holdings Ltd (in liq) v Walls* [2017] NZHC 3040 at [40]. See also Howes and Revill, above n 14, at [CA301.06(4)].

the time of supply and therefore there is no debt until that time. We accept the submission of the Attorney-General that any prospective liability to pay GST from the time of the purchase of the properties is not relevant to the issue of whether or not there was a breach of duty. It may, however, be relevant in calculating any relief ordered under s 301.

[94] We also accept the submission of the liquidators and the Attorney-General that it is clear from the existence of s 136 that it is not legitimate to enter into a course of action to ensure some creditors have a higher return where this is at the expense of incurring new liabilities which will not be paid. In other words, it is not legitimate to "rob Peter to pay Paul". This is also clear from the scheme of the Act, including the statutory priorities.

[95] In this case Mr Cooper knew from the beginning of November 2012 that there would be a GST shortfall and nothing that occurred after that point suggested that this assessment was inaccurate. This means that there must have been a breach of s 136 when the relevant properties were sold and the GST debts incurred. Indeed, the last two properties were sold after Inland Revenue had served a statutory demand.[107]

[96] We also note that, although Mr Cooper may have had reasonable grounds at the end of October 2012 to consider that all trade creditors would be paid, directors' duties are continuous. This means that, if any of the trade debts left outstanding at liquidation had been incurred at a time when it was clear those debts would not be paid, Mr Cooper breached the duty under s 136 in that regard also.

Did Mr Cooper breach s 131 of the Act?

[97] Section 131(1) provides:

> **131 Duty of directors to act in good faith and in best interests of company**
>
> (1) Subject to this section, a director of a company, 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.

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[107] See above at [21]–[23].

High Court decision

[98] The High Court held that Mr Cooper, by reducing the guaranteed liabilities of both Mr Cooper and the Trust, acted in his own interests rather than those of Debut (or its creditors).[108]

[99] The High Court held that Mr Cooper had breached his duty under s 131(1) in two respects. First, when he applied the funds realised from the sale of properties to fund further work and to satisfy secured debts which he had personally guaranteed. In doing so, the Court considered he "was not acting in good faith as he was not considering the obligations that Debut owed to *all* its creditors".[109] Secondly, Mr Cooper was acting in his own interests above those of Debut. The Court said:[110]

> By failing to pay GST to the Commissioner, Mr Cooper was creating a new debt for Debut, which would be subject to penalties and interest totalling $84,088.31, while limiting his own liability for debts guaranteed by himself. No director of a company could seriously believe in good faith that accruing a large tax debt, with no way of paying it, could be in a company's best interests.

[100] Mr Cooper created new debt for Debut, contrary to the company's best interests, and neglected to satisfy its GST obligations, contrary to good faith obligations. Indeed, the Court considered that there had been a deliberate strategy for Inland Revenue to carry the risk of the projected shortfall, pointing out that not all of the surplus funds from the sale of properties had been paid to secured creditors.[111]

[101] For all of these reasons, the High Court held that Mr Cooper had breached his duties under s 131(1) of the Act.

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108 HC judgment, above n 1, at [49].

109 At [50].

110 At [50]. This seems to be a factual finding that Mr Cooper had no honest belief he was acting in the best interests of Debut on the analysis set out in the last sentence of [109] below. The High Court did not consider there had been a decision to trade out of difficulties in any meaningful sense given such a large debt was allowed to accumulate and there was no contact made with Inland Revenue about that course of action: at [65].

111 At [39]–[40]. The High Court at [49] said: "Mr Cooper acted in his own interests when he sought to pay off the secured and guaranteed debts. In doing so he neglected to satisfy the obligation of Debut to account for GST to the Commissioner. The GST collected on the sales was instead used to pay off the guaranteed and secured debts and create cashflow which was applied to the completion of the other properties, the proceeds of which were used in similar fashion. The ultimate result was to reduce the guarantee liability of Mr Cooper and the Trust."

Court of Appeal decision

[102] The Court of Appeal's reasoning on s 131 was based on the same factors as for s 135. The Court of Appeal considered that Mr Cooper had taken a sensible business decision to complete the properties. In particular, Mr Cooper's actions had the effect of making it more likely that the secured creditors would be paid.[112] There would also be a better return for creditors as a whole.[113]

[103] The Court noted that Debut, as a property development company, had a potential liability to pay GST on each property from the time of the original purchase, despite the quantum of that obligation not then being known and despite the obligation to pay not then being crystallised.[114] In addition, the Court considered that Inland Revenue also benefited from the higher sale prices.[115]

[104] In light of the above background, the Court concluded that in deciding to complete the remaining properties, Mr Cooper was acting in good faith and in what he believed to be the best interests of the company. Any benefit to him taking that course was incidental. There was therefore no s 131 breach. The Court said:[116]

> Completing the buildings was a reasonable commercial course. Mr Cooper would get incidental benefits in that the secured debt would be more reduced, but he put in significant new funds, and provided one and a half years['] work without pay. But it could be said that everyone, including [Inland Revenue], stood to get more money because of his actions.

Liquidators' submissions

[105] The liquidators submit that, in continuing to trade, Mr Cooper knowingly caused Debut to incur obligations (in particular, GST obligations) without a reasonable belief they could be met, contrary to his duty to act in the best interests of Debut. Further, he was in a position of conflict of interest by causing Debut to use the GST raised from sales to ensure that those debts personally guaranteed by him or by related

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112 CA judgment, above n 4, at [49].
113 At [58]–[59].
114 At [39].
115 At [47]. The Court pointed out that Mr Cooper's actions had the effect of increasing the amount of GST that would be payable because of the greater sale prices. It said at [47]: "Ironically, [Inland Revenue] in this sense may have benefited from the extra work."
116 At [60] (footnote omitted).

parties were paid first, when he knew there would be no funds left to meet Debut's GST obligations. He thus breached s 131.

Intervener's submissions

[106] The Attorney-General submits that Parliament intended that the duties in the Act be read together. Thus the s 131 duty to act in the best interests of the company includes a consideration of risks to creditors in circumstances of doubtful solvency. It is also noted that a director who has, like Mr Cooper, guaranteed some of the liabilities of a company may have a significant incentive to replace an existing creditor with a new creditor.

Mr Cooper's submissions

[107] Mr Cooper supports the approach of the Court of Appeal of considering directors' duties from the perspective of the company and the body of creditors as a whole. It is submitted that the Court of Appeal was correct to assess the issue of good faith in s 131 in this light and in terms of the overriding duty to act in the best interests of the company. By contrast, the High Court wrongly considered the situation from the perspective of one creditor only, the Inland Revenue.

[108] Mr Cooper submits that the steps he took improved the overall asset base of Debut and minimised the ultimate loss to creditors as a whole. This meant that there was no conflict of interest and no lack of good faith. In any event, if liquidation had taken place in November 2012, there would not have been any funds left after paying the secured creditors.

The law

[109] The obligation in s 131(1) to act in the best interests of the company is expressed subjectively: the director must act "in what the director believes to be the best interests of the company". If it is a subjective test, as the wording would suggest, this would mirror the position at common law.[117] It does not detract from the subjective nature of the test that directors will probably have a hard task persuading

[117] *Re Smith and Fawcett Ltd* [1942] 1 Ch 304 (CA) at 306 per Lord Greene MR.

the court that they honestly believed that an act or omission that resulted in substantial and foreseeable detriment to the company was in the company's best interests.[118] Under a subjective test, the fact that an allegedly unreasonable belief was held may, however, provide evidence that the belief was not honestly held.[119]

[110] The original section proposed by the Law Commission was expressed objectively, imposing an obligation to act in good faith and "in a manner that [the director] believes on reasonable grounds is in the best interests of the company".[120] That proposal was explicitly rejected by the drafters of the bill.[121]

[111] It has been suggested, however, that the caselaw nevertheless currently tends towards the objective approach recommended by the Law Commission.[122] Reference in this regard is made to the following passage from *Sojourner v Robb* in the High Court:[123]

> … the standard in s 131 is an amalgam of objective standards as to how people of business might be expected to act, coupled with a subjective criterion as to whether the directors have done what they honestly believe to be right. The standard does not allow [directors] to discharge the duty by acting with a belief that what [they are] doing is in the best interest of the company, if that belief rests on a wholly inappropriate appreciation as to the interests of the company.

[112] We do not consider this passage is correct. The test is subjective. This follows from the wording of s 131 (expressed subjectively) and the legislative history (the fact that the Law Commission's reasonableness requirement was not enacted). This aligns with the common law test and policy considerations. Courts are not well equipped, even with the benefit of expert evidence, to second-guess the business decisions made by directors in what they honestly believed to be in the best interests of the company.[124]

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118 *Regentcrest plc (in liq) v Cohen* [2001] 2 BCLC 80 (Ch) at [120]. The Court did not refer in this context to the detriment to the company also being foreseeable, but this must be the case.

119 *Extrasure Travel Insurances Ltd v Scattergood* [2002] EWHC 3093 (Ch), [2003] 1 BCLC 598 at [90].

120 Law Commission, above n 13, at 241.

121 Companies Bill 1990 (50-1) (explanatory note) at vi. The explanatory note said the bill's clause confirms the approach of the courts in not reviewing the merits of individual business decisions.

122 See Watson and Taylor, above n 15, at [18.3.4], 525–526. By contrast, see the emphasis in other texts on the subjective standard in s 131: Howes and Revill, above n 14, at [CA131.02]; and Watts, above n 14, at [6.1], 141–142.

123 *Sojourner* (HC), above n 17, at [102]. This passage was not explicitly referred to by the Court of Appeal in *Sojourner* (CA), above n 17, but it must have accepted it in upholding the finding that there was a breach of s 131.

124 See Companies Act, long title para (d). See also Howes and Revill, above n 14, at [CA131.02].

The courts would also be judging directors' decisions with all the dangers of judging with the benefit of hindsight. A subjective test is consistent with English authority.[125] Further, there is also already an objectively-judged statutory duty of care in s 137.[126]

[113] Commentary and caselaw suggest that there are, however, a number of exceptions and qualifications to the subjective test:

(a) where there is no evidence of actual consideration of the best interests of the company;[127]

(b) where, in an insolvency or near-insolvency situation, there is a failure to consider the interests of creditors;[128]

(c) where there is a conflict of interest or where the action was one no director with any understanding of fiduciary duties could have taken (although some would suggest these may rather be treated as breaches of the duty of good faith (as the High Court did in this case) or of s 133 (powers must be exercised for a proper purpose));[129] and

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125 See *Regentcrest*, above n 118, at [120]; *Extrasure*, above n 119, at [90]; and *Re HLC Environmental Projects Ltd (in liq)* [2013] EWHC 2876 (Ch), [2014] BCC 337 at [91]. The authors of *Morison's Company Law* (online ed, LexisNexis) at [24.9] suggest the position in Australia regarding s 181 of the Corporations Act 2001 (Cth) is similar, relying on for example *Re Ledir Enterprises Pty Ltd* [2013] NSWSC 1332, (2013) 96 ACSR 1, but we do not consider that to be clearly supported by authority. See for example *Cassimatis v Australian Securities and Investments Commission* [2020] FCAFC 52, (2020) 376 ALR 261 at [23]–[30] per Greenwood J and [258] per Rares J; and *Re Idylic Solutions Pty Ltd* [2012] NSWSC 1276 at [1487]. But see *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239, (2008) 39 WAR 1 at [4619] per Owen J (with whom the Court of Appeal agreed in *Westpac Banking Corp v Bell Group Ltd (in liq) (No 3)* [2012] WASCA 157, (2012) 44 WAR 1 at [2736] per Carr AJA).

126 Section 137 was not relied on in this case.

127 *Re HLC*, above n 125, at [92(b)].

128 *Morison's Company Law*, above n 125, at [24.13], citing among other authorities *Nicholson*, above n 17, and *Sojourner* (CA), above n 17. See also *Re HLC*, above n 125, at [92].

129 *Australian Growth Resources Corp Pty Ltd (in rec and stat man) v Van Reesema* (1988) 13 ACLR 261 (SASC) at 269 per King CJ; and *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* [1927] 2 KB 9 (CA) at 18 per Bankes LJ. For New Zealand cases, see *Adtraction Marketing Ltd (in liq) v Ehrenfeld* [2018] NZHC 2777 at [55] (the director was held to be in breach of s 131 by authorising payments to companies made for the effective benefit of companies controlled by the director); *Holland Corporate Ltd v Holland* [2015] NZHC 1407 at [39]; *Vercauteren v B-Guided Media Ltd* [2011] NZCCLR 9 (HC) at [51] (the director was held to be in breach of s 131 when he proposed to the board of the company that dividends should be paid to himself and other directors, at a time when he alone knew of the company's finances and that various debts were at the time contingent liabilities); *Peace and Glory Society Ltd (in liq) v Samsa* HC Auckland CIV-2007-404-700, 2 December 2008 at [8] (the s 131 finding was not appealed); and *Delegat v Norman* [2012] NZHC 2358 at [103].

(d) where a director's decisions are irrational.[130]

[114] In this case, the relevant paragraph is [113(b)]. With regard to (a) and (b), we do not see these as being exceptions or qualifications to the subjective test at all.[131] The point is that directors cannot subjectively believe they are acting in the best interests of the company if they have failed to consider the interests of the company or, where required, the interests of all of the creditors, including prospective creditors.

[115] We do not for the purpose of this appeal need to decide if the factors set out at (c) or (d) are qualifications or exceptions. We do note, however, that in an insolvency situation where the interests of all creditors have not been considered (the situation set out in (b)), a conflict of interest may well exacerbate the breach.

Our assessment

[116] In this case, Mr Cooper believed that completing the properties would provide higher returns to some creditors. He failed, however, to consider the interests of all creditors in an insolvency situation.[132] He considered the interests of only some of the creditors. He also had Debut incur debts to Inland Revenue and some trade creditors that he knew would not be paid. We thus agree that he did breach his duties under s 131(1) in the two respects found by the High Court.[133]

[117] Mr Cooper's failure to consider the interests of all creditors was exacerbated by the fact that Mr Cooper acted in his own interests and in direct conflict with Debut's best interests when he sought to pay off the secured debts, ultimately reducing his own guaranteed liability and that of the Trust, instead of satisfying Debut's GST and other obligations incurred in completing the properties.

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130 See for example *Hutton v West Cork Railway Co* (1883) 23 Ch D 654 (CA) at 671 per Bowen LJ; and, more recently, *Westpac Banking Corp v Bell Group Ltd (in liq) (No 3)*, above n 125, at [2772] per Carr AJA. See also *Morison's Company Law*, above n 125, at [24.9], where the authors adopt Lord Sumption's explanation of irrationality in the context of criminal harassment (as in *Hayes v Willoughby* [2013] UKSC 17, [2013] 1 WLR 935 at [14]) and apply that to s 131 in the New Zealand context.

131 Something similar could be said about [113(c)]: a person cannot honestly believe that an action is in the company's best interests if that decision is distorted by a conflict of interest.

132 See above at [113(b)].

133 See above at [99].

[118] Also relevant is Mr Cooper's strategy of placing the whole loss on Inland Revenue, contrary to the statutory priorities and in circumstances where the GST portion of the sale price had been collected from the purchasers. As noted above, not all the proceeds from the sales made after October 2012 went to secured creditors.[134] Further, had the unfinished properties been sold to a developer as a going concern, no GST would have been payable and, in the event of a liquidation or receivership, any GST on the sales would have been paid by the liquidator or receiver.[135] In effect, Inland Revenue (and thus the taxpayer) was being used as an involuntary bank.

[119] For the above reasons Mr Cooper's actions were in breach of s 131.

Does s 138 assist Mr Cooper?

[120] Section 138 in relevant part provides:

> **138 Use of information and advice**
>
> (1) Subject to subsection (2), a director of a company, when exercising powers or performing duties as a director, may rely on reports, statements, and financial data and other information prepared or supplied, and on professional or expert advice given, by any of the following persons:
>
> …
>
> (b) a professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional or expert competence:
>
> …
>
> (2) Subsection (1) applies to a director only if the director—
>
> (a) acts in good faith; and
>
> (b) makes proper inquiry where the need for inquiry is indicated by the circumstances; and
>
> (c) has no knowledge that such reliance is unwarranted.

134 See above at [10] and [16]–[17].
135 See above at [51]–[52].

High Court decision

[121] The High Court doubted whether s 138 is properly characterised as a defence. The Judge accepted that if it were reasonable to rely on professional advice, that would go against there being a breach of duty.[136] Even if s 138 is a defence, the Court considered that it did not apply in the present case: the professional advice relied on was the 6 November 2012 advice but the GST deficit was discussed at that meeting and Mr Cooper therefore knew about the projected deficit.[137] The Court accepted that Mr Furlong probably used language that Debut "should be okay", or "should be able to trade out" but this is not the type of professional advice contemplated by s 138 and a director would "not be acting in good faith to rely on such generalised and loose statements".[138] Finally, as Mr Cooper considered dealing with Inland Revenue to be "the lesser of two evils", the High Court did not accept there was a plan to trade out of difficulties in any meaningful sense as there was no follow up with Inland Revenue.[139]

Court of Appeal decision

[122] As the Court found that Mr Cooper did not breach his duties to Debut, it did not need to deal with the s 138 issue. It commented, however, that it would have agreed with the High Court on this point as there was nothing in the way of "reports, statements, and financial data and other information" that would have fallen within s 138.[140]

Liquidators' submissions

[123] It is submitted that the High Court was correct to find that s 138 does not apply in this case. It would not be acting in good faith to rely on Mr Furlong's vague and generalised statements, particularly given the clear substantial projected shortfall that Mr Cooper either knew about or could readily calculate himself.

136 HC judgment, above n 1, at [58].
137 At [59] and [61].
138 At [62]–[63].
139 At [65].
140 CA judgment, above n 4, at [77].

[124] The liquidators further submit that Mr Cooper generated the key financial information himself and did not rely on Mr Furlong for this. He neither asked nor was advised whether or not his planned approach complied with his duties as a director. Ultimately, that was a decision for Mr Cooper himself to make, regardless of what Mr Furlong had said.

Mr Cooper's submissions

[125] Mr Cooper submits that s 138 does provide a defence. Mr Furlong was the appropriate person to rely on and Mr Cooper's reliance on him was reasonable. Mr Furlong gave critical advice as to whether Mr Cooper could continue to trade notwithstanding the shortfall in GST, encouraging Mr Cooper's belief that there was an ability to trade out and that completing the partially developed properties and then selling them was permissible. There was no suggestion by Mr Furlong that continuing to trade was a breach of duty and no advice given that the company should be liquidated.

Our assessment

[126] The approved question on which leave was granted was whether the Court of Appeal was correct to allow the appeal.[141] This question is arguably wide enough to encompass the application of s 138, which both of the Courts below found did not apply in this case.

[127] We agree that the advice given by Mr Furlong was generalised and not the type of advice to which s 138 is directed. As the High Court points out, the projected GST shortfall was discussed at the meeting on 6 November 2012. It should have been clear to Mr Cooper that continued trading in such circumstances would breach ss 131, 135 and 136.

[141] Leave judgment, above n 5.

Should the GSA have been set aside?

[128] Section 299(1) provides that the Court may set aside certain securities and charges:

> **299 Court may set aside certain securities and charges**
>
> (1) Subject to subsection (2), if a company that is in liquidation is unable to meet all its debts, the court, on the application of the liquidator, may order that a security or charge, or part of it, created by the company over any of its property or undertaking in favour of—
>
> (a) a person who was, at the time the security or charge was created, a director of the company, or a nominee or relative of or a trustee for, or a trustee for a relative of, a director of the company; or
>
> (b) a person, or a relative of a person, who, at the time when the security or charge was created, had control of the company; or
>
> (c) another company that was, when the security or charge was created, controlled by a director of the company, or a nominee or relative of or a trustee for, or a trustee for a relative of, a director of the company; or
>
> (d) another company, that at the time when the security or charge was created, was a related company,—
>
> shall, so far as any security on the property or undertaking is conferred, be set aside as against the liquidator of the company, if the court considers that, having regard to the circumstances in which the security or charge was created, the conduct of the person, relative, company, or related company, as the case may be, in relation to the affairs of the company, and any other relevant circumstances, it is just and equitable to make the order.

High Court decision

[129] The High Court made a s 299 order setting aside the Trust's GSA on the basis that it was just and equitable to do so.[142] It had already held that Debut was in liquidation, unable to meet all its debts, and that the security was created in favour of Mr and Mrs Cooper as settlors, trustees and principal beneficiaries of the Trust.[143] It

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142 HC judgment, above n 1, at [134] and [143(c)].

143 At [119]–[120].

then noted that much of the previous case law concerning s 299 was not analogous to this case.[144]

[130] The Court nevertheless concluded that this was an appropriate instance in which to exercise the s 299 jurisdiction, relying in part on *Madsen-Ries v Greenhill* and the fact that the Trust was in this case at least a closely related third party of Mr Cooper, if not his alter-ego.[145] It considered that it would frustrate the purpose of claiming against Mr Cooper for breaches of directors duties only to have the Trust able to claim the benefit of the judgment through the GSA, thus indirectly returning the compensation money to Mr Cooper.[146]

[131] The High Court accepted the liquidators' submission that the GSA should be set aside only in part to cover the amounts awarded to the liquidators in respect of compensation under s 301 and the voidable transaction under s 292. This meant that, if any other amounts later become available to satisfy the creditors of Debut, the Trust could invoke the GSA in relation to those additional amounts.[147]

Court of Appeal decision

[132] The Court of Appeal did not consider it just and equitable in the circumstances to set aside the GSA in whole or in part.[148] The GSA did not secure past advances. Rather, it secured advances made over the period from 4 March 2013 to 11 February 2014.[149] Mr and Mrs Cooper did not have an ulterior motive. They merely wished to make a significant new advance to Debut "to enable it to trade its way out of an insolvent situation".[150] Given the ultimate shortfall, the advance ranked below existing secured creditors and repayment would depend on the sale of the developed

144 At [121]–[125], citing *Petterson v Browne* [2016] NZCA 189; and *Harris v Bank of New Zealand* [2017] NZHC 2374. *Harris* has since been overturned on appeal but s 299 was not in issue: *Faupaito v Harris* [2018] NZCA 497, [2019] NZAR 192.
145 At [126]–[134], citing *Madsen-Ries v Greenhill* [2016] NZHC 3188, [2017] NZCCLR 6 at [111]–[112].
146 At [132].
147 At [133].
148 CA judgment, above n 4, at [85].
149 At [80].
150 At [84].

properties.[151] The Trust was only partly repaid, leaving a deficit of more than $200,000.

[133] The Court considered that this indicated the GSA was "a sincere and proper investment made for the benefit of the company and creditors".[152] Partial repayment could not be criticised because the money advanced ultimately significantly improved the return to the creditors. Further, no commercial person "would have advanced such a sum, so slenderly secured, to an insolvent company".[153]

[134] The Court expressly made no comment on any ability on the part of the liquidators to challenge any late proof of debt by the Trustees on other grounds.[154]

Liquidators' submissions

[135] The liquidators submit that this issue is discrete and not particularly complex. It is pointed out that the High Court set aside the GSA only in respect of the orders made in that judgment and not more broadly.

[136] The liquidators support the High Court's finding that the Trust was either an alter-ego of Mr Cooper or a closely related party.[155] The test under s 299 is that the court can make the order setting aside certain securities and charges if in the circumstances it is just and equitable to make the order. The liquidators support the High Court conclusion that it would be just and equitable to set aside the GSA because it would frustrate the liquidators' claim if the Trust or its trustees were able to claim the benefit of the judgment through the GSA and ultimately return that money to Mr Cooper.[156]

[137] Moving beyond the High Court's reasons, the liquidators also say that two other factors are relevant in terms of what is just and equitable. The first factor is that Mr Cooper was well aware of the facts giving rise to what the liquidators say were

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151 At [82].
152 At [84].
153 At [85].
154 At [86].
155 HC judgment, above n 1, at [132].
156 Supporting the HC judgment, above n 1, at [132].

breaches of his directors' duties. He was well aware of the GST shortfall. He was well aware of the ongoing cost overruns and he was well aware of Debut's precarious financial position. The second factor is that the Trust was a guarantor of the BNZ loan from April 2013. The Trust itself therefore had a vested interest in the completion of the last properties.

Mr Cooper's submissions

[138] Mr Cooper submits that the Court of Appeal was correct to quash the order setting aside the GSA in circumstances where the trustees had provided valuable and new consideration. He submits that the test for s 299 incorporates some of the same considerations of what is fair to the company as under s 161 of the Companies Act.[157]

[139] Mr Cooper relies also on policy considerations. The possible denial of credit from related parties to companies at the time of their greatest need should be avoided, as should catching spouses of directors (who are not directors themselves) within the net of directors' duties because of company funding coming from relationship property. Finally, if s 299 is allowed to operate to set aside charges where new consideration had been advanced by related parties, it may discourage banks from making funds available on collateral security.

Our assessment

[140] We accept that the money lent by the Trust consisted of new funds introduced to enable the properties to be completed. However, we agree with the High Court that it would frustrate the purpose of the liquidators pursuing judgment against Mr Cooper if Mr and Mrs Cooper as trustees of the Trust were able to reclaim the benefit of the judgment through the GSA and indirectly return any compensation to Mr Cooper.[158] Mr and Mrs Cooper control the Trust as trustees and are its primary beneficiaries.

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[157] Section 161 provides that a board of a company may (subject to constitutional restrictions) authorise the payment of remuneration or other benefits (such as the making of a loan) by the company to a director if the board is satisfied it is fair to the company to do so. Directors voting in favour of such proposals must certify and give reasons for their opinion as to why it is fair to the company.

[158] HC judgment, above n 1, at [132].

[141] It is also relevant that the loan and the security would not have existed but for the decision of Mr Cooper, in breach of his duties as a director, to cause Debut to continue trading in order to complete the properties. We also accept that it is relevant that the Trust itself was a guarantor of Debut's secured loans from April 2013.

[142] We therefore consider that the High Court was correct to set aside the GSA to the extent that it did. We would also restore the order reserving leave set out at [4(c)] above.[159]

What level of relief is appropriate?

[143] Section 301(1) in relevant part provides:

> **301 Power of court to require persons to repay money or return property**
>
> (1) If, in the course of the liquidation of a company, it appears to the court that a person who has taken part in the formation or promotion of the company, or a past or present director … of the company, has misapplied, or retained, or become liable or accountable for, money or property of the company, or been guilty of negligence, default, or breach of duty or trust in relation to the company, the court may, on the application of the liquidator … ,—
>
> (a) inquire into the conduct of the … director … ; and
>
> (b) order that person—
>
> (i) to repay or restore the money or property or any part of it with interest at a rate the court thinks just; or
>
> (ii) to contribute such sum to the assets of the company by way of compensation as the court thinks just;

159 We note that there was no argument in this case on whether the principle from *Re Yagerphone Ltd* [1935] Ch 392 (Ch) that liquidators' recoveries are held for the benefit of unsecured creditors applies not only to voidable preferences but also to recoveries under ss 135 and 136 of the Act. We thus make no comments on that point but note the Insolvency Working Group considers that the principle does not extend that far and recommends an amendment to the Companies Act so that recoveries from reckless trading claims under s 301 are for unsecured creditors only: Insolvency Working Group *Review of Corporate Insolvency Law: Report No 2 of the Insolvency Working Group, on voidable transactions, Ponzi schemes and other corporate insolvency matters* (Ministry of Business, Innovation and Employment, Wellington, May 2017) at 47. The Office of the Minister of Commerce and Consumer Affairs has accepted that recommendation: Cabinet paper "Insolvency Law Reform" (23 September 2019) at [39] and recommendation eight.

High Court decision

[144] The High Court said that, while Mr Cooper was in breach of his duties and clearly had preferred secured creditors and therefore himself, he thought his actions would provide the best likely outcome for the creditors as a whole and in particular unsecured trade creditors.[160] This was because he was operating on the mistaken assumption that the only parties who would receive funds on a liquidation would be the secured creditors, not appreciating that, on a liquidation, Inland Revenue becomes a preferential creditor.[161]

[145] The High Court considered that this was a case that fell into the general category of cases where the court approaches compensation from the starting point of debts incurred and not paid between the breach date and the date of liquidation.[162] It began by assuming that all of the unpaid unsecured debts were incurred after 31 October 2012, except for the GST consequent on the sales of 2 and 7 Karika Place. It deducted $100,000 for that GST debt, giving a total (excluding interest and penalties) of approximately $316,000.[163]

[146] In making its compensation determination, the High Court made an allowance of $80,000 to recognise the contribution of Mr Cooper and of the Trust after 31 October 2012, including Mr Cooper working for 18 months without salary and the fact that the Trust has not been repaid all of the funds it had lent to facilitate completion of the properties.[164] It considered that this was not one of the more extreme cases of director misconduct where all company losses should be made good.[165] It did, however, consider that any allowance had to be less than Mr Cooper's input and much less than the increase in core GST in order to recognise that his actions were in breach of duty.[166]

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160 HC judgment, above n 1, at [78]. The High Court said its understanding was that the trade creditors would not have fared well in a 31 October 2012 liquidation.

161 At [78]. See also above at [52]–[53].

162 At [74] and [79], referring to Lang J's comments in *Goatlands Ltd (in liq) v Borrell* (2006) 3 NZCCLR 726 (HC) at [119]–[120]. This case in turn referred to the decision of *Löwer v Traveller* [2005] 3 NZLR 479 (CA) at [80], upholding the award made by William Young J in the High Court in *Re South Pacific Shipping*, above n 83.

163 At [83].

164 At [84]–[85]. The Court found that the value of these inputs was at least $320,000.

165 At [75]–[76], referring to *Re Wait Investments Ltd (in liq)* [1997] 3 NZLR 96 (HC) at 103–105.

166 At [85].

[147] The High Court said that the figure finally taken into account in respect of the Inland Revenue debt was approximately half of the core debt, leading it to add half of the accrued GST interest and penalties, reaching a rounded compensation figure of $280,000.[167]

Court of Appeal decision

[148] The Court of Appeal considered it would be artificial for it to assess compensation under s 301, given it found Mr Cooper was not liable for breach of directors' duties.[168] The Court did observe that, even if a breach of duty was found to exist, the High Court's finding that compensation of $280,000 should be paid by Mr Cooper was clearly in error. The Court of Appeal considered that the High Court had failed to account for the fact that much of the GST liability was likely to have been pre-existing and also had failed to factor in the extent to which Mr Cooper increased the amount of that debt by completing the properties.[169]

Liquidators' submissions

[149] The liquidators submit that there is a principled basis for a higher award of compensation than awarded by the High Court. However, they did not cross-appeal in relation to the level of compensation awarded. In the Court of Appeal the liquidators reserved their right to justify the compensation on alternative approaches to that adopted by the High Court.

[150] It is submitted that compensation in this case should not be limited to the difference between what Debut's losses may have been had it stopped trading on 31 October 2012, and the amount of outstanding obligations on liquidation. Compensation should respond to the breach and, where appropriate, the manner of the ongoing trading.[170] Where the wrong is taking on fresh liabilities, it follows that compensation should be measured by the size of the liabilities wrongfully taken on

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167 At [86]. The Court did not consider that the obiter statement in *Peace and Glory Society*, above n 104, at [75] (that penalties and interest are not recoverable under s 301) was correct and noted that counsel for Mr Cooper and the Trust had not raised any argument to the contrary.

168 CA judgment, above n 4, at [94].

169 At [95].

170 The liquidators relied on Gabriel Moss "No compensation for wrongful trading – where did it all go wrong?" (2017) 30 Insolv Int 49.

and not paid. Limiting compensation to the net increase in outstanding obligations to creditors provides directors with the perverse incentive of continuing to trade as long as they are careful to "rob Peter to pay Paul" and to make sure that the net deficit remains constant.

[151] In any event, the liquidators argue that Mr Cooper has not demonstrated a reduction in total creditor losses by his actions. On the liquidators' figures, there was a net increased deficit of some $103,000, compared to a notional liquidation at the end of October 2012.[171] The liquidators' calculations include the shortfall owed to the Trust, arguing that this should be included because the amount that would have been owing to secured creditors is included at the time of the notional liquidation.

[152] The liquidators also point out that, while the Trust injected and lost funds, it advanced those funds as part of a scheme to help Mr Cooper avoid personal liability and later the Trust's own liability. It is submitted that Mr Cooper working for one and a half years without pay must also be seen in the context of avoiding liability.

Intervener's submissions

[153] The Attorney-General made no submissions on the appropriate level of compensation in this case but submits that the inquiry into a breach of directors' duties has two steps: whether there was a breach; and what relief the court should grant, if any. At that second step, courts should consider causation and the culpability of the director before assessing the level of compensation.[172]

Mr Cooper's submissions

[154] Mr Cooper submits that the appropriate approach to compensation is the net deficiency approach taken in *Re Ralls Builders Ltd (in liq)*.[173] This case was decided

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171 The liquidators' calculations assessed total liabilities as at 31 October 2012 to be $743,373.25 and total liabilities as at 7 March 2014 to be $845,416.23. These calculations were provided after the hearing in line with a direction from the Court. The parties were, however, not able to agree on the position and, as noted below, Mr Cooper takes issue with a number of the figures and assumptions in the liquidators' calculations.

172 Citing *Mason v Lewis* [2006] 3 NZLR 225 (CA) at [110].

173 See *Re Ralls Builders Ltd (in liq)* [2016] EWHC 243 (Ch), [2016] BCC 293 at [246]–[251].

under s 214 of the Insolvency Act 1986 (UK).[174] The net deficiency approach would determine compensation by calculating the difference between the deficit at the time trading should have ceased and that pertaining at eventual liquidation. He submits that no compensation order should be made where the director has improved the position of the company through trading.

[155] In this case it is submitted that there was no net deficiency as a result of the continued trading.[175] Mr Cooper does not accept the liquidators' calculations in this regard. He disagrees with some of the figures used.[176] He considers that the date of any notional liquidation should be the end of November 2012 and not the end of October 2012.[177] He says that the voidable transaction recoveries should be included as company assets[178] and that related party debt should not be taken into account.

The principles to be applied

[156] Section 301 gives the court power to order relief where, in the course of liquidation, it appears to the court that there has been a breach of directors' duties.[179]

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174 Section 214 of the Insolvency Act 1986 (UK) provides that, if at some time before the commencement of the winding up of a company in insolvent liquidation, the director of the company knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, the court may declare that the director is liable to make such a contribution to the company's assets as the court thinks proper. However, the court shall not make such a declaration if it is satisfied that the director, after knowing there was no reasonable prospect that the company would avoid going into insolvent liquidation, took every step he or she ought to have taken to minimise the potential loss to the company's creditors.

175 This assertion is not accepted by the liquidators, as noted above at [151].

176 For instance, Mr Cooper says it is unresolved whether the forced sale valuation is to be used for the Coby Sydney Drive property in its unsubdivided form. There is also dispute about whether the Love Earthmovers debt is to be included in the actual liquidation: see above at n 11.

177 The date change would mean the assets (the developed properties) would be worth the same or up to $80,000 more.

178 See above at n 3.

179 We have not been asked to decide how any relief ordered would be distributed amongst creditors. On this point see the discussion of *Re Yagerphone*, above n 159. We also note that s 301(1)(c) provides that, where an application is made by a creditor, the court may order a director to pay or transfer money or property to the creditor. It has been suggested that under s 301(1)(c), at least in cases where the liquidator takes no steps, the Court can order all restitution or compensation to go to the particular creditor: *Marshall Futures Ltd v Marshall* [1992] 1 NZLR 316 (HC) (Tipping J) at 332–333; and *Sanders v Flay* (2005) 9 NZCLC ¶96-989 (HC) (Heath J) at [18]–[19]. Note that *Marshall Futures* was decided under the 1955 Act, and *Sanders* was decided under the 1993 Act. We leave consideration of creditors' rights under s 301(1)(c) to a case where it arises and has been fully argued.

Relief can be restitutionary under s 301(1)(b)(i) or compensatory under s 301(1)(b)(ii).[180]

[157] Section 301(1)(b)(i) provides that an order can be made to "repay or restore" money or property. The word "repay" implies that the person has received company money or property and can be ordered to return it to the company. The word "restore" suggests rather that a person can be ordered to return the company to the position it would have been in absent the breach, including making good a company debt that should not have been incurred, even if the person has not received company money or property.

[158] With regard to s 301(1)(b)(ii), the caselaw has identified three factors to take into account: causation, culpability and duration of any breach.[181] Professor Watts considers that the reference to culpability should refer rather to lack of culpability as the purpose of a compensation award is compensatory and not punitive.[182]

[159] Generally, restitutionary remedies have been considered apt for breach of duties that can be categorised as fiduciary. Not all directors' duties are seen as fiduciary.[183] For example, ss 135 and 136 are considered to be statutory duties only.[184]

[160] We do not, however, consider restitutionary relief is necessarily limited to breach of fiduciary duties. There is nothing in the words of s 301 to point to that conclusion. In our view, the appropriate relief must respond to the duty or duties actually breached. Thus restitutionary relief can also be available for breaches of non-fiduciary duties.

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180 We agree with the Court of Appeal in *Sojourner* (CA), above n 17, at [53] that the language in s 301 naturally encompasses restitutionary claims.

181 The three factors first came from *Maloc Construction Ltd (in liq) v Chadwick* (1986) 3 NZCLC ¶96-109 (HC) at 99,809 per Tompkins J, which was decided under s 320 of the Companies Act 1955. These factors have been held to apply to s 301 of the 1993 Act: *Mason v Lewis,* above n 172, at [110].

182 Watts, above n 14, at [10.2.5], 287–288. In the case of s 135, Professor Watts considers that the language of its predecessor, s 320 of the 1955 Act (after its amendment in 1980), left open the possibility that awards for reckless trading (and, before that, fraudulent trading) might be penal.

183 See *FXHT Fund Managers Ltd (in liq) v Oberholster* [2010] NZCA 197 at [28]–[30]; and *Morgenstern v Jeffreys* [2014] NZCA 449, (2014) 11 NZCLC ¶98-024 at [99].

184 Watts, above n 14, at [10.2.2(a)], 275.

[161] We comment that there is not necessarily in any event such a dichotomy between compensation and restitution as might be suggested by the above discussion. Restitution can be seen as a type of compensation and therefore could come under s 301(1)(b)(ii), depending on the nature of the breach or breaches involved.[185]

[162] We agree with Professor Watts that s 301 is not designed to be punitive.[186] Relief ordered cannot be more than is required to compensate and/or to provide restitution. Within these limits, it can, however, take into account general deterrence.[187] The choice and quantum of any compensation or restitution must take into account all of the circumstances, including the nature of the breach, the level of culpability and what is required to hold a director to account. We also stress that, in the cases of multiple breaches of duty, any redress under s 301 must be tailored towards the combination of breaches found.

[163] In accordance with these principles, the choice of relief for breaches of s 131 would depend on the nature of the breach.

[164] In terms of a breach of s 135, we accept that in most cases the appropriate starting point would be an amount equal to the deterioration in the company's financial position between the date when trading should have ceased and the date of actual liquidation (the net deficiency approach).[188] This is because the section looks at the creditors and the business as a whole.

[165] We do not, however, consider that the same measure of compensation would necessarily respond adequately to breaches of s 136.[189] The breach of duty under s 136 is the incurring of obligations without a reasonable belief that they will be met. This

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185 See *Premium Real Estate Ltd v Stevens* [2009] NZSC 15, [2009] 2 NZLR 384 at [99] per Tipping J; and *Sojourner* (CA), above n 17, at [53], in which the Court determined that compensation under s 301(1)(b)(ii) can, depending on context, encompass restitutionary remedies. See generally Andrew Keay "Financially distressed companies, preferential payments and the director's duty to take account of creditors' interests" (2020) 136 LQR 52 at 71.

186 Watts, above n 14, at [10.25], 287. This is contrary to liability under s 320 of the 1955 Act (see comments in *Nippon Express (New Zealand) Ltd v Woodward* (1998) 8 NZCLC ¶96-779 (HC) at 261,778 per Anderson J).

187 *Löwer,* above n 162, at [60] and [83].

188 *Mason v Lewis,* above n 172, at [109].

189 We thus disagree with Professor Watts who suggests that the normal starting point for an award for breach of s 136 will be the same as for a breach of s 135: Watts, above n 14, at [10.2.5], 287.

section therefore concentrates on individual creditors. Section 136 is, however, like s 135 and others, framed as a duty to the company.[190] It follows that Parliament must have considered any breach of the duty would harm the company. It is therefore appropriate that any relief ordered should operate to reverse that harm and thus be restitutionary in nature.

[166] In cases where the breach is of s 136, limiting compensation to the net deficiency (the usual measure for s 135) would not respond to the breach and make good the harm, especially in cases where new obligations are incurred and used to pay other debts ("robbing Peter to pay Paul"). There is much force in the liquidators' submission that limiting compensation to the net increase in amounts owing would provide directors with the perverse incentive to continue to trade in breach of s 136 as long as they are careful to make sure that the net deficit remains constant. If relief under s 301 is calculated on a net deficiency basis in such cases, there would be no deterrent effect and directors would not properly be held to account. Nor would the harm to the company be reversed.[191]

Application to this case

[167] This case involves breaches of ss 131, 135 and 136. We consider that a restitutionary measure of relief would appropriately respond to the nature and combination of the breaches.[192] This is because of the following factors:

(a) continued trading involved satisfying current debts by incurring new obligations, knowing the new creditors would not be paid ("robbing Peter to pay Paul");

(b) Mr Cooper did not take the interests of all creditors into account (and this was exacerbated by the conflict of interest); and

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190 Companies Act, s 169(3)(f)–(g) (alongside ss 131, 133, 137 and 145, which are also duties owed to the company and not to shareholders); and see the language of s 136 – "must not agree to *the company* incurring an obligation" (emphasis added). On the s 135 duty being owed to the company, see also Law Commission, above n 13, at [217]–[220].

191 We note also that this argument would be strengthened if Tipping J in *Marshall Futures*, above n 179, and Heath J in *Sanders*, above n 179, are correct that an order can be made in favour of a particular creditor under s 301(1)(c). We do not, however, need to decide that issue.

192 This means that we do not need to resolve the dispute between the parties as to whether or not the continued trading increased the net deficit: see above at [151] and [155], and at nn 11 and 176.

(c) Mr Cooper had a deliberate strategy to place all of the deficit on Inland Revenue, contrary to the statutory priorities.[193]

[168] The starting point is that Mr Cooper knew, from the time of the November 2012 meeting with Mr Furlong, that Debut was insolvent and that continued trading would result in a GST deficit of at least $300,000. In these circumstances, continued trading would breach ss 135 and 136. We accept that there were measures, both formal and informal, that could have been taken. They were not, however, and we have no means of knowing if the measures would have been able to have been instituted. We therefore consider that the appropriate comparison point is with the position if Debut had been liquidated at the time of the breach. The High Court's starting point of all new debt incurred after the beginning of November 2012 was thus appropriate.

[169] We accept that the measure of restitution relating to unpaid GST should take into account the amount of GST that would have been payable if Mr Cooper had opted for immediate liquidation. We understand that the trade debts outstanding at liquidation were all incurred after 31 October 2012 and involved new creditors.

[170] In this case, had Debut been placed into liquidation at the end of October 2012, the liquidator would have been liable to pay any GST on the sales of the properties made by him or her.[194] This means that the High Court was justified in taking into account all of the GST debt incurred on sales after November 2012 when calculating the relief it ordered.[195]

[171] We consider that the deduction made by the High Court for matters such as Mr Cooper working on the properties for a period without pay was within range.[196]

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193 Contrary to the view of the Court of Appeal (CA judgment, above n 4, at [75]–[77]), we do not consider that Mr Furlong's advice can be taken into account to assess the reasonableness of Mr Cooper's actions and whether he was reckless. Mr Furlong's advice did not address the relevant directors' duties and, indeed, his advice condoned the continued trading which was in clear breach of ss 131, 135 and 136.

194 GST Act, s 58; and Companies Act, sch 7 cl 1(1)(a). If any of the properties had been sold to another developer as a going concern, the sale would have been zero-rated: see above at [51]. If the liquidator becomes liable to pay GST on the sale of the properties made by them, that GST is a properly incurred expense and therefore the first priority in a liquidation: sch 7 cl 1(1)(a).

195 The High Court did not take into account the GST debt on the sales of 2 and 7 Karika Place, which had taken place in September 2012: see above at [10].

196 HC judgment, above n 1, at [85].

We think, contrary to the submissions of the liquidators, that it was appropriate in these circumstances for the High Court to make some deduction given Mr Cooper did consider his actions in the best interests of some of the creditors. We agree with the High Court, however, that a full allowance would not have been appropriate, given Mr Cooper was in breach of his directors' duties.

[172] We do not think the amount added for GST interest and penalties was unreasonable in the circumstances. Interest and penalties are imposed by statute and form part of the debt to Inland Revenue.[197] The fact they were incurred was a direct result of Mr Cooper's decisions that Debut would continue trading and that the whole of the projected deficit would be borne by Inland Revenue.

[173] For all of the above reasons, there is no reason for interfering with the High Court's compensation order and we reinstate it.

Summary of conclusions on directors' duties

The law

[174] 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.[198] Subject to the use of the formal or informal mechanisms elsewhere discussed,[199] 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.

[175] 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

[197] See GST Act, s 2 definition of "tax payable"; and Parts 7 and 9–10 of the Tax Administration Act 1994.

[198] As noted above at [69], we are not dealing in this case with a situation where the business is high risk/high reward or where a business may be salvageable (for example, suffering temporary liquidity issues). We thus make no comment on the applicability (or otherwise) of s 135 in such circumstances.

[199] See above at [36]–[48].

need to arise from direct contractual arrangements between the company and the creditor.[200]

[176] That there will be breaches of ss 135 and 136 in the above circumstances is clear from the wording of those sections but also from the scheme of the Act with its emphasis on solvency,[201] the carefully prescribed statutory priorities on liquidation, as well as the all-important pari passu principle,[202] and the features of the formal mechanisms for dealing with insolvency or near-insolvency situations.[203]

[177] There will be no breach of s 131 if a director honestly believed they were acting in the best interests of the company.[204] 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.[205] Such a breach may be exacerbated by a conflict of interest.[206]

[178] 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.

[179] While informal mechanisms for dealing with an insolvency or near-insolvency situation can also be used, these must accord with directors' duties, the scheme of the Act and the salient features of the available formal mechanisms, such as ensuring all affected creditors are consulted and agree with the course of action proposed.[207]

[180] We do not suggest that directors must always consult all creditors if wishing to enter into an informal arrangement. It would be possible, for example, to make an arrangement with secured creditors for continued trading in order to increase the amount available for the secured creditors. But, if unsecured creditors are not to be

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200 See above at [91].
201 See above at [32]–[34].
202 See above at [40].
203 See above at [42]–[46].
204 See above at [112].
205 See above at [113(b)] and [114].
206 See above at [115].
207 See above at [47]–[48].

consulted, any such arrangement would have to be on the basis that all existing debts and future debts arising from continued trading, including any GST, would be met.

[181] Where directors allow a clearly insolvent company[208] to continue trading without using one of the available formal or informal mechanisms, this will be in breach of their duties as directors and will lead to relief being ordered under s 301.

[182] 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.[209]

This case

[183] Debut was insolvent by the beginning of November 2012. It was unable to pay its debts and continued trading was projected to result in a shortfall of GST of at least $300,000.[210] It should have stopped trading at that point unless a viable formal or informal mechanism was found.

[184] Liquidation was not the only available option. Mr Cooper could have asked the secured creditors to appoint a receiver. He could have opted for any of the formal mechanisms available under Parts 14, 15 and 15A of the Act. He could also have considered appropriate informal mechanisms. However, as we note above, any informal mechanism must align with the available formal mechanisms, including involving all creditors in every class. In this case Inland Revenue was not involved, either at the time the decision to finish the properties was made or subsequently.[211] Nor were trade creditors, either existing or new.

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208 We mean by this a company where there is no possibility of salvage. As noted above at [69] and n 83, we are not dealing in this judgment with a situation where there was a possibility of salvage.
209 See above at [156]–[166].
210 See above at [12].
211 See above at [75] and [121].

[185] The course of action taken by Mr Cooper meant he was in breach of his obligations under s 135. This is because there was a certainty of a loss of at least $300,000 to Inland Revenue. Further, at no stage did Mr Cooper revise his strategy, even though the overall trading position was worse than the costings projected in November 2012.[212]

[186] In addition, there was a breach of s 136. At the time the GST debts were incurred, Mr Cooper knew they would not be paid. The same may apply to the trade debts that were outstanding at liquidation.

[187] Mr Cooper failed to consider the interests of all creditors, despite Debut being insolvent. As this means he did not subjectively believe he was acting in the company's best interests, he was thus in breach of s 131. The breach was exacerbated by his conflict of interest.[213]

[188] The compensation ordered by the High Court was calculated on a restitutionary basis. This was appropriate considering the combination of the breaches involved. The deductions made were appropriate in all of the circumstances.

Result

[189] The appeal is allowed.

[190] The High Court orders outlined at [4(a)], (b) and (c) of this Court's judgment are restored.

[191] The respondents must pay the appellants costs of $25,000 plus usual disbursements. Costs in the Courts below are to be determined in accordance with this judgment.

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Crown Law Office, Wellington for Attorney-General as Intervener

212 See above at [77].
213 See above at [117].