



Rodewald Hart Brown

## Insolvency & Turnaround Management News Update July 2009



### Directors Liability

In these times of current economic turmoil, it is timely to remind clients of the potential personal risk they could face whilst operating under a limited liability structure.

Trading a business as a registered limited liability entity does give directors the ability to limit personal guaranteed debt, however in the event of failure this does come with some fish hooks.

A director of a company does owe a duty of care to creditors. These duties are outlined under sections 131-138 of the Companies Act 1993. If the requirements in these sections are not adhered to there is the ability for a liquidator or other interested parties to seek compensation against the director/s personally. This action can also be pursued against a “sleeping or dormant” director.

We outline recent reported cases of instances where action has been instigated (or contemplated):

#### ***Eastwood Farms v DS Henderson***

This case concerned an application seeking judgment against the director of a failed company. Briefly the facts were that Mr Henderson operated a limited liability company (KH) that had entered into an agreement to purchase land from Eastwood Farms (EF). KH was unable to settle, and placed into liquidation, which resulted in no prospect of a return to creditors. A creditor then commenced proceedings against the director personally. The sections used were 135 and 136 of the Companies Act, which deal with trading recklessly. The creditor argued that their loss was caused by the actions of the director. The matter failed as the judge could not grant judgment for an amount of a potential claim yet to be decided, or an action yet to be bought under the above sections. The judge did not rule out the ability to bring those actions. Whilst this action was unsuccessful, it highlights the potential and the fact that creditors are more aggressive in pursuing their loss.

#### ***Drilling Fluid Equipment v Murray James Falloon***

In this instance there was action instigated by DFE to set aside a judgment given against it in favour of Mr Falloon. The basis was that there was a potential action for recompense or cross claim against Mr Falloon as the director of a failed company in reliance of sections 131, 135 and 136 of the Companies Act 1993.

Section 301 gives the court the ability to order directors to compensate for losses of a failed company.

This was unsuccessful in this instance as there was potential counterclaim, with action not yet instigated and obviously no award given as yet. This case did not address the potential ability of any such claim succeeding, but did highlight these factors.

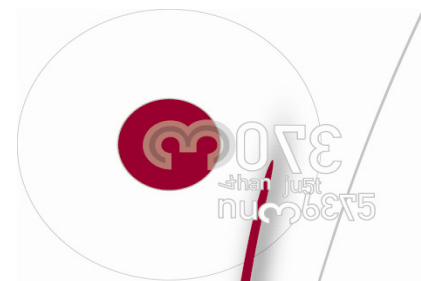
#### ***Boutique Tanneries Limited (In Liquidation) v Handley***

This case was reported within the last 12 months and involves a successful action against Handley for compensation under section 301 of the Companies Act 1993 brought by the liquidators. The liquidators were seeking a personal contribution from the directors for the losses incurred in the trading of the business. The debt involved an amount owed for PAYE, GST interest and penalties. This action was brought under several sections including section 194 and the keeping of records, and in this case the destruction of those records which were not available to the liquidators. It was held that the directors breached the duties owed to the company under sections 131, 135, 136 and 137 of the Companies Act. The director was ordered to contribute \$100,000 towards the losses caused in respect of those breaches and a further \$20,000 for losses caused for not maintaining proper records under section 194.

#### ***Ace Toolmakers Limited***

There was a recent case detailed in the National Business Review and decided in the Court of Appeal where the director of a company was held personally liable for the non payment by his company (Ace Toolmakers Limited), to the IRD of PAYE deducted from the company’s employees. One of the defence points was that he was a passive spectator as he initially signed the returns, but recently had left this to his accountant. This ground was rejected as the director was the sole director and was in sole charge of the company and its bank account, and knew the moneys should have been accounted for to the IRD on the 20<sup>th</sup> of each month. This made him personally liable for the money due.

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### Directors Liability .. contd

#### *FXHT Fund Managers Limited (In Liquidation) & Another v Oberholser*

This case has been recently decided but is still open for appeal, whereby a successful action was taken by the liquidators against a non-executive director of a company for compensation for losses of the liquidated company. The director abrogated his responsibility for the control and operation of the company to another director, but did not ensure the ability or fitness of the director to run a company. This led to acts being committed that are subject to seven counts of theft against him (yet to be heard). A ruling was made against the non-executive director for breaching his duties to the company and creditors. Judgment was entered against him to contribute \$300,000 towards the losses.

#### *Regal Castings Limited v GM and GN Lightbody & AC Horrocks, GM Lightbody and GN Lightbody.*

Lightbody and Horrocks operated a company Capro Three Limited which was placed into liquidation in 2003. Regal Castings was a creditor of Capro Three, and faced a total loss on the liquidation in excess of \$165,000. It pursued personal judgment against Mr Lightbody for this debt under a guarantee given for the company's trading. This was unrecoverable as Mr Lightbody had filed in bankruptcy.

The debt owed concerned a trading history between the parties. RC allowed the debt to accumulate to Capro in the belief that the director's personal guarantee had worth, as he had an interest in a property and if there was a failure the debt could be recovered from this interest if no other avenue was available. RC did not know that the house property that Mr Lightbody had an interest in was transferred to a family trust with the interest gifted away to the trust over a period of four to five years, and was completed in 2002. The company was wound up in 2003.

The case was a very complex one regarding the recovery, but was successful in overturning the gifting of Mr Lightbody's half share in the property.

This interest was ordered to be made available to the Official Assignee in the bankruptcy for the benefit of his creditors of which RC was one, even though the gifting was completed prior to liquidation and his subsequent bankruptcy. The case focused on the fact that credit was extended and allowed to accumulate in the belief that there was a guarantee in place. It was felt that Mr Lightbody had committed a fraud by not keeping his major creditor informed as to the change in circumstances during the trading of his company.

Although the successful action was by a creditor who had a guarantee for the company debt, there may be potential for an action to be taken against a director by a creditor who was successful in obtaining an order under section 301 to contribute to the losses of a failed company including assets that were believed to have been validly gifted.

It is timely to issue a reminder of the duty of care required in all dealings with a company's creditors whilst trading, and the subsequent implications this has in relation to the liability of the directors outside of the 'limited liability' veil.

### Deeds of Priority—Enforcement Date

Two district cases have dealt with the issue as to the correct interpretation of the meaning of enforcement date in the standard NZ Bankers Association Deed of Priority form.

These decisions are in conflict.

These cases are:

Liberty Financial Limited v Finco Holdings Limited and JT Jamieson & Co Limited v FM Custodians Limited.

We strongly recommend where priority amounts are an issue that care is taken to seek further advice.