IN THE HIGH COURT OF NEW ZEALAND
TIMARU REGISTRY

CIV-2014-476-000055
[2015] NZHC 1846

BETWEEN	DAMIEN GRANT AND STEVEN KHOV (AS LIQUIDATORS OF RAILMARK NEW ZEALAND LIMITED) Plaintiffs
AND	ALLEN BROWN Second Defendant

Hearing: 3 August 2015

Appearances: A Cherkashina for Plaintiffs
No Apperance for Second Defendant

Judgment: 5 August 2015

JUDGMENT OF GENDALL J

Introduction

[1] Railmark New Zealand Limited (In Liquidation) ("the company") was incorporated on 6 May 2010 and was placed into liquidation a little over two years later on 7 August 2012.

[2] Railmark Holdings Inc (Railmark US) is the sole shareholder of the company. The second defendant (Mr Brown) has been a director of the company from the date of its incorporation and remains as a director. The first respondent (Mr Collins) was a director of the company from its incorporation until he resigned on 24 March 2011.

[3] It seems the company was set up for the purpose of managing rail and rail logistic operations in New Zealand, Australia, Canada and South America. It was to form part of the global network of railways operated by Railmark US.

[4] In these proceedings the plaintiffs (the liquidators) who were appointed by this Court as liquidators of the company on 7 August 2012 sought orders for Mr Brown and Mr Collins to contribute to the assets of the company pursuant to s 301 of the Companies Act 1993. These orders were to cover the full outstanding creditor debt of the company, being $29,532.36 together with a further $14,067.93 for other costs incurred by the liquidators while investigating the company's affairs. In seeking these orders the liquidators claimed in their pleadings that both Mr Brown and Mr Collins breached their duties to the company pursuant to s 135 Companies Act 1993 (the Act) in that they conducted the affairs of the company in a reckless way and thereby caused damage to both the company and its shareholders and, further, pursuant to s 136 of the Act, they agreed to the company incurring obligations which, as directors, they did not believe at the time on reasonable grounds that the company would be able to perform those obligations.

[5] On 28 July 2015 the Court was advised that the liquidators no longer sought the relief claimed in this proceeding against the first defendant, Mr Collins, and by consent leave to discontinue the proceeding against him was granted.

[6] So far as the second defendant, Mr Brown, is concerned, he has filed no statement of defence, nor provided any opposition to the liquidators' claim against him. This matter proceeded therefore in terms of r 15.9 High Court Rules simply as a formal proof seeking judgment by default, on the basis that this claim against Mr Brown is not one for payment of a liquidated demand.

[7] This proceeding was listed for formal proof in terms of r 15.9(2) High Court Rules. In terms of r 15.9(4):

> **15.9 Formal proof for other claims**
>
> (4) The plaintiff must, before or at the formal proof hearing, file affidavit evidence establishing, to a Judge's satisfaction, each cause of action relied on and, if damages are sought, providing sufficient information to enable the Judge to calculate and fix the damages.

[8] Before me the liquidators called one witness who provided and spoke at length to a brief of evidence he had filed in support of this claim. The witness was

Kieren Michael Jones (Mr Jones) who is a senior insolvency officer employed by the liquidators who had investigated the affairs of the company under the liquidators' supervision. His brief of evidence was dated 24 July 2015.

Background facts

[9] I turn now to the background facts which I find established in the evidence of Mr Jones before the Court.

[10] As I have noted, the company was incorporated on 6 May 2010 and then it incorporated a subsidiary company, Kingston Rail Limited (Kingston Rail), on 27 August 2010 for the purpose of carrying out endeavours to acquire the Kingston Flyer railway operation and its associated land near Queenstown. Kingston Rail was struck off from the company's office register on 24 August 2011. Using this subsidiary in the period it remained registered, attempts were made by the company to acquire the Kingston Flyer business. These attempts ultimately were unsuccessful.

[11] As part of these attempts, on 16 August 2010 the company engaged Christchurch solicitors, Wynn Williams, to act for it in relation to the potential purchase of the Kingston Flyer.

[12] Both Mr Brown and Mr Collins, as directors, were involved in the day to day management of the company and its subsidiary Kingston Rail. It seems clear that Mr Brown took active steps in instigating and overviewing the work undertaken by Wynn William. Although it seems he remained in the United States through this period, he had regular phone calls and email correspondence throughout with the parties who were doing the work in Wynn Williams.

[13] The company began incurring fees for the legal work undertaken by Wynn Williams in September 2010, it having initially negotiated with Wynn Williams for a retainer of $10,000 which the company paid for the initial services to be provided to it.

[14] By 2 November 2010 Wynn Williams had used the $10,000 retainer funds in full. Mr Brown and Mr Collins, as directors of the company, then authorised Wynn Williams to provide continuing legal services for the company on credit.

[15] At that point the company had no income. It was merely endeavouring to secure the Kingston Flyer business as its start up operation but, nevertheless, as time passed, it continued to incur more liabilities including by way of legal fees to Wynn Williams. These liabilities clearly exceeded any assets which the company had. What monies the company was receiving at that point were merely GST refunds and advances made to it to meet continuing expenses.

[16] Further, there was no set date as to when the acquisition of the Kingston Flyer business might take place (even if a purchase contract could be negotiated) and, if this was successful, when the Kingston Flyer would start operation. There seemed little reasonable prospect at the time that the company would generate income in the foreseeable future.

[17] It follows that, in the liquidator's view, Mr Brown throughout was aware of the financial position of the company but nevertheless he continued to engage Wynn Williams for their legal services on credit.

[18] Other than the initial retainer payment of $10,000 and interest earned on that amount, no other amounts were paid by the company to Wynn Williams other than one further partial payment of $10,000 made on 16 May 2011. Notwithstanding this and continuing promises for payment made by the directors, Wynn Williams continued to provide legal services to the company on credit right through to their last invoice which was issued on 30 August 2011.

[19] At that point, after all payments were taken into account, there remained a balance debt owing by the company to Wynn Williams of $25,860.50. The table summarised below sets out all transactions between the company and Wynn Williams to arrive at this figure.

Date	Reference	Money paid by Railmark and interest on the retainer	Invoices issues by Wynn Williams and the default interest	Balance
13 August 2010	Payment	$10,000.00		$10,000.00
30 September 2010	Interest	$27.75		$10,027.75
19 October 2010	Invoice		$912.60	$9,115.15
19 October 2010	Invoice		$8,406.00	$709.15
30 November 2010	Invoice		$11,979.09	-$11,269.94
31 December 2010	Interest	$62.68		-$11,207.26
4 February 2011	Default interest		$27.66	-$11,234.92
4 February 2011	Default interest		$254.71	-$11,489.63
1 November 2011	Default interest		$197.40	-$11,687.03
21 March 2011	Invoice		$10,323.90	-$22,010.93
31 March 2011	Interest	$60.25		-$21,950.68
16 May 2011	Payment	$10,000.00		-$11,950.68
17 May 2011	Interest	$27.76		-$11,922.92
31 May 2011	Invoice		$10,548.70	-$22,471.62
30 August 2011	Invoice		$239.20	-$22,710.82
1 November 2011	Default interest		$526.62	-$23,237.44
1 November 2011	Default interest		$428.32	-$23,665.76
2 November 2011–6 September 2012	Default interest		$2,194.74	-$25,860.50
Total		**$20,178.44**	**$46,038.94**	**-$25,860.50**

[20] This $25,860.50 debt was the basis of the liquidation proceeding Wynn Williams brought which ultimately resulted in the company being placed into liquidation on 7 August 2012.

[21] Added to this $25,860.50 debt now is the sum of $3,671.86 which represents the costs incurred by Wynn Williams in placing the company into liquidation. These

amounts total $29,532.36, being the full extent of the company's outstanding creditor debt due now to Wynn Williams.

[22] And, so far as fees and disbursements incurred by the liquidators in their liquidation of the company are concerned, specific details of these amounts which total $14,067.93 are before the Court. These details, and the evidence of Mr Jones here, I am satisfied, confirms that these amounts for the liquidation are properly incurred.

Issues for consideration

[23] Turning now to the issues for consideration by the Court in this proceeding, these are:

(a) Whether in terms of s 135 of the Act Mr Brown agreed, caused or allowed 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;

(b) Whether in terms of s 136 of the Act Mr Brown agreed to incurring of this debt of the company without believing on reasonable grounds that it would be able to repay the debt when it was required to do so; and

(c) If the answer to paras (a) and/or (b) is "yes", whether Mr Brown ought to contribute such sums as are claimed to the assets of the company pursuant to s 301(1)(b)(ii) by way of compensation as this Court thinks just.

Reckless trading – s 135

[24] Section 135 of the Act provides that:

> **135 Reckless trading**
>
> 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.

[25] In *Mason v Lewis*[1] the Court of Appeal at [51] addressed the "essential pillars" of s 135. In doing so the Court stated:

> [51] The essential pillars of the present section are as follows:
>
> - the duty which is imposed by s 135 is one owed by directors to the company (rather than to any particular creditors);
> - the test is an objective one;
> - 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;
> - what is required when the company enters troubled financial waters is…a "sober assessment" by the directors…of an ongoing character, as to the company's likely future income and prospects.

[26] The Court of Appeal also endorsed the approach taken by the High Court and the Court of Appeal in *Re South Pacific Shipping Limited*[2] and *Lower v Traveller*[3] in identifying a distinction between legitimate risks of a company which could properly be taken and illegitimate risks which could not.

[27] And, as to the issue of what constituted a "substantial risk of serious loss" in *Mason v Lewis* at [48] the Court adopted the following interpretation:

> [51] As to what is meant by "substantial risk" and "serious loss" Ross, Corporate Reconstructions: Strategies for Directors (1999) suggests:
>
> > 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

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1 *Mason v Lewis* [2006] 3 NZLR 225.
2 *Re South Pacific Shipping Limited* [2004] 9 NZCLC 263570.
3 *Lower v Traveller* [2005] 3 NZLR 479.

> the company winning the contract? Even if the company wins the contract, how reasonable are the prospects of performing the contract at a profit? (at 40)

[28] Turning now to the present case, there are before the Court draft statements of account and balance sheets for the company for the calendar years ending 2010 and 2011. These accounts are not questioned in any way and they clearly demonstrate that throughout 2010 and 2011 the company had very limited material assets to cover its liabilities. In the year ending 31 December 2010 the company had current assets of $20,649 with current liabilities of $99,179 leaving a net deficit of $78,530. This position worsened for the year ending 31 December 2011. The draft accounts for that period showed the company had current assets totalling only $439 with current liabilities of $111,580, leaving a net deficit of $111,141.

[29] Addressing the trading situation of the company for those periods, the draft profit and loss statements which were before the Court showed that for the year ending 31 December 2010 the company made a net loss of $78,530, and for the year ending 31 December 2011 it made a net loss of $32,612.

[30] All of this clearly reflected the fact that set up costs and initial liabilities were incurred by the company in its (unsuccessful) attempts through its subsidiary to acquire the Kingston Flyer business, and only a portion of these were covered by funds made available to the company from its shareholders or through other outside arranged borrowing. No income of any type was generated through this period.

[31] From the evidence of Mr Jones before the Court, in summary I make certain findings. Given first, that at the time the growing debt to Wynn Williams was incurred the company was insolvent and had traded at a loss with little reasonable prospect of generating any income to satisfy its liabilities, and secondly, that there was no commitment from Railmark US or others to provide funds or arrange proper borrowings to satisfy the liabilities, but nevertheless the directors including Mr Brown continued the company's operation and trading by incurring additional liabilities, I find there was a substantial risk of serious loss to the company's creditors in terms of s 135 of the Act. To place the company's creditors and its appointed lawyers Wynn Williams in a situation of such risk in my view was reckless

and illegitimate. Mr Brown, as the continuing director and guiding hand of the company, in my view agreed to it continuing trading after it had become insolvent and he authorised and requested Wynn Williams to provide further services on credit without any real prospect of there being paid. I find Mr Brown agreed to the business of the company being carried on in a manner likely to create substantial and illegitimate risk to its creditors, given particularly that he was aware throughout of the company's financial position as the evidence before the Court has confirmed.

[32] If I may be wrong in this aspect however then, even if Mr Brown was not aware of the precarious financial position of the company, as a prudent director he ought to have been aware and to have turned his mind to the outstanding debts of the company and the lack of any assets available to satisfy those debts linked with the absence of any prospects of future income being earned by the company.

[33] In conclusion, I find therefore that the actions or inactions of Mr Brown here have been such that they created substantial risk of serious loss to the company's creditors in terms of s 135 of the Act which ultimately resulted in the creditor, Wynn Williams, suffering the loss seen here.

Duty in relation to incurring of obligations – s 136

[34] Section 136 of the Act provides:

> **136 Duty in relation to obligations**
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> 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.

[35] Section 136 imports a subjective element in its application.

[36] In *Goatlands Ltd (In Liq) v Borrell*[4] this Court considered the degree of certainty with which a director must believe that the company will be able to perform an obligation in order to satisfy the requirements of s 136 of the Act. There the Court held that the directors belief that the company had "a reasonable

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4 *Goatlands Ltd (In Liq) v Borrell* [2007] 23 NZTC 21,107.

likelihood" of being able to perform the obligation was not sufficient to meet the s 136 threshold of certainty. To meet that threshold a director must believe that the company "will be able" to perform the obligation, rather than "will be likely to be able to perform the obligation".

[37] At [114] in *Goatlands*, the Court said that:

> the use of the words "will be able" suggests…that there needs to be a degree of certainty in the directors' minds that the company will be able to perform the obligation when it is required to do so."

[38] Next, the directors' belief that the company will be able to perform the obligation within the meaning of s 136 of the Act must be held on reasonable grounds. This imparts an objective element which in *Lawrence v Jacobsen*[5] the Court held is to be that of the "reasonable prudent director" faced with the circumstances of the company.

[39] On all of this in *Jordan v O'Sullivan*[6] Clifford J summarised the principles of the objectivity test in the following way:

> [56] The need for the director's belief to be based on objectively reasonable grounds means the director must have sufficient knowledge of the company's position and ability to meet the obligation so as to give rise to reasonable grounds. It is implicit that the director must take sufficient steps to obtain this knowledge – claiming ignorance will not be a defence.
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> …
>
> [58] Where the ability to meet the obligation is dependent on anticipated income, the reasonableness of expecting this income to eventuate is highly relevant…
>
> [59] Section 136 does not appear to require that the company's inability to meet the obligation arises from the company's separate resources, as long as the director believes on reasonable grounds that the company will be able to do so. Therefore, it would appear that a director who believes on reasonable grounds that the obligation will be met by means of shareholder or director contributions will not breach the duty…
>
> [60] Under s 136, the required belief is that at the time the obligation is incurred …

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5 *Lawrence v Jacobsen* [2001] 9 NZCLC 262,477.

6 *Jordan v O'Sullivan* HC Wellington, CIV-2004-845-2611, 13 May 2008.

[40] Turning now to the circumstances prevailing here, at the time the company incurred the debt in question with Wynn Williams (and indeed continued to undertake its business in the hope of acquiring the Kingston Flyer), Mr Brown, as director and in effect the guiding controller of the company, clearly agreed to this debt being incurred. Indeed, he requested the work the subject of the debt be undertaken for the company. In doing so Mr Brown authorised Wynn Williams on a continuing basis to provide services to the company on credit and at no time during this operative period did he request the lawyers to cease providing services to the company. Rather, he continued to deal with Wynn Williams on a regular basis requiring them to carry out further work for the company.

[41] And, at these operative times, I am satisfied on the evidence before the Court that Mr Brown could not in any sense have believed that the company "would be able" to repay the debt being incurred with Wynn Williams. As I have indicated above, at the time these debts were being incurred, the company had serious financial issues, it was effectively insolvent, it had no income or prospect of funds being provided to meet its debts, and throughout, Mr Brown was clearly aware of this.

[42] Alternatively, even if Mr Brown may have believed that the company "would be able" to repay the debt (and I suggest otherwise here), as I see the position, he certainly did not have reasonable grounds for such a belief. As a prudent director, he was required to obtain sufficient knowledge of the company's financial position before agreeing to it incurring the debt, and if he did not take the steps then his belief could not be said to be reasonable.

[43] In either of these cases, I am satisfied that Mr Brown agreed to the company incurring the debt to Wynn Williams when he did not, or could not on reasonable grounds, believe that the company would be able to repay the debt and thus he was in breach of s 136 of the Act. Ultimately the company, as we know, could not repay the debt and it was placed into liquidation.

[44] For all these reasons I find that Mr Brown is also in breach of his duty outlined in s 136 of the Act.

As an aside

[45] As an aside, at this point it is useful to note that the Court has before it a copy of the "Client Engagement Agreement" dated 17 August 2010 between Wynn Williams as lawyers and the company as client. This contract of engagement was signed on behalf of Wynn Williams and also signed, it is apparent, by Mr Brown on behalf of the company.

[46] Significantly, clause 4 of this Client Engagement Agreement, which is headed "Liability for Payment", provides:

> 4.1 Each client named in this agreement is jointly and severally liable to us under this agreement. If a client is a company, then each person who signs this agreement on the company's behalf acknowledges that he or she has asked us to supply services to the company, and, in consideration of us supplying services to that company, agrees:
>
> (1) To guarantee the company's payment to us of all money it (from time to time) owes,
>
> (2) That he or she can be treated by us as a principal debtor for that money, and
>
> (3) To indemnify us against all costs, losses, and liabilities we incur or suffer because the company fails to pay us that money.

[47] The schedule to the Client Engagement Agreement, which sets out the names of the clients concerned, states:

> Railmark New Zealand Limited (Jim Collins and Allen Brown – Directors)

[48] A strong argument exists therefore that, particularly as he signed the Client Engagement Agreement on behalf of the company, and given that he is also noted in the schedule as a director of the company, in terms of clause 4.1 Mr Brown has personally guaranteed the debt of the company to Wynn Williams and indemnifies Wynn Williams against any costs or losses arising. As a result, Wynn Williams might well have chosen to sue Mr Brown direct for the fees in question under this personal guarantee. As I understand it, that did not occur, but in any event, as I see it, such an action would be likely to succeed.

[49] Nevertheless, the proceeding before this Court is one by the liquidators of the company against Mr Brown in terms of ss 135 and 136 of the Act, and in my view, at one level, he can hardly complain that this step as been taken. This is because his potential liability as guarantor under the company's Client Engagement Agreement with Wynn Williams & Co would provide another avenue by which he might be held liable to meet the outstanding Wynn Williams debt.

Measure of contribution – s 301

[50] Turning now to the third issue noted at [23](c) above, s 301 of the Act states:

> **301 Power of court to require persons to repay money or return property**
>
> (1) If, in the course of the liquidation of a company, it appears to the court that…a past or present director,…has…been guilty of negligence, default, or breach of duty or trust in relation to the company, the court may, on the application of the liquidator or a creditor or shareholder,—
>
> (a) inquire into the conduct of the promoter, director, manager,… liquidator, or receiver; and
>
> (b) order that person—
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> …
>
> (ii) to contribute such sum to the assets of the company by way of compensation as the court thinks just…

[51] Here, as I have noted above, I am satisfied that the liquidators have shown Mr Brown breached his duties to the company under both ss 135 and 136 of the Act, and it is therefore necessary in line with the decision in *Peace and Glory Society Ltd (In Liq) v Samsa*[7] to assess the measure of contribution that Mr Brown ought now to make to the assets of the company.

[52] Here, for the reasons I have outlined above, I am satisfied that the company was effectively insolvent from at least November 2010 and from that date Mr Brown agreed the company would continue to trade. This was in the hope (which did not eventuate) of obtaining the Kingston Flyer business. He also instructed Wynn Williams to carry out further work for the company which would thus incur

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7 *Peace and Glory Society Ltd (In Liq) v Samsa* [2009] NZCA 396 at [48].

additional debt without any basis for payment being properly considered. From this November 2010 date, up to the date of its liquidation, I am satisfied that the extent of deterioration in the company's financial position was clearly represented by the claimed amount of $25,860.50 noted at para [20] above. In addition, the further cost incurred by Wynn Williams of $3671.86 for placing the company into liquidation was a proper debt incurred which flowed directly from these factors.

[53] In terms of s 301 of the Act therefore I find that Mr Brown here ought to be liable for the whole amount of this total debt, being $29,532.36. There was a causative link between his failure to comply with his duties as a director under ss 135 and 136 of the Act, and the company's indebtedness to Wynn Williams which contributed to their loss as a creditor here.

[54] And finally, in terms of culpability, in looking at the overall conduct of Mr Brown in this case, first, he was involved in day to day management of the company, secondly he was a clearly experienced business person, and thirdly, on all the evidence before the Court he was responsible for the company's business and finances and the instructions given to the lawyers at the operative time. There can be no doubt that, although the actions of the company at issue related to its setting up of the intended business and its unsuccessful attempts to acquire the Kingston Flyer, Mr Brown would have been well aware that the company needed finance to undertake this, which it did not have. Further, he would have known it was entering potentially troubled financial waters, but notwithstanding this, Mr Brown chose to continue to trade the company recklessly and to incur debt without believing on reasonable grounds that the company would be able to repay it. It cannot be reasonably suggested that in doing all of this, he relied on the statements of others and, as I see it, his culpability here is therefore high.

[55] Lastly, addressing the issue of costs incurred by the liquidators claimed in this proceeding, amounting to $14,067.93, in *Richard Gee Wiz Gee Consultants Ltd (In Liq)v Gee*[8] Brown J said it was appropriate that a director of a liquidated company, who breached duties, including duties under ss 135 and 136 of the Act, should be liable to pay compensation for the amount of costs and disbursements

[8] *Richard Gee Wiz Gee Consultants Ltd (In Liq)v Gee* [2014] NZHC 1483.

incurred in the liquidation. That is the situation here and, as I have noted above, I am satisfied on the evidence before the Court that the $14,067.93 fees and disbursements claimed by the liquidators are appropriately charged and in order.

[56] In addition to the indebtedness to Wynn Williams totalling $29,532.36, I find therefore that Mr Brown is to be liable for the liquidators' fees and disbursements totalling $14,067.93.

Conclusion

[57] For all the reasons outlined above, I find that Mr Brown has breached his duties as a director under both ss 135 and 136 of the Act, and he is liable to contribute to the assets of the company pursuant to s 301 of the Act to the full extent of its indebtedness to Wynn Williams amounting to $29,532.36, and the liquidators' costs and disbursements amounting to $14,067.93. The company's claim against Mr Brown to this extent succeeds. Orders will follow.

[58] So far as costs on this proceeding are concerned, the liquidators were represented here by in-house counsel, Ms Cherkashina. Notwithstanding this, the authorities are clear, as McGechan on Procedure at HR Pt 14.12 notes that:

> In fixing costs, no distinction is to be drawn between counsel and solicitors in the practising profession, and "in-house" counsel; i.e. those employed by the relevant party: *Henderson BC v Auckland Regional Authority* [1984] 1 NZLR 16 (CA) at 23…

[59] The company has succeeded in its claim and, in my view, is entitled to an order of costs and disbursements against Mr Brown calculated on the usual category 2B basis together with disbursements as fixed by the Registrar. An order to this effect will follow.

Orders

[60] It is ordered:

(a) The second defendant Mr Brown shall contribute to the assets of the company by way of compensation under s 301 of the Act the sum of $29,532.36 and the sum of $14,067.93; and

(b) The second defendant Mr Brown shall pay the liquidators' costs in respect of these proceedings on a category 2B basis together with disbursements as fixed by the Registrar.

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Gendall J

Solicitors:
Waterstone Insolvency, Auckland
Kennelly Law, Orewa