

Predicting the future: Assessing solvency and contingent liabilities in New Zealand

Scott Abel, Kelly Paterson

20 October 2017

In New Zealand, a court may appoint a liquidator to a company if, among other reasons, it is satisfied that the company is unable to pay its debts.^[1] Unlike other jurisdictions, that assessment is focused only on cashflow, rather than balance sheet, insolvency.^[2] Nevertheless, the New Zealand Supreme Court in *David Browne Contractors Ltd v Petterson* [2017] NZSC 116 has, in the context of a liquidator's challenge to voidable transactions, considered the extent to which contingent liabilities (in particular, a disputed claim in damages) ought to be taken into account when determining whether a company is able to pay its due debts. The Court decided that future or contingent debts should be taken into account where there is sufficient certainty that liability will crystallise into an actual debt within a reasonable timeframe, consistent with relevant case law from Australia and the United Kingdom.

Mr and Mrs Browne operated a group of companies including Polyethylene Pipe Systems Ltd (PPS), David Browne Contractors Ltd (DBC) and David Browne Mechanical Ltd (DBM). In 2007, PPS welded pipes under a subcontract with McConnell Dowell Constructors Ltd (MCD). In late 2007 and early 2008, two of the welds failed and MCD was also concerned about a third weld. MCD promptly notified PPS that it intended to recover losses from PPS pursuant to an indemnity clause in the subcontract.

In June 2008, the directors of PPS put in place a scheme in which PPS resolved to repay \$1.2m in unsecured advances to DBC, DBM and Mr Browne. PPS also granted security to Mr Browne over all of its assets under a General Security Agreement (GSA), in return for \$450,000 to fund ongoing operations.

Three days after MCD notified PPS of its losses (\$2.5m), Mr Browne advanced \$700,000 to PPS under the GSA. Shortly after, PPS repaid the debts owed to DBC, DBM, and Mr Browne. MCD was subsequently successful in the adjudication of its claim and its losses were assessed as \$2.9m. In response, pursuant to his GSA, Mr Browne appointed a receiver to PPS.

MCD appointed a liquidator to PPS and the liquidator then sought to set aside the payments made to DBC, DBM and Mr Browne, and the GSA. The liquidator was unsuccessful in the High Court but succeeded in the Court of Appeal. The Court of Appeal ordered the payments be repaid to PPS, and set aside the GSA. The Supreme Court granted leave to appeal the Court of Appeal's decision on the voidable transactions.

Due debts and contingent liabilities

The main issue before the Supreme Court was whether the payments being challenged were made at a time when PPS was "unable to pay its due debts". A transaction is voidable by a liquidator if it is an insolvent transaction and is entered into two years prior to liquidation^[3] A transaction is an "insolvent transaction" if it was entered into at a time when the company is "unable to pay its due debts" and enables a creditor to receive more than it would receive, or would be likely to receive, in the company's liquidation.^[4]

The PPS directors argued that as the focus was on cashflow, rather than balance sheet, solvency at the time of the transactions, the assessment should include debts that were due in a very short time after the transaction, but not contingent or prospective debts. Furthermore, "due debts" would extend only to debts which are legally due, whereas the MCD claim was a disputed, unliquidated claim in damages.

The Court held that "due debts", in the context of the relevant voidable transaction provisions, encompassed both present and contingent debts, drawing upon Australian and the United Kingdom authorities.^[5] Furthermore, the Court accepted the liquidator's submissions and held that a contingent debt can be a due debt if it is "reasonably temporally proximate" (assessed in light of the facts of the case) to the insolvent transactions.^[6] The Court found that an objective assessment of solvency taking a "practical business perspective" is required, such that:

If a reasonable and prudent business person would be satisfied that there is sufficient certainty that a contingent debt will, within the relevant period, become legally due then it must be taken into account.

...

The issue of whether a claim is a due debt is assessed objectively from the perspective of a reasonable and prudent business

person. *Specious claims would not need to be taken into account under this test. Nor would claims where there was a credible defence if there was not sufficient certainty those claims would crystallise into a debt legally due within a reasonably temporally proximate time frame.*^[7]

In this case, the Court found that there was no proper reason for the directors of PPS to dispute the debt.^[8] At the time of the payments, the directors had knowledge of evidence (in terms of reports from independent experts) that PPS was responsible for the failed welds. Accordingly, the MCD claim was "sufficiently certain to crystallise into a legally due debt in the relevant time frame that it should have been taken into account in the cash flow solvency assessment".^[9] The scheme to strip PPS of its assets through payments to related parties was also held to show that the directors "considered there was, at least a real and substantial risk" that the claim would succeed.^[10] There was sufficient certainty as to both liability and quantum so that it should have been treated as a due debt.^[11] The Court noted that the existence of an indemnity provision in the subcontract strengthened its conclusions.^[12] Accordingly the Court concluded that the MCD debt ought to have been taken into account and, had it been, PPS would not have met the cash flow solvency test.

Conclusion

Overall, the Supreme Court's decision confirms that the New Zealand courts will adopt "a practical business approach (as against one which is unduly technical)" to the determination of due debts when considering a company's ability to pay its due debts, consistent with Australia and the United Kingdom.^[13] Future and contingent debts are to be included in the assessment where it is sufficiently certain that they will crystallise within a reasonable timeframe. Insolvency practitioners and company directors will need to therefore carry out a fact specific, rather than technical, assessment to determine whether a company is able to pay its due debts.

This article was written by Scott Abel and Kelly Paterson for INSOL International (September 2017).

[1] Companies Act 1993 (NZ), s 241(4)(a). The authors would like to acknowledge and thank Colleen Columbus of Buddle Findlay for her assistance in the preparation of this article.

[2] Compare, for example, s 128 Insolvency Act 1986 (UK).

[3] Companies Act 1993, s 292.

[4] Companies Act 1993, s 292(2).

[5] *Fryer v Powell* [2001] SASC 59, (2001) 159 FLR 433; *Bank of Australasia v Hall* (1907) 4 CLR 1514; *New Cap Reinsurance Corp Ltd (in liq) v Grant* [2008] NSWSC 1015, (2008) 68 ACSR 176; *Re Cheyne Finance Plc (No 2)* [2007] EWHC 2402, [2008] 2 All ER 987 (Ch) and *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc* [2013] UKSC 28, [2013] 1 WLR 1408.

[6] *David Browne Contractors v Petterson* [2017] NZSC 116, at [90].

[7] At [91] and [96].

[8] The directors of PPS had signed a solvency certificate in July 2008 which stated that the contingent liability to MCD was disputed, would be offset by counterclaims for extras and variations and, in any event would be covered by MCD's insurers. No evidence was provided to support any offset, and later legal advice confirmed that the liability was not covered by insurance.

[9] At [108].

[10] At [109].

[11] At [113].

[12] At [114].

[13] At [95].

Auckland

**PwC Tower
188 Quay Street
Auckland 1010**

**PO Box 1433
Auckland 1140
New Zealand**

**P: +64 9 358 2555
F: +64 9 358 2055**

Wellington

**Aon Centre
1 Willis Street
Wellington 6011**

**PO Box 2694
Wellington 6140
New Zealand**

**P: +64 4 499 4242
F: +64 4 499 4141**

Christchurch

**83 Victoria Street
Christchurch 8013**

**PO Box 322
Christchurch 8140
New Zealand**

**P: +64 3 379 1747
F: +64 3 379 5659**