IN THE HIGH COURT OF NEW ZEALAND
NEW PLYMOUTH REGISTRY

CIV 2008-443-000377

BETWEEN	DRILLING FLUID EQUIPMENT NZ LIMITED Applicant
AND	MURRAY JAMES FALLOON Respondent

Hearing: 28 January 2009

Counsel: D J Anderson for applicant
G Brittain for respondent

Judgment: 27 March 2009 at 4:00pm

JUDGMENT OF ASSOCIATE JUDGE ABBOTT

This judgment was delivered by me on 27 March 2009 at 4:00pm, pursuant to Rule 11.5 of the High Court Rules.

Registrar/Deputy Registrar

Solicitors:
Dennis King Law, PO Box 1092, New Plymouth 4340 for applicant
Keam & Associates, PO Box 998, Tauranga 3140 for respondent

Introduction

[1] Drilling Fluid Equipment NZ Limited (DFE) applies to set aside a statutory demand served on it by the respondent, Mr Falloon. The sum demanded ($11,078) was for costs which DFE was ordered to pay Mr Falloon following discontinuance of a claim made against him as guarantor of a trading debt incurred by a company of which Mr Falloon was director, Water Treatment Products Limited (WTPL).

[2] DFE does not dispute that it owes Mr Falloon the sum demanded. However, it says that it should not have to pay as it has a counterclaim in the form of a potential proceeding against Mr Falloon under the Companies Act 1993.

[3] Mr Falloon accepts that DFE has the ability to bring a claim against him under the Companies Act but says that even if the claim was to be successful (which he disputes), WTPL will receive the benefit of the claim. Accordingly, Mr Falloon says the claim is not a counterclaim which can be taken into account for the purpose of setting aside his statutory demand.

Background

[4] There is a lengthy history to the present proceeding. It has its origins in a trading debt which WTPL incurred with DFE between October 2004 and January 2005.

[5] WTPL was incorporated in March 2003 to develop and market a water treatment system known as the "magnetic circle". Mr Falloon was at all material times a shareholder and director of WTPL. The technology for the magnetic circle was unproven at the time that WTPL was formed. The system proved difficult to market. The shareholders provided continuing financial support (by way of shareholder advances) as WTPL attempted to establish itself. The parties disagree as

to the extent and effect of this support in relation to WTPL's solvency. It is not in dispute, however, that WTPL ceased trading in January 2005.

[6] In mid-2004 WTPL decided to diversify its business into well-drilling. The rationale was that this work would complement sales of the magnetic circle system. WTPL purchased drilling equipment. In October 2004, it engaged DFE to supply with an experienced driller. A dispute arose over DFE's services. The relationship was terminated. DFE rendered to WTPL an invoice for $41,807.05 for its services (supply of the driller).

[7] In January 2005 (after its relationship with DFE had ended), WTPL sold its well-drilling equipment to Bore-Well Services Limited. Bore-Well was incorporated on 23 December 2004, with WTPL as its major shareholder and Mr Falloon as a director.

[8] In April 2005, WTPL sold its "magnetic circle" water treatment business to Technical Water Systems Limited (TWSL). At that point, Mr Falloon was sole shareholder and director of TWSL. TWSL was incorporated on 5 April 2005. It appears to have been formed for the express purpose of purchasing the magnetic circle business.

[9] In December 2005, DFE issued a claim against WTPL in the District Court to recover the amount of its unpaid invoice. Mr Falloon was also named as a defendant, on the grounds that he had guaranteed WTPL's obligation. DFE's claim was initially defended by both WTPL and Mr Falloon.

[10] WTPL was put into liquidation on 11 September 2006. The Official Assignee was appointed liquidator. He gave his final report on 14 November 2006. There was no money available to pay WTPL's creditors. The Official Assignee gave notice that WTPL was to be removed from the Register. That took place on 22 January 2007.

[11] After discovery had taken place in DFE's District Court proceeding, Mr Falloon applied for summary judgment. That application was heard on 4 April 2007. At the hearing DFE elected to discontinue its claim against Mr Falloon, and was subsequently ordered to pay the costs of $11,078 which Mr Falloon seeks in his demand.

[12] Mr Falloon took steps to enforce the costs order. In response, on 30 May 2007, DFE informed Mr Falloon (through their respective legal advisors) that it would "shortly be filing proceedings against [him] for reckless trading and breach of directors duties", and claimed an equitable set-off. Through his counsel, Mr Falloon responded that he might reconsider the issue of a demand if persuaded that there was any merit to a reckless trading claim. He invited DFE to disclose the basis of any claim. DFE's solicitors wrote back on 22 June 2007, outlining the claims now being relied upon, and stating that steps were being taken to commence the appropriate proceedings.

[13] On 24 July 2008, Mr Falloon served his statutory demand, leading to the present application. DFE had taken no steps to pursue its claims against Mr Falloon at that time.

[14] In September 2008, DFE applied to this Court for orders reinstating WTPL to the Register of Companies and re-opening the liquidation. Mr Falloon did not oppose the application. An order was made restoring WTPL to the Register on 1 December 2008. On 15 December 2008 the Court made a further order, reversing the Official Assignee's final report and appointing new liquidators.

Applicable principles

[15] DFE's application is brought under s 290 of the Companies Act 1993, the relevant parts of which read:

> **290 Court may set aside statutory demand**

(1) The Court may, on the application of the company, set aside a statutory demand.

….

(4) The Court may grant an application to set aside a statutory demand if it is satisfied that —

(a) There is a substantial dispute whether or not the debt is owing or is due; or

(b) The company appears to have a counterclaim, set-off, or cross-demand and the amount specified in the demand less the amount of the counterclaim, set-off, or cross-demand is less than the prescribed amount; or

(c) The demand ought to be set aside on other grounds.—

….

[16] The onus is on the applicant to show a fairly arguable basis on which it is not liable on the demand: *United Homes (1988) Limited v Workman* [2001] 3 NZLR 447 at para [27].

[17] Where liability for the debt being demanded is not in dispute, a company may still resist the demand on the basis that it has a claim against the issuer of the demand which it is entitled to set-off against the undisputed debt. However, to impeach the demand (and thereby overcome the statutory presumption that it is unable to pay its debts), the applicant must point to evidence before the Court which shows a real basis for the claimed set-off: *Covington Railways Limited v Uni-Accommodation Limited* [2001] 1 NZLR 272, p274.

[18] It is not necessary that there be any link between the debt demanded and the subject matter of the counterclaim*: Phoenix Organics Limited v RD2 International Limited* (2003) 9 NZCLC 263, 380.

Does DFE have an arguable counterclaim against Mr Falloon?

[19] Counsel for DFE argued that Mr Falloon had breached his duties as a director of WTPL, initially by permitting or causing WTPL to enter into the contract with

DFE and then by selling its well-drilling equipment to Bore-Well and, subsequently, the "magnetic circle" water treatment business to TWSL. He contended that:

a) WTPL was arguably insolvent at the time engaging DFE to supply drilling services, and that entry into the contract was a breach of s 135 of the Companies Act 1993.

b) Mr Falloon was also in breach of his duty under s 131 of the Companies Act 1993 to act in good faith and in the best interests of WTPL (also requiring him to take the interests of WTPL's creditors into account) by selling assets arguably at under-value.

He submitted that DFE was entitled to bring a claim against Mr Falloon under s 301 of the Companies Act 1993 (this was not contested by Mr Falloon), under which the Court could order compensation for the loss suffered by DFE (and, indeed, by any other creditors). He submitted that if DFE was successful in its claim under s 301, the recovery was likely to exceed the amount of the demand.

[20] Counsel for Mr Falloon argued that DFE had failed to establish a sufficient evidential basis for either of the alleged claims. He submitted that there was no clear and persuasive evidence that WTPL was insolvent before late 2004 or early 2005 (after entry into the contract with DFE) and no evidence at all that WTPL's assets had been sold at under-value. However, his principal argument was that even if there is an arguable basis for either of these claims, neither can be a counterclaim for the purposes of s 290(4)(b) because they are claims on behalf of WTPL (and its creditors generally) rather than claims in DFE's own right.

The nature of the claim under s 301

[21] The key issue in this application is whether DFE's acknowledged entitlement to claim under s 301 is a counterclaim as contemplated by s 290(4)(b).

[22] The relevant parts of s 301 read:

> **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 person who has taken part in the formation or promotion of the company, or a past or present director, manager, administrator, liquidator, or receiver of the company, has misapplied, or retained, or become liable or accountable for, money or property of the company, or 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, administrator, liquidator, or receiver; and
>
> (b) Order that person—
>
> (i) To repay or restore the money or property or any part of it with interest at a rate the Court thinks just; or
>
> (ii) To contribute such sum to the assets of the company by way of compensation as the Court thinks just; or
>
> (c) Where the application is made by a creditor, order that person to pay or transfer the money or property or any part of it with interest at a rate the Court thinks just to the creditor.

[23] The legal nature of the rights conferred by s 301 of the Companies Act 1993 was considered in *Benton v Priore* [2003] 1 NZLR 564. The plaintiffs in that case were creditors of a company of which the defendant was a director. They brought a proceeding against the director, following liquidation of the company, relying on s 301. They alleged, inter alia, that the director had intentionally removed assets from the company at an under-value prior to its liquidation. The director applied to strike out six causes of action. The application was dismissed, both at first instance by a Master, and on review.

[24] In the course of his judgment on the review, Heath J held (at paras [40] – [47]) that s 301 provided a procedural mechanism to allow claims at common law or equity to be determined after liquidation, rather than providing a substantive remedy. This view of s 301 was confirmed by the Court of Appeal *in Sojourner v Robb* [2008] 1 NZLR 751 (at para [53]).

[25] The construction of s 301 was also considered in *Mitchell v Hesketh* (1998) 8 NZCLC 261, 559. The plaintiff (Mr Mitchell) brought a proceeding under s 301 against a company's managing director (Mr Hesketh) for breach of his duties under s 135 of the Companies Act 1993 (reckless trading). Mr Mitchell sought an order under s 301(1)(c) for Mr Hesketh to compensate him directly. In the judgment, Master Venning (as he then was) analysed the section and found that it contemplated two circumstances. The first was where a director owes a specific item of money or property to the company; the second was where a director has breached his duties to the company and caused loss generally. The provision in s 301(1)(c) for the Court to order a payment by the director to the creditor was found, as a matter of construction, not to apply to any general damages that might flow from the second circumstance (a breach of duty causing loss). In that circumstance, the Court had to assess the loss flowing from the breach and determine what amount the director should pay. The section did not provide for payment to the applicant. It had to be paid to the company for the benefit of all creditors. The Master summarised his findings as follows (at p 261, 563):

> I find therefore that a creditor cannot rely upon s 301(1)(c) to recover directly from a director in the second circumstance where the director has been guilty of negligence, default or breach of duty or trust in relation to the company. In this case the Plaintiff relies upon a breach of s 135 of the Act which is clearly within the second circumstance. The Plaintiff is not entitled to recover directly from the director.

[26] Both counsel referred me to *Sojourner v Robb*. In that case the plaintiff, Mr Sojourner, and a co-plaintiff were creditors of a company of which Mr and Mrs Robb were directors and shareholders. The company ran into financial difficulties. The Robbs caused the company to sell the bulk of its assets to another company, of which they were also the directors and shareholders. The company did not pay Mr Sojourner and his co-plaintiff before it was put into liquidation (there had been a dispute over those debts). The liquidator subsequently accepted proofs of debt from them, but the company did not have the money to pay the debts. Mr Sojourner and his co-plaintiff then sued the Robbs for breach of s 131 of the Companies Act 1993. The High Court found that the sale was at under-value, and that there was a breach of s 131. The Robbs were ordered to pay the liquidator such amount as was

necessary to allow the company's debts, as accepted by the liquidators, to be paid. The Court of Appeal upheld the finding of a breach of s 131. It confirmed that relief could be calculated either on a compensatory or a restitutionary basis. It took a slightly different approach to that of the High Court to quantifying the relief, but the sum reached on its approach was within the sum ordered by the High Court.

[27] Counsel for DFE submitted, relying on *Sojourner v Robb*, that the fact that the Court had the ability, on DFE's application under s 301, to order Mr Falloon to pay a sum which could be applied in payment of DFE's debt was all that was needed to satisfy the requirement for a counterclaim in s 290(4)(b). He argued that the technicality of it being a claim on behalf of the company was irrelevant.

[28] I cannot accept that submission. The duties imposed on directors by ss 131 and 135 are owed by directors to the company (rather than to any particular creditor): refer *Mason v Lewis* [2006] 3 NZLR 225 at para [51]. The authorities are clear that s 301 is merely a procedural mechanism for bringing those claims after the company's liquidation. Although the claims, once determined, may be sufficient to allow the liquidators to pay the whole of DFE's debt, that does not alter the fundamental nature of the claim as one on behalf of the company. The claims will be for loss generally, rather than for specific money or property. Any compensation or distribution ordered will be payable to WTPL. DFE does not have a claim in its own right against Mr Falloon: *Mitchell v Hesketh* at 261, 563; *Sojourner v Robb* at paras [53] and [55]. DFE has recognised this by applying to have WTPL restored to the Register before applying under s 301. I find that any claim which DFE may bring against Mr Falloon under s 301 does not constitute a counterclaim, set-off or cross-demand for the purposes of s 290(4)(b).

The specific claims

[29] For the sake of completeness, I will also refer briefly to the arguments in respect of the two bases of counterclaim, namely reckless trading and failing to act in the best interests of the company by selling assets at under-value.

[30] Counsel for DFE submitted that there was at least an arguable case that WTPL was not able to pay its debts in the ordinary course of business by 11 October 2004, when it entered into the contract with DFE:

a) It filed two affidavits by its accountant, Mr C J Lynch. In the first, he reviewed WTPL's position as at 31 March 2004 and its subsequent trading. He referred to a decline in net tangible assets from a surplus of $77,000 as at 31 March 2004 to a deficit of $164,000 as at 31 March 2005 (a loss for the period of $241,000).

b) A former director, Mr W J Bracks, gave an affidavit (in reply) in which he said that WTPL achieved only three substantial sales of its water treatment system, and had no income from that business, after the beginning of June 2004. He said that WTPL did not reduce its expenditure through the balance of 2004, but instead purchased equipment to establish the well-drilling business. In his view this created a "cash burn" which was unsustainable. He referred to problems experienced on the well-drilling side of the business and produced reports that he had prepared in September 2004 in which he expressed concern about expenses (exacerbated by problems with the well-drilling business) and a concern that the company was in danger of collapse.

c) In his second affidavit (in reply) Mr Lynch expressed the view that WTPL was also likely to be insolvent by that date on a balance sheet basis, as its goodwill should have been written off (its technology was not patentable and a technical report had raised unanswered questions as to the effectiveness of the system). He contended that the liabilities would have exceeded assets when shareholder advances exceeded the shareholder equity as at 31 March 2004 of $77,000 (because the advances came in as shareholder loans rather than equity). He identified shareholder advances of $85,000 during the 2005 financial year. He rejected evidence by Mr Falloon that the company in fact

only became unprofitable in late 2004, contending that was not credible in light of the company's financial position as disclosed by the accounts and trading positions.

d) Both Mr Lynch and Mr Bracks took the view that WTPL was insolvent (on a cash flow basis) by the time it entered into the contract with DFE.

[31] In an affidavit in support of his opposition to the application, Mr Falloon replied to Mr Lynch's evidence as to the decline in net tangible assets through the 2005 financial year and the likelihood that WTPL was insolvent about mid-2004. He said that shareholder advances were made to ensure that the company could pay its debts as they fell due during 2004, that WTPL anticipated earning income from the drilling operation to cover the obligation to DFE , and that the problems encountered with the drilling business in late 2004 caused losses to increase beyond a level that the shareholders could fund. He says that the directors then moved promptly to cease trading and realise WTPL's assets. He did not have opportunity to comment on the Mr Lynch's second affidavit or the affidavit of Mr Bracks, as they were both given in reply.

[32] Counsel for Mr Falloon submitted that it could not be said from this evidence when WTPL became insolvent but that that was only part of what DFE had to establish. He contended that DFE had to go further, and show that Mr Falloon ought to have been aware at the point of entering into the contract with DFE that continuing to do so would create a substantial risk of serious loss (relying on *Mason v Lewis* at paras [44] to [51]).

[33] This claim (for reckless trading) will have to be determined by an objective assessment of the way in which the company was conducting its business at the relevant time, and whether that created a substantial risk of serious loss. In *Mason v Lewis,* the Court of Appeal said (at para [51]):

> …when a company enters troubled financial waters [what is required] is … a "sober assessment" by the directors … of an ongoing character, as to the company's likely future income and prospects.

[34] The evidence shows that the directors turned their minds to these matters in September 2004. Mr Falloon's evidence suggests that he made an assessment along the lines referred to by the Court of Appeal. On the other hand, Mr Bracks was sufficiently concerned about the position that he resigned as a director. These conflicting views cannot be resolved on a summary application such as this. However, although disputed and incomplete, the evidence put forward for DFE is just sufficient, in my view, for an arguable case under s 135. Whether it will succeed is quite a different matter.

[35] DFE's claim under s 131 is even weaker on the evidence before the Court. The critical issue, for present purposes, is whether DFE has shown that the sales to Bore-Well and TSWL caused loss to WTFL in circumstances where the alternative was "the counter factual [of] an immediate liquidation": *Sojourner v Robb* at para [28].

[36] Counsel for DFE submitted that the assets should not have been sold to Bore-Well and TSWL. He argued that there would have been value to creditors if they had remained in WTPL. There is no direct evidence as to the terms of these sales. Mr Falloon says merely that the directors realised the assets. Counsel for DFE relied on statements made in a memorandum prepared for WTPL's Annual General Meeting on 5 April 2005, and a letter from WTPL to its creditors on 13 May 2005, to the effect that creditors would be paid out of the proceeds of sale of the assets. That did not occur but does suggest a value was set for the assets. Counsel for DFE argued that there was no record of any value for the sale to Bore-Well in the accounts for 31 March 2005. Again, the evidence is incomplete. Mr Lynch does not cover the point in his evidence. Contrary to counsel's argument, the depreciation schedule, which forms part of those accounts, shows a sum close to book value having been realised on disposal of the drilling assets. Unfortunately, the notes to the accounts, which could have explained the disposal, were not produced. There is

no evidence as to the price for the sale of the "magnetic circle" system to TSWL, as I have said, but an inference can be taken from the letter of 13 May 2005 that a price was agreed for those assets.

[37] I accept the submission of counsel for Mr Falloon that DFE has failed to establish an evidential basis for a sale at under-value. Counsel for DFE was critical of Mr Falloon for not providing evidence of the sales. I do not accept that as a valid criticism. First, it was a matter for DFE to establish. Secondly, the issue was not raised squarely in the affidavits in support of the application. The memorandum of 5 April 2005 and letter of 13 May 2005 were produced in the affidavit of Mr Bracks in reply.

[38] Counsel for Mr Falloon also submitted that a contingent and unquantified demand could not constitute a counterclaim for the purpose of s 290(4)(b): *Datasouth Holdings Limited v Melco Sales (NZ) Limited* (HC CHCH, M41/07, 17 May 1996, Master Venning) and *Alfex Doors & Windows Limited v Alutech Windows & Doors Limited* (2001) 16 PRNZ 963. In both of these cases, the claimed set-off was contingent on a claim by a third party. Although I do not have to decide the present case on this point, if my analysis of DFE's claim (as one on behalf of WTPL rather than in its own right) is correct, the case would appear to fall within these authorities (WWTPL being the third party). On this reasoning, the uncertain claim is insufficient to impeach the debt claimed in the demand.

Other grounds

[39] DFE's application also raised the ground that it was solvent. In his affidavit in support of the application, Mr Lynch stated that DFE's business generated revenues of some $5 million per year and that it was either able to pay its debts as they fell due out of that revenue, or was able to arrange banking accommodation which would allow that. No accounts, bank statements or other documents were produced in support of this statement. Counsel for DFE did not pursue this ground in his argument. He was right not to do so. It will be a very rare case where solvency will constitute a stand-alone ground for setting aside a notice. In general, if

a company cannot establish either of the grounds in s 290(4)(a) or (b), it should have to prove its ability to pay, so as to rebut the statutory presumption, at the hearing of the application for liquidation: *AMC Construction Limited v Frews Contracting Limited* (2008) 19 PRNZ 13.

Residual discretion

[40] Counsel for Mr Falloon also invited me to exercise my discretion against setting aside the demand on the grounds that DFE should not be allowed to avoid payment of a costs order simply on the ground that it has a potential and unquantified claim which it has done nothing about since WTPL was placed in liquidation in September 2006.

[41] It is only in rare cases that the Court will exercise its residual discretion to refuse to set aside a demand where grounds are clearly made out under s 290(4): *Alfex Doors & Windows Limited v Alutech Windows & Doors Limited*.

[42] Although I do not need to decide the case on this point, I consider that there is a basis for doing so. The outcome of any claim is uncertain, including the amount of any compensation that may be ordered (which is a matter for the Court's discretion). There is also a case for saying that costs orders should be met when due, and should not be avoided by a claim to an equitable set-off: *Wiseline Corporation Limited v Hockey* (HC AK CP143-SD 99 26 July 2002, Nicholson J) and *Volcanic Investments Limited v Dempsey & Wood Civil Contractors Limited* (2006) 18 PRNZ 97. Finally, I infer from Mr Lynch's evidence as to DFE's liquidity that a requirement to pay the costs will not prevent DFE pursuing the claims against Mr Falloon, if that is its wish.

Decision

[43] For the reasons I have given I find that DFE does not have a counterclaim, set-off or cross-demand against Mr Falloon as contemplated by s 290(4)(b) of the

Companies Act 1993, and that there are no other grounds on which Mr Falloon's statutory demand should be set aside. The application is dismissed.

[44] I extend time for compliance with the statutory demand to 5:00pm on 9 April 2009. If DFE does not pay the debt by that time, Mr Falloon may apply to put DFE into liquidation.

[45] As the successful party, Mr Falloon is entitled to costs of and incidental to this application on a 2B basis, together with disbursements as fixed by the Registrar.

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Associate Judge Abbott