WGL RETAIL HOLDINGS LIMITED & SUBSIDIARY COMPANIES
COMMENTARY ON THE REPORT OF THE ADMINISTRATORS DATED 26 JULY 2011

Introduction

The purpose of this analysis is to critically appraise the report of Ferrier Hodgons (FH), the administrators, as has been prepared for the purposes of reporting to the creditors in accordance with section 239AU(3) of the Companies Act 1993 (the Act).

As FH note, administrators are obliged to provide a report which, amongst other things, advises if in the opinion of the administrators:

- Whether it is in creditors' interests to agree to a DOCA; and
- Whether it is in creditor's interests to wind the company (or in this case companies) up.

Summary of FH's opinions

FH state that it is in the interest of creditors to enter into a DOCA because there is a pool of money available to the creditors of about $3 million if the DOCA is agreed to. According to FH the alternative, liquidation, will yield nothing for the creditors.

The basis for making this claim is that no remedies available to a liquidator apply in the present circumstances. In this regard two sets of remedies are discussed:

- Those arising from breaches of directors' duties.
- Those pertaining to the setting aside of securities held by the shareholders for debt the shareholders claim against the various companies (for ease of reference this will be referred to a as the process of voidance).

Central to the FH's contentions is the state of solvency of the various companies or, more particularly, the point of insolvency of the companies.

Clarification

FH has presented a report on the New Zealand operation as if it were one entity. They refer to this as a group. The group comprises, in the main, the New Zealand holding company and its two subsidiaries Whitcoulls and Borders, though all of the names have been changed.

For the purposes of considering Companies Act remedies there is no such thing as a group in the sense meant by FH. Unless such companies are formally pooled, which can only happen on liquidation, each company must be dealt with separately.

However, as I have insufficient information to treat each company separately, I am forced to consider the various issues from the perspective of the artificial construct of a group.

Because FH have failed to deal with the each company in isolation, they have failed to comply with their duties under section 239AU.

The determination of solvency

FH comment on the point of insolvency or otherwise at two points in their report.

At paragraph 9.2.2.10 they state:

> … it is our preliminary view that it is difficult to maintain an argument that the Group was insolvent for any material period prior to 17 February 2011 principally as a result of the support available from PEP.

This is an extremely important statement for it is an express claim, dealt with elsewhere in the report that the directors of the various companies, could rely on PEP to ensure debts were met. Self-evidently, this understanding was a profound misapprehension at the very best.

At paragraph 9.3.1.1 they state, following a discussion of the guarantee given by the New Zealand operation presumably to the Australian holding company's lenders,:

> In our view, it is not likely that a Court would find that the Group was insolvent on 15 December 2010.

It is not clear whether this is a blanket statement or a statement restricted to the adverse consequences of the provision of guarantees across the Tasman. As will be seen the guarantees, assuming they were enforceable, could only have made a very bad situation much worse.

FH state that there are two ways in which solvency is determined, a balance sheet test and a cash flow or liquidity test. This is not untrue. However, the legal position is more complex than that claim allows.

In the matters pertaining to voidance it is, strictly, the case that a liquidity test applies. Whilst solvency is central to breaches of directors' duties, there is no express test which applies. Usually reference will be made, however, to section 4 of the Act. This prescribes a dual test for the determination of solvency, being both a balance sheet test and a cash flow test.

These tests were introduced primarily to protect creditors against invalid distributions, where a distribution is a payment to a shareholder. As will be seen this is an important issue in the context. In any event, the basis to these tests was imported at the time of the enactment of the Act from North America. New Zealand made a very significant change to the originals. The balance sheet test here is linked overtly to generally accepted accounting practice (GAAP).

Before I discuss the application of the solvency test in New Zealand I should say that, in my opinion, the differences between the balance sheet test and the cash flow test are not as great as supposed. A full analysis of why they don't differ is complex and beyond what I the scope of what I write here. Suffice to say that in considering the cash flow test the question is: should future sales be taken into account? Such sales cannot be in a balance sheet test for that would be to recognise internally generated goodwill and that is prohibited. I, therefore, say not. In consequence, a balance sheet is, in essence, a distillation of future cash flows the only difference between it and a cash flow is timing. That makes the cash flow test considerably more demanding than the balance sheet test. It follows that if a balance sheet test is failed so too is the cash flow test.

Source of information

I am not able to apply a balance sheet test because I don't have a balance sheet to work with. This state of affairs, in my opinion, is scandalous. Had I prepared the report (or more correctly reports) on the administration I would have been bound by professional rules applicable to me in virtue of my membership of the New Zealand Institute of Chartered Accountants (NZICA).

The *New Zealand Preface* (to International Financial Reporting Standards) published by NZICA states:

> Compliance with the *Code of Ethics* is mandatory for all members of the Institute. Members must be able to demonstrate at all times that their actions, behaviour and conduct comply with the *Code of Ethics*. *The Code of Ethics* includes rules on compliance with professional and technical standards. For example, the *Code of Ethics* (paragraphs 103 and 104) requires that:
> (a) members who are involved in, or have responsibility for, the preparation or presentation of general purpose financial statements and non-financial statements should take all reasonable steps within their power to ensure that generally accepted accounting practice is complied with; and
> (b) all material departures from generally accepted accounting practice should be disclosed and explained. The explanation should include the reasons for the departure and its financial and non-financial effects.

Accordingly, I would have been obliged, when presenting financial information as FH have done, to either present it as special purpose (which FH specifically have not done) or as general purpose. If the reports are general purpose, as they are, I would have been in breach of my ethical obligations had I done what FH did.

As members of the Institute of Chartered Accountants in Australia FH are obliged in a similar way as chartered accountants are here in New Zealand. APES 205 *Conformity with Accounting Standards* (APESB December 2007) states at paragraph 4.3:

4.3 Members who are involved in, or are responsible for, the preparation and/or presentation of Financial Statements of a Reporting Entity shall take all reasonable steps to ensure that the Reporting Entity prepares General Purpose Financial Statements.

And then at paragraphs 5.1 and 5.2

5.1 Members shall take all reasonable steps to apply Australian Accounting Standards when they prepare and/or present General Purpose Financial Statements that purport to comply with the Australian Financial Reporting Framework.

5.2 Where Members are unable to apply Australian Accounting Standards pursuant to paragraph 5.1, they shall take all reasonable steps to ensure that any departure from Australian Accounting Standards, the reasons for such departure, and its financial effects are properly disclosed and explained in the General Purpose Financial Statements.

Notwithstanding that FH would have been obliged to comply with Australian accounting standards, the effect is basically the same. A full set of financial statements was required and not produced.

However, on the basis that New Zealand law operates, for better or worse, on the basis of GAAP in the preparation of a balance sheet and a chartered accountant operating here is obliged to follow GAAP, FH should have prepared a proper financial report. They have failed to do so.

I am therefore reliant upon the financial information presented in the Report such as it is.

The financial information
The financial information is set out at paragraphs 5.1 and 5.2 of the Report.

This information is of very poor quality, it is incomplete and it certainly does not comply with any form of GAAP.

The information is set out as a comparison between a Statement of Position (SOP) provided by the directors and a version presented by the administrators, both dated 17 February 2011.

In terms of quality the following examples will suffice to demonstrate inadequacy:

- The directors state that cash was $8.2 million but the administrators say $3.6 million. This is an unexplained adverse difference of $4.6 million. One might assume that there can be three possible explanations – fraud or incompetence or error by FH. Apparently, the difference pertains to moneys which appear to have the character of trust moneys. In which case, this fact was certainly worthy of mention.
- There is an analysis of cash at paragraph 5.2.1.1. It does not agree with what is represented on the SOPs. No explanation is given, but by consulting Appendix F it is possible to determine that Calendar Club has been omitted. The note is wholly uninformative.
- Debtors have declined between the two SOPs by more than $1 million. No explanation is given. One might assume the difference relate to valuation and excessive optimism shown by the directors. Apparently, the differences relate to sums off-set against credits due. This state of affairs was worthy of mention.

The financial information is incomplete in too many respects to mention. There are three material examples.

The reader of the Report is not entitled to know the value of either inventories or property, plant & equipment (the physical assets). Given the administrators cash flows it seems certain that the physical assets were disposed of at materially lower values than stated.

It might be noted at this point that physical and intangible assets in a GAAP based financial report would be subject to IAS 36 *Impairment of Assets* and specifically paragraph 30 of that Standard. It is no doubt difficult to operationalize but, having done so, the point of loss would be determined. It is likely this was early, probably in 2008.

Three assets previously reported, goodwill, related company receivables and deferred tax asset, have been omitted from the SOPs. Of the goodwill and the deferred tax asset, there is no mention at all.

There are far too many instance of non-compliance with GAAP to list them all. GAAP has four primary statements – balance sheet, P&L, equity movement and cash flow. These are linked and are intended to explain what happened between two points in time. In this case: what caused a company holding itself out as solvent to fall so disastrously insolvent?

This information is augmented, firstly, with comparative information. The reader is able to see at a glance what has transpired across the year and, more importantly, whether the financial reporting has integrity in the transition from one year into another (see also Table 1 below).

Financial reports are invariably accompanied by a statement of accounting policies. This enables the reader to understand what underpins the balances represented on the balance sheet. This is conspicuous by its absence in the present matter.

Table 1 sets out a comparison of the last published financial report of the Whitcoulls group to that which I can glean from the FH Report.

Table 1 **WGL Retail Holdings Limited**
Balance sheet

$000	Feb-11	Aug-09	Diff
Assets			
Cash	3,579	2,729	850
Receivables	618	3,380	(2,762)
Related party receivables	0	62,309	(62,309)
Other	0	818	(818)
Physical assets	47,053	59,112	(12,059)
Intangibles (goodwill)	0	65,567	(65,567)
Deferred tax asset	0	7,231	(7,231)
	51,250	201,146	(149,896)
Liabilities			
Payables & provisions	22,497	43,797	(21,300)
Related party payables	153,320	131,181	22,139
	175,817	174,978	839
Equity	(124,567)	26,168	(150,735)
	51,250	201,146	(149,896)

Notes:

1. The carrying value of physical assets is assumed to be the realised amount per the receipts and payments schedule.
2. Where there is no information given the value of any given asset is assumed to be nil.

The latest published financial report is for August 2009. The directors, and probably the administrators deploying directorial powers, were obliged to complete and file another set of financial statements about six months after the balance date. That would have been in about February of this year. The Financial Reporting Act 1993 has been breached.

As can be seen the Group's solvency was dependent upon:

- The carrying value of goodwill.
- The carrying value of the deferred tax asset.
- The carrying value of related party receivables.

It is extremely unlikely that any of these supposed assets would have been able to satisfy a test of impairment for many months if not years. There can be little doubt that the Group, and therefore presumably the underlying companies, have been insolvent for a considerable period.

Having said that, there is one argument that would hold the Group is not insolvent. This is an argument in regard to the funding side of the balance sheet. Some argue that because the shareholder cannot withdraw money from the various companies because to do so would represent a distribution. If that was the case, the credit due to the related parties would not fall within the definition of a liability. If it is not a liability it is equity.

In the event that the sum due to the related parties is equity, the Group is solvent to a value of about $30 million. The problem for the shareholder is that any moneys paid to them or their proxies would be subject to the rule prohibiting distributions when the solvency test cannot be satisfied.

The idea that sums due to related parties are equity and not debt is consistent with the notion that the directors relied upon the support of PEP to judge the Group and the individual companies to be solvent.

Actions available to a liquidator

The administrators argue that a liquidator would have little chance to void the security due to related parties or to successfully sue the directors because of doubts over the point the companies became insolvent. In view of the analysis set out above, this is highly unlikely to be the case.

In my opinion, contrary to assertions made by the administrators, claims arising for breaches of duty by directors are eminently provable. In this matter, I note that I have significant experience in this jurisdiction in taking such action and the administrators have none.

The administrators claim that the various means by which a liquidator can challenge the security will founder on the solvency of the Group (and presumably the various companies) until very recently. This is patent nonsense. The Group (and presumably the companies) have been insolvent for a considerable period. The administrators also point out that the burden of proof falls upon the liquidator to prove solvency. That is true – but is an irony as the length of the administration has made this the case.

To successfully challenge the security would depend upon more than just the matter of solvency, whether that challenge is under sections 292, 293 or the section not mentioned by the administrators, section 299. Matters of good faith and fairness may enter into. However, it seems unsecured creditors are to lose most of the sums due to them whilst the shareholder and its interests gets, it would seem, as much as $50 million. From a common sense point of view this is hardly fair.

Miscellaneous legal issues

The DOCA is also false. It pre-supposes that the staff and the Crown have a prior right. Accordingly, these people are fully satisfied and the residue of unsecured creditors scrap over very little. Yet this prior right remains incomplete until liquidation. At the point of liquidation these priorities do not necessarily prevail. Creditors can self-select in liquidation to rank above staff and the Crown by supporting the liquidator. In short, it is not valid to replicate what would happen on liquidation and reflect it in the DOCA as the results cannot be known because of the discretion afforded the creditor

The voting documentation has been inadequately prepared such that the meeting cannot now be valid. A meeting of creditors convened for the purpose of considering proposals are really a series of meetings. In essence administration is a complex form of compromise. It is an arrangement in which loss is apportioned.

The Act requires recognition of classes. It specifically mentions classes of creditors at s239AK(2). It is a long standing principal of English law that the interest of one will prevail over another. The example is that of Dodd in *Sovereign v Dodd* (1892). A complex democracy takes place. Creditors do not have mutual interests. They must vote in groups where the interest is common.

The broad classes that are always recognised are: secured, preferred, the rest. In my opinion, unless such classes are recognised, no vote will be valid.

Robert B Walker
2 August 2011