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Directors' duties in difficult financial circumstances

■ BY ANDREW SKINNER

The Supreme Court recently handed down its decision in Debut Homes Limited (In Liq) v Cooper, which is an important case regarding the individual liability of directors when trading in difficult financial circumstances.

This case emphasises the importance of continually monitoring the financial performance of a company and provides guidance that the company should not continue trading if it is clear that the situation is not salvageable. Rather, in insolvent or near-insolvent circumstances, the company should use the various formal mechanisms available under the Companies Act 1993 (Act).

KEY FACTS

Debut Homes Limited was a property developer. Mr Cooper was its sole director. By the end of October 2012, the company was in financial trouble. It had four properties to complete and more funds were required to complete them. Debut Homes' financiers were no longer prepared to fund the company. A decision was made to wind down the company and it was expected that the managed wind down would result in a GST shortfall of approximately $300,000. On 20 February 2013, Mr and Mrs Cooper (as trustees of their family trust) lent money to Debut Homes as further working capital.

All of the properties were subsequently sold, but without payment of GST on the sale of the properties. Most of the money was paid towards arm's length secured and trade creditors, but some was paid to the family trust. In March 2014, Debut Homes went into liquidation on the IRD's application for unpaid GST. The liquidator then brought claims against Mr Cooper for alleged breaches of his duties as director of Debut Homes.

THE HIGH COURT AND COURT OF APPEAL

The High Court decided that Mr Cooper had breached his duties and ordered him to pay $280,000 to the liquidators. The Court of Appeal disagreed and decided that Mr Cooper's decision to complete the homes under the circumstances was a "sensible business decision", notwithstanding that the IRD would be more at risk than other secured creditors as there was no specific provision for payment of the GST.

SUPREME COURT

The Supreme Court overturned the Court of Appeal and restored the High Court's decision against Mr Cooper. The Supreme Court confirmed that the directors of a company must consider the interests of creditors where the company is insolvent or near insolvent.

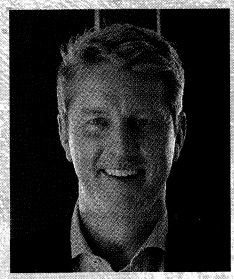
Based on the Supreme Court's reasoning, it is now clear that if a company reaches the point where continued trading will result in a shortfall to creditors and the company is not salvageable, then continued trading will be in breach of section 135 (reckless trading) of the Act. This principle applies 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.

Further, entering into a course of action designed to ensure that some creditors receive a higher return at the expense of new liabilities that will not be paid will be in breach of section 136 (duty not to incur obligations) of the Act.

The Supreme Court confirmed that solvency is a key value in the Act. Where a company is insolvent, there are statutory priorities for the distribution of funds to creditors. There are alternatives other than liquidation open to directors where continued trading is projected to result in a shortfall (including compromises with creditors and approval of arrangements by the court). The Supreme Court considered that:

"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".

This case is important as it identifies some clear principles for directors to consider when projecting a shortfall from continued trading. Rather than trying to make the best of a bad situation, directors must now consider the options available for independent involvement or risk personal liability in circumstances where a company is insolvent and cannot be salvaged.



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