Directors’ Liability on Insolvency

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1. Introduction

When a company enters a formal insolvency procedure its directors are more likely than at any other time in the company’s existence to face civil and/or criminal action for breach of duties or obligations imposed on them by company law or other more generally applicable rules such as those in the Fair Trading Act 1986. Part of a liquidator’s primary duty is to realise the assets of the company, those assets including, of course, causes of action that the company may have against its directors.\(^1\) Additionally, on liquidation, other specified actions that may be taken against company directors accrue to the liquidator.\(^2\) What, if any, action a company is able to take against its directors will form part of the administrator’s report sent to creditors of a company in administration prior to the watershed meeting\(^3\) and may well have an impact on the decision made by the creditors at the watershed meeting. Both an administrator and a liquidator have a duty to notify the Registrar if they suspect directors have committed offences under specified legislation including the Companies Act 1993, the Securities Act 1978 and the Securities Markets Act 1978.\(^4\)

However, despite the apparent breadth of the title to this paper, I have been asked to focus on two particular aspects of directors’ liability on insolvency. The first is the nature, and potential liability arising from breach, of directors’ duties on insolvency. The second is the new prohibition on director involvement in phoenix companies in ss 386A-386F of the Companies Act 1993.

2. Directors’ Duties on Insolvency

The duties that first spring to mind when the topic of directors’ duties on insolvency is raised are those set out in ss 135 and 136 of the Companies Act 1993, the so called ‘insolvent trading’ provisions. However, I have chosen to begin with a third duty, a duty that predates ss 135 and 136, the duty to have regard to the interests of creditors. As the following overview of recent case law illustrates, the overlap in the ambit of each of these three duties appears to be steadily increasing.

I make one reminder at this stage. Section 126(1) of the Companies Act 1993 defines a director, for the purposes of the statutory duties imposed upon directors, to include not only formally appointed directors but also de facto directors and shadow directors as well as those upon whom the constitution confers powers which would ordinarily

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2. See, eg, Companies Act 1993, s 300.
3. Companies Act 1993, s 239AU.
4. Companies Act 1993, ss 239AI, 258A.
be exercised by the board and those to whom the board has delegated a power or duty.

2.1 The duty to act in good faith and in the best interests of the company

The duty to act in good faith and in the best interests of the company is but one aspect of the fiduciary obligation of loyalty owed by directors to their companies. The duty is restated in s 131(1) of the Companies Act 1993:

(1) Subject to this section, a director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company.
(2) A director of a company that is a wholly-owned subsidiary may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company.
(3) A director of a company that is a subsidiary (but not a wholly-owned subsidiary) may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company and with the prior agreement of the shareholders (other than its holding company), act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company.
(4) A director of a company [that is carrying] out a joint venture between the shareholders may, when exercising powers or performing duties as a director in connection with the carrying out of the joint venture, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of a shareholder or shareholders, even though it may not be in the best interests of the company.

In the case of a solvent company, the traditional view is that the interests of the company are represented by the interests of its shareholders.5 The rationale for this is that the shareholders of a solvent company are its ultimate residual claimants.6 At the other end of the continuum, when a company is insolvent the interests of its creditors override those of its shareholders.7

The point in time at which directors are obliged to have regard to the interests of creditors was addressed by Cooke J in the Court of Appeal decision in Nicholson (NZ) Ltd v Permakraft. Cooke J’s comments are clearly obiter because the transaction under scrutiny, payment of a capital dividend, occurred at a time when the company was solvent. Although the other members of the Court of Appeal, Somers and Richardson JJ, declined to offer a view on Cooke J’s comments, those comments have now been applied in a number of subsequent High Court decisions and to this extent they represent the law in New Zealand.8

8 See, eg, Sojourner v Robb [2006] 3 NZLR 808; McCullagh v Gellert (2002) 9 NZCLC 262,942; Lion Nathan Ltd v Lee (1997) 8 NZCLC 261,360.
Cooke J expressed the obiter view that creditors are entitled to ‘consideration, ..., if the company is insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency.’ He added:

The criterion should not be simply whether the step will leave a state of ultimate solvency according to the balance sheet, in that total assets will exceed total liabilities. Nor should it be decisive that on the balance sheet the subscribed capital will remain intact, so that a capital dividend can be paid without returning capital to shareholders. Balance sheet solvency and the ability to pay a capital dividend are certainly important factors tending to justify proposed action. But as a matter of business ethics it is appropriate for directors to consider also whether what they do will prejudice their company’s practical ability to discharge promptly debts owed to current and likely continuing trade creditors.\(^9\)

The objective test ultimately adopted by Cooke J is ‘whether at the time of the payment in question the directors “should have appreciated” or “ought to have known” that it was likely to cause loss to creditors or threatened the continued existence of the company.’\(^11\)

On the other hand, Cooke J did not consider the duty extended to consider the interests of future new creditors. His view that that ‘[s]hort of fraud’, future new creditors ‘must be the guardians of their own interests.’\(^12\)

Some guidance as to how, if at all, directors ought to balance what may be the conflicting interests of different classes of creditors is given in the first instance English decision of *Re Pantone 485 Ltd*:

where the company is insolvent, the human equivalent of the company for the purposes of the directors’ fiduciary duties is the company’s creditors as a whole, ie its general creditors. It follows that if the directors act consistently with the interests of the general creditors but inconsistently with the interest of a creditor or section of creditors with special rights in a winding up, they do not act in breach of duty to the company.\(^13\)

The relationship between s 131(1) and s 131(2)-(4) in instances when a company is insolvent or near insolvent was addressed by Baragwanath J in *Mountfort v Tasman Pacific Airlines of NZ Ltd*.\(^14\) Baragwanath J had earlier found that solvency was a general and fundamental requirement of companies under the 1993 Act.\(^15\) He then categorised s 131(2) as an ancillary provision which did not operate to relieve directors of a wholly owned insolvent subsidiary of their obligation to cause

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\(^10\) [1985] 1 NZLR 242, 250.


\(^12\) [1985] 1 NZLR 242, 249.

\(^13\) [2002] 1 BCLC 266, [73]. See, also, the similar comments made by Smellie J in *Mogal Corporation Ltd v Australasia Investment Ltd (in liq)* (1990) 3 NZBLC 19,783.

\(^14\) (2005) 9 NZCLC 263,864.

\(^15\) At [20].
it to cease trading or, it also follows, their obligations under s 131(1) or s 135.16

In the case of a company that is not in liquidation, given that the duty is owed to the company, its creditors, acting individually or in concert, have no right to take enforcement action against directors. On the appointment of a liquidator, creditors have standing to make an application to the High Court under s 301(1). Section 301(1) creates a summary means of enforcing breaches of duty owed to a company by its directors and specified others when the company is in liquidation.17 Individual creditors and shareholders, as well as the liquidator, can apply to the High Court for an investigation into the conduct of the director and, if a breach of duty is found to have occurred, the Court can order the director to ‘contribute such sum to the assets of the company by way of compensation as the Court thinks just’.18

The most recent of the cases applying the duty to have regard to the interests of creditors is *Sojourner v Robb*19 where two contingent creditors of a company in an insolvent liquidation made an application under s 301 of the Act for an investigation as to whether the company’s directors had breached the statutory duty in s 131(1).

In *Sojourner v Robb* the defendant directors, who were also the company’s only shareholders, caused the company to transfer its assets to a phoenix company, of which they were also the only directors and shareholders, at an undervalue. Fogarty J’s assessment was that if the solvency test had been applied correctly at the time the decision to sell the company’s assets was made, the company met the cash flow test but there was ‘considerable doubt’ as to whether it was solvent in a balance sheet sense. The defendant directors caused the company to use the sale proceeds from the asset transfer to meet its existing debts with the result that there were no funds in the liquidation to meet the plaintiffs’ contingent claims. Fogarty J held that the purpose of the sale was twofold: to avoid the plaintiffs’ contingent liabilities and to enable the company’s goodwill to be acquired for no value. The net effect of the transaction, said Fogarty J, was that the defendant directors retained the benefit of the company’s business via another company that they owned.

Fogarty J took the stance that the Companies Act 1993 restates, rather than supplants, directors’ duties as they exist at common law.20 He then accepted, following Cooke J’s dicta in *Permakraft*, that when a company is insolvent or near insolvent, its directors are required to consider the interests of it creditors, including its contingent creditors. Fogarty J accepted that the defendant directors had acted in good faith and

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16 At [82].
17 Section 301 may also be used to pursue other defalcations a company has suffered at the hands of those specified such as misapplication or retention of money or property of the company or ‘negligence, default, or breach of duty or trust in relation to the company.’
18 Companies Act 1993, s 301(1)(b)(ii).
19 [2006] 3 NZLR 808.
20 See, also, *Benton v Priore* [2003] 1 NZLR 564, [46].
in what they believed the best interests of the company to be but that they were mistaken as to how those interests were assessed in this particular context. He said:

In this context the standard in s 131 is an amalgam of objective standards as to how people of business might be expected to act, coupled with a subjective criteria as to whether the directors have done what they honestly believe to be right. The standard does not allow a director to discharge the duty by acting with a belief that what he is doing in the best interests of the company, if that belief rests on a wholly inappropriate appreciation as to the interests of the company. 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 interests of the company include the obligation to discharge those obligations before rewarding the shareholders.\(^{21}\)

Given the finding of a breach of s 131(1), the focus then turned to s 301(1)(b)(ii) and what was a just sum to be contributed by the defendant directors to the assets of the company. Fogarty J adopted the stance that, given the equitable origins of s 131(1), the position in equity was applicable when it came to assessing a ‘just’ level of compensation under s 301(1)(b)(ii). Here it was no longer possible for the company’s intangible asset, its goodwill, to be returned to it, meaning that the applicable equitable remedy was compensation. The plaintiff creditors were able to put forward expert evidence, accepted by Fogarty J, that if the assets, including goodwill, had been sold on the open market, sufficient proceeds would have been generated to meet their claims. This meant that the burden of proof transferred to the defendants to show that the plaintiffs would not in fact have been able to recover all or part of their claims\(^{22}\) and the defendants were unable to discharge this onus. Fogarty J made orders that the defendants pay to the liquidator an amount sufficient to enable the defendants to recover the amount specified in their proofs of debt that had been accepted by the liquidator together with interest and any incidental costs of the liquidator.

*Lion Nathan Ltd v Lee\(^{23}\)* is an earlier case involving a sale of company assets but where a claim that directors failed to have regard to the interests of creditors was not made out. The defendant directors believed, at the time the transfer was formulated and implemented, that it was the only alternative to a receivership or an insolvent liquidation in which there would be no proceeds available for distribution to unsecured creditors. The directors’ motivation in proceeding with the asset transfer, which was not at an undervalue, was to ‘preserve the business of the company for the benefit of employees and creditors as a whole.’ The net effect of the transfer was to prefer the body of creditors over the plaintiff creditor but, as already noted, in a liquidation all unsecured creditors, including the plaintiff creditor, would have received nothing.

\(^{21}\)[2006] 3 NZLR 808, [102].

\(^{22}\) See Bank of New Zealand v Guardian Trust Co Ltd [1999] 1 NZLR 664, 687.

\(^{23}\)(1997) 8 NZCLC 261,360.
The duty to have regard to the interests of creditors was also applied by Potter J in *McCullagh v Gellert.* The defendant directors caused the company to enter into a work sharing arrangement with the plaintiff creditor. The arrangement broke down and the plaintiff successfully sued the company for a share of the profits arising under the arrangement. Soon after this, the company was placed in liquidation. On an application under s 301(1) by the liquidator and a creditor, Potter J held that the defendant director had breached the duty to consider the interests of the company’s creditors in three instances: the reversal of an account payable entry made in respect of the plaintiff creditor in the amount of $48,782 when a reasonable and prudent director would have made provision for this amount; by resolving to pay salaries at a level which put the solvency of the company at risk; and, causing the company to cease trading and to transfer its assets to a phoenix company without making provision for the plaintiff creditor. Potter J, following case law arising in the context of the statutory duty to avoid reckless trading, saw three factors, causation, culpability and duration, as relevant when it came to the exercise of her discretion to determine the amount of compensation payable by the defendant director under s 301(1)(b)(ii). An order was made that the director contribute $93,000 by way of compensation to the company, this sum reflecting the plaintiff’s claim in the liquidation.

Although the New Zealand cases applying the duty to have regard to the interests of creditors have focussed on asset transfers, the English Court of Appeal decision in *West Mercia Safetywear Ltd (in liq) v Dodds* provides a further illustration of circumstances where it might be useful to plead a breach of this duty. Directors of an insolvent company caused it to make a payment constituting a fraudulent preference but the company was unable to recover the preference because the party to whom it was made was insolvent. The directors were found to have acted contrary to the interests of the company as reflected by the interests of its creditors as a whole and were ordered to pay compensation, reflecting the amount of the preferential payment, to the company.

### 2.2 Reckless Trading: s 135

Section 135 imposes a duty on directors to avoid reckless trading. Like the duty in s 131(1), this is a duty owed to the company. Section 135 provides:

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.

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25 *Fatupaito v Bates* [2001] 3 NZLR 386.
27 Companies Act 1993, s 169(3)(f); *Mason v Lewis* [2006] 3 NZLR 225, [51].
Section 135 has attracted a considerable amount of critical academic comment\textsuperscript{28} and obiter judicial criticism.\textsuperscript{29} However, to some extent, these comments and criticisms have been answered by the Court of Appeal decision in *Mason v Lewis*,\textsuperscript{30} at least in the case of the most common allegation of reckless trading, that directors have allowed a company to continue trading when it is insolvent.\textsuperscript{31} The focus in this section is accordingly on the decision in *Mason v Lewis* and subsequent developments. Earlier cases on s 135 are documented elsewhere.\textsuperscript{32}

2.2.1 *Substantial risk of serious loss*

The legislative history regarding the incorporation of this particular phrase in s 135 is well traversed elsewhere.\textsuperscript{33} Briefly, the Law Commission viewed the precursor to s 135, s 320(1)(b) of the Companies Act 1955, as it had been interpreted in cases such as *Thompson v Innes*,\textsuperscript{34} as inhibiting the use of the company as a vehicle for taking business risks. (It was only directors who were knowingly a party to the carrying on of any business of the company in a reckless manner that fell within the ambit of s 320(1)(b) of the Companies Act 1955). As a consequence, the Law Commission, its draft Bill, proposed that directors be subject to a duty to avoid agreeing to a company entering into a contract or arrangement unless they believed, on reasonable grounds, that the act did not involve an unreasonable risk of causing the company to fail to satisfy the solvency test.\textsuperscript{35} The Law Commission's proposal did not make it into the Companies Bill introduced into Parliament in 1990. Instead, cl 113 of the Bill prohibited a director from agreeing, causing, or allowing, the business of the company to be carried on recklessly. The present duty was inserted into the Companies Bill as it was reported back from the Justice and Law Reform Select Committee and apparently paraphrases the explanation of 'reckless' given by Bisson J in the context of s 320(1)(b) of the Companies Act 1955:


\textsuperscript{29} See *Re South Pacific Shipping Ltd* (2004) 9 NZCLC 263,570.

\textsuperscript{30} [2006] 3 NZLR 225.

\textsuperscript{31} *Goatlands Ltd (in liq) v Borrell* (2007) 23 NZTC 21,107, [27].


\textsuperscript{34} (1985) 2 NZCLC 99,463.

Was there something in the financial position of this company which would have drawn to 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 which s 320(1)(b) was intended to prevent?\textsuperscript{36}

The phrase has been criticised because it does not provide directors with a ‘clear standard against which their actions will be measured.’\textsuperscript{37} In the words of Peter Watts, it apparently ‘imposes liability for carrying on business in a way which contains real risks of not unimportant loss to creditors’\textsuperscript{38} However, as the Court of Appeal in Mason v Lewis recognised, the criticism most often directed at it is that it is ‘potentially unduly deterring directors from taking business risks.’\textsuperscript{39} Prior to Mason v Lewis, commentators and the judges at first instance had been divided in opinion as to whether, when assessing whether a director’s conduct created a ‘substantial risk of serious loss to creditors’, it was possible to balance the risk taken against the likelihood of any prospective gain. Tompkins J, writing extra judicially, had said

If a risk of loss is reasonably balanced by the prospect of gain, the risk could not be characterized as substantial. In assessing the degree of risk the courts are likely to take the attitude which is commercially realistic. The two words of emphasis in the phrase ‘a substantial risk of serious loss’ support the view that a court is unlikely to consider a director in breach of that duty if the risk of loss created is commensurate with the likelihood of profit.\textsuperscript{40}

O’Regan J, in Fatupaito v Bates, responded to these comments by stating:

I would hesitate to interpret s 135 as allowing the kind of balancing of risk and reward referred to by Tompkins J – it refers only to risk and does not qualify the reference to risk by wording such as ‘except where the potential for substantial gain justifies the taking of such risk.’\textsuperscript{41}

The Court of Appeal in Mason v Lewis noted that in a number of instances the courts had responded to the concern that s 135 might unduly to deter the taking of business risks and cited, as evidence of this, comments made by Anderson J in one of the first High Court decisions to consider the meaning of the phrase,\textsuperscript{42} Nippon Express (NZ) Ltd v Woodward: ‘if a company operates at a loss for an extended period and has few, if any, realizable assets, there must be some risk to creditors’ but that s 135 ‘is

\textsuperscript{36} (1985) 2 NZCLC 99,463, 99,472.
\textsuperscript{38} H Rennie & P Watts, Directors’ Duties and Shareholders’ Rights (1996) 36.
\textsuperscript{39} [2006] 3 NZLR 225, [46].
\textsuperscript{41} Fatupaito v Bates [2001] 3 NZLR 386, [64].
\textsuperscript{42} The actual provision under consideration was s 189 of the Companies Act 1955, which is drafted in identical terms to s 135 of the Companies Act 1993.
concerned, however, with not mere risk but *substantial risk of serious loss* ... (italics added).\(^43\) The Court of Appeal then referred to the fact that both the High Court and Court of Appeal, in the context of s 135 or its predecessor in the Companies Act 1955, s 320(1)(b), had drawn a distinction between ‘legitimate’ and ‘illegitimate’ loss and emphasised that s 135 was only concerned with the latter.\(^44\) William Young J first drew this distinction in *Re South Pacific Shipping Co Ltd*, a decision affirmed by the Court of Appeal, and it is worth setting out in full, but with citations omitted, the factors he saw as relevant to an assessment of whether a business risk was legitimate:

1. Was the risk fully understood by those whose funds were in peril? It would be contrary to the principles of limited liability (which, amongst other things, promote the taking of risks) to find directors liable where risks which were recognised by creditors have crystallised.

2. On the other hand, where a company is insolvent (or on the edge of insolvency) the persons who are primarily interested in its fortunes are the creditors and not the shareholders. In this context, the decision of the Court of Appeal in *Nicholson v Permakraft (NZ) Ltd* is relevant. The facts of that case are of no materiality to the present situation. What is relevant, however, is the recognition by all members of the Court that in the case of an insolvent company, the obligation of the directors to the company required them to have regard to the interests of the creditors.

3. No-one suggests that a company must cease trading the moment it becomes insolvent (in a balance sheet sense). Such a cessation of business may inflict serious loss on creditors and, where there is a probability of salvage, such loss can fairly be regarded as unnecessary. The cases, however, make it perfectly clear that there are limits to the extent to which directors can trade companies while they are insolvent (in the balance sheet sense to which I referred) in the hope that things will improve. In most of the cases, the time allowance has been limited, a matter of months.

4. Was the conduct of the director in question in accordance with orthodox commercial practice? The relevance of this consideration is apparent from the passage in *Re Bennett* which I have already cited. The cases, in fact, are full of references to what would have been understood by reasonable directors and what reasonable directors would have done in the relevant circumstances. Implicit at least in all of this is that liability for reckless trading is likely where the directors have acted otherwise than in accordance with orthodox commercial practice.\(^45\)

The Court of Appeal commented that the purpose of s 135 is the ‘avoidance of *inappropriate* loss to the company’s creditors through reckless trading’ (emphasis

\(^{43}\) (1998) 8 NZCLC 261, 765, 261,773.  
\(^{44}\) See *Re South Pacific Shipping Ltd (In Liquidation)* (2004) 9 NZCLC 263,570 (HC); *Lower v Traveller* [2005] 3 NZLR 479; *Walker v Allan* HC Nelson, CP13/00, 18 March 2004, Ellen France J.  
\(^{45}\) (2004) 9 NZCLC 263,570, [125].
added).\textsuperscript{46} So, it seems that we can take from this that the Court does not consider that s 135 deters risk taking per se, but risk taking that is inappropriate or illegitimate. As to what to what constitutes ‘substantial risk’ (which is, presumably, inappropriate or illegitimate risk), the Court cited the following suggestion made by Mike Ross:

The first phrase, ‘substantial risk’ requires a sober assessment by directors as to the company’s likely future income stream. Given current economic conditions, are there reasonable assumptions underpinning the director’s forecast of future trading revenue? If future liquidity is dependent upon one large construction contract or a large forward order for the supply of goods or services, how reasonable are the director’s assumptions regarding the likelihood of the company winning the contract? Even if the company wins the contract, how reasonable are the prospects of performing the contract at a profit?\textsuperscript{47}

The Court then set out what it termed the ‘essential pillars’ of s 135:

- the test is an objective one;\textsuperscript{48}
- it focuses not on a director’s belief, but rather on the manner in which a company’s business is carried on, and whether that modus operandi creates a substantial risk of serious loss; and
- what is required when the company enters troubled financial waters is what Ross accurately described as a ‘sober assessment’ by the directors, we would add of an ongoing character, as to the company’s likely future income and prospects.\textsuperscript{49}

Later comments by the Court indicate that the objective assessment is in terms of what a ‘reasonable and prudent director’ would have known and done.\textsuperscript{50}

The last ‘pillar’ dictates a positive step that is required of company directors. Directors will be in breach of s 135 if they fail to undertake the required ‘sober assessment’ on an ongoing basis, when a reasonable and prudent director would have done so and appreciated and acted on a conclusion that either the company required ‘radical surgery’ or should cease trading. Section 135 accords no protection for ‘sleeping directors’, indeed the Court later commented that ‘[t]he days of sleeping directors with merely an investment interest are long gone.’\textsuperscript{51} Directors will also be in breach of s 135 if they do conduct the sober assessment, as when a reasonable and prudent director would have done so, but do not come to the same conclusion and/or undertake the same action as a reasonable and prudent director. The Court also

\textsuperscript{46} [2006] 3 NZLR 225, [57].
\textsuperscript{47} M Ross, Corporate Reconstructions Strategies for Directors (1999) 40.
\textsuperscript{48} The Court referred to Fatupaito v Bates [2001] 3 NZLR 386.
\textsuperscript{49} [2006] 3 NZLR 225, [51].
\textsuperscript{50} See, also, Mounfort v Tasman Pacific Airlines of NZ Ltd (2005) 9 NZCLC 263,864, [31].
\textsuperscript{51} [2006] 3 NZLR 225, [83].
commented that s 300 of the Companies Act 1993 works ‘in tandem’ with s 135. (Under s 300 a liquidator may apply for an order that a director contribute to the shortfall in an insolvent liquidation if the company has failed to keep proper accounting records.) ‘[A] director is not permitted to say that he or she did not realise what the financial position of the company is because the accounting records necessary to determine this were not in existence.’\(^{52}\)

2.2.3 Reliance on others

In \textit{Mason v Lewis} the Court of Appeal confirmed that s 138 could operate as an affirmative defence to an allegation of breach of s 135. Section 138 provides:

\begin{itemize}
\item \textbf{138 Use of information and advice}
\item (1) Subject to subsection (2) of this section, a director of a company, when exercising powers or performing duties as a director, may rely on reports, statements, and financial data and other information prepared or supplied, and on professional or expert advice given, by any of the following persons:
\begin{itemize}
\item (a) An employee of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned:
\item (b) A professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional or expert competence:
\item (c) Any other director or committee of directors upon which the director did not serve in relation to matters within the director's or committee's designated authority.
\end{itemize}
\item (2) Subsection (1) of this section applies to a director only if the director—
\begin{itemize}
\item (a) Acts in good faith; and
\item (b) Makes proper inquiry where the need for inquiry is indicated by the circumstances; and
\item (c) Has no knowledge that such reliance is unwarranted.
\end{itemize}
\end{itemize}

Section 138(1) and (2) both require a subjective assessment as to a particular director’s belief but also that the director’s belief be underpinned by objective grounds. Although s 138 was not specifically pleaded by the defendants in \textit{Mason v Lewis}, the Court did consider the issue of reasonable reliance and effectively confirmed the stance taken by Anderson J in \textit{Nippon Express (NZ) Ltd v Woodward}\(^{53}\) that once an individual has proven to be unreliable, it is unreasonable for a director to rely on that individual’s advice without making proper enquiries. The Court of Appeal also indicated that reliance on others may be relevant to the Court’s determination of any compensation payable under s 301(1)(b)(ii).

\(^{52}\) [2006] 3 NZLR 3 NZLR 225, [85].
\(^{53}\) (1998) 8 NZCLC 261, 765
2.2.4 The carrying on of the company’s business

Two recent High Court decisions have confirmed, with no discussion on the point, that s 135 also applies to one-off transactions. In *Kings Wharf Coldstore Ltd (in rec & liq) v Wilson*\(^{34}\) the transaction in issue, a removal of assets from the company accompanied by an intention on the part of the company’s sole director to defraud the company’s creditors, was clearly outside the company’s ordinary course of business. In *Goatlands Ltd (in liq) v Borrell*\(^{35}\) the transaction involved the company incurring a contingent liability to the IRD and Lang J had this to say about the assessment of substantial risk of serious loss to creditors:

> the directors of a company will be permitted to take risks so long as those risks do not place the company’s creditors at substantial risk of serious loss. Those risks are legitimate, and the creditors of the company have no real interest in them. Creditors will generally only be at risk, and have an interest in the outcome of a transaction, in the event that the company becomes insolvent to the point where it is in danger of being placed in liquidation.

If, as in the present case, the directors are considering whether the company should enter into a single transaction that has the potential to cause its complete demise, they must reach their decision after a ‘sober assessment’ of the level of risk that the transaction entailed for the company and its creditors. They should only proceed to commit the company to the transaction if, objectively viewed, the risk of failure is sufficiently small to warrant the company taking it. If the risk of failure is substantial, in the sense of real and significant, it should not be taken.\(^{36}\)

To the extent that s 135 applies in the case of a one-off transaction, it may now overlap with both the duty to have regard to the interests of creditors under s 131(1) and the duty in relation to obligations in s 136. However, it seems that at least insofar as there is an overlap between s 131(1) and s 135, a director’s duty under s 131(1) effectively now reflects the duty under s 135 as it has been interpreted by the courts.

2.2.5 Appropriate Relief

In *Mason v Lewis* the Court of Appeal noted that it was important not to ‘conflate the provisions of s 135 and s 301 of the Companies Act when determining the “liability” issue. The issues are twofold; should there be liability, then, what is the appropriate relief?’\(^{37}\) In the end the Court of Appeal decided that it was not in a position to determine the relief to be awarded to the company and remitted this issue back to the High Court. Nevertheless, the Court provided some guidance (although technically

\(^{34}\) Miller J, HC Wellington, 24/11/05, CIV 2001-485-954.


\(^{36}\) (2007) 23 NZTC 21,107, [45], [46].

\(^{37}\) [2006] 3 NZLR 225, [51].
only obiter) as to the principles to be applied. The Court noted that the standard approach was to ‘begin by looking to the deterioration in the company’s financial position between the date inadequate corporate governance became evident (really the “breach” date) and the date of liquidation.’

Once that sum is ascertained, three factors are relevant to the exercise of the Court’s discretion:

- **Causation (the link between the breach and subsequent indebtedness to creditors).** In *Löwer v Traveller*, in the context of s 320(1)(b) of the Companies Act 1955, the Court of Appeal noted that:

  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.

The Court added that if calculations are uncertain, a conservative approach should be adopted.

- **Culpability (the blameworthiness of the director).** In *Mason v Lewis* it was accepted that the culpability of the manager on which the defendant directors relied was clearly more than that of the defendants but the Court emphasised that it was the defendants’ culpability qua directors that was in issue. This, however, was only the starting point as the Court then pointed out certain actions taken by one of the directors which might be taken into account into the assessment of his particular culpability. The Court of Appeal in *Löwer v Traveller*, in the context of s 320(1)(b) of the Companies Act 1993, said:

  The relevance of culpability is linked to the deterrent purpose of the provision. This factor calls for an assessment of the blameworthiness of Mr Löwer’s conduct, bearing in mind that at one end of the range the nature of a director’s involvement will be blind faith or muddleheadedness, while at the other end there will be actions or instances of inaction which are plainly dishonest.

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58 At [109].
60 [2005] 3 NZLR 479, [79].
61 [2005] 3 NZLR 479, [80].
62 [2005] 3 NZLR 479, [83].
• Duration (the duration of the time the director was a party to the reckless trading).

Finally, the Court of Appeal noted in *Mason v Lewis* that ‘claims of this character necessarily have to be approached in a relatively broad-brush way. The jurisdiction to order recompense is of an “equitable” character.’ 63 So, as Miller J put it in *Kings Wharf Coldstore Ltd (in rec & liq) v Wilson*, ‘the essential task is to compensate whatever real loss or detriment the company may have suffered, subject to equitable discretionary considerations of “conscience, fairness and hardship and other features such as laches and acquiescence”.’ 64 However, as noted in case law predating *Mason v Lewis*, given that s 135 is a duty owed to the company, imprudent conduct by a creditor or creditors does not mitigate a director’s liability for breach of s 135. 65

Having set out the law, what follows are case notes of the two most recent examples of the application of the law, the Court of Appeal decision in *Mason v Lewis*, 66 an example of the most usual scenario where allegations of breach of s 135 are made, and *Goatlands Ltd (in liq) v Borrell,* 67 an example of the application of s 135 in the case of a one-off transaction.

2.2.6 *Mason v Lewis*

The defendants, Mr and Mrs Lewis, became directors and minority shareholders of Global Print Strategies Ltd (Global Print) on its incorporation in November 1999 at the invitation of a Mr Grant (described by the Court of Appeal as ‘a crook’). Grant ultimately became the manager of the company. The Lewises invested $100,000 of borrowed funds in the company as shareholders and also became directors of the company. The other directors and shareholders of the company were Mrs Grant and three company employees.

Global Print’s business was based on one key contract which, unfortunately, it lost after only three months of trading in February 2000. The Lewises did not find out about this loss for another two months but Mr Lewis was apparently then reassured by Grant that matters were ‘under control’. Grant also showed Mr Lewis information indicating an upward trend in Global Print’s income. In fact, this never eventuated; Global Print was in ‘serious financial difficulty’ from February 2000 onwards.

Aside from Grant’s assurances, the other information received by Mr Lewis concerning the company’s financial performance from April 2000 onwards was all

63 [2006] 3 NZLR 225, [118].
64 HC Wellington, 24/11/05, CIV 2001-485-954, [113].
negative. (It is not apparent from the Court of Appeal judgment that Mrs Lewis took any steps as a director of the company):

- In April 2000 the three employee/directors resigned as directors after being asked but declining to invest money in the company and transferred their shareholding to Mrs Grant.

- A meeting in June 2000 took place between Mr Lewis, Mr Grant and an accountant employed from time to time by the company at which there was 'plainly a concern as to the financial position of the company.' Following this meeting, Mr Lewis and the accountant had a meeting to seek further funding from Mr Lewis’s brother, who had already invested a significant amount ($275,000) in the company.

- Draft accounts produced in July 2000 for the period November 1999 – March 2001 showed a trading loss of $376,760 and a small balance sheet surplus of $44,000.

- Debtor and creditor reconciliations prepared in August 2000 showed the company was trading at a loss and a significant amount was owed to the IRD.

- In October 2000 Mr Lewis’s permission was sought by Grant to factor some of the company’s debts. Mr Lewis refused permission but Mrs Grant went ahead and signed a factoring agreement. It later became apparent that Grant was generating and factoring false invoices.

- In March 2001 the Lewises received a letter from the IRD detailing a total outstanding tax liability of $163,000. It was not until June 2001 that the Lewises received a letter from the accountant, employed by the company from time to time, indicating that matters ‘will shortly be resolved’ with the IRD.

In addition to receipt of the information detailed above, Mr Lewis was apparently in the habit of visiting the company’s offices from time to time and it was on one such visit, in December 2001, that he was informed by an employee that Grant was generating false invoices. Mr Lewis then employed a forensic accountant to undertake an investigation of the company’s financial records. A liquidator was appointed by shareholder resolution in February 2002.

As to the particular context under consideration, the Court of Appeal noted that Mr and Mrs Lewis appeared to have no understanding of their duties as directors: the internal workings of Global Print were never recorded or regularised; they were content to leave everything in the hands of Grant when as early as April 2000 they should have been put on guard about his reliability; and, they paid no proper attention to the financial affairs of the company. On this last point, there had been a finding, not challenged in the Court of Appeal, that there had been a failure by the company to keep proper accounting records, which led to a further and successful claim by the liquidator for a declaration of liability of the Lewises under s 300 of the Act.
The Court noted the steady stream of negative information received by Mr Lewis from mid-April 2000 onwards about the company’s financial performance but held that by August 2000 there was overwhelming evidence that the company was ‘in very serious financial trouble.’ From this time, ‘[t]here was an urgent need for a close investigation to accurately determine the company’s financial position, and whether it could and should continue trading. On any view of the matter, solvency was by that time an absolutely critical issue.’\(^{68}\) However, despite further negative information being received by Mr Lewis, the company was allowed to trade on until February 2002. Thus ‘for a period of 15 months (at a minimum) creditors were left at the mercy of a hopelessly insolvent company, which was in any event being run by a crooked manager,’\(^ {69}\) making this ‘a paradigm case of reckless trading under s 135 of the Companies Act.’\(^ {70}\)

The Court of Appeal also disagreed with the High Court finding that the Lewises had reasonably relied on information supplied to them by Grant and the accountant employed from time to time by the company. As to the information supplied by Grant, the Court noted they had relied on this information without making proper inquiries. As to the admittedly limited information supplied by the accountant on the solvency of the company, the Court noted that this did not preclude the Lewises from reaching their own informed opinion on this issue. Thus, s 138, which deals with the circumstances in which directors may rely on information or advice supplied by others did not provide the Lewises with a defence.

In terms of criteria relevant to the exercise of the court’s discretion, the Court noted, first, that causation caused no difficulty; there appeared to be a clear link between the Lewises continuing the company to trade and the resulting company indebtedness to creditors. In terms of culpability, the Court noted that ‘[i]t was the Lewises’ underlying failure to see this company properly set up, with adequate and ongoing books of account, and monitored, which created the very context in which Mr Grant’s unauthorised steps, expenditure and dishonesty could thrive. The neglect of their duties by the Lewises in this case can fairly be described as “reckless”. In all the circumstances, we view the culpability of the Lewises as being significant.’\(^ {71}\) But having said that, the Court said that it did not necessarily follow that the Lewises’ liability ought to be the same or joint and several. The Court noted, with respect to Mr Lewis, that he took steps to avoid involvement with the factoring arrangement but that it and a subsequent security purportedly given to the factoring company were effectively foisted upon him and the company by Mrs Grant, who acted without authority. Countering this, however, were the steps, if any, that Mr Lewis could have taken to avoid the transaction.

\(^{68}\) At [69].
\(^{69}\) At [75].
\(^{70}\) At [76].
\(^{71}\) At [115].
The Court did suggest that it would be in the interests of all concerned if the matter settled although the Court did note what it considered to be the outer limits of the Lewises’ liability. Taking into account the deficiencies identified in the assessment of quantum put forward for the liquidator, it was possible that the indebtedness flowing from the Lewises’ default exceeded $1 million. However, it would not be appropriate, given that the remission of the matter back to the High Court was due in large part to the way in which the liquidator’s claim was pleaded, the Lewises should not be liable for any greater amount than that claimed by the liquidator on the appeal, $560,000. The Court also noted it could not see how the Lewises’ liability could be any less than $100,000.

2.2.7 Goatlands Ltd (in liq) v Borrell

The defendants, Mr and Mrs Borrell, were goat farmers and amateur property developers. Mr and Mrs Borrell made the decision to subdivide the land on which they carried out their goat farming operation into two large and several smaller blocks of land and borrowed the necessary funds to achieve this. They duly obtained resource consent for their subdivision but one of terms upon which consent was given was that they remove the farm buildings necessary for their goat farming operation. The defendants accordingly found themselves in the position where they had to find quickly a new location for their farming operation. They located such a property and, after consulting their real estate agent and a solicitor, entered into an unconditional agreement for sale and purchase in May 2001 at a price of $922,222 plus GST with settlement to take place in May 2002.

The defendants intended that a company would hold title to the new property and nominated the company, Goatlands Ltd, which was incorporated by them for this purpose, as purchaser. (It was agreed in the proceedings that this step did not render the company liable under the agreement for sale and purchase and that liability under this contract remained with the defendants). The defendants entered into immediate possession of the property under a lease contained in the agreement for sale and purchase.

Mr and Mrs Borrell caused Goatlands Ltd to apply for a GST refund ($111,509) on the purchase price from the IRD, which it received in June 2001. It was further agreed that on receipt of the refund the company incurred a contingent liability to repay this sum should it not complete the purchase of the property. The refund was used to pay the deposit on the agreement for sale and purchase and the first six months rental with the balance being spent on improvements to the new property. The refund was entirely spent two months after being received by the company.

The defendants always understood that they would have to sell one of the large blocks of subdivided land to finance the balance of the purchase price of the new property. Ultimately, however, the necessary sale did not occur. The company therefore became liable to pay the GST refund but was unable to do so. Liquidators
were appointed on the application of the IRD and they brought an application under s 301 alleging the defendants were in breach of ss 135 and 136 of the Act. In the liquidation the IRD was the only substantial creditor; the only other creditor made a claim for $650 for unpaid work carried out to improve the new property.

With respect to s 135, Lang J accepted that entering into a single transaction fell within the ambit of s 135. The issue was accordingly whether the defendants’ decision to spend the GST refund, before they knew whether the company was going to be able to complete the purchase, created a substantial risk of serious loss to the IRD.

Lang J categorised the potential loss to which the IRD was exposed, $111,500, as a substantial sum, so that it therefore qualified, in his view, as a serious loss. The focus accordingly turned to whether the defendants had assumed a ‘substantial risk’.

The defendants pointed to the following factors as supporting the absence of a breach of duty:

- By May 2001 they had already entered into unconditional contracts of sale for two of the smaller blocks
- At around this time they were advised by their real estate agent that he expected to be able to sell at least one of the larger blocks within a three month period.
- They had obtained the agreement of their mortgagee that it would transfer its mortgage to the new property on settlement. So, as long as they could sell one of the larger blocks, they would be in position to fund the purchase price on the new property.
- They also had a fallback position in that their mortgagee, on the condition that one of the larger blocks sold, also agreed to provide any necessary bridging finance.
- The defendants also sought the advice of a solicitor who assessed the risk as ‘manageable’.
- The attitude of the vendor was, at the time of entry into the agreement for sale and purchase, supportive and encouraging.

Overall, the defendants assessed the risk associated with their decision to spend the GST refund as no more than 5%. Lang J offered no comment as to whether, if the defendants’ assessment of risk had proved to be correct, he would still have classified this as a ‘substantial risk’.

Of the arguments put forward by the liquidator countering the defendants’ assessment of risk, Lang J accepted the following as having some significance:

- The only means by which the defendants could obtain the necessary funds to allow the company to meet its contingent liability was to sell one of the larger blocks of land: there was no ‘plan B’.
• The refund was spent on items of no value or that were irrecoverable in the event that the purchase was not completed.

• There was no guarantee that the larger blocks would sell and that, should a purchase depend upon the sale of an existing property, it would generally be prudent for a purchaser to make the purchase of the new property conditional upon the sale of the old. (The vendor in the present case would only accept an unconditional offer.) However, if the defendants had entered into an unconditional contract, they would have received their deposit back and could have applied that towards repayment of the GST refund.

Lang J then turned to consider the particular context within which the defendants found themselves. He categorised the root cause of the defendants’ predicament was that they were undercapitalised and that, although they purported to take advice from others, their hands were effectively tied. He found that their only real option, given the terms on which resource consent for the subdivision of their property had been given, was to move onto the new property and hope that one of the larger blocks of subdivided land would sell within the following 12 month period. This made the defendants vulnerable to any adverse movements in the property market. Lang J noted that despite the assurances the defendants had received from their real estate agent, the agent had been marketing the larger subdivided blocks for four months prior to the defendants entering into the agreement for sale and purchase and no purchaser had expressed interest in either of these blocks.

Lang J held that the terms of s 138 prevented the defendants from relying on the real estate agent’s advice: ‘I do not consider that any reasonable person in the position of Mr and Mrs Borrell would have relied upon [the agent’s] opinion as providing any guarantee or assurance that the blocks would sell within 3 or 4 months or, for that matter, that they would sell within any given period.’

Lang J also held that the defendants could not reasonably rely on the advice they received from the solicitor they consulted for two reasons. First, the solicitor gave the advice without being aware of the background to the defendants’ financial position. Additionally, the advice that defendants ought to be able to sell one of the larger blocks within the 12 month period prior to settlement was arguably outside his area of expertise.

Lang J’s assessed the risk the Borrells took in making the decision to spend the GST refund as real and significant. In percentage terms, he classified, apparently on his own accord, the risk that Goatlands would not be able to complete the purchase at 25%. Such a risk, he concluded, was a substantial and illegitimate risk: ‘Mr and Mrs Borrell should not have used the GST refund to meet Goatlands’ capital and operating expenses until such time as they had obtained bridging finance or until they knew that they had a buyer for at least one of the large blocks.’ Lang J also held the

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72 At [93]
Borrells’ actions to be outside orthodox commercial practice. An orthodox approach, he said, would be to protect the company from the risk and this could only have effectively been done if the Borrells had sufficient other liquid assets to make available to the company to enable it to meet its contingent liability to the IRD. It followed that Mr and Mrs Borrell were in breach of s 135.

When it came to assessing the amount to which the defendants should contribute to the assets of the company, Lang J accepted that the factors of causation, duration and culpability were relevant. The factors of causation and duration gave rise to no real issue and Lang J spent most time considering the issue of the defendant’s culpability. Under this head, Lang J considered a number of subjective factors: that the defendants genuinely intended and wanted the company to complete the purchase; that to a certain extent matters were beyond their control (and there was no evidence that they stopped trying to arrange a sale of the larger blocks at any time); and, the factors raised by the defendants as negating their liability. All of this led him to conclude that their culpability did not lie at the top end of the scale. He concluded that it was just and equitable for the Borrells to make a contribution to the assets of the company that represented the extent of the illegitimate risk that they took, in this case, 25% of the company’s indebtedness or $34,500.

2.3 Duty in relation to obligations

Section 136, like s 135, is a duty owed by directors to the company. It provides:

136 Duty in relation to obligations
A director of a company must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.

Section 136 features far less prominently in the case law than s 135. Nevertheless the following points of interpretation have emerged:

- the duty blends both objective and subjective elements: a director must subjectively believe that the company will be able to perform the obligation when required to do so but that belief must be based on reasonable grounds.  
- the provision applies to one off transactions.
- the words ‘will be able’ suggests that there needs to be a degree of certainty in a director’s mind that the company will be able to perform the obligation when it is required to do so.

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73 Companies Act 1993, s 169(3)(g).
Its most recent application is in *Goatlands Ltd (in lig) v Borrell*\(^{27}\) where the issue was whether the defendant directors had breached s 136 in committing the company to the contingent obligation to repay a GST refund when the directors knew that the only way in which the company could be put in funds to meet this obligation was if they sold other land that they owned.

Lang J concluded that the defendants met neither the subjective or objective thresholds as to belief. He accepted that the defendants believed that the company had reasonable likelihood of completing the purchase but that such a belief did not meet the statutory threshold which a required a belief that the company ‘will’ be able to perform the obligation when required to do so. For the same reasons advanced for finding the defendants had breached s 135, Lang J was also of the view that the defendants had no reasonable grounds to believe that they would be able to sell other land owned by them in sufficient time so that they could then put the company in funds to complete the purchase and extinguish the contingent liability to the IRD.

Lang J dealt with the defendant directors’ liability for breach under s 136 in the same manner as under s 135, that is, it was determined by the factors of causation, culpability and duration. The amount for which the defendants were liable under s 136 was for the same amount they were ordered to pay in respect of the breach of s 135.

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4. Phoenix Companies

The new provisions in the Companies Act 1993 regulating director involvement in phoenix companies, ss 386A – 386F, were inserted by s 35 of the Companies Amendment Act 2006 and are to come into force on a date to be fixed by Order in Council. They are intended as an additional ‘low cost statutory disincentive that can be easily enforced’\(^{78}\) against two elements of ‘mischief’ associated with phoenix arrangements: ‘the danger that the business of the old insolvent company might be acquired at an undervalue – or is otherwise to be expropriated – to the detriment of creditors; and secondly, the danger that the creditors of the old company may be misled into the belief that there has been no change in corporate vehicle.’\(^ {79}\)

There are of course other provisions in the Act that operate to prevent inappropriate phoenix arrangements or to give relief to creditors if such arrangements occur and these include: the directors’ duties in s 131(1), 135 and 136; the pooling provision in s 271; the voidable transaction provisions in ss 297 and 298; and, the summary means of enforcing breaches of directors’ duties in s 301. Directors responsible for inappropriate phoenix arrangements may also face criminal consequences: s 380(2) makes it an offence for a director, with intent to defraud creditors, to cause property of the company to be given or transferred to another person and a new s 380(3), inserted by s 56 of the Companies Amendment Act 2006, makes it an offence for a director, with intent to defraud a creditor or creditors of the company, to do any thing that causes material loss to any creditor.

Sections 386A-386F are based on ss 216 and 217 of the Insolvency Act 1986 (UK). To date, ss 216 and 217 have not generated a significant amount of case law but this can be seen as a positive point as, in the most usual circumstance in which they likely to be relied upon, making directors liable for the debts of phoenix companies, no court involvement is required. In an editorial published in August 2007, David Milman commented that ss 216 and 217 were a ‘favourite tool’ of individual creditors taking recovery action against directors and that they had been ‘extensively used over the part year, particularly by Her Majesty’s Revenue and Customs.’\(^ {80}\)

4.1 The general prohibition in s 386A(1).

Section 386A provides that, unless one of the specified exemptions set out in s 386A(1) and ss 386D – 386F applies, a director of a company which has gone into an insolvent liquidation (the failed company) cannot act as a director, or be involved in the management, of another company or business (the phoenix company) that is known by a pre-liquidation name of the failed company or a similar name for a period of five years after the commencement of the liquidation of the failed company.

\(^{78}\) Hon Lianne Dalziel, Phoenix Companies Cabinet Paper, 6 January 2004, [48].

\(^{79}\) Penrose v Official Receiver [1996] 2 All ER 96, 104.

4.2 Some definitions

At this point it is necessary to stop and focus on the definitions, set out in s 386B(1), of the key phrases in s 386A(1).

The first is ‘failed company’, defined as a company placed in liquidation at a time when it was unable to pay its due debts.

The second is ‘director of a failed company’, defined as a person of a failed company at any time in the period of 12 months before the commencement of the liquidation of the failed company. Section 126(1) of the Act defines a ‘director’ for the purposes of ss 386A-386F as including those individuals formally appointed as directors as well as de facto directors, shadow directors (s 126(1)(b)(i),(ii)), those upon whom the constitution confers powers that would otherwise be exercised by the board (s 126(1)(b)(iii)) and those to whom the board has delegated powers or duties (s 126(1)(c)).

‘Phoenix company’ is defined to mean, in relation to a failed company, a company that, at any time before, or within 5 years after, the commencement of the liquidation of the failed company, is known by a name that is also a pre-liquidation name of the failed company or a similar name.

Section 386B(2) provides that a company is known by a name if that name is its registered name or if it carries on business, or carries on a part of its business, under that name.

A company’s ‘pre-liquidation name’ is defined in s 386B(1) to mean any name (including any trading name) of the failed company in the 12 months before the commencement of its liquidation. ‘Similar name’ is defined to mean a name so similar to a pre-liquidation name as to suggest an association with that company.

The leading English authority on the statutory definition of similar name is *Ad Valorem Factors Ltd v Ricketts* where the issue before the Court of Appeal was whether Air Equipment Co Ltd was a similar name to The Air Component Co Ltd. The Court of Appeal confirmed the finding at first instance that it was. Mummery LJ said:

> It is necessary, of course, to make a comparison of the names of the two companies in the context of all the circumstances in which they were actually used or likely to be used: the types of products dealt in, the locations of the businesses, the types of customers dealing with the companies.  

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81 *Ad Valorem Factors Ltd v Ricketts* [2004] 1 All ER 894, [22].
The particular context of the case before the Court was that the two companies dealt in the same product in a similar market and 'there was a continuity of [the defendant's] interest in the two companies.' Mummery LJ concluded that 'when viewed in that context I have no doubt that the name of Air Equipment suggests an association with Air Component.'

Simon Brown LJ agreed that whether or not a name was a 'similar name' had to be considered in the context of all the circumstances but added that the 'similarity between the two names must be such as to give rise to a probability that members of the public, comparing the names in the relevant context, will associate the two companies with each other, whether as successor companies or, as here, as part of the same group.' Simon Brown LJ agreed that in the case before him the necessary association was made out.

In Commissioners for HM Revenue & Customs v Walsh the issue was whether Walsh Construction Ltd was a similar name to SG & T Walsh Company Ltd. In terms of the relevant context, the two companies were both operated by the same persons and traded in the building and civil engineering field from the same trading address with the same telephone and fax numbers. It was submitted for the defendant that a finding of association would be inappropriate because the name 'Walsh' is such a common name but Laddie J, following comments made by Mummery LJ in Ad Valorem Factors Ltd v Ricketts, noted that the mere fact that a word is in common usage is not a bar to a finding of association. He also noted that '[t]here is no requirement under the 1986 Act that the second company should be causing customers of the liquidating company to believe it is the liquidating company.' Laddie J also applied Simon LJ's additional requirement to hold that there was a probability that members of the public would associate the phoenix company with the failed company.

In Inland Revenue Commissioners v Nash the failed company's registered name was John Nash Specialist Services Ltd but it also traded under a variety of other names including Alpine Specialist Services and Alpine Specialist Drilling. The name of the phoenix company, Alpine Specialists Ltd, was held to be a similar name to the trading names of the failed company.

The most recent case on this point is Revenue and Customs Commissioners v Benton-Diggins. The defendant was a director of two companies, Williams Hair Studio Ltd (the failed company) and Williams and Xpress Ltd (the phoenix company). Williams and Xpress Ltd was also for a period known by the name of Williams Hair Studio. The relevant context was that the two companies carried on substantially the same

82 Ad Valorem Factors Ltd v Ricketts [2004] 1 All ER 894, [22].
83 Ad Valorem Factors Ltd v Ricketts [2004] 1 All ER 894, [30].
85 [2005] BPIR 1105, [16].
86 [2003] BPIR 1138.
87 [2006] 2 BCLC 255.
hair dressing business in a close proximity and were both fronted by the defendant. It was accepted that the registered name of the phoenix company was so similar to the registered name of the failed company so as to suggest a real probability of association and the same finding was made in respect of the name that the phoenix company had been known by for a time.

4.3 The prohibited participation in the phoenix company

Section 386A(1)(a)-(c) prohibits the following participation in a phoenix company:

- Being a director of a phoenix company: s 386A(1)(a).
- Being directly or indirectly concerned in or taking part in the promotion, formation, or management of a phoenix company: s 386(1)(b)
- Being directly or indirectly concerned in or taking part in the carrying on of a business that has the same name as the failed company’s pre-liquidation or similar name: s 386A(1)(c).

‘Director’ in this context includes those falling within the ambit of s 126(1)(a)-(c) of the Companies Act 1993.

There is little United Kingdom authority on the prohibited involvement set out in s 386A(1)(b) and (c). In *Inland Revenue Commissioners v Nash* 38 the defendant was a director of a phoenix company for two periods of time in the year after commencement of the liquidation of the failed company. During the times he was not a director, his son, a young man in his early twenties, was appointed as director. Peter Smith J accepted that during the times that the son was the phoenix company’s director, the defendant was concerned in its management. Peter Smith J held that the defendant’s son lacked the necessary experience to negotiate the complex contracts the phoenix company entered into whilst he was a director and concluded that the defendant was concerned in the management of the phoenix company because ‘he was the only one who had the necessary expertise.’

Under s 382(1) of the Companies Act 1993, a person who has been convicted of specified offences, including those involving dishonesty or in connection with the promotion, formation or management of a company, is similarly prohibited from being directly or indirectly concerned in or taking part in the promotion or management of a company. The following points have emerged from the case law on s 382(1) and are likely, also, to apply in the context of s 386A(1)(b) and (c):

- The prohibition ‘is not intended to operate as a blanket disqualification against persons to whom the section applies from obtaining employment in the corporate

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sector. Rather, it is intended to stop such persons from directly or indirectly being concerned or taking part in the management of a company.  

- ‘It may be difficult to draw the line in particular cases, but ... the concept of “management” for present purposes comprehends activities which involve policy and decision making, relating to the business affairs of the corporation, affecting the corporation as a whole or a substantial part of that corporation, to the extent that the consequences of the formation of those policies or the making of those decisions may have some significant bearing on the financial standing of the corporation or the conduct of its affairs.’  

- Carrying out day to day routine functions in accordance with predetermined policies is not within the concept of management.  

- ‘Take part in’ connotes ‘the active participation’ in the management of a company.  

- To ‘be concerned in’ is not synonymous with ‘take part in’, it has a wider operation and ‘connotes participation at a variety of levels and at differing intensities’, it prohibits a person ‘from taking any hand in the real business affairs of the company.’  

4.4 The consequences of a contravention of s 386A(1)  

4.4.1 Criminal Consequences  

Section 386A(2) provides that a person who contravenes s 386A(1) commits an offence and is liable on conviction on indictment to the penalty specified in s 373(4), a term of imprisonment not exceeding 5 years or to a fine not exceeding $200,000.  

There have been two English Court of Appeal decisions focusing on the mens rea component of the identically worded offence in s 216(4) of the Insolvency Act 1986 (UK). In R v Cole it was held that the offence was one of strict liability in the sense that the prosecution does not have to prove knowledge or intention to defraud or deceive. This point was confirmed in R v Doring, the Court categorising as irrelevant the appellant’s argument that she did not realise what she was consciously or deliberately doing counted as management of a phoenix company. The English Court of Appeal, in adopting this position, was following an authority dealing with a similarly worded offence of acting as a company director whilst an undischarged

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89 Thompson v District Court at Christchurch (2002) 9 NZLC 262, 824, [23].  
91 Commissioner for Corporate Affairs v Bracht [1989] VR 821, 831.  
92 Commissioner for Corporate Affairs v Bracht [1989] VR 821, 831.  
93 Commissioner for Corporate Affairs v Bracht [1989] VR 821, 832.  
bankrupt,\(^{97}\) an offence in very similar terms to that in s 382(4) of the Companies Act 1993 where, without reference to the English authorities, the same position has been adopted. Section 382(4) makes it an offence to be a director or to be directly or indirectly concerned, or taking part, in the management of a company after being convicted of certain offences unless the consent of the Court is first obtained, an offence which carries the same maximum penalty as does that in s 386A(2). In *Attorney-General v Auckland District Court*\(^{98}\) a defendant charged under s 382(4) did not dispute the fact that he had become a director whilst prohibited from doing so but argued that lacked the requisite degree of mens rea because he was unaware of his ability to apply to the Court for leave to become a director. Doogue J confirmed that ‘for the defendant to be guilty of the offence it must be established that he knowingly and intentionally become a director of the company’,\(^{99}\) but left open the point whether the prosecution must prove that the defendant did so without first obtaining leave from the Court or whether it is up to the defendant to put forward evidence that he did obtain leave. The defendant’s argument that he must also have knowledge of the requirement of obtaining leave from the Court was rejected because to accept it would allow the defendant to take advantage of his ignorance of the law, contrary to s 25 of the Crimes Act 1961.\(^{100}\)

### 4.4.2 Civil Consequences

Under s 386C(1) a person who contravenes s 386A(1)(a) or (b) is personally liable for all of the relevant debts of the phoenix company. As the English Court of Appeal has noted, the Court has no discretion as to whether personal liability should be imposed.\(^{101}\) Obviously it is unnecessary to provide for this consequence in relation to s 386A(1)(c) as those who carry on business as sole traders or in partnership have unlimited personal liability for the obligations incurred by such businesses.

‘Relevant debts’ is defined in s 386C(3)(a) to mean the debts and liabilities incurred by the phoenix company during the period when the person liable was involved in its management and the phoenix company was known by a pre-liquidation name of the failed company or a similar name.

Section 386C(1) is drafted in similar terms to ss 384 and 386 of the Act, which, respectively, impose personal liability for acting in contravention of ss 382 (acting as director after being convicted of specified offences) or 383 (acting as director whilst disqualified by the Court) and s 385 (acting as director whilst prohibited by the

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\(^{97}\) This offence is set out in s 11(1) of the Company Directors Disqualification Act 1986 (UK) and the relevant authority is *R v Brockley* [1994] 1 BCLC 606 (CA). The equivalent offence in New Zealand can be found in s 128A of the Insolvency Act 1967 and s 436 of the Insolvency Act 2006.

\(^{98}\) (2000) 8 NZCLC 262,314.

\(^{99}\) (2000) 8 NZCLC 262,314, [9]. This finding is also consistent with Australian authority: see Poyer v Commissioner for Corporate Affairs [1985] VR 533;

\(^{100}\) Section 25 of the Crimes Act 1961 provides that [t]he fact that an offender is ignorant of the law is not an excuse for any offence committed by him.

Registrar). To date, neither s 384 nor s 386, provisions new to the Companies Act 1993, have been the subject of judicial comment. Some assistance may, however, be gleaned from case law relating to s 300, which deals with a director’s liability in a liquidation following a failure by the company to keep proper accounting records. Section 300(4) provides that the Court may make a declaration that a director is personally liable for the debts or liabilities of a company even though the director concerned is liable to be convicted of an offence. In Maloc Construction Ltd (in liq) v Chadwick, Tompkins J said of proceedings under s 151 of the Companies Act 1955 (the equivalent of s 300 of the Act) that the appropriate standard of proof was the civil standard on the balance of probabilities ‘but because the subject matter of the inquiry involves facts that, if established, would also be an offence, then a higher degree of probability is required than would otherwise be the case. But it remains the civil standard — the liquidator does not have to prove non-compliance beyond reasonable doubt.’

As noted by the United Kingdom Court of Appeal in Thorne v Silverleaf, there is no limitation placed on the right of a creditor to enforce the personal liability created by s 386C(1). A creditor who knew of, and effectively encouraged, the conduct that contravened the statutory prohibition on involvement in phoenix companies was not prevented from making a claim, although in that the case the creditor was not in fact aware of the statutory prohibition. However the Court did acknowledge that the statute did not exclude the operation of any common law rule, such as waiver, which might otherwise disentitle a creditor from making a claim.

A further point to note is that liability under s 386C(1) arises notwithstanding the fact that the phoenix company has not failed.

Liability under s 386C is not limited to those who have contravened s 386A(1). Under s 386C(2) liability extends to a person (A) who is involved in the management of a phoenix company and who, when so involved, acts or is willing to act on instructions given by another person (B) and, at that time, A knows that, in relation to the phoenix company, B is contravening s 386A(1)(a) or (b). Under s 386C(5) if it is the case that A has at any time acted on the instructions given by B at a time when A knew that B was contravening s 386A(1)(a) or (b), A is presumed, unless the contrary is shown, to have been willing at any later time to act on any instructions given by B. A’s liability, under s 386C(1)(b) extends to the debts and liabilities incurred by the phoenix company during the period when A was acting or willing to act on the instructions of B and the phoenix company was known by a pre-liquidation name of the failed company or a similar name.

If, in relation to a phoenix company, more than one individual is liable under s 386C(1) and/or (2), s 386C(4) provides that the liability of each is joint and several.

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4.3 The exceptions

On the face of it, s 386A(1) effectively ‘extend[s] beyond the particular abuses’ at which it is directed.\(^{104}\) Its ambit is however limited by three exceptions: where the permission of the Court is obtained; where a successor company notice is issued; and, in the case of non-dormant phoenix companies.

4.3.1 Permission given by the Court

The prohibition in s 386A(1) is prefaced with the words, ‘[e]xcept with the permission of the Court’. Similarly, under s 382(1) of the Companies Act 1993, a person prohibited from acting as a director because he or she has been convicted of certain specified offences may, nonetheless, seek the permission of the Court to act as such. The Court, in considering whether to grant an application for leave under s 382(1), looks to see that the purpose behind the prohibition, protection of the public from the risk of similar future re-offending by the applicant, is met.\(^{105}\) With this lead, it is to be expected that, as has been the case in England, the New Zealand courts, when faced with an application for leave under s 386A(1) will look to its purpose: prevention of the danger to the creditors of the failed company that its assets have been transferred to the phoenix company or business at an undervalue or that such creditors will be misled as to the identity of the entity they are dealing with.\(^{106}\) If neither of these factors exists, other issues, such as the risk that the phoenix company will fail because of undercapitalisation or lack of experience on the part of its directors, are not relevant considerations. As Chadwick J noted in Penrose v Official Receiver:

[The Court] should exercise its discretion under s 216(3) with regard only to the purposes for which s 216 was enacted and not on the more general basis that the public requires some protection from this applicant’s activities as a company director.\(^{107}\)

However, Chadwick J did note that the position would be otherwise if there was evidence before that Court that an applicant was unfit to act as a director, which in the New Zealand context might be evidence that the applicant was prohibited from acting as a director by s 382(1) or that grounds existed for the applicant to be the subject of an order of disqualification by the Court under s 383 or by the Registrar under s 384. Chadwick J indicated that if such circumstances existed, leave should not be granted.

\(^{104}\) Ad Valorem Factors Ltd v Ricketts [2004] 1 All ER 894, [2].
\(^{106}\) Penrose v Official Receiver [1996] 2 All ER 96, 104
There is one earlier United Kingdom authority, *Re Bonus Breaks*,\(^\text{108}\) where Morritt J granted leave on the condition that the applicants gave undertakings relating to maintenance of the phoenix company’s capital but, as has been noted in later authorities, the applicants in *Bonus Breaks* offered those undertakings of their own accord.

Section 386E makes provision for a temporary period of leave whilst an application for an exemption under s 386A(1) is made. Section 386E(1) provides that a person does not contravene the prohibition in s 386A if he or she applies to the Court for permission to act in relation to the phoenix company within 5 working days after the commencement of the liquidation of the failed company. Section 386E(2) sets out the length of the temporary period of exception: the period beginning on the date of commencement of the liquidation and ending on the earlier of the close of six weeks after the commencement of the liquidation or the date on which the Court makes an order of exemption (or, although not expressly mentioned, presumably the date on which the Court declines the application for exemption).\(^\text{109}\)

### 4.3.2 Successor company notices

Section 386D(1) provides that s 386A does not apply to a person named in a successor company notice. ‘Successor company’ is defined in s 386D(2) to mean ‘a company that acquires the whole or substantially the whole of the business of a failed company under arrangements made by a liquidator or receiver or made under a deed of company arrangement under Part 15A.’

‘Successor notice’ is defined in s 386D(3). It is a notice by a successor company that

- (a) is sent by the successor company to all creditors of the failed company for whom the successor company has an address; and
- (b) is sent to those creditors within 20 working days after the arrangements for the acquisition of the business are made under subsection (2); and
- (c) specifies—
  - (i) the name and registered number of the failed company; and
  - (ii) the circumstances in which the business has been acquired by the successor business; and
  - (iii) the name that the successor company has assumed, or proposes to assume, for the purpose of carrying on that business; and
  - (iv) any change of name that the successor company has made, or proposes to make, for the purpose of carrying on that business; and
- (d) states, in respect of a person named in the notice,—
  - (i) his or her full name; and
  - (ii) the duration of his or her directorship of the failed company; and

(iii) the extent of his or her involvement in the management of the failed company.

Given the length of the period within which s 386A(1) operates, a successor company notice is useful insurance against contravention of s 386A(1) for the directors of the failed company.

Creditors are presumably given no right to object to the successor company notice procedure because the involvement of an independent liquidator, receiver or, in the case of a deed of company arrangement, the approval of creditors, ought to be a sufficient safeguard against inappropriate phoenix company arrangements and further, the giving of notice prevents them from being misled in the event that they decide to extend credit to the successor company.\(^{110}\) To the extent that entry into such an arrangement by a liquidator or receiver is in breach of a duty owed to the failed company, a creditor of that company has the right to apply to apply to the Court for an inquiry into the conduct of the liquidator or receiver under s 301. To the extent that a creditor objects to such an arrangement under a deed of company arrangement, the creditor has a right to seek an order terminating the deed of company arrangement under s 239ADD or an order under the Court's general power under s 239ADO.

The scope of the protection conferred on directors of a failed company by successor company notices was the subject of the English Court of Appeal decision in Churchill v First Independent Factors and Finance Ltd\(^{111}\) where it was held that then applicable equivalent exception in Rule 4.288 of the Insolvency Rules 1986 (UK) did not operate to relieve liability in the case of an individual who had contravened the general prohibition by acting as a director of the successor company prior to the giving of the successor company notice. The defendants in Churchill were directors of the failed company, Arctic Distribution Ltd, at the time it went into liquidation. At the date of commencement of the failed company's liquidation they were also directors of another company, Arctic Distribution (2001) Ltd (the phoenix company). The failed company, acting through the liquidator, sold its goodwill to Arctic Distribution (2001) Ltd, now the successor company, some three and half months after the commencement of its liquidation. The defendants were held to be personally liable for the debts of the successor, phoenix company.

Rule 4.228(3) of the Insolvency Law Rules 1986 differed from s 386D(3)(d), as set out above, in that inclusion of information about the person named in the notice was not mandatory. Rule 4.338(3) provided:

(3) The notice may name a person to whom section 216 may apply as having been a director or shadow director of the insolvent company, and give particulars as to the nature and duration of that directorship, with a view to his

\(^{111}\) [2007] BPIR 14
being a director of the successor company or being otherwise associated with its management (emphasis added).

The Court of Appeal did note that the expression ‘with a view to his being a director’ in Rule 4.28(3) had a prospective flavour to it but this was just one reason supporting its interpretation. Others that bear relevance to the New Zealand context are:

- if the exception had been intended to have retrospective effect an express provision to this effect would have been expected but is absent and, further, the temporary period exemption (in s 386E) also strongly suggested a retrospective effect was not intended in the case of the successor company exception.
- ‘in the context of the “Phoenix phenomenon” the particular purpose of r 4.228 is to alert creditors of the company in liquidation to the fact that a person who is involved in the management of that company is also to be involved in the management of the successor company so that such creditors can make an informed assessment of the risk of extending credit to the new company. To ensure that that purpose is achieved, notice must be given to such creditors before the person in question starts to involve himself in the management of the successor company.’

Given the hearing date of the decision in Churchill, 30 November 2006, it can have had no effect on the drafting of s 386D. Nevertheless, at the time of drafting, there was English commentary, referred to in Churchill, that the successor company notice exemption is ‘unavailable if the director is already working with the management of the successor company.’ If it was intended that the exception be available to those involved in the management prior to the giving of the successor notice, this could have been made plain. Presently, as was the case of the regulation under scrutiny in Churchill, the position under s 386B is ambiguous. As to ascertaining what was intended by Parliament, the Explanatory Note to the Insolvency Law Reform Bill is equally ambiguous:

The second exception applies where the business of the company is taken over by a successor company by arrangement with the liquidator or receiver of the failed company or by way of scheme of arrangement [sic]. If the director is identified in a notice to creditors of the failed company (together with various other information) which is sent within 20 working days after the business is acquired, then that person is free to take part in the management of the successor company even if it is also a phoenix company in relation to the failed company.

From a director’s perspective, until the matter is clarified by the Court, the prudent course is for those in a similar position to the directors in Churchill to seek the

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112 [2007] BPIR 14, [32].
permission of the Court to continue to act as such in relation to an intended successor company on the commencement of liquidation of the failed company.

In the United Kingdom the result in *Churchill* led to a substituted Rule 4.288 being inserted by r 3 of the Insolvency (Amendment) Rules 2007, which came into effect on 6 August 2007. The substituted Rule 4.288 provides:

(1) This Rule applies where—

(a) a person ("the person") was within the period mentioned in section 216(1) a director, or shadow director, of an insolvent company that has gone into insolvent liquidation; and

(b) the person acts in all or any of the ways specified in section 216(3) in connection with, or for the purposes of, the carrying on (or proposed carrying on) of the whole or substantially the whole of the business of the insolvent company where that business (or substantially the whole of it) is (or is to be) acquired from the insolvent company under arrangements—

(i) made by its liquidator; or

(ii) made before the insolvent company entered into insolvent liquidation by an office-holder acting in relation to it as administrator, administrative receiver or supervisor of a voluntary arrangement under Part 1 of the Act.

(2) The person, will not be taken to have contravened section 216 if prior to his acting in the circumstances set out in paragraph (1) a notice is, in accordance with the requirements of paragraph (3),—

(a) given by the person, to every creditor of the insolvent company whose name and address—

(i) is known by him; or

(ii) is ascertainable by him on the making of such enquiries as are reasonable in the circumstances; and

(b) published in the Gazette.

(3) The notice referred to in paragraph (2)—

(a) may, subject to compliance with sub-paragraph (a), be given and published before the completion of the arrangements referred to in paragraph (1)(b) but must be given and published no later than 28 days after that completion;

(b) must state—

(i) the name and registered number of the insolvent company;

(ii) the name of the person;

(iii) that it is his intention to act (or, where the insolvent company has not entered insolvent liquidation, to act or continue to act) in all or any of the ways specified in section 216(3) in connection with, or for the purposes of, the carrying on of the whole or substantially the whole of the business of the insolvent company; and
(iv) the prohibited name or, where the company has not entered insolvent liquidation, the name under which the business is being, or is to be, carried on which would be a prohibited name in respect of the person in the event of the insolvent company entering insolvent liquidation; and

(c) must in the case of notice given to each creditor of the company be given using Form 4.73.

(4) Notice may in particular be given under this Rule—

(a) prior to the insolvent company entering insolvent liquidation where the business (or substantially the whole of the business) is, or is to be, acquired by another company under arrangements made by an office-holder acting in relation to the insolvent company as administrator, administrative receiver or supervisor of a voluntary arrangement (whether or not at the time of the giving of the notice the director is a director of that other company); or

(b) at a time where the person is a director of another company where—

(i) the other company has acquired, or is to acquire, the whole, or substantially the whole, of the business of the insolvent company under arrangements made by its liquidator; and

(ii) it is proposed that after the giving of the notice a prohibited name should be adopted by the other company.

4.3.3 Non-dormant phoenix companies

The final exception, set out in s 386F, is that the prohibitions in s 386A(1)(a) and (b) do not apply in respect of a phoenix company that is known by a name or names that are the same as the failed companies pre-liquidation name or are similar names if:

(a) it has been known by that name or those names for not less than the period of 12 months before liquidation commences; and

(b) it has not been dormant during those 12 months.

Section 386F(2) provides that a company has not been dormant if transactions required by s 194(3) of the Act to be recorded in its accounting records have occurred throughout that period.

The Explanatory Note to the Insolvency Law Reform Bill 2006 provides an example of this exception in operation:

ABC Ltd trades under the name ‘Wonderco’ for at least 12 months before the liquidation of Wonderco Limited; a director of ABC Limited does not breach section 386A(1) when ABC Ltd continues to trade under the name ‘Wonderco’.
In such a scenario, if this exception did not exist, the general prohibition in s 386A would apply in circumstances where the mischief at which it is aimed does not exist. 113

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113 ESS Production Ltd (in admin) v Sully [2005] 2 BCLC 546, [91].