THE RESPONSIBILITY OF DIRECTORS AND SHAREHOLDERS FOR A COMPANY'S DEBTS

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At a time of recession companies often delay or decline to pay their debts. Traditionally New Zealand company law has been reluctant to pierce the corporate veil in favour of creditors in striking contrast to the corporation laws of the U.S.A. However, since 1929 English law has allowed statutory piercing the veil in the case of fraudulent trading. New Zealand followed suit in section 268 of the Companies Act 1933 and in 1980 extended the scope of the legislation. As Bisson J. said in *Thompson* v. *Innes*[1] in 1985:

> In the field of directorship responsibility for carrying on the business of the company within the shield of limited liability I see in those three paragraphs of s320(l) a graduation of conduct sufficiently blameworthy to pierce that shield and to render a director in the discretion of the court personally liable for all or any part of the debts and other liabilities of the company. Such liability may arise out of contracting one debt or out of fraudulent conduct or generally out of carrying on any business of the company in a reckless manner.

In fact New Zealand had a similar provision in force in section 170 of the Companies Act 1903 which was limited to private companies and made cross reference to the criminal offences in Bankruptcy. This is now section 364 of the Companies Act 1955.

Recently there has been an increasing tendency in the caselaw to give greater recognition to the creditor interest and some indications of a movement towards an equitable concept of piercing the veil or a common law duty of care in circumstances falling short of fraud. Whether such movements always have underlying economic sense is questionable. In this paper I will consider first the caselaw, and secondly sections 320 and 461 D (l) and (2) of the Companies Act 1955. I will not deal with sections 319 (failing to keep proper accounts) and 321 (misfeasance) as they are adequately dealt with in the excellent New Zealand Law Society seminar paper "*Recent Developments in Insolvency Law and Practice*" by Peter Howell and Mike Whale.[2]

I The Caselaw

Obviously there are the statutory duties which apply on winding up. A difficult question under the present Commonwealth caselaw is the extent to which company directors owe duties to its creditors *before winding up*. The old view was that there were no such duties. There are clear statements in a number of cases that directors' duties are owed to the company and directors are not trustees for the creditors of the company.[3] However, there is a growing

[1] (1985) 2 N.Z.C.L.C. 99,470.

[2] N.Z.L.S. Seminar July/August 1987 pp.21 et seq.

[3] *Re Wincham Shipbuilding & Boiler Co.* (1878) 9 Ch.D. 322; *Re Dronfield Silkstone Coal Co.* (1881) 70 Ch.D. 76; *Bank of Toronto v Cobourg, Peterborough and Marmora Ry* (1885) 10 O.R. 376 (C.A.). See R. Barrett (1977) 40 M.L.R. 226; M. Russell (1982) 1 Canta L.R. 417 and F. Dawson [1984] 11 N.Z.U.L.R. 68. For the U.S. position see 19 *Corpus Juris Secundum* para. 837. Except in a few jurisdictions directors are not considered as bearing a direct trust or fiduciary relationship to the corporate creditors. In some jurisdictions such relationships arise on insolvency.

trend in the authorities to recognise the creditor interest. This was recognised as legitimate by the High Court of Australia in 1976 in *Walker* v. *Wimborne*,[4] where Mason J. said: [5]

> The directors of a company in discharging their duty to the company must take account of the interests of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them. The creditor of a company . . . must look to that company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent.

The case involved a liquidator's misfeasance summons under section 367B of the New South Wales Companies Act 1961 in respect of (1) a pension to a retired director, (2) an intergroup loan between two insolvent companies, (3) salaries paid by an insolvent company, and (4) an inter group payment by an insolvent company for work which had never been done. The High Court held that the first instance judge had rightly rejected (1) but wrongly rejected (2)-(4).

As Jacobs J. noted in the South Australian case *Grove* v.*Flavel*[6] there was nothing in Mason J.'s statement to suggest that it is insolvency which gives rise to the duty to take account of the interests of creditors. Indeed Mason J. spoke of prejudice in the future in the event that the company becomes insolvent. *Ring* v. *Sutton*[7] in 1980 which followed *Walker* v. *Wimborne*, seemed to be just such a case. There a loan at less than market rates which was held by the New South Wales Court of Appeal to be detrimental to the creditors' interests had been entered into when the company was solvent. It was successfully challenged in a misfeasance summons by a liquidator in a creditors' voluntary winding up.

Let us look at the more recent cases.

1. *Conflicting English Dicta*

In 1980 in the House of Lords in *Lonrho Ltd* v. *Shell Petroleum Co. Ltd.*[8], which concerned an alleged conspiracy to breach sanctions against Rhodesia by Shell, Lord Diplock said "the best interests of the company are not necessarily those of the shareholders but may include those of the creditors". On the other hand, the English Court of Appeal in *Re Horsley & Weight Ltd.*[9] in 1982 held that a pension policy was *intra vires* and Buckley L.J.[10] said that, although it may be somewhat loosely said that the directors owe an indirect duty to the creditors not to permit any unlawful reduction of capital to occur, it was in fact more accurate to say that the directors owe a duty to the company in this respect and if the company went into winding up the liquidators owe a duty to enforce the right to repayment. In *Multinational Gas & Petrochemical Co.* v. *National Gas and Petrochemical Services Ltd*[11] in 1983 the Court of Appeal held, by a majority, that where the shareholders had approved the

4 (1976) 50 A.L.J.R. 446. Noted by R. Barrett (1977) 40 M.L.R. 226.
5 Ibid., 449
6 (1986) 4 A.C.L.C. 654, 660
7 (1980-81) 5 A.C.L.R. 546
8 [1980] 1 W.L.R. 627, 634.
9 [1982] 3 All E.R. 1045.
10 Ibid., at 1055 b-c.
11 [1983] 3 W.L.R. 492.

directors' acts, these became acts of the company and barred a claim by the liquidator against the company. In approving the directors' acts the shareholders owed no duty to future creditors. Dillon L.J.[12] said: "A company owes no duty of care to future creditors . . . so long as the company is solvent the shareholders are in substance the company."

More recently Lord Templeman made some wide ranging remarks in the House of Lords in *Winkworth* v. *Edward Baron Development Co. Ltd*[13] which seem to conflict with Buckley L.J.'s dicta in *Re Horsley & Weight Ltd.* *Winkworth* was a case involving a claim by a wife in respect of an equitable interest in the proceeds of sale of a matrimonial home. The proceeds had been paid into the overdrawn bank account of a family company of which the wife and husband were the shareholders and directors. They had used the company's funds for the purchase of the shares in question and had caused the company to purchase a house which was occupied as the matrimonial home. Unknown to the wife the husband had mortgaged the house to the appellant, forging his wife's signature in the process. The immediate issue was whether the wife had an equitable interest which prevailed over the appellant's interest. The Court of Appeal, reversing the trial judge, upheld her claim but the House of Lords allowed the appeal. Lord Templeman with whom the other law lords agreed said:[14]

> . . . a company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. The conscience of the company, as well as its management, is confided to its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.

With respect, these remarks are too widely stated and seem to be based on a vague recollection of Jessel M.R.'s famous remarks in *Flitcroft's Case.*[15] If they are simply regarded as a restatement of the capital maintenance doctrine then there is no harm done. If they represent an equitable extension of that doctrine from the core of stated capital to a penumbra of guaranteed solvency then they go further than existing authority. They would represent an extension of the previous law in a way which is contrary to *Salomon* v. *Salomon & Co Ltd.*[16] They seem to use the alter ego theory (in the guise of the corporate conscience) to pierce the corporate veil in favour of creditors in a way which is unprecedented in Commonwealth caselaw.[17] It is probably better to regard the remarks as loosely expressed (and possibly obiter) dicta which are addressed

[12] Ibid, at 519. It is clear that his Lordship was talking there of a solvent company, see his later comments in *Liquidator of West Mercia Safetywear Ltd* v. *Dodd (1988) 4 B.C.C. 30.*

[13] [1987] 1 All ER 114. Lord Templeman also sat in *Re Horsley & Weight Ltd.*

[14] Ibid 118c-e.

[15] *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 Ch.D. 519. This had been cited in argument in *Re Horsley & Weight Ltd.* It is not clear whether it was cited in *Winkworth.* Compare Jessel M.R. arguendo at 21 Ch.D. 530 with his more measured statement at 533-4.

[16] [1897] A.C. 22.

[17] See *Farrar's Company Law*, 2nd ed., p.64. The courts will, however, pierce the corporate veil in cases of fraud. US courts have long been willing to pierce the corporate veil in cases of confusion or intermingling of assets by a controlling shareholder. See *Ballantine on Corporations*, 294.

to the particular problems of capital maintenance and misfeasance in a winding up. The directors' actions were not normal trading activities but were a clear example of self dealing in a thinly capitalised and actually insolvent company with cavalier disregard of the company's separate entity. Lord Templeman said that the breaches of duty would not have mattered if the company had remained solvent. Since a breach of section 42 of the U.K. Companies Act 1981 (as it then was) (company financing purchase of its own shares) appears to have been committed with criminal as well as civil consequences it is difficult to agree entirely with his Lordship on that ground either.[18]

2. *Nicholson v. Permakraft (N.Z.) Ltd.*

The matter was considered in some depth by Sir Robin Cooke in the Court of Appeal in *Nicholson* v. *Permakraft (N.Z.) Ltd*[19] in 1985. In that case the company had been restructured in 1975 by the incorporation of a new company ("Holdings"), the distribution of a capital profit on revaluation of properties, the purchase by the shareholders of shares in Holdings and a simultaneous sale of most of their shares in the company to Holdings. Two years later the company was ordered to be wound up and the liquidator commenced proceedings to recover the amount of the capital dividend. In the High Court it was held that the directors, in failing to take into account the interests of the company or its creditors, were guilty of a breach of duty. The Court of Appeal, however, allowed an appeal on the basis that the finding that the interests of the company had not been considered was contrary to the evidence. The company was solvent at the time and there were sound commercial reasons for the restructure. Therefore, the decisions of the directors and the shareholders could be regarded as reasonable at the time and not unfair to creditors. However, Cooke J. made some interesting philosophical remarks on the question of a duty to creditors.[20] He said that the duties of directors are owed to the company. On the facts of particular cases this may, however, require the directors to consider, *inter alia* the interests of creditors. The creditors were entitled to consideration if the company was insolvent, or near insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency. The criterion should not be simply whether the step proposed would leave a state of ultimate solvency in the sense of total assets exceeding total liabilities. Nor should it be decisive that on the balance sheet the subscribed capital remained intact so that a capital dividend could be paid without returning capital to the shareholders. Balance sheet solvency and the ability to pay a capital dividend were certainly important factors but "as a matter of business ethics it is proper for directors to consider also whether what they do will prejudice the company's practical ability to discharge promptly debts owed to current and likely continuing trade creditors".[21] His Honour thought that to translate this into a legal obligation would be consistent with the now pervasive concept of duty to a neighbour and the linking of power with obligation. He thought that to make out a

[18] The provisions of s.43 of the Companies Act 1981 did not appear to have been complied with.

[19] [1985] 1 N.Z.L.R. 242. See F. Dawson [1984] 11 N.Z.U.L.R. 68; J.H. Farrar [1985] JBL 413; Heydon op. cit. 128 et seq. See also *Re Avon Chambers Ltd* [1978] 2 N.Z.L.R. 638 and *Re Day Nite Carriers Ltd* [1975] 1 N.Z.L.R. 172.

[20] Ibid., pp.249-250.

[21] Ibid., p.249.

duty to future new creditors would be much more difficult. Those who commence trading and give credit to a limited liability company do so on the basis that the subscribed capital has not been returned to shareholders but otherwise they take the company as it is. Short of fraud they have to be guardians of their own interest. His Honour thought that in the case of a supplier with an established trade relationship there was a distinction between current and future debts but that it was not necessary or desirable to use that distinction so as to limit the duties of the directors of the debtor company to consider whether debts already incurred can be paid. He said "If the company's financial position is precarious the fortunes of such suppliers may be so linked with those of the company as to bring them within the reasonable scope of the directors' duty".[22] He concluded by saying that the recognition of duties to creditors restricted in this way was justified on the basis that limited liability was a privilege. It was open to abuse. Irresponsible structural engineering to the prejudice of creditors was a mischief but a balance has to be struck. There was no good reason for cultivating a paternal concern to protect business people perfectly able to look after themselves. The other two members of the Court of Appeal, Richardson and Somers J.J., were not prepared to address such broader issues.

Cooke J.'s obiter remarks are an interesting discussion of the law as it is developing but perhaps go further than the remarks of Mason J. and Lord Diplock. They are, however, predicated on insolvency or financial difficulty bordering on insolvency. If the company is not insolvent then it is arguable that the directors should be under no liability at all.

Cooke J. agreed with the approach of Cumming-Bruce and Templeman L.J.J. in *Re Horsley & Weight Ltd.*,[23] both as to an objective test and as to ratification. The test is *ought* the directors to have known that the particular thing was likely to cause loss to creditors. In the circumstances where such a duty is owed the unanimous consent of the shareholders will not be sufficient to justify the breach of duty. Indeed, the concurrence of the shareholders, although it prevents any complaint by them, merely compounds rather than excuses the breach as against the creditors.

3. *Kinsela v. Russell Kinsela Pty Ltd*

In *Kinsela* v. *Russell Kinsela Pty Ltd*[24] in 1986 the issue was the validity of a lease granted by a company in a state of imminent collapse to two directors. The aim was to put the assets beyond the reach of creditors. The lease was approved by all the shareholders. The New South Wales Court of Appeal held that it was a voidable transaction. Street C.J. expressed the matter neatly when he said:[25]

> It is, to my mind, legally and logically acceptable to recognise that, where directors are involved in a breach of their duty to the company affecting the interests of shareholders, then shareholders can either authorise that breach in prospect or ratify it in retrospect. Where, however, the interests at risk are those of creditors I see no reason in law or in logic to recognise that the shareholders can authorise the breach. Once it is accepted, as in my view it must be, that the directors' duty to a company as a whole extends in an insolvency context to not prejudicing the interests

22 Ibid., p.250.
23 [1982] Ch. 442, at 454-6. C.f. Buckley L.J.
24 (1986) 4 A.C.L.C. 215.
25 (1986) 4 A.C.L.C. 223.

of creditors (*Nicholson & Ors* v. *Permakraft (N.Z.) Ltd* and *Walker* v. *Wimborne*) the shareholders do not have the power or authority to absolve the directors from that breach.

He hesitated to formulate a general test of the degree of financial instability which imposed a duty on directors to consider the interests of creditors. He continued:[26]

For present purposes, it is not necessary to draw upon *Nicholson & Ors* v. *Permakraft* as authority for any more than the proposition that the duty arises when a company is insolvent inasmuch as it is the creditors' money which is at risk, in contrast to the shareholders' proprietary interests. It needs to be borne in mind that to some extent the degree of financial instability and the degree of risk to the creditors are interrelated. Courts have traditionally and properly been cautious indeed in entering boardrooms and pronouncing upon the commercial justification of particular executive decisions. . . . The plainer it is that it is the creditors' money that is at risk, the lower may be the risk to which the directors, regardless of the unanimous support of all of the shareholders, can justifiably expose the company.

At the end of the day, however, he said that he agreed with the Cooke dicta.

4. *Grove v. Flavel*

In *Grove* v. *Flavel*[27], also in 1986, the Supreme Court of South Australia was concerned with the breach of the predecessor of section 229(3) of the Companies Code (making improper use of information). The Court held that a director of a company which he knew faced a real risk of liquidation acted improperly when he took steps to safeguard himself and other companies of which he was a director from the consequences of such liquidation. Jacobs J. referred to *Nicholson* v. *Permakraft* and the *Kinsela* case and said that both of them involved directors of companies known to be insolvent. His Honour was not persuaded that the authorities supported a wider proposition that a duty is owed quite independently of insolvency or financial instability.

5. *David Neil and Company Ltd v. Neil*

In the New Zealand case of *David Neil and Co Ltd* v. *Neil*[28] the matter arose in the context of a caveat lodged by the governing and sole director of an insolvent company against its only assets which he had agreed to buy the day before the bank appointed receivers. The receivers purported to cancel the contract. Smellie J. held that the contract was voidable and possibly void ab initio. His Honour looked at Cooke J.'s obiter dicta in *Nicholson* v. *Permakraft* and regarded it as legitimate to take those principles into account in exercising his discretion under section 143 of the Land Transfer Act 1952 to remove the caveat.

6. *Hilton International Ltd (in liquidation) v. Hilton*

In the recent case of *Hilton International Ltd (in liquidation)* v. *Hilton*[29] Tipping J. considered the authorities in the context of the distribution of a capital dividend. This dividend had been declared and paid when the company

26 Ibid.
27 (1986) 4 A.C.L.C. 654.
28 (1986) 3 N.Z.C.L.C. 99, 658. See too *Re Lake Tekapo Motor Inn Ltd (in liq.)* (1987) 3 N.Z.C.L.C. 100,156.
29 (1988) 4 NZCLC 64,721.

was having liquidity problems. The facts of the case are quite complex but the issues were relatively simple. The principal argument put forward by the liquidators was that the capital dividend had been declared contrary to law and either fraudulently or negligently. His Honour did not find fraud but found an unlawful return of capital which constituted a breach of duty and took the opportunity of restating the dividend rules in conjunction with the duties of directors to creditors. His main reason for not finding fraud was that at all material times the defendants had acted in close consultation with their accountants. After referring to the recent cases on directors' duties and the leading authorities on dividends his Honour attempted a restatement of principle as follows:

(i) Dividends including capital dividends may be paid only out of profits, or putting the matter conversely, may not be paid out of paid up capital without the Court's approval of a reduction of capital.

(ii) The payment of a dividend out of paid up capital will occur if the payment has the effect of reducing the company's net assets (often referred to as shareholders' funds) below the amount of its paid up capital. The expression net assets for present purposes means the amount which remains after deducting all the company's liabilities both actual and contingent prudently assessed from the sum of all its assets prudently valued. Accounts should be taken to demonstrate the company's position overall. A capital or income transaction should ordinarily not be viewed in isolation.

(iii) Whether there are profits and if so how much thereof should be paid out as dividend is essentially a matter of commercial assessment and judgment but that assessment and judgment must be made and exercised with these and the following propositions in mind.

(iv) No dividend may be paid, whether out of capital or income profits, if the company is in a state of trading insolvency.

(v) No dividend may be paid, whether out of capital or income profits, if the company is in a state of balance sheet insolvency, or will enter that state as a result of the payment.

(vi) No dividend may be paid, whether out of capital or income profits, if the company is in a state of doubtful trading or balance sheet solvency unless the directors can demonstrate, if later challenged, that they believed in good faith and on reasonable grounds that the payment of the dividend would not jeopardise the company's ability promptly to satisfy its creditors present and future and whether secured or unsecured.

(vii) Even if the company is fully solvent in both the trading and balance sheet senses no dividend may be paid whether out of capital or income profits if the directors ought to have appreciated that such payment was likely to jeopardise the company's balance sheet or trading solvency.

(viii) The directors of a company, when declaring a dividend, owe a duty not only to the company but also to its creditors, of all kinds likely to be affected, to act in accordance with the foregoing principles. In a proceeding against them by the liquidator of the company the directors are not protected from liability for a breach of such duty by any ratification of their actions by the shareholders.

(ix) Directors who act in breach of any of the foregoing principles are liable to compensate the company for its loss arising as a result of the breach unless the Court relieves them in whole or in part from that liability

pursuant to section 468 of the Companies Act 1955 if and to the extent that that section applies.

It is interesting to note that his Honour by combining the two lines of authority has restated the law in a way which approximates to the legislative reforms now contained in section 40 of the Canada Business Corporations Act which have recently been considered by the Law Commission in its review of the Companies Act 1955.[30] In other words, while dividends can be paid out of current profits without first making up previous losses dividends can only be paid while the company is still solvent. Solvency is to be determined either by trading solvency or balance sheet solvency. Trading solvency is where a company is able to pay its debts as they fall due. Balance sheet solvency is where the company has got assets, which reasonably assessed, exceed its liabilities properly brought into account at the relevant time. This is the first time that a judge has stated the law in a manner which enables one to link mainstream directors' fiduciary duties (including care and skill) with the dividend rules and the law which applies on insolvency. This is an interesting and useful rationalisation of the law.

7. *Summing up the caselaw trends*

Although the recent developments can be argued to be inconsistent with earlier authority,[31] the earlier authority was concerned with the question of whether there was *a trust* for or a fiduciary obligation to creditors and it was held that there was not. In the recent developments Street C.J. in *Kinsella*, like Mason J. in *Walker* v. *Wimborne*, seems to see the matter as one of fiduciary obligations to the company as a whole while *Grove* v. *Flavel* represents an attempt to plumb the murky depths of section 229 of the Australian act. On the other hand, the dicta of Lord Templeman in *Winkworth* seem to pierce the corporate veil in Equity while those of Cooke J. in *Nicholson* v. *Permakraft*, while paying lipservice to prevailing orthodoxy, seem to hint at a duty of care owed by directors in respect of creditors at least in cases of insolvency or near insolvency. In other words there may be a duty owed to the company to take reasonable care even where the company itself would not be under such a duty to the creditors. There are in fact some precedents in favour of direct liability of directors to creditors in negligence and deceit which Cooke J. did not consider. Thus in *Fairline Shipping Corporation* v. *Adamson*[32] in 1975 a managing director of a company in liquidation was held personally liable for negligence in respect of a failure to store perishable goods at the right temperature. Again in the South African case of *Orkin Bros Ltd* v. *Bell*[33] in 1921 the court held that there was an implied representation when the directors of limited companies order goods from a merchant that they believe the company will probably be able to pay and if they know that there is no likelihood of payment and no means of payment they commit a fraud. It might even be possible to argue in a suitable case that there is

[30] Law Commission Preliminary Paper No.5, *Company Law*, A Discussion Paper, para. 89. See too the U.S. Model Business Corporations Act provision discussed in para. 91 ibid.

[31] See Dawson, op cit. 12.

[32] [1974] 2 W.L.R. 824. See A. Diamond (1975) 38 M.L.R. 198 who argues that this presupposes an independent tort which cannot be inferred from the company's tort. Cf. *Pollnow* v. *Garden Mews St Leonards Pty Ltd & Others* (1984) 9 A.C.L.R. 82.

[33] 1921 T.P.D. 92. See too *Brenes & Co* v. *Downie* 1914 S.C. 97; *Ruto Flour Mills (Pty) Ltd* v. *Moriates and Anor* 1957 (3) S.A. 113(T).

a constructive trust on the basis of money having been paid for a purpose which has not been fulfilled.[34]

The recognition of a duty of care would obviate any awkward question of locus standi of the creditor to sue before winding up. This would not mean that there would be a duty owed in all circumstances, as Cooke J. recognised, and indeed Lord Denning M.R. recognised in the analogous context of a receiver's duty to creditors in *Standard Chartered Bank* v. *Walker*.[35] The concept of a duty of care, although arguably in strict logic a category of a concealed circular reference,[36] may be adequate to regulate the extension of liability in this context in practice. However this innovation may be without any underlying economic sense as we shall see.

Tipping J. in the *Hilton* case still seems to regard the matter as one of directors' fiduciary duties to the company. His Honour's judgment contains a useful restatement of the law tying up a number of loose ends. In restating the dividend rules in the light of the new authority on directors' duties in respect of creditors his Honour inevitably breaks new ground and anticipates legislative reform. His judgment provides a useful link with the statute law which applies in winding up. To this I now turn.

II Statute Law

A. Civil Liability

1. *Unreasonable incurring of debts*

Section 320 (1)(a) of the Companies Act 1955 provides as follows:

> If in the course of the winding up of a company it appears that —
>
> (a) Any person was, while an officer of the company, knowingly a party to the contracting of a debt by the company and did not, at the time the debt was contracted, honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due for payment as well as all its other debts (including future and contingent debts).

Coverage

(a) The term "*officer*" as used in section 320(1)(a) and 320(1)(b) is defined in section 2(1) as including a director, manager or secretary. An auditor can be held liable under these sections[37] but a receiver and manager is not an officer.[38]

(b) Section 320(1)(a) and 320(1)(b) were introduced by section 32 of the Companies Amendment Act 1980 and they only apply to acts or omissions occurring after 31 March 1981.

(c) Under section 320 (1)(a) the first point which the liquidator has to establish is that the defendant officer was "knowingly a party to the contracting of a debt by the company".

Peter Howell and Mike Whale in "Recent Developments in Insolvency Law and Practice"[39] state that in the context of section 320(1)(a) "The word knowingly

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[34] *Brenes & Co* v. *Downie* (Supra) 104; *Quistclose Investments Ltd* v. *Rolls Razor Ltd* [1968] 2 W.L.R. 478 (H.L.).

[35] [1982] 1 W.L.R. 1410 (C.A.).

[36] See Julius Stone, *Legal Systems and Lawyers' Reasonings*, 258.

[37] *R* v. *Shactor* [1960] 1 All E.R. 61.

[38] *Re B Johnson & Co (Builders) Ltd* [1955] 2 All E.R. 775 (C.A.).

[39] N.Z.L.S. 1987 at p.30.

probably does not require an element of mens rea but is likely to protect officers who have not taken an active part in management and have no knowledge of the affairs of the company — See *Re J.E. Hurdley and Son Ltd (in liquidation)* [1941] N.Z.L.R. 686". In *Hurdley* the Court of Appeal was concerned with what is now section 364 and Ostler and Fair J.J. held that the object of the Legislature in using the word "knowingly" was to protect such members of the company as do not take an active part in its management, and, therefore, have no knowledge of the state of its finances. Ostler J. said:[40] "If a reasonable man at the time that the debt was incurred and with the knowledge of the directors as to the affairs of the company would have known that the company was insolvent, and that there was no reasonable chance of its being able to pay the debt incurred together with all its other debts, then, in my opinion, the directors are liable under the section". Myers C.J.[41] held that the word "knowingly" in section 170(1) did not import mens rea but meant that, before an order can be made, it must be shown that the member of the company sought to be mulcted knew that the particular debts were being incurred, and that he also had a knowledge generally of the company's affairs, so that, as a reasonable person, he should have known that, at the time when the particular debts were contracted, the company could not have had any reasonable or justifiable expectations of being able to pay the same as well as all its other debts. So on the basis of this case it would seem that in order for an officer to be "knowingly a party" he has to have actual knowledge of the incurring of the particular debt and a general knowledge of the company's affairs. He must also have taken an *active part* in the prohibited act (i.e. the contracting of the debt) and a mere omission to act will not make him liable.

(d) Having shown that the officer is knowingly a party to the contracting of a debt by the company the liquidator has to prove the absence of honest belief on reasonable grounds that the company would be able to pay the debt when it fell due for payment as well as all its other debts existing as at the incurring of the debt in question.[42] That burden may be discharged either by the liquidator establishing the absence of honest belief, or by showing that notwithstanding its presence, such belief was not based on reasonable grounds, judged by the objective standard of a reasonably competent officer of the company in that position.

So in summary there are two tests to be applied in conjunction — the subjective test of an honestly held belief by the officer that the company can meet its debts, must be confirmed by an objective test, namely the reasonableness of that belief. Whether "the belief is reasonable or not will be a question of fact to be decided in each case. The belief must not be a fanciful or unreasonable hope".[43]

(e) In *Re Petherick Exclusive Fashions Ltd (in liquidation)*[44] Eichelbaum J. came to some conclusions as to the applicability of Australian authorities to our section.

He held that the following matters of law decided by Foster J. in *3M*

[40] *Re J.E. Hurdley & Son Ltd (in liq.)* [1941] N.Z.L.R. 686 at 743.
[41] Ibid. at p. 734.
[42] Per Eichelbaum J. in *Re Petherick Exclusive Fashions Ltd* (1986) 2 B.C.R. 177; (1987) 2 N.Z.C.L.C. 99, 946-58.
[43] Ibid.
[44] (1987) 3 N.Z.C.L.C. 99,946 at 99,958.

Australia Pty Ltd v. *Kemish*[45] were also applicable to section 320 (l)(a) of the New Zealand Act:

"1. The word 'reasonable' imports an objective test of reasonableness."

"2. The opinion expressed on the meaning of the phrase 'immediately before the incurring of the subject debt' which occurs in the Australian legislation is, I think, equally applicable to the expression 'at the time the debt was contracted' in the New Zealand section. The court must look to the facts relating to the ability of the company to pay all its debts as they existed at that time".

"3. . . . the existence of reasonable grounds should be tested by the standard of an officer of the company of reasonable competence."

On the issue of when a debt became *due*, his Honour said that

"4. . . . a debt does not necessarily become '*due*' on the date originally stipulated for payment. Arrangements for extended time for payment or, even where no express arrangements have been made, but previous dealings suggest an extension would be allowed, are factors which should be considered when determining when a debt is 'due'."

On this fourth finding Eichelbaum J. said:[46]

"These conclusions, based on a judgment of Mahoney JA in *Dunn v Shapowloff*[47] may equally be applied to the corresponding expression in s 320 (l)(a) and, agreeing as I do with the views expressed I adopt them for the purposes of this judgment".

2. *Reckless trading*

Section 320(1)(b) reads

If in the course of the winding up of a company it appears that

(c) Any person was, while an officer of the company, knowingly a party to the carrying on of any business of the company in a reckless manner.

Coverage

(a) "Party to the carrying on of any business of the Company"

This phrase is found in both section 320(1)(b) and section 320(1)(c).

(b) When is a person a party in the context of section 320(1)(b) and (c)?

I have already discussed this issue in relation to section 320 (1)(a) and reference should be made to that discussion. In *Thompson* v. *Innes & Anor*[48] in a claim under section 320(1)(b), Bisson J.held that:

"For a person to be a party to the carrying on of a business he must take some positive and active part in the actual conduct of the business operations of the company (see *In re Maidstone Buildings Provisions Ltd* [1977] 1 WLR 1085). Such positive and active part may take various forms and would include the giving of advice".

So being a party necessitates some form of "positive involvement, not mere inertia". On the facts in *Thompson* the company secretary and accountant had not advised the defendant to act recklessly by incurring unnecessary spending. Rather "such advice as Mr Fletcher gave was to

[45] (1986) 10 A.C.L.C. 371.

[46] *Re Petherick* supra at 99,958.

[47] [1978] 2 NSWLR 235

[48] (1985) 2 NZCLC 99,463 at 99,470. 48. Ibid. at 1093.

restrain Mr Innes from incurring unnecessary expenditure".[49]

As Gordon Williams argues in his article[50] what is implicit in the court's finding is that being "a party to" necessitates positive action with regard to the acts tainted with fraud but does not include mere participation in the general conduct of the business.

In *Thompson*, the positive act (advice) was an attempt to stop the reckless act, rather than encourage it.

Finally, what is meant by being "knowingly" a party in the context of section 32(1)(b) and (1)(c)? What precisely must the person in question know? There is no New Zealand, English or Australian authority directly on this point. Reference can be made to the *Hurdley* case (supra) on section 364. R.C. Williams submits that in the context of the Australian equivalent of section 320 (1)(c) — [51]

> This word means that the person in question participated in the act of the company in the requisite manner and was either himself possessed of a fraudulent intent or purpose or knew that another participant in the act had such an intent or purpose.

(c) "Any business of the company"

This phrase which is common to sections 320(1)(b) and 320(1)(c) was recently discussed by the Court of Appeal in *Re Nimbus Trawling Company Ltd: Keegan and Anor* v. *Page Vivian Motors Ltd*[52].

In summary the court held by majority (Cooke P. and Somers J.; Richardson J. dissenting) that in section 320 the expression "any business of the company" included an *isolated* transaction even when the transaction was not in the course of carrying on the company's usual business. It was held that the section was applicable to the process of carrying out by the company of *any* transaction which was a business transaction.

In *Nimbus*[53] the company incurred a debt in respect of repair work done on its only asset, a fishing vessel. The company disputed this debt because it alleged the work done was not satisfactory. Before the creditor's action to recover the debt could be heard, the company sold the vessel to a sister company. Some of the proceeds of sale were used to repay the director's loan account with the company. That money was then used by the directors to purchase 50% of the sister company's shares. The effect of the transaction was that the company was left without any assets with which to satisfy the judgement obtained by the creditor in respect of the debt owed.

On the facts it was held that the sale of the asset and the disposition of the proceeds were the carrying on of a business for the purposes of the section.

Both Cooke P. and Somers J. emphasised that section 320 used "any business" as opposed to "the business". In their opinion this indicated that the section did not refer to the totality of the company's activities.

[49] Ibid at 99,470 per Bisson J.

[50] "Directors' Liability for Fraudulent Trading" [1984] 11 N.Z.U.L.R. 189 at 197.

[51] (1986) 4 C & S.L.J. at 29.

[52] (1986) 3 N.Z.C.L.C. 99,646.

[53] Supra, fn.52. In this case the Court was considering the old s.320 (1) before the section was amended in 1980. That does not matter as the phrase was in all material respects the same.

It would be sufficient for liability if in the course of business generally a particular piece of business was carried out with requisite intent. While the sale of an asset and the disbursement of its proceeds was not the company's business in the normal commercial sense of trading for the purpose of profit making, it was held that where the company had ceased trading and engaged in winding up the business it was still business being carried on by it.

As Cooke P. stated: [54]

> In short I agree in substance with Prichard J. that the provision covers any dealing or transaction of the company performed, carried out, or conducted with the intention of defrauding creditors. That longer phraseology is in my view a paraphrase that is reasonably open and should be adopted of the idea more shortly expressed in the statutory language. Remedial legislation of this kind should not be narrowly construed.

(d) Reckless

The most important concept in section 320 (l)(b) is that of recklessness. There is no Australian equivalent of section 320(l)(b). The leading New Zealand case is *Thomson* v. *Innes*[55]. The relevant principles can be stated as follows.

(i) The fact that at a particular time a company was unable to pay its debts as they fell due, does not of itself prove recklessness in carrying on the business.[52]

It was said in that case that many companies experienced liquidity problems but with some forbearance by their creditors they were able to trade their way out of difficulties. But at 99-468 Bisson J. said that "there are grave responsibilities on directors who take that course as without reasonable prospects of success, their actions may amount to a reckless disregard for the losses they impose on company creditors".

(ii) In considering recklessness under section 320(1)(b) it is necessary to inquire if the conduct was *blameworthy* and this was an *objective test*, (thus distinguishing it from sub section (1)(a) where an honest belief, or (1)(c) an intent to defraud are relevant and involve a subjective test).[57]

(iii) But the carrying on of any business of the company in a reckless manner under (1)(b) does not necessarily require proof of blameworthy behaviour to the extent of dishonesty.[58]

(iv) The appropriate test to be adopted under (1)(b) to decide if someone has been reckless was formulated by Bisson J. as follows:[59]

> [W]as there something in the financial position of this company which would have drawn the attention of an ordinary prudent director to the real possibility not so slight as to be a negligible risk, that his continuing to carry on the business of the company would cause the kind of serious loss to creditors of the company which section 320 (1)(b) was intended to prevent.

54 Ibid. at 100,165.
55 Supra footnote 43.
56 Ibid. 99,468.
57 Ibid. 99,470.
58 Ibid. 99,472.
59 Ibid. 99,472.

See also *Re Rex Wood Service Centre Ltd (in liquidation)*,[60] where the liquidator of an insolvent company sought to make a director personally liable for an amount equivalent to the total amount claimed by creditors proving in the liquidation. It was held by Doogue J. that proper company records would have explained the substantial loss suffered by the company. As the director was responsible for the lack of records and as that information was not available, the director had acted in a reckless manner. Orders were made under sections 319 and 320(l)(b) declaring the director personally liable for the amount claimed with interest at 11%.

Both these two cases must be compared with the unsuccessful action in *Re Lake Tekapo Motor Inn Ltd (in liquidation)*.[61] A company liquidator brought an action against a director under section 320 (1)(b) and 320(1)(c) to recover the sum of two capital dividends which the director had caused to be declared. It was held by Tipping J. that the company was solvent when the first dividend was declared. Thus the director had not behaved recklessly. Bisson's J. test was not met as regards this first dividend. At the time of the second dividend the company was insolvent, but the plaintiffs had not established that the dividend had been recklessly made. Nor had they shown with the necessary degree of certainty that the director's intention was to defraud the creditors. It was more probable that the director intended to perfect what he saw as an integral part of a family agreement.

3. *Fraudulent trading*

Section 320 (l)(c) reads as follows:

If in the course of the winding up of the company it appears that

(c) Any person was knowingly a party to the carrying on of any business of the company with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose.

Coverage

(a) Person

Unlike (l)(a) and (l)(b), (l)(c) applies to *any person*, it is not limited to an "officer" of the company.[62]

In New Zealand the Court may impose civil liability for fraudulent trading under section 320, but it has no power under *that* section to direct criminal sanctions against the offender. In Australia the Companies Code states that criminal liability under section 556(5) which is the prerequisite for a declaration of civil liability under section 557 (2) arises:

If a company does any act . . . with intent to defraud creditors of the company . . . or for any other fraudulent purpose

R.C. Williams[63] submits that this means the requisite intent to defraud or fraudulent purpose must be imputable to the company itself, so that

[60] (1986) 3 N.Z.C.L.C. 100, 199.

[61] (1987) 3 N.Z.C.L.C. 100-156.

[62] See *Re Gerald Cooper Chemicals Ltd* [1978] 2 All E.R. 49 where it was said that *a creditor* was liable if he accepted money which he knew had been procured by carrying on business with the intent to defraud creditors.

[63] Ibid. at 25.

the person with the intent must have been the directing mind and will of the company.

I think that both the New Zealand and English sections cannot be limited in this way. If Parliament had meant to limit liability to management why did it not use the term "any officer" (as in (l)(a) and (l)(b)) instead of using the term 'any person'? Parliament has deliberately used wider wording. Also it seems that R.C. Williams' view does not take into account the decisions in *Re Maidstone Buildings Provisions Ltd*[64] and *Re Gerald Cooper Chemicals Ltd.*[65]

(b) The concept of "intent to defraud" or "fraudulent purpose"

In order to prove that business is carried on with intent to defraud creditors of the company *actual dishonesty* must be shown. This section is directed at persons who deliberately and knowingly set out to cheat and defraud creditors.[66]

The same point was recently reaffirmed by the Court of Appeal in *Nimbus* where it was held that intent to defraud meant actual dishonesty, actual fraudulent intent or morally blameworthy conduct according to the current notions of fair trading among commercial men.[67]

It is clear that a genuine but unjustified hope that creditors would be paid is sufficient to prevent a successful action. See *Re Southmall Hardware Ltd (in liquidation)*[68] where the action failed. It was said that the officers' blameworthy irresponsibility did not amount to fraudulent conduct for the purposes of the section.

The majority of the Court of Appeal recently reaffirmed this latter principle in *Nimbus.*[69] Both Somers and Richardson JJ. held that section 320 was not aimed at persons who were blameworthy, irresponsible or even hopelessly optimistic but was directed against persons who deliberately and knowingly set out to cheat or defraud creditors.

In England the cases, influenced by the significance of dishonesty in the law of theft, have tended to import dishonesty into the equivalent section as a separate element in addition to intent to defraud and knowledge of the carrying on of the business. The leading case is *R* v. *Grantham*[70] which we examine below.

Successful applications under section 320 (l)(c) have been rare. One example was *Re Casual Capers Ltd (in liquidation).*[71] In that case the director knew the company was insolvent and was knowingly a party to the company continuing to carry on business with intent to defraud creditors. The significant fact was that the directors had systematically banked moneys and failed to apply available funds for the benefit of creditors, and continued the trading of the company only for so long as it was necessary to avoid liability under their guarantee to the bank. The court held (in relation to the other allegations relied on by the liquidator to substantiate the claim) that the disappearance of cash books and stock

64 [1971] 1 W.L.R. 1085.
65 [1978] Ch. 262.
66 For example see Menzies J. in *Hardie* v. *Hanson* (1960) 105 C.L.R. 451 at 355.
67 Supra note 52. See especially Cooke P. at 99,650.
68 (1984) 2 N.Z.C.L.C. 99,102.
69 Supra note 48.
70 [1984] 2 All E.R. 166.
71 (1983) 1 N.Z.C.L.C. 95-074.

cards while arousing suspicion, was not sufficient on the evidence to support the allegation of fraud.

Section 320 declares that the person shall be personally liable without any limitation of liability for all or any part of the debts and other liabilities of the company.

(c) Quantum of liability

Once a finding has been made under either section 320 (l)(a), (b) or (c) the question as to quantum of liability arises. In considering the extent of the director's personal liability in *Re Casual Capers* Bisson J. said that the following three principles were applicable:

(i) The amount of the declaration is in the discretion of the court and should be in respect of a specific sum.

(ii) That the amount ordered would generally be limited to the amount of the debts of the defrauded creditors.

(iii) That the moneys recovered by the liquidator under the court's order form part of the assets of the company available for all creditors in the winding up.

While this case was decided under the old section the three principles were held by Eichelbaum J. in *Petherick* to be applicable to the new legislation. He said: [72]

> Although the decision was under the old section I consider that the principles previously laid down remain applicable to cases under the third limb (fraud). In my opinion they may also be applied directly to cases under the new first limb and indirectly to the second.

In relation to principle (i) that the declaration should be "a specific sum" — he said that this is necessary because as section 320(4) says "... every declaration under subsection (l) of this section shall be deemed to be a final judgement within the meaning of paragraph (d) of subsection 19 of the Insolvency Act 1967". Section 19 (a) of the Insolvency Act 1967 provides for a bankruptcy notice to be served when a creditor has obtained a final judgment or order against the debtor for any amount. That clearly contemplates a judgement or order for a specific sum.

Principle (ii) — was based on the comment of Maugham J. in *Re William C Leitch Brothers Ltd*[73] construing the equivalent provision dealing with intent to defraud: [74]

> I am inclined to the view that s 275 is in the nature of a *punitive* provision, and that where the court makes such a declaration in relation to 'all or any of the debts or other liabilities of the company' it is in the discretion of the court to make an order *without* limiting the order to the amount of the debts of those creditors proved to have been defrauded by the acts of the director in question, though no doubt the order would in general be so limited.

In *Petherick* Eichelbaum J. expressly extended this principle to limbs (l)(a) and l(b) as well.[75]:

[72] (1987) 3 N.Z.C.L.C. 99,946 at 99,960.
[73] [1932] 2 Ch. 71.
[74] Ibid. at 79-80.
[75] (1987) 3 N.Z.C.L.C. 99,946 at 99,960.

> The same general principle in my opinion should be applicable in cases under the legislation in its expanded form where liability under either the first or second limb of s 320 (l) has been established . Normally the order should relate and be limited to those debts incurred in the absence of honest belief, on reasonable grounds, that the company would be able tq pay them as they fell due; or alternatively, to such debts as were incurred while the officer was knowingly a party to the carrying on of any business of the company in a reckless manner. In the latter case, some correlation between the reckless carrying on of the business, or the particular part of the business, and the amount of recovery should be required.

Although the court has a discretion to take into account the punitive aspect no declaration made under section 320 has yet done this. Put simply the declaration only takes into account the debts *caused to be incurred* when the officer had the state of mind required under section 320 (1)(a), (b) or (c).

(d) Other practical points on an application for declaration of personal liability

(i) Before an application can be brought before the Court, the company must be in liquidation as we have seen.

(ii) Section 320 creates a new cause of action. It enables the applicant to show that misdealings committed some time before the winding up should be the subject of a declaration of personal liability. The Limitation Act 1950 requires that an application be made under section 320 *within six years* of the winding up order or from the date the liquidator was appointed. This is because the liquidation is a material part of the course of action.[76]

(iii) The burden of proof under section 320 is the civil standard but since the subject matter of the inquiry involves facts which, if established, would constitute an offence it will require a higher degree of probability than would otherwise be the case.[77]

(iv) In *Re Bennett Keane & White Ltd (in liquidation)*[78] in proceedings against them for personal liability the directors sought orders that (l) the liquidator file full particulars; (2) that his evidence be given by affidavit and (3) that he give security for costs. The court required him to specify the amounts for which he sought to make the directors liable but he was not required to file further particulars to the extent that his allegations were opinion and inference. If there were any factual matters on which the liquidator was relying, he was to give particulars. Nor would the court order the liquidator to give security for costs. This was not general practice, and there were no factual matters to take the case out of the ordinary.

(v) In *Official Liquidator of Waikato Frozen Products Ltd (in liquidation)* v. *Gower and Ors*[79] in an action to make a person personally liable for all the debts of a company in liquidation and to set aside a debenture, the High Court held that Rule 4 of the High Court Rules, taken in conjunction with Rule 455, made it appropriate that the

76 See especially *Re Maney & Sons de Luxe Service Station Ltd, Maney* v. *Cowan* [1969] N.Z.L.R. 116 per North P. at 128.

77 *Maloc Construction Ltd (in liq.)* v. *Chadwick & others* (1986) 2 N.Z.C.L.C. 99,794, 99,802 and the unreported case of *Re Bennett Keane & White Ltd* High Court Napier, 29 March 1988, M.17/83.

78 (1987) 3 N.Z.C.L.C. 99,905.

79 (1987) 3 N.Z.C.L.C. 100,254.

evidence be given by affidavit, in the first instance, with a right to cross examine at the hearing.

(vi) Section 468 provides for the possibility of relief. Section 468(l) provides:

> If in any proceeding for negligence, default, breach of duty or breach of trust, against an officer of a company or a person employed by a company as auditor (whether he is or is not an officer of the company) it appears to the court hearing the case that the officer or person is or may be liable in respect of negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as the court may think fit.

In *Re Lake Tekapo Motor Inn Ltd (in liquidation)*[80], Tipping J. said that the power to exonerate under section 468 was in addition to the discretion given under section 320 as to the amount for which relief should be awarded assuming that liability is established.

A close examination of the section shows that section 468 only becomes available if the person in question has acted honestly and reasonably. Thus if a person has been found liable under section 320 (1)(c) of intent to defraud it would follow that section 468 was not available as an element of dishonesty would be present.

Tipping J. was of the opinion obiter that where a person was found to be reckless under section 320(1)(b), while honesty might still be able to be established, it would be very hard to show that he acted reasonably because "ex hypothesi, a finding of recklessness suggests a substantial degree of commercially blameworthy negligence which itself suggests a failure to take reasonable care."

But section 468 itself contemplates that the court can excuse liability for negligence on the basis that the person has acted honestly and reasonably. Therefore it must be possible: parliament has turned its mind to it.

Tipping J. said: [81]

> Although I do not rule out the possibility of s 468 being available to relieve in whole or in part liability under one of the three limbs of s 320 I would think that the granting of such relief would be most unlikely and only possible under l(b) as the other paragraphs of s 320(l) i.e. paras (a) and (c), involve by their very terms a finding of dishonesty or lack of honest belief.

B. Criminal Liability Under Section 461 D (1) and (2)

In New Zealand Company Law there is no criminal liability as regards the incurring of a debt, but a person can be criminally liable under section 461 (D) if he or she fraudulently carries on business. In Australia there is criminal liability for both offences and civil and criminal liability are embodied in the same sections which causes difficulties in practice.[82]

Section 461 D(l) is worded in the same way as section 320(1)(c).

The concept of fraud involves the conscious attempt to act to deceive another to that person's disadvantage.

80 (1987) 3 N.Z.C.L.C. 100, 156.

81 Ibid. at 100, 174.

82 Compare also s. 126(1)(a) of the Insolvency Act 1967 and s. 364 of the Companies Act 1955.

Because the wording is the same as section 320(l)(c) it is submitted that the principles discussed above are relevant. Thus for this reason it may be assumed that any person convicted of an offence under section 461 D(l) will suffer the consequences of a declaration of personal liability if the company is placed in liquidation. Also where a declaration is made under section 320(1)(c) the person may also be prosecuted under section 461 D.

In New Zealand, therefore, either criminal or civil liability can be determined first, whereas in Australia the civil liability must await a prosecution of the defendant for the criminal offence. In Australia the criminal prosecution cannot be initiated by creditors, but only by the Corporate Affairs Commission. This causes delay and only the company can recover. The New Zealand section is silent on who may bring the action.

The penalty for conviction under the provisions of section 461 D is set out in section 461 E(l):

(1) imprisonment up to two years
(2) $1000 maximum fine
(3) or both.

In addition to section 461 D(l) section 461 D(2) covers fraudulently obtaining credit, and fraudulently transferring property.

Accommodating the English Court of Appeal decision in R v. Grantham[83] *in the New Zealand scheme*

In the criminal context the crucial issue is whether intent to defraud is to be determined on a purely subjective basis or an objective basis or a mixture of both.

If a purely subjective approach is adopted then genuine optimism, though completely unfounded, negates an intent to defraud. If an objective approach is taken then fraud is negated only if the optimism is based on reasonable grounds.

The old English cases such as *Re William Leitch* and the Australian cases like the High Court decision in *Hardie* v. *Hanson*[84] adopted the purely subjective standard.

However, the recent English cases of *R v Cox and Hedges*[85] and *R* v. *Grantham* endorse an objective view of intent to defraud in the context of criminal provision. It was held by the Court of Appeal in *R* v. *Grantham*, following decisions on dishonesty in the context of the Theft Act, that the following direction to the jury by the trial judge was correct in law: [86]

> Members of the jury, if a man honestly believes when he obtains credit that although funds are not immediately available he will be able to pay them when the debt becomes due or within a short time thereafter, no doubt you will say that is not dishonest and there is no intent to defraud, but if he obtains or helps to obtain credit or further credit when he knows there is no good reason for thinking funds will become available to pay the debt when it becomes due, or shortly thereafter, then though it is entirely a matter for you, this question of dishonesty, you might well think that is dishonest and there is an intent to defraud.

Grantham thus adopted a test whereby objectively there must be no good reason for thinking that funds will be available to pay the debt. Subjectively

83 [1984] 3 All E.R. 166.
84 (1960) 105 C.L.R. 451.
85 (1982) 75 Cr. App. R. 29.
86 [1984] 3 All E.R. at p.169.

the person in question must know there is no good reason. So unfounded optimism according to this case does not negate an intent to defraud. Therefore *Grantham* is not compatible with *Hardie* v. *Hanson* which was not cited.

If *Grantham* were to be adopted many difficulties would arise.[87] I will not discuss these difficulties because in my submission *Grantham* is not applicable in New Zealand for the following reasons.

(a) *Hardie* was not cited in *Grantham.*
(b) *Hardie* has been expressly adopted and *Grantham* has been implicitly rejected by the Court of Appeal in *Nimbus*, decided after *Grantham.*
(c) The English did not then have an equivalent to our section 320 (l)(b) on which they could fall back. The New Zealand legislation would probably have resulted in the defendant being *civilly* liable under section 320 (l)(b).
(d) The New Zealand reforms of 1980 must be read as a whole. There is a clear intention to separate reckless trading from fraudulent trading. The position is similar in Australia.
(e) *Grantham* is capable of harsh effects in a time of recession.

III Conclusion

Economic recession has motivated the courts and the legislature to adopt a harder attitude to directors of failing companies. The recent trends in the caselaw seem to go beyond the earlier authorities. The modern trend is to incorporate regard for the creditor interest in the directors' fiduciary duty to the company as a whole. The decision of Tipping J. in the *Hilton*[88] case appears to follows this trend. The dicta of Lord Templeman in *Winkworth*[89] and of Cooke J. in *Nicholson v Permakraft*[90] arguably represent the breaking of new ground. There is a hint of a direct duty in Equity or a duty of care in tort. To allow a remedy in negligence would overcome problems of locus standi for a creditor before winding up. To pierce the veil indirectly in this way is unusual but not revolutionary in Commonwealth legal terms. It is certainly not revolutionary when compared with the willingness of some U.S. courts to recognise a trust or fiduciary relationship to creditors on insolvency and to pierce the corporate veil in cases of thin capitalisation and group relationships.[91] An alternative remedy would be to allow creditors locus standi under section 209. This is done in Canada to some limited extent.[92] Here it might be necessary to distinguish a debenture holder from a trade creditor. Nevertheless, at the end of the day it is unlikely that a creditor will pursue either remedy in normal circumstances. First, it will not make economic sense for him to do so. He will want to be repaid, not to intermeddle in the affairs of his debtor or expose himself to the hazards of tricky litigation. Secondly, the parties to contracts can and often do bargain about the allocation of risks and the compensation for bearing them.[93] It has been argued persuasively

87 These are noted at p.25 in Williams' article supra, note 51.
88 (1988) 4 N.Z.C.L.C. 64,721.
89 [1987] 1 All E.R. 114.
90 [1985] 1 N.Z.L.R. 242.
91 See e.g. 19 *Corpus Juris Secundum*, para. 837; J.M. Landers "A Unified Approach to Parent, Subsidiary, and Affiliate Question in Bankruptcy" 42 U. Chi. L. Rev. 589 (1975).
92 See Iacobucci, Pilkington and Prichard, *Canadian Business Corporations* (1977), 205.
93 See R.C. Clark, "The Duties of a Corporate Debtor to its Creditors" 90 Harv. L. Rev. 505, 544 (1977).

by U.S. writers that such bargaining will result in an equal or better resource allocation than a flat legal rule.[94] Thus a finance creditor in the nature of things will have provided for default in the terms on which he made his advance.[95] Therefore it is arguable that to give these additional remedies against directors is unnecessary and even arguably unfair.

The statute law as amended in 1980 represents a more coherent approach to the problem than either English or Australian law. The Australian reforms of 1981 are absurdly complicated. The graduation of conduct referred to by Bisson J. in *Thompson* v. *Innes*[96] is rational and its relationship to the Criminal Law is in line with mainstream principles of Criminal Law. The English case of *R* v. *Grantham*[97] should not be followed as it muddies the waters as well as being harsh and impractical.[98]

In conclusion I would refer you to the Australian Law Reform Commission's latest proposals on this topic. The essence of the proposals is: [95]

* The legislation imposes on directors a *duty to prevent* the company from engaging in *insolvent trading.*
* Breach of the duty will give rise to a *civil liability* to the company. There is to be *no criminal liability* for breach.
* *Insolvent trading* involves
  — the incurring of debts when *circumstances of insolvency* in relation to a company exist and
  — the subsequent winding up in insolvency of the company.
* *Circumstances of insolvency* exist when there are reasonable grounds for suspecting that a company is *unable to pay its debts.*
* *Action for breach* of the duty is to be brought *by the company* through the liquidator or, if the Court grants leave, through a creditor.
* Proof of the existence of circumstances of insolvency is to be assisted by the following three presumptions:
  — a presumption of inability to pay debts where an examination of the assets and liabilities of the company indicates that the company is insolvent
  — a presumption that circumstances of insolvency exist where proper and adequate accounting records detailing the company's financial affairs are, for whatever reason, not available to the liquidator and
  — a presumption that circumstances of insolvency, once established to exist at a particular time within the 12 months preceding the commencement of the winding up, continued to exist.
  These presumptions can be rebutted.
* Where it is shown that a company has engaged in insolvent trading, a director of the company can avoid liability by establishing at least one of three defences:
  — that he had reasonable grounds to expect that the company would have been able to pay its debts from its own resources
  — that he took reasonable steps to minimise the possible loss to creditors

[94] R. Coase, "The Problem of Social Cost" 3 J. Law and Econ. 1 (1960).
[95] See R. Posner, *Economic Analysis of Law*, 3rd ed., 370.
[96] (1985) 2 N.Z.C.L.C. 99,463.
[97] [1984] 3 All E.R. 166.
[98] David Lanham, Mark Weinberg, Kenneth E. Brown & George W. Ryan, *Criminal Fraud*, p. 268.
[99] The Law Reform Commission of Australia, General Insolvency Inquiry Report No. 45, Vol. 1, Chap. 7, para. 283.

— that he was not able, for good reasons, to participate in the management of the company at the relevant time.

* The first of these defences, that of having reasonable grounds to expect that the company would be able to pay its debts, is established if the director had reasonable grounds to believe that a competent and reliable person
  — had responsibility for providing directors with sufficient information to prevent the company from engaging in insolvent trading and
  — discharged that responsibility.
* The second of these defences, that of taking reasonable steps to minimise the loss to creditors, is established if the director
  — endeavoured to prevent the insolvent trading or
  — endeavoured to place the company under a form of administration in insolvency.
* If a director is found liable, the amount of the liability is to be determined by the court and measured by reference to the *loss or damage sustained by the creditors.*
* The sum recovered is to be applied for the benefit of *all unsecured creditors.*

My comments on these proposals are

(a) The proposals are well argued and represent a considerable improvement on existing Australian law. They are more coherent and practical, but I can see problems.

(b) There is no general duty on a natural person not to engage in insolvent trading provided there is no deceit or criminal fraud. The most that there is, is a fairly general duty of co-operation under the contract — see *Stirling* v. *Maitland.*[100] Why should a director be treated differently?

(c) A duty *to prevent* is too onerous an obligation anyway bearing in mind the present legal conception of a director's role which is to act as part of a collegiate body. The matter is not totally addressed by the defences. Prevention is a difficult concept to use in this context.

(d) I agree that breach should only give rise to *civil* liability in the absence of fraud.

(e) I do not like the use of the word "suspect". Where it is used in Criminal Law it is often dealt with in tautological terms see e.g. *R* v. *Spencer.*[101]

(f) I agree that the duty should be enforceable by the company or by a creditor with leave of the court in what would in effect be a derivative action. In my opinion the latter should be spelt out.

There is a need to reconcile these proposals with the law applicable before winding up. Tipping J.'s decision in the *Hilton* case is a useful start in this direction in New Zealand. It is a pity that the thoroughness of the Australian Law Reform Commission's Report has not so far been matched by our own law reform agencies. The untidy division of labours between the Law Reform Division of the Justice Department and the Law Commission needs to be sorted out so that we can consider the matter in its proper context of a comprehensive review of our company and insolvency laws.

[100] (1864) 5B and S.841, 852 and J.F. Burrows (1968) 31 M.L.R. 390; J.W. Carter, *Breach of Contract*, para. 235.

[101] (1863) 3F and F 857, 857-8 per Baron Martin.