'Uta'atu v Afeaki

Supreme Court, Nuku'alofa
Hampton CJ
C205/95

6, 7, 8 March, 11 April 1996

Company - duties of a director - fraudulent trading
Fraud - proof - director of company
Company - unpaid calls on shares

The liquidator of a company sued the managing director, a shareholder, for damages for (a) acting in an unreasonable and/or reckless manner causing losses to the creditor of the company or (b) trading in a fraudulent, reckless or negligent way;and for the balance unpaid on shares.

Held:

1. The common law duties of directors are stated in s.214(4) - Insolvency Act 1986 (U.K.).
2. Defraud in s.213 connotes actual dishonesty involving real moral blame.
3. S.214 relates to wrongful trading and liability is incurred if the company has gone into insolvent liquiditation and the director, before the commencement of the winding-up, knew or ought to have known that there was no reasonable prospect that the company would have avoided going into insolvent liquidation and did not take the steps he ought to have taken to minimise the potential loss to the company's creditors.
4. In the circumstances the defendant allowing the secured chattels not to be preserved or be disposed of was not wrongful trading.
5. The test in s.214(4) is a compound (objective and subjective states) and difficult one. And, in any event, the court had a discretion which would be exercised in favour of the defendant in view of the supine inactivity of the secured creditor.
6. All claims against the defendant, an director, were dismissed.
7. The balance claimed unpaid on shares was found proved however.

Case considered re Purpoint Ltd [1991] BCC 121
D'Jan [1994] 1 BCLC 561
re Patrick Lyon Ltd [1933] Ch 786
re William C Leitch Ltd [1932] 2 Ch 71
In re Produce Consortiun [1989] 1 WLR 745

Statutes considered : Evidence Act ss.104-6
Insolvency Act 1986 (U.K.) ss213-215

Counsel for plaintiff : Mr Hogan
Counsel for defendant : Mr L. Foliaki

Judgment

The Plaintiff as liquidator of Ha'alata Fisheries (Tonga) Limited ("the Company") sued the Defendant, a shareholder in, and the managing director of, the company for:

(a) damages of $10,000 and compounded interest thereon for either (i) using the company as a "front" for his own personal commercial activities and acting in an unreasonable and/or reckless manner causing losses to the Bank of Tonga("the Bank"), the sole proven creditor of the company; or (ii) trading in the company, or allowing the company to trade, and in particular in so far as such trading related to securing borrowings from the Bank of Tonga, in a fraudulent and/or reckless and/or negligent way; such as to entitle the liquidator to recover the losses of the Bank against the defendant personally and thereby compensate that sole proven creditor for the morally reprehensible activity of the managing director.

(b) payment of $2820 being the amount allegedly owing for the balance unpaid on 3000 $1.00 shares in the company.

At the completion of the hearing of evidence on 8 March 1996 I had a clear view of factual issues and that view has not been altered by the written submissions subsequently received from both parties and which I have carefully considered. I add that the Defendant's submissions were filed a day late. I find the explanation (on oath by Mr. Foliaki) acceptable and have allowed the submissions to be received.

That view of the facts is determinative of both claims which have been made.

FRAUDULENT/WRONGFUL TRADING

Five specific particulars were put forward by the Plaintiff. All relate to the dealings of the company, and the Defendant, with the Bank, as to overdraft accommodation and/or a term loan from the Bank to the Company and the security for such accommodation and/or loan.

Here we now enter the real area of contention between the parties and what I express from now on are my findings of fact on the evidence which I heard and from the exhibits which I have studied. I judge the matter, and make my findings, on the balance of probabilities and guided by the burden of proof provisions of the Evidence Act (Cap.15) sects. 104-106. I also take heed (i) of the judgment of Vinelott J in re Purpoint Ltd [1991] BCC 121 insofar as it touches on the evidentiary burden of showing where payments went; and (ii) that the Plaintiff has elected to allege fraud.

The company, despite the defection of the Koreans, elected to carry on in business and turned to other projects one involving supply of fish to the local market (the fish to come from e.g. Ha'apai and from New Zealand - to be bought in cheaply in New Zealand and resold in the Kingdom) and the other involving collection and export to Korea (to a different company) of Black Lip mother of Pearl shells.

From just before, and following, the departure of the 3 Korean boats (i.e. from 11

April 1987 on) there were no credits into the Bank account and by 10 November 1987 the credit balance was down to $1148.70 (Exh. 47v.10). I accept that the company was meeting legitimate accounts during that period in 1987. I accept that the company's records have been destroyed - not as it were at the hand of and by the design of the Defendant - and that does make for difficulties after a lapse of some 8 or more years, human memory being as imperfect as it undoubtedly is and suffering degradation from the passage of time.

The basis for the claim against the Defendant is put this way:

> "From May 1987 (the departure of the Korean fishing boats) the Defendant used the Ha'alata corporate shell as a "front" for his personal commercial activities.
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> Alternatively: from May 1987 the Defendant's trading of the company in so far as it related to securing borrowings from the Bank of Tonga was either fraudulent or reckless or negligent such as to entitle the liquidator to recover the Bank's losses against the Defendant personally and thereby compensate the sole proven creditor of the company. The claim is for compensation for the morally reprehensible activity of the managing director."

I note that although e.g. (a) fraud has been alleged and (b) it was claimed that the subsequent ventures did not exist (particularly the Black shell one) no evidence was called by the Plaintiff to contradict what the Defendant said in evidence. The lapse of time and loss of documents and records do not help, but some support for the Defendant's account can be seen in the Bank's records.

That is significant. On the evidence (given the delay, the loss of records and the absence of any evidence to the contrary) I cannot find established the claims of either personal trading or fraudulent and/or reckless and/or negligent trading (i.e. fraudulent or wrongful trading) of the company by the Defendant as at this stage (using the test, as to fraudulent and wrongful trading as set out below; and as well, in relation to wrongful trading, referring to re Purpoint Ltd [1991] BCC 121 at 127). As I say by then the debt to the Bank was $10,000 or thereabouts of borrowings, secured on the van.

Still no attempt was made by the Bank to further explore, let alone inspect and/or take possession of, the articles offered as security (see Exh. 26: "In the event of failure by the borrower .... the Bank is entitled to take possession of the said articles pledged as security without further process of law ...."). Nothing has been done to date - whether by taking possession or suing for possession. Other actions were taken against the company - but nothing done concerning the chattels. Even on the 5 March 1993 there was no suggestion of seizure (let alone actual inspection).

The liquidator, in effect speaking for the Bank as the company's sole proved creditor, now complains vigorously about the failure by the Defendant to maintain and secure and not dispose of the goods secured (as has undoubtedly been done in relation to 2 of the open boats). The company was liquidated in April 1993. Why was not something done then to seize, take possession of, these chattels? They were recorded on the bank documents.

It would seem the 2 small boats disposed of were disposed of in mid 1990 and early 1991. That is of concern. Despite the lack of precision in description and the probable late inclusion in the loan document (Exh. 26) the company did sign that document and the Defendant did know the position. He seems to have been somewhat cavalier in his

treatment of the boats and in his disregard for the Bank's rights. Perhaps he was influenced somewhat by the Bank's own rather casual attitude, as I have described.

Does that behaviour by the Defendant make him liable as claimed by the liquidator? It seems to me that that is the one, the only one, of the 5 particulars of the claim of fraudulent and/or wrongful trading which, on the factual findings as above, requires real scrutiny.

I turn to paragraph 9 of the Statement of Claim and the 5 particulars given (2 in the Statement of Claim itself, the other 3 on notice before trial):

9.1 : there it is claimed that the Defendant sought and secured moneys from the Bank for the Company by falsely (and knowingly falsely) representing that the company owned the 3 large named Korean fishing vessels. I find that allegation to be not proved. There is no evidentiary basis for such an allegation of, in effect, fraud. Any reference to vessels at all did not come until September 1988 and the reference then, and from then on, in the Banks own records was, consistently, to small boats. It is also significant in my view, both here and generally, that by the time of the reference to boats and to a term loan secured on boats and van the company indebtedness to the Bank was already at about the $10,000 figure (and had been from March 1988).

9.2 : this is a claim that the Defendant drew against the credit given the company by the Bank at a time and in such circumstances as he, the Defendant, knew or ought reasonably to have known that there was no reasonable prospect that the company could repay the Bank. Given the matters I have traversed I do not find that established in all the circumstances here.

9.3 : there it is said that the Defendant's claim to the Bank of the company's proposal for export of black shells was false and was known to him to be false (i.e. a fraud), and that representation led the Bank to extend overdraft accommodation to the company. Again in view of my findings as set out above I do not find such a serious allegation proved. Exhs. 17-21, inclusive, set out the position and I have detailed my findings above.

9.4 : this is a claim that in October 1988 the Defendant induced the Bank to convert the overdraft (of then $10,000 approx) to a term loan by pledging the van and 3 boats knowing the items to be worthless and/or rotting and, insofar as the boats, to not belong to the company: Again I find that not proved. I refer to my findings above. The evidence shows quite clearly that it was the Bank who wanted the term loan and approached initially and later repeatedly - to sign - the Defendant about that. The bank loan concept suited, and better secured, the Bank. The concept was the Banks. So the Bank was not "induced" whether as claimed by the pledging of van and boats or in any other way. There is no satisfactory evidence before me that in October 1988 the van and boats were rotting and worthless; and on the evidence I heard the 3 boats, if it is the 3 small boats, although originally Korean owned, had been abandoned with the company by the Koreans some 18 months before and with the Korean partner in debt to the company.

9.5 Here it is said that the Defendant failed to preserve carefully the van and boats and has sold or disposed of them to the detriment of the Bank's secured interests. On my findings above 2 boats have been disposed of (in 1990-91). The van, 6 years after it was first offered as security, no longer goes. There is no detailed evidence before me as to its actual state or when it fell into a condition of non-useability. (Still the bank has not even tried to inspect it - for purposes of trial or otherwise). Exh. 32 indicates it was off the road by March 1993. I have already commented on the laxity of the Bank and the apparent lack of interest in the security (even e.g. in 1988 on the change to a term loan when there were very obviously financial difficulties for the company - and the Defendant who was trying to meet what he saw as his moral obligation). The van was always his and his wife's personal property (as opposed to the company's property). I cannot make a finding of fraudulent and/or wrongful trading on the basis of this evidence. As to the boats - 1 still sits awaiting the Bank and/or the liquidator - after 5 1/2 years. The other 2 have gone. Does that disposal found liability against the Defendant personally?

Accepting Mr. Hogan's arguments as to the law for the moment I then look for guidance, as he suggests I should, to sects. 213-215 of the Insolvency Act 1986 (U.K.). (See re D'Jan [1994] 1 BCLC 561, 563 and the claim that sect. 214(4) accurately states the common law duties of directors).

Sect. 213 relates to "fraudulent trading". It provides that a court may declare a person, knowingly party to carrying on the business of a company with intent to defraud the creditors, "to be liable to make such contributions (if any) to the company's assets as the court thinks proper". The term "defraud" connotes actual dishonesty involving real moral blame (see re Patrick Lyon Ltd [1933] Ch.786, at 790-1) - a test of subjective moral blame (see re William C Leitch Ltd [1932] 2 Ch. 71 at 77). I do not find such proved here whether as to van or boats (or indeed generally on all allegations). I have traversed the facts in detail earlier. I do not intend repeating them. I have looked at, and had regard to, the authorities provided by Mr. Hogan.

Sect. 214 relates to "wrongful trading". A court may declare a director liable to make a contribution to the assets of the company if it has traded wrongfully. Liability is incurred if the company has gone into insolvent liquidation and the director, before the commencement of the winding-up, knew or ought to have known that there was no reasonable prospect that the company would have avoided going into insolvent liquidation and did not take the steps he ought to have taken to minimise the potential loss to the company's creditors.

I am looking at the non-preservation and/or disposal of the van and boats in this context. On the evidence I find that certainly from early 1989 on this company was insolvent and had no reaonable prospects of avoidance of liquidation. The Defendant must have known that. He sat; the Bank sat; the chattels sat. No one acted. But from late 1988 (if not slightly earlier) on the company was not operating - in ordinary parlance it was not trading so could not "trade wrongfully". And I so find. If I am wrong in that, I go on. I find the Defendant to be naive and inexperienced insofar as business affairs, and companies, are concerned. He had not been actively involved in a company before. His letting the chattels sit I do not find would constitute wrongful trading in all these

circumstances (applying the tests in sect. 214). As to the disposal of 2 of the boats (in 1990-91 when the company had not been trading for 2-3 years), I do not find that that was done at the time with any sense of affecting adversely, or with the intent to affect adversely, the Bank. It was a combination of naivety (if not stupidity) and of lack of thought (perhaps aided by an effectively dead company) on the Defendant's part, in conjunction with a dormant and inactive Bank, that latter being a very - in fact the most - important factor in my view, lulling the Defendant into a false sense that the Bank had no interest in the security and had lost interest generally. I am aware of the compound, and very difficult, test in sect. 214(4). I have applied that objective/subjective test as best I can in the above. (How a reasonably diligent person can have both states (a) and (b) in sect. 214(4) is very hard to comprehend let alone apply. But given the facts as I have found them even a person only in state (a) could have reached the view I have just described). I also have regard to the way the claim is framed in the Statement of Claim (para.8: "the obtaining of credit"; para. 9: "in carrying out such duties") and as put forward in argument in opening. The emphasis was on the obtaining of credit from the Bank.

Overall then, for a number of reasons I conclude that there was no "wrongful trading". Even if I am wrong in the above I view the law (as in sect.214 "may declare ... to be liable") as giving me a discretion; (see eg. In re Produce Consortium [1989] 1 W.L.R. 745, 751-2 and Re D'Jan [1994] 1 B.C.L.C. 561 at 564). In all the circumstances as I have found them, and in particular given the Bank's role (and it is the only creditor - the liquidator is in effect trying to recover for the Bank) and it's supine inactivity (and disinterest, in any shape or form, in the so called security) for so long I am not prepared to make a declaration of liability (for the full or any amount of the $10,000 Bank lending plus compounded interest - some $21,435 total now according to Exh.48) as sought. Justice is against that.

All claims under this head are dismissed.

Balance Unpaid on Shares

I turn now to the claim for the balance said to be unpaid on shares ($2820).

This is a very straight forward issue. Apart from the initial call, paid, of 6 seniti per share (as recorded at Exh. 8.2) the liquidator found no other evidence of payment for the balance - whether by the Defendant or the other 2 shareholders although, for reasons unknown to me, she has chosen to pursue only the Defendant.

She made formal demand on the Defendant, for payment of the balance, on 3 January 1995 (Exh.45). No payment has been made. The Defendant says the shares had been paid in full prior to the winding-up.

Again difficulties, from both parties point of view, are caused by the destruction of company record (in early 1993). (The judgment then traverses the facts).

Given that I have reached the view that it is indeed more probable than not that the Defendant has not paid the balance of his share commitment after the first 6% call (which can be seen and confirmed in both Exh. 8.2 and 47.1 - the bank account record - in contrast with any claimed subsequent payments on calls) the Plaintiff has accordingly succeeded on the second cause of action; which means that there should be judgment for the Plaintiff for $2820.

The Plaintiff having partially succeeded, for a comparatively minor part of the claims, I wish to have memoranda from counsel on the issue of costs: where they should fall and in what amount; particularly given the failure of the fraud allegations made by the

Plaintiff in the circumstances as I have described and found them.