

IN THE COURT OF APPEAL OF NEW ZEALAND

CA27/2013
[2014] NZCA 91

BETWEEN

IAN CHARLES SCHULER
First Appellant

INDEPENDENT LIVESTOCK 2010
LIMITED (IN LIQUIDATION)
Second Appellant

AND

DAMIEN GRANT AND STEVEN KHOV
AS LIQUIDATORS OF INDEPENDENT
LIVESTOCK AGENTS LIMITED (IN
LIQUIDATION)
Respondents

Hearing: 10 March 2014

Court: Harrison, White and Venning JJ

Counsel: D G Hayes for Appellants
C W Grenfell and B J Norling for Respondent

Judgment: 24 March 2014 at 10 am

JUDGMENT OF THE COURT

A The appeal is dismissed.

B The appellants are to pay the respondents indemnity costs on the appeal being actual costs reasonably incurred by the respondents and disbursements.

REASONS OF THE COURT

(Given by Venning J)

Introduction

[1] Mr Schuler and Independent Livestock 2010 Limited (in liquidation) (IL 2010) appeal against a decision of Potter J in favour of the respondents.¹ The respondents are the liquidators of Independent Livestock Agents Limited (IL Agents).

[2] Potter J found that Mr Schuler had breached the duty he owed IL Agents in relation to a debt the company owed to Mr and Mrs Mudge, and ordered Mr Schuler to pay the liquidators \$70,601 together with interest and costs.

Background

[3] We take the summary of the factual background largely from the Judge's decision.

[4] Mr Schuler was the sole director and shareholder of IL Agents, which sold stock for Mr and Mrs Mudge on three occasions in April 2007, June 2008 and July 2008. IL Agents received sale proceeds totalling approximately \$90,000 but did not pay the net proceeds out to Mr and Mrs Mudge.

[5] In May 2008 Mr Schuler introduced a Mr Dodunski to Mr and Mrs Mudge, who were wanting to sell their farm. Mr Dodunski later purchased the Mudges' farm on 4 July 2008.

[6] Between May 2007 and June 2009 Mr and Mrs Mudge sought payment of the sale proceeds from Mr Schuler and IL Agents. Mr Schuler gave them a number of excuses for the non-payment, but payment was not forthcoming.

[7] In June 2009 Mr Mudge told IL Agents that, unless the sale proceeds were paid, he would refer the matter to his solicitor. A few days after that the Mudges received an invoice from IL Agents claiming commission for facilitating the sale of their farm to Mr Dodunski. The commission claimed was two per cent on the sale

¹ *Grant & Khov v Independent Livestock 2010 Ltd* [2012] NZHC 3458.

price of \$4,500,000, amounting to \$90,000 plus GST. The invoice was dated 25 May 2008.²

[8] Mr and Mrs Mudge had never agreed to pay Mr Schuler or IL Agents commission in relation to the sale of their farm to Mr Dodunski.

[9] On 10 March 2010, Mr and Mrs Mudge issued a statutory demand to IL Agents for the proceeds of the stock sold by IL Agents on their behalf.

[10] On 30 March 2010 IL 2010 was incorporated. Mr Schuler was the sole director and shareholder of that company also. IL 2010 took over the business of IL Agents and continued to operate that business.

[11] On 21 June 2010 IL Agents was placed into liquidation. Mr and Mrs Mudge were its only substantial creditors.

[12] In August 2011 the liquidators took proceedings against Mr Schuler and IL 2010. On 27 September 2011 IL 2010 was liquidated.

The High Court judgment

[13] In the High Court the liquidators sought orders pursuant to s 271(1)(b) of the Companies Act 1993 (the Act) pooling the assets and liabilities of IL Agents and IL 2010. The liquidators also pursued a second cause of action alleging that IL 2010 was a “phoenix company” as defined in s 386B of the Act and that s 386C applied.

[14] As a third cause of action the liquidators sought relief under s 301 of the Act. They pleaded misapplication or retention of company funds equivalent in value to the Mudge debt, negligence and breach of duty or trust by Mr Schuler in relation to IL Agents.

[15] Potter J rejected the liquidators’ first cause of action. She found that IL Agents and IL 2010 were not related companies under s 2(3) of the Act. Accordingly

² The Judge concluded that despite its date the invoice was created in June 2009 when Mr Schuler realised that delaying factors would no longer be effective to forestall Mr and Mrs Mudge (at [90]).

there was no jurisdiction to make a pooling order under s 271(1). The Judge also rejected the “phoenix company” cause of action because, absent a pooling order, the appellants could have no liability for the debts of the failed company.

[16] However, Potter J found for the liquidators on their third cause of action. In holding for the liquidators she held:

[158] The following factual findings in this case are relevant to this assessment: Mr and Mrs Mudge had made several inquiries as to payment, Mr Schuler had deliberately misrepresented the reasons for non-payment, the invoice for commission was created when it became clear that such tactics would no longer forestall action by Mr and Mrs Mudge; there was no agreement that Mr Schuler was entitled to charge commission or a fee (and any such agreement would have been unenforceable); and funds available to satisfy the debt due to Mr and Mrs Mudge had been applied to the ongoing business of the company and were no longer available to the Mudges at the date of liquidation.

[159] Each of these findings may establish a breach of director’s duties. Together, they demonstrate deliberate and ongoing conduct that was designed to mislead and forestall the creditors in pursuing the recovery of their debt. The deliberate nature of this conduct evidences a lack of good faith; no issues arise as to honest belief or constructive knowledge. Such actions were also clearly detrimental to the company, which remains indebted to the creditors.

(Footnotes omitted)

[17] Importantly the Judge also made the further findings:

[177] IL Agents held the proceeds of the sale of the Mudges’ stock on trust for Mr and Mrs Mudge. They were under a fiduciary duty to account to Mr and Mrs Mudge for those proceeds. Mr Schuler’s direction that payment not be made caused the company to act in breach of its fiduciary obligations to Mr and Mrs Mudge. The actions of Mr Schuler were the sole and direct cause of Mr and Mrs Mudge’s loss. The culpability for their loss rests solely with him. Any actions by Mr Leatham in relation to this matter were, I am satisfied, taken at the direction of Mr Schuler.

[178] I have held that Mr Schuler dishonestly misrepresented to Mr and Mrs Mudge the reasons for delay in payment of the moneys due to them and did so intentionally. Further, in the face of continuing and frequent requests for payment by Mr and Mrs Mudge from 2007, in relation to the Fairfax sale proceeds, and from 2008 in respect of the Kahuwera Farms sale proceeds, Mr Schuler either ignored or met their requests with false and dishonest excuses and explanations. Ultimately IL Agents reached a point where it was insolvent and unable to meet the debt due to Mr and Mrs Mudge.

[18] Potter J ordered Mr Schuler to pay the liquidators of IL Agents the sum of \$70,601 pursuant to s 301(1)(b)(i) of the Act together with interest.³

[19] Finally, the Judge ordered costs on a 2B basis in favour of the liquidators.

The grounds of appeal

[20] In support of the appeal Mr Hayes advanced the following arguments:

- (a) Potter J was wrong to find that the funds were held on trust. The funds were held by IL Agents in a debtor/creditor relationship. Alternatively, s 301 had no application if the funds were held on trust because in that case they were not company property;
- (b) there was no jurisdiction to make an order under s 301;
- (c) the Judge was wrong to find that Mr Schuler had breached s 131 of the Act;
- (d) even if an award was to be made it should not have been for the full amount of \$70,601 plus interest;
- (e) having rejected the first two causes of action the Judge should not have awarded costs in favour of the liquidators.

Decision

[21] Mr Hayes conceded that he could not attack the factual findings of the Judge, but nevertheless submitted she was wrong in the conclusions she drew from those factual findings. The difficulty with that submission is, however, given the factual findings, the legal conclusions drawn from them are inevitable.

³ The figure of \$70,601 was calculated as the net proceeds of the sales after GST was deducted and after allowing IL Agents commission at 7 per cent.

(a) *Were the funds from the sale of the Mudges' stock held on trust?*

[22] Mr Hayes first submitted that the funds were not held on trust. He did so to support an argument that the third cause of action, which pleaded the funds were held on trust, could not succeed.

[23] Mr Hayes sought to rely on *North Shore City Council v Stiassny* to support his submission on this point.⁴ That case involved commercial and corporate entities engaged in a series of running transactions. The company in liquidation had funds in its bank account. There were competing claims as to the beneficial ownership of the funds. In that case this Court held that the absence of a requirement to keep the funds due to the Council in a separate account was fatal to the agency-trust argument. Mr Hayes noted the funds were not required to be held in a separate fund in the present case either. However, the *North Shore City Council v Stiassny* case was a quite different case to the present. As this Court observed, it all depends on the circumstances.⁵ Importantly in the present case, the funds were not held, rather they were misapplied. *North Shore City Council v Stiassny* does not assist the appellants.

[24] Mr Hayes next referred to the conditions of sale signed by Mr Mudge and submitted they were not consistent with IL Agents holding the funds on trust for the Mudges. The relevant provisions of the conditions are:

1. (a) The Purchaser will pay the Purchase Price to [IL Agents] in cash in one sum on the due date for payment.
- (b) If any portion of the Purchase Price is not paid on the due date for payment, the Purchaser shall pay to [IL Agents] interest at the Penalty rate on the portion of the Purchase Price so unpaid from the Due Date until payment. This provision is without prejudice to any of the [Mudges'] or [IL Agents'] other rights against the Purchaser including the right to additional expenses or damages.
2. [IL Agents] shall pay the [Mudges] the Purchase Price within five working days from the date of receipt of same by [IL Agents] from the Purchaser (less selling commission and charges which shall be first deducted by [IL Agents] from any amount paid by the Purchaser.)

⁴ *North Shore City Council v Stiassny* [2008] NZCA 522, [2009] 1 NZLR 342.

⁵ At [22].

...

5. ...

- (c) The [Mudges] authorises [IL Agents] to deduct its commission from the Purchase Price.

[25] Mr Hayes sought to argue that because clause 1(b) provided that if the purchaser defaulted he was to pay IL Agents interest at the penalty rate the moneys were due to IL Agents rather than the Mudges. However clause 1(b) is ancillary to clause 1(a) which requires the purchaser to pay the purchase price to IL Agents. Clause 1(b) does no more than confirm interest is payable on the purchase price if payment is late.

[26] The operative provision regarding IL Agents' obligations to the Mudges is clause 2. As the Judge found, IL Agents received the purchase price (and would have received any interest for late payment) as agent for the Mudges. Clause 2 requires IL Agents to pay the Mudges the purchase price within five working days (which is sufficient time for payments to be cleared). The requirement for IL Agents to account to the Mudges within such a short timeframe is consistent with a relationship of agency which justifies the Judge's finding of a fiduciary relationship in this case.

[27] Next, Mr Schuler effectively conceded that, when selling the stock, IL Agents held the money for the Mudges. The following exchange appears in Mr Grenfell's cross-examination of him at trial:

Q. So all the money that would be received in would be identifiable to the person selling it?

A. Normally yes.

Q. So effectively that money comes in and you're holding it for the person that sold the animals. Is that right?

A. Yes mmm.

...

Q. Were you holding this money in the company's account, what is there to stop you from accidentally using someone's money that you're holding it for?

A. Well we don't do that.

[28] Further, clause 5(c) of the conditions of sale is relevant. It authorises IL Agents to deduct its commission from the purchase price. Such a clause is necessary, given the requirement to account within five working days in clause 2. In the circumstances, it also supports the finding IL Agents held the funds as trustee. If IL Agents held the money in its own right there would be no need for the express authority to make the deduction from the sale proceeds.⁶

[29] We conclude it was open to Potter J to find that IL agents held the sale proceeds on trust for the Mudges.

[30] Mr Hayes' response was to submit that if the funds were held on trust they were not the property of the company so that s 301, which refers to money or property of the company, had no application.

[31] The short answer to that submission is that s 301 goes on to provide an alternative basis for relief where a director has been guilty of negligence, default or breach of trust in relation to the company.

[32] In any event, as Mr Grenfell submitted, whether the proceeds of the sale are characterised as trust moneys or a debt is of no moment in the context of relief pursuant to s 301 resulting from a breach of s 131. Either way IL Agents was obliged to pay them to the Mudges. Any other application of the funds as in this case to the general business of IL Agents, amounts to a misapplication of the funds.

[33] Finally, we note the third cause of action pleaded in the second amended statement of claim was not as confined as Mr Hayes suggested. In addition to the trust allegation the liquidators pleaded failure to account and negligence in the retention of the sale proceeds.⁷

⁶ Compare *Paragon Finance plc v D B Thakerar & Co (a firm)* [1999] 1 All ER 400 (CA) at 416.
⁷ At [5.1](III)–(IV) of the second amended statement of claim.

(b) *Was there jurisdiction for an order under s 301?*

[34] Mr Hayes next submitted there was no jurisdiction for an order under s 301 of the Act. We agree that s 301 does not create a cause of action. Rather it provides a procedural mechanism through which the Court can order relief for breaches of duty: *Arataki Properties Ltd (in liq) v Craig*.⁸ In this respect Mr Hayes' submissions raised a challenge to the liquidators pleading but he did not pursue it in argument.

[35] But even accepting Mr Hayes' submission that s 301 is not available for the recovery of a simple contract debt owed by a director to the company,⁹ that is not the issue in the present case. The issue in the present case is whether Mr Schuler breached the duty he owed IL Agents.

(c) *Was the Judge correct to find Mr Schuler in breach of s 131?*

[36] Section 131(1) provides:

- (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.

[37] Since at least the decision of *Nicholson v Permakraft (NZ) Ltd*¹⁰ this Court has accepted that the duties directors owe to the company may, in particular cases, require the directors to consider the interests of creditors:¹¹

The recognition of duties to creditors, restricted as already outlined, is justified by the concept that limited liability is a privilege. It is a privilege healthy as tending to the expansion of opportunities and commerce; but it is open to abuse. Irresponsible structural engineering – involving the creating, dissolving or transforming of incorporated companies to the prejudice of creditors – is a mischief to which the Courts should be alive. But a balance has to be struck. There is no good reason for cultivating a paternal concern to protect business people perfectly able to look after themselves.

For those reasons, among the many authorities cited to us I would respectfully adopt the approach of Cumming-Bruce and Templeman LJ in *Re Horsley & Weight Ltd* [1982] Ch 442, 454–456. Both Lord Justices

⁸ *Arataki Properties Ltd (in liq) v Craig* [1986] 2 NZLR 294 (CA).

⁹ *In re Etic Ltd* [1928] Ch 861.

¹⁰ *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 (CA) per Cooke J at 249–250, cited with approval by this Court in *Robb v Sojourner* [2007] NZCA 493, [2008] 1 NZLR 751 at [25].

¹¹ *Nicholson*, above n 10, at 250.

favoured an objective test: 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. ...

[38] As Mr Grenfell submitted, this was not a case of a director of a struggling company having to make difficult choices about which creditors to repay. Rather Mr Schuler deliberately and flagrantly sought to retain funds due to the Mudges for the benefit of IL Agents.

[39] In the present case, the Judge's findings that Mr Schuler deliberately misrepresented the reasons for non-payment and applied funds available to satisfy the debt due to Mr and Mrs Mudge to the ongoing business of IL Agents so that they were no longer available to Mr and Mrs Mudge at the date of liquidation provided a clear factual basis for the conclusion that Mr Schuler was in breach of the duties he owed IL Agents. Mr Grenfell's table based on Potter J's findings and IL Agents' accounts shows that were it not for the funds wrongly retained by Mr Schuler in IL Agents, neither salaries nor drawings would or could have been paid. Further, as the Judge held, Mr Schuler's actions demonstrate deliberate and ongoing conduct that was designed to mislead and forestall the Mudges in pursuing recovery of their debt.

[40] Mr Hayes then made the rather novel submission that s 131 and s 301 only applied to negligence and breach of duty, not to dishonesty. Taken to its logical conclusion the effect of Mr Hayes' submission would be that if Mr Schuler had acted negligently in relation to the funds due to Mr and Mrs Mudge s 131 would apply but, because he had acted dishonestly, it did not apply. Apart from the obvious inconsistency in that proposition it is met by s 301(2), which provides the section has effect even though the conduct may also constitute an offence.

[41] The liquidators sought to support the judgment on the basis of a breach of s 135 of the Act as well. We consider there to be force in Mr Grenfell's submissions that Mr Schuler's actions were also a breach of s 135 but, as the appeal is to be dismissed for the above reasons, there is no need to consider that matter further.

(d) *Was the Judge wrong to award the net amount of the Mudge debt?*

[42] To suggest that by requiring Mr Schuler to account the Court was acting in a paternalistic way is to misread the comments of Cooke J in *Nicholson*.¹² Rather such an order was and is necessary in the present case to prevent the type of abuse and “irresponsible structural engineering” that Cooke J was referring to in that case.

(e) *The costs in the High Court*

[43] Finally Mr Hayes took issue with the costs awarded in the High Court. The fundamental principle is that costs are to follow the event. While the liquidators did not succeed on their first two causes of action, they succeeded for the full amount that was due to the Mudges. Further, the factual basis underpinning all three causes of action was essentially the same. There is no merit in the costs appeal.

Costs in this Court

[44] We are satisfied there is no merit in any of the points raised by Mr Schuler. Potter J’s findings that Mr Schuler acted dishonestly, which were not challenged in this Court, necessarily dictated findings of liability for breaches of statutory duties as a director of IL Agents. This appeal was hopeless and should not have been pursued, particularly given the comprehensive reply submissions filed by Mr Grenfell.¹³

Result

[45] The appeal is dismissed.

[46] The appellants are to pay the respondents indemnity costs on the appeal being actual costs reasonably incurred by the respondents and disbursements.

Solicitors:
Hunwick Law, Hamilton for the Appellants
Edmonds Judd, Te Awamutu for the Respondents

¹² Above n 10.

¹³ Court of Appeal (Civil) Rules 2005, r 53E(3)(a).