IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

CIV 2005-404-004785

BETWEEN	JAMES PRODUCTS LTD Plaintiff
AND	APL INVESTMENTS LTD (FORMERLY KNOWN AS AEROSOL PRODUCTS LTD) First Defendant
AND	CUSTOM CHEMICALS INTERNATIONAL LTD Second Defendant
AND	IVAN KEITH PAUL Third Defendant
AND	ROBERT PARKINSON Fourth Defendant
AND	DAMAR INDUSTRIES LTD Fifth Defendant

Hearing: 12 August 2008

Appearances: G D Wiles for Plaintiff
P Davison QC for First, Second, Third and Fourth Defendants
B J Upton for Fifth Defendant

Judgment: 19 August 2008 at 4:00 pm

JUDGMENT OF ASSOCIATE JUDGE HOLE

This judgment was delivered by me on 19 August 2008 at 4:00 pm pursuant to Rule 540(4) of the High Court Rules.

Registrar/Deputy Registrar

Date: ……

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Introduction

[1] In 2004 and 2005, the plaintiff was in business as an importer, manufacturer and distributor of various cleaning products. Negotiations took place between it and the various defendants as a result of which it was hoped that all parties would go into business together. The proposed arrangements failed to come to fruition and as a result the plaintiff has brought proceedings against the various defendants claiming approximately $2,573,000.

[2] The defendants have brought an application against the plaintiff seeking an order for security for costs.

[3] In 2006, there was an earlier application for security for costs. On 25 August 2006, this was settled by Mr Stenner (then, the second plaintiff) undertaking that a shareholder in the plaintiff, Klasse Asia Limited, would undertake not to advance its current account in the plaintiff ahead of any order for costs made in favour of the defendants in the event of the liquidation of the defendant.

[4] The defendants are no longer satisfied with that undertaking and accordingly have brought this new application.

Principles

[5] Rule 60(1)(b) of the High Court Rules states:

> Where the Court is satisfied on the application of a defendant that there is reason to believe that a plaintiff will be unable to pay the costs of the defendant if the plaintiff is unsuccessful in the plaintiff's proceedings, the Court may, if it thinks fit in all circumstances, order the giving of security for costs.

[6] A useful summary of the relevant principles can be found in *Lunn v Fourth Estate Holdings Ltd* 11 PRNZ 316 at p 318:

> (1) The enquiry in the instant case is a twofold one, namely:

(a) Is there reason to believe that the plaintiff will be unable to pay the defendant's costs if he is unsuccessful and, if so,

(b) Is it appropriate for the Court to exercise its discretion to order security?

(2) The discretion is not hampered by special rules or regulations nor is it to be put into a straitjacket by considerations of burden of proof. It is a discretion which the Court will exercise having regard to all the circumstances of the case: *National Bank of New Zealand Ltd v Donald Export Trading Ltd* [1980] 1 NZLR 97.

(3) Something more than difficulty in payment is required to establish a reason to believe that the plaintiff will be unable to pay costs. This can be looked at in a various of ways, for example, that a plaintiff is outside the usual run of plaintiffs in terms of financial ability to pay costs. There must be some evidential foundation for the allegation before a Court will draw an adverse inference: *NZ Kiwifruit Marketing Board v Maheatataka Cool Pack Ltd* (1993) 7 PRNZ 209, 213.

(4) Applications for security for costs should not be allowed to be a tactical weapon which can be used by a defendant. The issue in essence is whether there is good reason to fear that a costs order might not be satisfied: Beck, *Principles of Civil Procedure*, 1992, p 161, cited with approval in *NZ Marketing Board v Maheatataka Cool Pack Ltd* (supra) p 213.

(5) If the plaintiff's financial position is improving and likely to improve still further that may tell against an order: *Edwards v Epplett* unreported, Master Williams QC, 23 February 1993, HC NAP CP877/91).

(6) Although the Court will give due weight to the plaintiff's assertion that he will be able to meet costs if awarded, that will not be decisive: *Nikau Holdings Ltd v BNZ Ltd* (1992) 5 PRNZ 430, 436.

(7) Failure by a plaintiff to disclose financial circumstances may give rise to an adverse inference as to the plaintiff's ability to meet costs if unsuccessful: *Arklow Investments Ltd v MacLean* (1994) 8 PRNZ 188.

(8) As far possible, bearing in mind the early stages of the proceeding, the Court will endeavour to assess the merits and prospects of success of the claim. There is, of course, a very real limit as to how far that such inquiry can be made, particularly at an early stage of a proceeding: *Meates v Taylor* (1992) 5 PRNZ 524.

[7] The Court of Appeal in *AS McLachlan Ltd v MEL Network Ltd* (2002) 16 PRNZ 747 referred to the discretion inherent in the rule. Whilst it recognised that the rule contemplated that there should be an order for security where a plaintiff

would be unable to meet an adverse costs award, care needed to be taken that such order would not prevent a plaintiff from pursuing its claim.

[8] In *New Zealand Kiwifruit Marketing Board v Maheatataka* (supra) Thomas J noted that the very nature of the application made it difficult for a defendant to produce conclusive proof as to a plaintiff's financial position. All a defendant could do, generally speaking, was to point out the surrounding circumstances from which it might reasonably be inferred that a plaintiff would be unable to pay the costs. He doubted that it was a requirement under the rule that a plaintiff is invariably obliged to furnish financial information when challenged to do so. However, a Court might be prepared to draw the inference of an inability to pay where a plaintiff is silent as to its financial position. He stated:

> It follows that it is not enough for a defendant to challenge the plaintiff's ability to pay costs … there must be some evidential foundation or indication to support the charge that there is reason to believe that the plaintiff will be unable to pay the costs.

Defendants' case

[9] The defendants argued that there was evidence indicating that the plaintiff would be unable to pay the defendants' costs because:

a) The plaintiff was unable to produce finalised accounts for the years ending 31 March 2007 and 2008;

b) Such accounts as were provided were inaccurate;

c) When analysed, the plaintiff's liabilities exceed its assets;

d) There is insufficient cash flow to meet the costs;

e) In the year ending 31 March 2008, there has been a substantial and unexplained reduction in the shareholders' current account of the plaintiff.

Plaintiff's case

[10] The plaintiff argues that there is good reason for the financial accounts not to have been finalised. Discrepancies raised in those accounts are capable of explanation. Even if the company's net liabilities do exceed its assets (which is not conceded), the plaintiff is earning sufficient revenue to enable an award of costs to be paid over a period of time.

Value of plaintiff

[11] It would have been desirable for the 2007 and 2008 accounts to have been finalised. That the 2007 accounts were not finalised because the plaintiff was awaiting a ruling from the Inland Revenue Department, seems a somewhat lame excuse. Nevertheless, there is no obligation on the plaintiff, in the context of this application, to have completed its accounts.

[12] There is some duplicity in the plaintiff's position as to the accuracy of the accounts. Mr Stenner, at p 6 of his affidavit, has deposed as to their accuracy. Nevertheless, he has agreed, at para 15 of his affidavit, that the intangible asset of the trademark is over-valued. I note that in the 2008 accounts, it was valued in the sum of $602,805. Apparently, the plaintiff does not have the exclusive rights to that trademark and I agree with the defendants that its worth must be questionable.

[13] Further, it is significant that, at para 15 of his affidavit, Mr Stenner notes that the plaintiff owns assets not recorded in the accounts at their full value. Indeed, as I understand the position, a flow wrapper machine (which he says is worth $100,000 but his witness, Mr Leonard, says is worth $80,000) is not included at all.

[14] The 2007 and 2008 accounts both record goodwill as being valued in the sum of $25,000 and yet, according to Mr Leonard, that figure should be upgraded to $608,000. Mr Loughlin, the expert accountant for the defendant, doubts that there is any goodwill.

[15] If one treats the value of the trademark in the sum of $100,000 (which is $100,000 more than Mr McLoughlin thinks it is worth), and if one leaves the goodwill figure in the sum of $25,000, then the current assets would be worth $496,132 and the non-current assets $125,000, making a total of $621,132. If one deducts the recorded liabilities in the 2008 accounts from that sum, then the plaintiff has net liabilities of $147,833 rather than the net assets recorded in the accounts of $594,659.

[16] As Mr McLoughlin pointed out in his second affidavit, even if the original figures in the 2008 accounts are correct, the total equity therein is recorded in the sum of $645,379, whereas the net assets are noted as being $594,659. These two figures should balance.

[17] I conclude that very little reliance can be placed on the draft accounts. Of the two sets of accounts, the ones most useful to the Court would have been the 2008 accounts. Without too much difficulty, it is possible to reach a very different financial conclusion from those accounts than that actually recorded in them.

Stock

[18] The 2008 accounts record stock as being worth $322,563. In the 2007 accounts, stock was recorded as being worth $401,273. The 2008 accounts record stock of $167,674 having been purchased. All of this is confusing when Mr Leonard has deposed that over the relevant time the company was operating like an agency receiving commission income: para 35 of his affidavit. The sales of stock noted in the 2008 accounts are not consistent with his description of the plaintiff's current business. In addition, there is a suggestion that the stock is worth much less than that suggested by the plaintiff as it is old. The plaintiff, however, claims that, whilst the stock may be old, it has not lost its value. It is impossible to draw any conclusions from this conflicting evidence except that, if the plaintiff had so substantially changed the nature of its business, one would have thought it would have made greater efforts to quit its old stock.

Profitability and cashflow

[19] The plaintiff relies on this to support its contention that it would be able to meet an award of costs if necessary.

[20] The plaintiff's 2008 accounts show a gross profit of $834,762, less expenses, of $430,275, leaving a net profit of $404,487.

[21] According to Mr McLoughlin, the financial statements fail to take into account:

a) The debt to Giro – say, $90,000;

b) The debt to Holdfast – say, $80,000;

c) The possibility that the stock would not realise $322,563;

d) Whether the accounts receivable of $154,327 would be fully recoverable. In this regard, Mr Leonard says that approximately $50,000 is in dispute.

[22] If one ignores the stock issue, the net profit needs to be adjusted to allow for approximately $220,000 of relatively undisputed commitments, being the debt to Giro, the debt to Holdfast, and the dispute in respect of accounts receivable. This reduces the net profit to $210,000. From this sum must be deducted the plaintiff's own legal expenses (say, $100,000) and a possible cost liability to the defendants (of about $170,000). This worst scenario indicates a net loss of about $60,000.

[23] I appreciate that the foregoing analysis is simply one way (and possibly a quite inaccurate way) of looking at the information available to the Court. As against this, the plaintiff's assurance that it would be able to meet costs from its cashflow must not be discounted.

Reduction in shareholders' current account

[24] According to the 2006 financial statements, the shareholders' current accounts remained static in the years ending 31 March 2005 and 31 March 2006 in the sum of $637,202. However, the draft 2007 accounts notes that for the year ending 31 March 2006, the shareholders' current account stood at $495,523 and was increased in the 2007 accounts to $552,467. Why there should have been two different figures recorded for the year ended 31 March 2006 is not known. What is more significant is that in the year ended 31 March 2008, the shareholders' current account was reduced to $230,771. The reduction of $321,696 in one financial year is not explained. However one looks at this, it can only mean that the plaintiff has returned to its shareholders $321,696 in the last financial year when virtually no reductions were made in the previous years.

[25] Not only is this significant in itself, but it becomes more significant when one considers the undertaking referred to in paragraph [3]. Effectively, the value of the undertaking has been reduced by $321,696 and if the trend were to continue, the undertaking would become valueless. It will be recalled that the undertaking only applied if the plaintiff were to go into liquidation. There is nothing in the undertaking which prevented the plaintiff from reducing its shareholders' current account to a nil balance.

Conclusion on plaintiff's ability to meet costs

[26] I conclude that there is evidence available which leads me to believe that there is reason to believe that the plaintiff will be unable to pay the costs of the defendants if the plaintiff is unsuccessful. All the matters referred to in the preceding paragraphs are relevant to a greater or lesser degree. Of particular significance, however, is the fact that upon a liquidation the company could be worthless. Its value, according to the 2008 accounts, depends on tangible assets being accounts receivable and stock. Both of those assets seem to be of questionable value. Upon a liquidation, the tangible assets might well be valueless.

[27] The other disturbing matter is the conduct of the plaintiff in not only failing to complete financial statements but producing inaccurate ones. In addition, the substantial recent reduction in the shareholder' current account is of concern, particularly when one refers to the previous undertaking. The cashflow is, of course, completely dependent upon the activities of Mr Stenner: quite regardless of my reservations set out in paragraph [22], if Mr Stenner were to cease working for the company, the cashflow would come to a sudden halt.

Merits

[28] The plaintiff claims that it has a good case against the defendants and that its various allegations are backed up with documentary evidence. The defendants agree that there is some documentary evidence which supports the plaintiff's case but say that there are important gaps in the documentation which can only be filled by *viva voce* evidence. In this regard, the credibility of the witnesses is crucial. The defendants say that the outcome of this proceeding will depend upon an assessment of credibility.

[29] The only conclusion available to the Court is that it is possible that an award of costs could be made against the plaintiff in favour of the defendants.

Court's discretion

[30] If costs were awarded against the plaintiff, they could be in the vicinity of approximately $170,000. The plaintiff's assertion that it could meet such an award over time is relevant not only to an assessment of its solvency but also to the exercise of the Court's discretion. If an unsuccessful plaintiff claims it is able to meet a costs award, then presumably it is also in a position where it is able to pay some security for costs into Court without prejudicing its ability to continue with its claim. This seems to be the plaintiff's position in this case; although it does not wish to pay security.

Conclusion

[31] The defendants have sought security in accordance with costs awarded on a category 2B basis. This would amount to costs of about $170,000 for two sets of defendants.

[32] There is evidence leading me to believe that if unsuccessful, the plaintiff will be unable to pay the defendants' costs. Nevertheless, the plaintiff has indicated that it does have that ability "over time". The time factor constitutes a reason not to award security for the full amount of the defendants' likely costs. To order security now in the full amount sought could have the effect of prejudicing the plaintiff's ability to continue the proceeding.

[33] I conclude that security for costs should be given in the sum of $100,000.

[34] There is an order that the plaintiff give security for costs by making a payment into Court in the sum of $100,000. The proceeding is stayed pending the making of such payment.

[35] The defendants have been successful in obtaining the order sought. They are entitled to costs. The parties are agreed that these should be awarded on a category 2B basis. Accordingly, the plaintiff is ordered to pay costs to the defendants in accordance with category 2B.

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Associate Judge J D Hole