Can you liquidate your company and avoid liability for its debts?

When the Government appointed Messrs Hunn, Bond & Kernohan to enquire into the causes of the leaky building syndrome in 2002 (they were called "The Overview Group on Weathertightness") they took it upon themselves to investigate and report on all the failings of the construction industry in New Zealand. In their otherwise excellent report (issued in two parts on 31 August & 31 October 2002) they offered the following comments:

> *it is understood that [the Companies Act] offers little … protection to a home-builder/buyer consumer in the event of the vendor company … being put into voluntary liquidation by the directors"*
>
> *there is currently nothing to stop the unscrupulous … builder from liquidating their company … to avoid claims and action from dissatisfied purchasers*

Since then I have lost count of the number of times I have heard a Minister of Building and Construction express disgust at the ease at which a builder can simply wind up his company and escape liability to his creditors while setting up business under a new company the very next day. It is a very popular misconception, and it is frequently parroted by the news media. So entrenched is the belief that this strategy will work, that accountants routinely advise their builder clients to put their companies into liquidation as a means of "cleaning the slate" and unsurprisingly, many builders take that advice.

Busting the Myth

The only problem with that theory, is that it is a complete fallacy. Since the early 1990s our Courts have consistently ruled that the people who run companies can be equally as liable as the companies themselves, for wrongful acts and omissions committed in the course of the company's business activities. A limited liability company does protect shareholders from having to contribute more money if the company can no longer pay its debts, but it does not protect the directors and senior managers from liability if the company does something wrong and they were responsible.

The principle is best illustrated in the context of leaky home claims. When a homeowner is bringing a claim in the Weathertight Homes Resolution Service (**WHRS**) against a number of respondents including a small building company, it is virtually automatic that the owner/operator of that company is joined as a respondent as well. In WHRS Claim no. 734 known as *Heng v Walshaw*, Adjudicator Green when issuing his decision on 30 January 2008, went so far as to say (at paragraph 297) "*In the case of a one man building company it will be an almost insuperable hurdle for a director to avoid personal liability for defective work".*

Small Business Owners Are Most at Risk

Why does the fallacy persist, if that is the case? One reason is that directors and officers of large companies (as distinct from small-medium enterprises) do tend to escape liability when their company goes under. That is because personal liability usually stems from the director or officer being actively involved on site, either on the tools, or in a supervisory capacity. The Courts talk of the person being "in control" or "personally assuming responsibility". In a large development or a large construction company the senior people tend to be more remote from the action, and they delegate to project managers or site supervisors. Ironically, that means the big guys tend to get off the hook while the little guys don't. And it is the large, spectacular failures like Mainzeal that attract all the publicity.

Our law on personal liability lacks clear guidelines on when you will or won't be personally liable. The Courts come up with all sorts of justifications for it, but in reality they tend to find senior people personally liable in situations where they and the company are effectively one and the same, and the creditor the insolvent company owes the money to, deserves a lot of sympathy. It is pretty tough on the small business proprietor, because after all, a company is a fictional entity that you can't touch or feel, so it can't do anything without some human being doing it for it. When that person volunteers to be the action man/woman for the company, I imagine it would the last thing on their mind that they are offering to expose all their personal assets to risk, in the course of simply doing the company's business. And yet the Courts routinely find that they did.

Liquidation Can Be a Double-Edged Sword

Outside of the leaky home context, putting a company into liquidation may sometimes be an effective ploy simply because it creates an obstacle that the creditors can't be bothered trying to overcome. It's not an obstacle in a WHRS case because that is a low-cost, informal system where the personal liability of an owner/operator is simply assumed. In the Courts or in an arbitration, however, the creditor would have to spend a lot of money in the hope of persuading the Judge or Arbitrator that the case law points to personal liability on the facts of their particular case. Nevertheless, when their only other option is to pursue a defunct company, they will be more motivated to do so.

Liquidation isn't exactly a cure-all either. No matter how friendly the Liquidator may appear to be, they have a duty to the creditors to bring in as much money as they can. That means that if you want to take the business assets like the vehicles, the tools, the plant & equipment, office furniture & appliances, computer hardware and software, etc. and put them into your new company, then you will need to pay a fair price for them. You also need to be wary of the liquidator's powers to claw back benefits that you extracted out of the company at an undervalue, in the years leading up to the liquidation. And if the company can't pay all its debts, you might find yourself facing an action for breach of your director's duties, and you might struggle to get credit terms from your building materials supplier for a while.

Finally, you need to know that if your company was insolvent, our phoenix trading laws limit your ability to trade under the same business name in the future, and you might ultimately be banned from being a company director if you leave too many failed companies in your wake. So tread carefully, before regarding liquidation as the easy option.