IN THE HIGH COURT OF NEW ZEALAND
CHRISTCHURCH REGISTRY

CIV-2016-409-000036
[2016] NZHC 1465

BETWEEN	CGES LIMITED (IN LIQUIDATION AND RECEIVERSHIP) First Plaintiff
	VIVIEN JUDITH MADSEN-RIES Second Plaintiff
	HENRY DAVID LEVIN Third Plaintiff
AND	MARK STEPHEN KELLY First Defendant
	DONNA ANNE MARIE KELLY Second Defendant

Hearing: 20 June 2016

Appearances: J V Angelson and K M Wakelin for Plaintiffs
No Appearance for Defendant

Judgment: 30 June 2016

JUDGMENT OF GENDALL J

Introduction

[1] CGES Limited ("the company"), formally traded as Bakers Delight Tower Junction Limited, and was placed into liquidation on 14 May 2015. The company in liquidation and its liquidators now sue its former directors, the defendants, in their personal capacity for their current account debts owing to the company and also in their previous capacities as directors for breaching their obligations as such.

[2] This proceeding came before the Court as an undefended hearing since the defendant directors did not file any opposition to the plaintiffs' claims against them.

[3] Originally in their pleadings in this proceeding, the plaintiffs advanced three causes of action against the defendants. These were:

(a) A claim for the amount owing to the company under the shareholders' current account; and

(b) Claims under the Act for breaches of directors' duties as follows:

(i) Reckless trading (s 135 of the Act Companies Act 1993 ("the Act')); and

(ii) Agreeing to incur obligations without a belief that the obligations could be fulfilled (s 136 of the Act); and

(iii) Failing to exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances (s 137 of the Act)

(c) a claim for failing to keep financial statements and adequate accounting records (s 300 of the Act).

[4] The third cause of action noted at [3](c) above, however, has now been abandoned.

Procedural history

[5] The plaintiff filed this proceeding on 29 January 2016. The notice of proceeding and accompanying documents were served on the first defendant on 18 February 2016, and served on the second defendant on 22 February 2016. The first defendant's statement of defence was due to be filed by 24 March 2016. The second defendant's statement of defence was due to be filed by 30 March 2016. The defendants did not do so, nor have they taken any formal action of any kind to oppose these proceedings.

[6] The plaintiffs now seek judgment by default against the defendants, pursuant to r 15.9 of the High Court Rules. In accordance with the requirements of r 15.9(4), the plaintiffs are required to file affidavit evidence to establish the two causes of action to the Court's satisfaction. The onus is on the plaintiffs to convince the Court that judgment should be entered against both defendants. As Davidson J noted in *Tech Voice Limited (in liq) v Ovenden*, "the plaintiffs' submissions and evidence are therefore untested and, given the immediate and wider implications of judgment, the Court in the circumstances must be careful in reaching conclusions."[1]

Background

[7] The Company was incorporated on 8 November 2005. It traded as a bakery. The first and second defendants have been the sole directors and shareholders of the company since its inception.

[8] The Company was placed into liquidation by this Court on 14 May 2015, following an application by the Commissioner of Inland Revenue Department ("IRD"). The second and third plaintiffs were appointed as liquidators of the company.

Insolvency of the company

[9] Based on the company's financial statements, the plaintiffs submit that the company was insolvent from at least 30 June 2006, as its liabilities were greater than

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1 *Tech Voice Data Limited (in liq) v Ovenden* [2015] NZHC 2766 at [2].

its assets. At no point from 30 June 2006 until its liquidation did the company recover from this position. The Company began to default in various tax obligations owed to the IRD from 31 July 2009. By the end of 2011, the company's cash flow insolvency worsened further to such an extent that decisions for the company were made that it would not meet its goods and services tax obligations with the IRD.

[10] In various tax periods subsequently the company also defaulted on its obligations to account to IRD for a variety of tax types which were deducted from, or owed in relation to the earnings of the employees.:

(a) Kiwisaver employee deductions (KSE): for the tax periods ending 30 November 2014 and 31 December 2014 the company failed to pay IRD $700.25 in KSE when it was due, and incurred interest and penalties of $118.71. Of this total, $581.54 is a preferential claim for unpaid KSE.

(b) Kiwisaver employer contribution (KSR): for the tax period between 30 June 2014 and 31 December 2014, the company failed to pay IRD $199.48 in KSR when it was due, and incurred interest and penalties of $69.41. Of this total, $130.07 is a preferential claim for unpaid KSR.

(c) Employer Superannuation Contribution tax (ESCT): for the tax periods ending between 31 August 2012 and 31 December 2014 the company failed to pay IRD $486.05 in ESCT when it was due.

(d) Student Loan Employer Deductions (SLE): for the tax period ending 31 December 2014 the company failed to pay IRD $139.65 in SLE when it was due, and incurred interest and penalties of $19.41. Of this total, $120.24 is a preferential claim for unpaid SLE.

[11] Mr Levin gives evidence that, based on his experience, a failure to pay PAYE and GST on a regular basis is a sign that a company is in trouble. Under s 167(1) of

the Tax Administration Act 1994, amounts deducted from, or owed in relation to employee earnings are the subject of a statutory trust.

[12] The plaintiff therefore submits that the company was balance sheet insolvent from 6 June 2006, and cash flow insolvent from 31 July 2009. The Company went into liquidation owing $301,256 to various creditors, which included $266,699.57 owing to the IRD. It had negligible, if any, assets.

[13] The plaintiffs say that they attribute the loss to the company and its creditors to the defendants' failure to repay their overdrawn current accounts, their failure to properly discharge their responsibilities as directors of the company, and their failure to protect the interests of the company and its creditors.

Causes of Action

Debt Owing by the defendants to the company

[14] The first claim is made against the defendants for debts said to be owing by them to the company. It is not disputed in any way that the defendants do owe a combined total of $262,073 to the company by way of outstanding shareholder current account debts. From the company's various financial accounts and the statements generated from its Xero accounting system which are before the Court, these shareholders' current accounts demonstrate a constant rise in the amounts withdrawn annually over an eight year period from 2006 to 2014. The combined current total calculation for these current accounts on the spreadsheets before the Court is confirmed at this figure of $262,073.

[15] Under s 194 of the Act, directors are responsible for the maintenance and accuracy of a company's accounting records. The plaintiffs here are entitled to rely on the company records as they are at the date of liquidation.[2] The burden is on the directors to show that the accounting records are therefore not correct in some way to escape liability for this loan account debt.[3] In the present case nothing is before the

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2 *Thom Contractors ltd (in liq) v Thom* HC Auckland CIV-2008-404-6829, 28 April 2009; *Chesterton Holdings v Durney* HC Napier CIV-2011-441-007, 19 May 2011; *New Zealand Meat Export Ltd (in liq) v Yat Fan Lau* HC Whangarei CP 34/98, 19 March 1999.

3 *Bay Kiwifruits contractors ltd (in liq) v Ladher* [2015] NZHC 63 at [18].

Court to show why the plaintiffs cannot rely on the signed-off account records for the company as they were at the date of the liquidation.

[16] Generally, advances made by the company to its shareholders as debts owed by the shareholders to the company, are repayable on demand.[4] When the company's accounting records provide no explanation for the drawings from the shareholders' account, they must be treated as advances from the company to the shareholders.[5] The High Court in *Re Samarang Developments Ltd (in liq)* held that shareholders are jointly and severally liable for overdrawn current accounts.[6]

[17] In the absence of any explanation for the drawings from the shareholders' current account, I am satisfied that the amount by which the shareholders' current account was overdrawn at the date of liquidation is recoverable by the company as a debt on demand. Indeed, demand for repayment of this current account debt was made by the company on each of the defendants on 5 June 2015. This met with absolutely no response however. The defendants are therefore jointly and severally liable for the payment of the debt due from them amounting to $262,073. Judgment for this amount and interest to accrue from the date of liquidation is to follow.

Second cause of action: breaches of directors' duties

[18] Claims made by the plaintiffs for various breaches of directors' duties by the defendants are brought under s 301 of the Act. This section provides:

> **301 Power of court to require persons to repay money or return property**
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> (1) If, in the course of the liquidation of a company, it appears to the court that a person who has taken part in the formation or promotion of the company, or a past or present director, manager, administrator, liquidator, or receiver of the company, has misapplied, or retained, or become liable or accountable for, money or property of the company, or been guilty of negligence, default, or breach of duty or trust in relation to the company, the court may, on the application of the liquidator or a creditor or shareholder,—

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4 *Thom Contractors ltd (in liq) v Thom,* above n 2, at [16].

5 *Re Samarang Development ltd (in liq)* HC Christchurch CIV-2003-409-2094, 30 September 2004 at [55].

6 At [67]

(a) inquire into the conduct of the promoter, director, manager, administrator, liquidator, or receiver; and

(b) order that person—

(i) to repay or restore the money or property or any part of it with interest at a rate the court thinks just; or

(ii) to contribute such sum to the assets of the company by way of compensation as the court thinks just; or

(c) where the application is made by a creditor, order that person to pay or transfer the money or property or any part of it with interest at a rate the court thinks just to the creditor.

(2) This section has effect even though the conduct may constitute an offence.

(3) An order for payment of money under this section is deemed to be a final judgment within the meaning of section 17(1)(a) of the Insolvency Act 2006.

(4) In making an order under subsection (1) against a past or present director, the court must, where relevant, take into account any action that person took for the appointment of an administrator to the company under Part 15A.

[19] The Court of Appeal in *Mason v Lewis* held that claims brought under s 301 involve a two-stage evaluation:[7]

(a) Has there been a breach of a duty owed by a director to the company?

(b) If so, to what extent should the director contribute to the losses of the company?

[20] I therefore proceed to consider first, whether there has been any breach by the defendants of their duties as directors of the company and, if so, secondly, the relief to which the plaintiffs may be entitled. At the outset, I do note that many of the alleged breaches of duty overlap and to an extent are somewhat repetitive in nature.

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7 *Mason v Lewis* [2006] 3 NZLR 225 (CA) at 52.

Did the defendant's breach their duties to act in good faith and in the best interests of the company?

[21] As to this aspect, the plaintiffs plead that the defendants breached their directors' duty contained in s 131 of the Act, which provides:

> **131 Duty of directors to act in good faith and in best interests of the company**
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> (1) Subject to this section, a director of a company when exercising power or performing duties must act in good faith and in what the director believes to be the best interest of the company.

[22] The duty is a subjective one. It extends to creditors once a company is of doubtful solvency. As to this, Fogarty J in *Sojourner v Robb* held:[8]

> If a director believes that the duty to act in the best interests of the company is a duty always to act in the best interests of the shareholders, and never in the interests of the creditors, in a situation of doubt as to the solvency of the company, the director cannot be said to be acting in good faith. Creditors are persons to whom the company has ongoing obligations. The best interest of the company includes the obligation to discharge those obligations before rewarding the shareholders.

[23] The plaintiffs argue that the defendants breached this s 131 duty here by continuing to trade while the company was insolvent and in doing so they disregarded the interests of the company's creditors. This breach of the duty it is said is underlined by the fact that the defendants made extensive withdrawals from the company, presumably for their own benefit, throughout the period that the company was insolvent.

[24] I accept that the defendants failed to act in good faith and in the best interests of the company by allowing the company to continue trading and incurring further debts to creditors after it had become insolvent. The defendants were directors and therefore can be taken to have known of what was in reality the company's dire financial position.

[25] As I have noted, the defendants took drawings from the company and this started in about 2006, clearly for their own benefit and they continued to take significant funds from the company in each year after that. This was at a time when

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8 *Sojourner v Robb* [2006] 3 NZLR 808 (HC) at [102].

I am satisfied the company was already insolvent. The Company's financial situation continued to worsen. By 31 July 2009 the company was defaulting in meeting its tax obligations. The defendants allowed the company to continue trading for several years after that, without considering whether the company was capable of meeting future liabilities.

[26] As a result, the company and its creditors suffered increasing losses until the company was finally placed into liquidation. I find therefore that such losses were suffered as a direct result of the defendants' failure to act in good faith and in the best interests of the company.

Did the defendants trade recklessly?

[27] The plaintiffs further allege that the defendants also breached their duty as directors not to trade recklessly pursuant to s 135 of the Act. That provision states:

> **135 Reckless trading**
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> A director of a company must not—
>
> (a) agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or
>
> (b) cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

[28] In *Mason v Lewis,* the Court of Appeal set out the "essential pillars" of a claim under s 135 of the Act. They are:[9]

(a) The duty imposed by s 135 of the Act is one owed by directors to the company (rather than to any particular creditor);

(b) The test is an objective one;

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9 *Mason v Lewis*, above n 7, at [51].

(c) It focuses not on the directors' belief, but on the manner in which a company's business is carried on, and whether the modus operandi creates a substantial risk of serious loss; and

(d) What is required when a company enters troubled waters is a sober assessment by the director of an ongoing character, as to the company's likely future income and prospects.

[29] In *Boutique Tanneries (in liquidation) v Hadley,* the defendant ran a tannery and leather-goods retailer.[10] The Court formed the view that the director had operated the company in a very informal and relaxed way, with scant regard to formal requirements. The company had been kept afloat for a number of years by paying all its creditors, with the exception of the IRD. The Court was of the opinion that it was only IRD's forbearance that the company's trading was prolonged. As a result, the director was found to have breached various duties, including that contained in s 135.

[30] The current circumstances, in my view, share a number of similarities with the position that prevailed in the *Boutique Tanneries* decision. The company here was kept afloat for a number of years it seems at the expense of the IRD. The company began defaulting on its obligations to remit to the IRD PAYE tax (being effectively employees' monies held under a form of trust) which it had withheld from as long ago as 31 July 2009. By 31 December 2011 the company had also failed to account to the IRD for GST the company had collected on the IRD's behalf. (Again, these GST monies virtually took the character of trust monies held by the company.)

[31] I am satisfied therefore that for a prolonged period of time first, the defendants would have been well aware of the troubled circumstances in which the company was operating and, secondly, notwithstanding this, the defendant's proceeded to incur further liabilities that created a substantial risk of serious loss to the company and its creditors. I find therefore that the defendants did trade recklessly here for the period at from least 31 July 2009 in breach of their duties under s 135 of the Act.

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[10] *Boutique Tanneries (in liq) v Handley* HC Auckland CIV 2006-404-2713, 24 July 2008.

Did the defendants breach their duty in relation to obligations?

[32] Thirdly, the plaintiffs allege that the defendants breached their duty not to incur or undertake obligations knowing that the company was unable to carry them out. Section 136 of the Act states that "a director of a company must not agree to the company incurring an obligation unless the director believes at the time on reasonable grounds that the company will be able to perform the obligation when it is required to do so."[11]

[33] Assessing whether there is a breach of this s 136 requires both a subjective and objective test. In *Fatupaito v Bates,* O'Regan J held that to establish a breach of s 136, the plaintiff must show that the defendant agreed to the company incurring an obligation at the time when they did not believe (a subjective test), on reasonable grounds (an objective test), that the company would be able to perform that obligation when required to do so.[12] There is therefore to a degree a certain overlap between the breaches of directors' duties in ss 135 and 136. Both sections involve illegitimate risks. However, the difference between ss 135 and 136 appears to be that s 135 focuses on directors engaging in a course of action, and s 136 on incurring specific liability.[13]

[34] As I have already noted above, the company has been insolvent since 2006. The defendants have chosen not to respond to the claims against them in this proceeding and have advanced no submissions here. I am satisfied that the defendants were well aware throughout the last decade of the dire financial position of the company. Given the amount of debt that was being both incurred and accumulated with the IRD and other creditors, the defendants could not have reasonably believed that the company would be able to satisfy its past debt while incurring new obligations. A breach of s 136 of the Act is also established here.

Did the defendants fail to exercise the care, diligence and skill that reasonable directors would exercise in the same circumstances?

[35] As to this, s 137 of the Act provides:

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11 Companies Act 1993, s 136.
12 *Fatupito v Bates* [2001] 3 NZLR 386 (HC) at [80].
13 *Jordan v O'Sullivan* HC Wellington CIV-2004-485-2611, 13 May 2009 at [69].

Director's duty of care

A director of a company, when exercising powers of performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation—

(a) The nature of the company; and

(b) The nature of the decision; and

(c) The position of the director and the nature of the responsibilities undertaken by him or her.

[36] The test under s 137 is an objective one based on "the requisite skill set required of a reasonable director in the same position as the defendant."[14] The directors' personal knowledge and experience are not relevant. In this case, the defendants held positions as directors of a relatively small trading business common to the general business community and the economic culture of New Zealand.

[37] Reasonable and prudent directors, in the position of the defendants here, clearly in my view would not begin to take and continue to extract substantial drawings from the company solely for their own personal benefit when their company was facing both balance sheet and trading insolvency.[15] Reasonable directors would not carry on and incur further liabilities when they ought to have known that those obligations and liabilities were unlikely to be satisfied.

[38] I therefore hold that there was also a breach of s 137 of the Act here.

Quantum

[39] The standard approach to awarding relief under s 301 of the Act is to assess the extent of the deterioration in a company's financial position between the date of breach and the date of liquidation.[16] In *Mason v Lewis* held that:[17]

> Once the figure has been ascertained, New Zealand Courts have seen three factors - causation, culpability and the duration of the trading - as being distinctly relevant to the exercise of the Court's discretion…

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14 *Boutique Tanneries,* above n 10 at [31].
15 Companies Act 1993, s 4.
16 *Mason v Lewis,* above n 7, at [109].
17 At [110].

[40] In *Lower v Traveller,* the three factors were explained to be as follows:[18]

> The element of causation is concerned with the link between the carrying on of the company's business recklessly, to the knowledge of the impugned director, and the indebtedness of the company for which it is sought to impose personal liability. In a case such as the present that involves an assessment of how much the liabilities of the company were increased because of the illegitimate delay in its ceasing to trade and the identification of a point in time when the director knew that continuing to trade would be reckless. The resulting figure however is no more than a relevant consideration for the Court although the amount of the director's liability would not exceed the sum identified as caused by the known reckless trading.
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> …
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> The relevance of culpability is linked to the deterrent purpose of the provision. This factor calls for an assessment of the blameworthiness of Mr Lower's conduct, bearing in mind that at the end of the range the nature of the director's involvement will be blind faith or muddledheadedness, while at the other end there will be actions or instances which are plainly dishonest.
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> As to the duration of the wrongful trading, the company continued to trade after April 1995 until February 1998 accumulating an increasing deficit in the shareholders' funds. The duration of the wrongful trading to which Mr Lower was a party was lengthy.

[41] Here, as I see it, there is a causative link between the conduct of these defendants and the company's losses. As directors they were responsible to ensure the company's obligations to the IRD were met which they failed to do. Clearly they defaulted on this obligation resulting in the company incurring substantial penalties. Further, the use of company money for their own personal benefit alone, exacerbated the extent of the company's liabilities right up to the time of liquidation. If the money extracted for their personal benefit had remained in the company's bank account, liquidity would have improved substantially and any amounts owing to the IRD would have been significantly reduced.

[42] It is difficult to escape the conclusion that both these defendants bear real culpability for the company's eventual position. They were effectively the directing minds of the company and, as I have already noted, as directors they ought to have known over what was almost eight years of the company's insolvency, that it was in dire and worsening financial circumstances. With this knowledge, the defendants as

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[18] *Lower v Traveller* [2005] 3 NZLR 479 (CA) at [79], [83], [86].

directors ought to have carefully proceeded in their management of the company, and in particular not favoured themselves personally at the expense of company creditors, but they failed to do so repeatedly.

[43] The duration of the breaches of these statutory duties was also extensive. I accept Mr Levin's evidence that the initial breach of the director's statutory duties occurred on about 30 June 2006. From that time onwards, the company continued to trade at a loss until the date of liquidation. The breach therefore happened over what was a nine year period.

[44] One issue does potentially arise here. This is the question of possible double recovery. As to this, at first glance there might seem to be an overlap of claiming both the current loan account debt owed by the defendants and the loss which the company's creditors have suffered. The relief which counsel for the plaintiffs is seeks here is for reimbursement of the loss of $301,256 to creditors, on top of the $262,073 that the defendants owe as current account debt.

[45] On this aspect, however, before me counsel referred to the Court of Appeal decision in *Morgenstern v Jeffreys*, where the Court rejected an appellant's submission that damages under s 301 could only be awarded up to the maximum figure of the total net liability of a liquidated company to its creditors. In that case the Court of Appeal held:[19]

> Nor do we accept Mr Walker's submission that the maximum amount payable under s 301 should be the loss suffered by the creditors. The problem with that approach is that it does not leave any funds to pay the respondents. We see no reason why Mr Morgenstern should not be ordered to pay the full $3,499,999 on the basis that, if there is a surplus in the liquidation, the money will be returned to him as the sole shareholder in any event.

[46] I am therefore satisfied that ordering the defendants to pay both their outstanding loan account debt owed to the company, and also to reimburse the company for the loss incurred by company creditors due to their breaches of duties as the company's directors, would not be double recovery here.

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19 *Morgenstern v Jeffreys* [2014] NZCA 449 at [103].

Conclusion

[47] For all the reasons outlined above, the plaintiffs' claim against the defendants succeeds. The plaintiffs are therefore entitled to judgment which I now enter against the defendants jointly and severally:

(a) In relation to the first cause of action, for the shareholders' loan account debt owed to the company, being a total of $262,073.

(b) In relation to the second cause of action for breach of directors' duties in the exercise of my discretion under s 301(1)(b)(ii) of the Act, for the sum of $301,256.

[48] The plaintiffs are also entitled to interest on each of the amounts specified above at [47] from 14 May 2015, the date of liquidation, at the Judicature Act 1908 rates.

[49] The plaintiffs are also entitled to costs on this proceeding which I award on a category 2B basis plus reasonable disbursements as approved by the Registrar.

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Gendall J

Solicitors:
Meredith Connell, Auckland.