

The corporate shield: What happens to directors when companies fail?

By Susan Watson and Chris Noonan

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When companies crash into liquidation they often leave behind a string of disgruntled unsecured creditors. Because the company has limited liability, those creditors, who might struggle to keep their own businesses afloat as a result of the failure to pay, and may be forced to write off the money owed. Creditors often assume that limited liability means that there is little prospect of recovery from those who operate the company. Some may curse the rules of company law that appear to allow dishonest and incompetent business people

to hide behind companies and force others to bear the loss for their failures. Others may fear a backlash where honest and diligent directors will be unjustifiably punished for their unsuccessful ventures, crushing entrepreneurial conduct and spirit. Many unsecured creditors of companies seem to be unaware that the limited liability company is not an impenetrable shield. Directors may sometimes be made responsible for losses suffered by the company creditors.

Indeed, in a recent decision involving the reckless trading provisions in the Companies Act 1993,¹ Priestley J colourfully commented:

“The shield of incorporation will be of no avail to a director on the battlefield of trade if that director knows full well, or ought to have known, that creditors’ claims cannot be met or if the shield-carrying director is allowing the company to trade recklessly.

If a company is in a situation where there is a substantial risk of serious loss to its creditors or a director cannot hold a reasonably grounded belief that the company will perform its obligations then the company should cease to trade. The shield is not required after surrender and will not protect a combatant who refuses to surrender.”



Graham Fletcher, DPM2, 2001, Enamel on tapa canvas, Auckland Art Gallery Toi o Tamaki, purchased 2001

This article sets out several remedies available against malfeasant directors of companies that go into insolvent liquidation. In some cases these remedies have allowed creditors to recover not just a proportion of the money they are owed, but all of it.

The limited liability fallacy

Where a director has breached a duty to the company or otherwise acted unlawfully, many unsecured creditors are not prepared to incur the expense of pursuing errant company directors through the courts. In part this is due to high litigation costs and in part this is due to a belief that any ac-

“If a cause of action can be established against a director, there is no bar against proceeding...”

tion brought is unlikely to have a successful outcome. Many creditors erroneously believe that the directors have limited liability. They do not. The primary reason that individuals operate their businesses using the corporate structure is to take advantage of limited liability. But the liability that is limited is that of shareholders. Although many individuals who are directors of companies may also be shareholders, it is in their capacity as directors that actions can be brought against these individuals and it is in that capacity that their liability will be assessed. As *Salomon's case*² tells us, a company is a separate person at law from those who operate on its behalf and through it; namely its directors, employees and shareholders. But this does not necessarily protect directors from liability; it means only that the liability of directors must be assessed separately from the liability of the company. If a cause of action can be established against a director, there is no bar against proceeding with that action just because that director is also a shareholder in the company and has limited liability in their capacity as shareholder. The issue in these cases will be whether the words and actions of the director can be assessed separately from those of the company. Creditors will particularly look for a cause of action against the directors of a failed company when the company director has deeper pockets than the insolvent company.

Actions under the Fair Trading Act 1986

The most effective remedy against company directors or, in fact, against any individuals who give misleading or deceptive information on behalf of a company, will usually be an action under the Fair Trading Act 1986. When a company is in financial difficulty and creditors are not being paid, creditors may seek reassurance from the director of the company. Directors may then assure the creditors that the company is in sound shape and promise that the creditors

will be paid. If the company later fails, the creditors may not be paid or may receive only a small proportion of what they are owed. If a director makes a statement to an unsecured creditor that misleads or deceives that unsecured creditor into believing that, for example, a company is not in financial difficulties when in fact it is, that director may be personally liable for the loss the creditor suffers. Even though the statement was made on behalf of and about the company, the corporate shield does not provide protection against liability for company directors under the Fair Trading Act 1986. There have been a number of cases where Fair Trading Act actions have been brought successfully against company directors.

*Hill Country Beef NZ Ltd v Sharplin*³ is an example of such a successful action. Hill Country supplied processed meat to butchers. Sharplin was a shareholder and director of Fresh Freezer Foods Ltd (FFF), a butchery company. Sharplin negotiated with Hill Country for it to supply FFF with large quantities of meat. Due to financial difficulties, FFF was unable to pay for the meat. At a meeting between the parties, Sharplin gave assurances to Hill Country that FFF Ltd's finances were improving and that payment would be forthcoming. In fact, the company was facing financial ruin with little prospect of long-term viability. Sharplin continued to assure Hill Country that there was “no problem” and all payments would be made right up until the company went into liquidation. Hill Country sued Sharplin for misleading conduct under section 9 of the Fair Trading Act 1986.

Sharplin was found liable for breaching the Fair Trading Act 1986. Discussing the liability of directors under that Act, Gullen J considered that agents of a company will not normally be liable for merely acting under instructions or passing on company information without assuming any personal responsibility. But here Sharplin gave personal assurances as to FFF Ltd's financial state. As there was no reasonable grounds to support these statements, he had clearly misled Hill Country and was in breach of the Act.

There have been two recent Court of Appeal decisions that, whilst they do not deal directly with the issue of liability of directors to trade creditors, involve common business transactions. These cases make it clear that operating through or on behalf of a company will not afford individuals who are company directors blanket protection against liability under the Fair Trading Act 1986. The first is *Kinsman v Cornfields Ltd and Others*.⁴ “Gourmet Burgers” was a company that initially operated successfully in Lower Hutt and which later franchised its business. Mr Kinsman was a director of the company; Cornfields Ltd was a franchisee that operated the company in Palmerston North. In discussions with the franchisees, Mr Kinsman represented that

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projections he presented reflected the current performance of the Lower Hutt business when in fact they were no longer correct. It was on this basis that Cornfields Ltd agreed to buy the business and operate the franchise. The issue on appeal was the liability of Mr Kinsman under the Fair Trading Act 1986. Section 9 of that Act says “No person shall in trade, engage in conduct that is misleading or deceptive or is likely to mislead or deceive.” It was clear that the company Gourmet Burgers Ltd could be liable under the Fair Trading Act 1986. It was less clear whether Mr Kinsman himself could be made personally liable. Heron J said that there was nothing here to suggest that the “utterances of Mr Kinsman should be taken as those only of his company or that he was a mere conduit.” The Court considered that it would be a rare case where a director who participated directly in negotiations would be able to avoid section 9 liability on the basis that he or she was acting only on the company’s behalf.

More problematic was the interpretation of section 45 of the Fair Trading Act 1986. Section 45(2) says that “any conduct engaged in on behalf of a body corporate – (a) By a director, servant, or agent of the body corporate acting within the scope of that person’s actual or apparent authority; or (b) By any other person at the direction or with the consent or agreement (whether express or implied) of a director, servant, or agent of the body corporate, given within the scope of the actual or apparent authority of the director, servant or agent – shall be deemed, for the purposes of this Act, to have been engaged in *also* by the body corporate.”

Heron J found that “the use of the word “also” suggests liability under the Act for both director and company where the director is acting within his actual or apparent authority.” Section 45(2) in fact appears to have been intended to provide a mechanism by which liability can be imposed on *companies* for the actions of their directors, servants and agents. By using the provision to impose liability on directors, the court unnecessarily “stretched” the provision, especially because the statute already expressly provided a means of imposing liability. That is, to assess the liability of the directors under section 43 of the Fair Trading Act 1986. That provision allows accessory liability to be imposed for aiding, abetting, counselling or procuring a breach of the Fair Trading Act 1986 and has been the approach taken by the Australian courts applying their similar legislation. Directors could therefore be made liable under sections 43 and 9 of the Fair Trading Act 1986 if, for example, they aid, abet or procure the company in misleading or deceiving a trade creditor about the solvency of the company.

A similar approach by the New Zealand Court of Appeal was taken in *Specialised Livestock Imports Ltd and Others v Borrie*,⁵ where liability was imposed not only on a director but also on two shareholders of a company who acted as agents for the company. Mr Gordon Bendall, Mrs Doreen Bendall and their son Philip Bendall were equal shareholders in a company. Philip Bendall was the managing director of the company. The Bendall family farmed ostriches and

developed a scheme to import live ostriches from Australia. The company entered into various ostrich importation contracts with the respondents but for a variety of reasons the ostriches never were imported. One of the actions brought by the respondents was against the Bendalls under sections 9 and 13 of the Fair Trading Act 1986. Section 13 states that “no person shall, in trade, in connection with the supply or possible supply of goods or services or with the promotion by any means of the supply or use of goods or services (a) falsely represent that goods are of a particular kind, standard, quality, grade, quantity, composition, style, or model, or have had a particular history or particular previous use.” Both the duties in section 9 and section 13 apply to persons who are in trade. The issue was whether the Bendalls were in trade as individuals as well as the company being in trade. The Court agreed with the interpretation of the lower court that the Bendalls were “in trade” in their activities on behalf of the company and adopted the same approach to section 45(2)(b) as in *Kinsman*. The Court considered that provision allowed them to assess the liability of the directors and agents separately from the company. Once the elements of sections 9 and 13 were established, the fact that the Bendalls were directors and/or shareholders within the company afforded them no protection against liability. Liability was thus imposed on all three family members.

What is surprising, given the number of companies that go into insolvent liquidation every year, is that more creditors do not take advantage of the potentially potent Fair Trading Act remedy. Of course, many directors may not have engaged in the requisite misleading conduct. Others, either inadvertently or through the use of devices such as trusts, may not have enough assets to make expensive litigation through the courts worthwhile. But for some it may be simply because either the creditors or their advisors are unaware of this effective remedy. If they have any doubts about the financial health of a company, creditors would be well advised to question directors and senior managers of the company about its financial health and keep records of any assurances they receive. A failure to receive a clear answer or coyness from the company officers would be revealing.

Common law actions against company directors

As we have seen, the courts are not prepared to treat company directors differently from other individuals when assessing liability under the Fair Trading Act 1986. At common law, however, the status of a person as a director of a company for a time appeared to afford some protection for such persons against tort liability to third party creditors. From the perspective of a trade creditor, common law actions against directors of failed companies might potentially provide effective causes of action. For example, a director might personally reassure trade creditors that the company is in good financial shape. If that director knew about the perilous financial position of the company, he or she could be made liable under the tort of deceit if the company cannot

meet its obligations. If that director was carelessly unaware of the perilous financial situation of the company when he or she gave those assurances, that director could be liable for negligent misstatement.

In fact the issue of when, at common law, the actions of a director can be taken to have been only on behalf of a company, thus exempting the director from liability, and when they can be taken to be the actions of the director as an individual is one that has troubled courts across many jurisdictions in recent years. It is an issue of vital importance not only to company directors but also to those who deal with companies, including trade creditors. Separating the conduct of the director from the actions of the company when assessing liability would at first sight appear to be the correct approach but it is not one which has, at least until recently, been taken by the courts.

The difficulty in the area is epitomised in the New Zealand Court of Appeal decision *Trevor Ivory Ltd v Anderson*.⁶ Trevor Ivory Ltd was a “one man” company owned and controlled by Trevor Ivory. The company was engaged by Mr Anderson to give horticultural advice. The company, through Trevor Ivory, negligently advised Mr Anderson to spray couch-grass weed with Roundup, a herbicide, without telling Mr Anderson to cover up his raspberry crop. The raspberry crop was destroyed. While the company was clearly liable for breach of contract and negligent misstatement, Mr Anderson appealed against the finding that Trevor Ivory was not personally liable. The Court of Appeal said Trevor Ivory was not liable even though the company was liable because, in giving the advice, Trevor Ivory was acting as the mouth piece of the company and had not assumed personal liability.

Under the common law, directors can, by agreement or representation, assume a special duty to a third party such as a company creditor. In *Trevor Ivory*, the Court focused on whether Trevor Ivory as director of the “one man” company had assumed personal responsibility for advice given to a third party. In concluding he did not, the Court considered that the fact an individual chooses to trade in the company structure is prima facie evidence he or she wishes to limit liability. To be personally liable the director had to take some extra step (do “something extra”) which shows he or she assumed personal responsibility.

New Zealand cases subsequent to *Trevor Ivory* have done little but create uncertainty for litigants. The courts’ approaches have varied widely with some judges applying *Trevor Ivory* and others making every effort to distinguish it. In *Jagwar Holdings v Julian*,⁷ Thorp J distinguished *Trevor Ivory* by stating that, unlike *Trevor Ivory*, in *Jagwar* there was no evidence that the company was set up for the express purpose of limiting personal liability. Thorp J followed a similar line in *Banfield v Johnson*.⁸ By way of contrast, Doogue J, in *Livingston v Bonifant*⁹ suggested that a director of a company of any size will never owe a duty of care to a third party unless the director assumes personal responsibility.

Much of the basis of the argument in *Trevor Ivory* was the principle derived from *Tesco Supermarkets v Natrass*.¹⁰ That case established the legal principle that the words and actions of a director who is the controlling mind of the company may be treated as the actions of the company for the purposes of determining the statutory liability of the company. The effect of *Tesco*, as applied in *Trevor Ivory*, is that a director could avoid tortious liability to third parties if the director was deemed the embodiment of the company. An employee at a lower level within the company who was not deemed to be the controlling mind of the company could however be made personally liable. Such a principle is counterintuitive and can be viewed as a misapplication of *Tesco*. *Tesco* was primarily concerned with making a company criminally liable. It has been suggested that rather than focusing on Mr Ivory’s role as a director, the Court of Appeal should have considered him as an employee of the company. Thus, he could have been personally liable for his negligent action and the company vicariously liable for the same action. Such an approach risks widespread liability for directors for negligent misstatement. An alternative approach is to ask if all of the elements of the tort are present. The question for negligent misstatement then becomes whether, as was decided in *Trevor Ivory*, the director in giving the advice is the mere mouthpiece of the company or whether, as an agent, the director incurs personal liability as well as liability for the company as principal. For negligent misstatement this is determined by deciding whether the director assumed responsibility for the statement. That is a question of fact that can be largely answered by deciding whether the director induced reliance on him or herself personally rather than simply purporting to represent the company.

This was the approach taken by the House of Lords when they looked at the question of the liability of directors in tort in two recent cases. Notwithstanding the Court of Appeal’s decision in *Trevor Ivory*, it is likely that New Zealand courts will find the reasoning in these cases persuasive. In *Williams v Natural Life Health Foods*,¹¹ the House of Lords considered that in a company context the issue will always be whether the fact of incorporation is enough to operate as an effective disclaimer of liability for a director for negligent misstatement. Lord Steyn made it clear that an objective assessment of the conduct of the director is required to determine whether or not the “notional disclaimer” brought about by the fact of incorporation is effective (at p.838):

“In the present case there was no personal dealings between [M] and the plaintiffs. There were no exchanges or conduct crossing the line which could have conveyed to the plaintiffs that [M] was willing to assume personal liability to them... I am also satisfied that there was not even evidence that the plaintiffs believed that [M] was undertaking personal responsibility to them.”

The test set out in the *Williams* case provides a relatively clear way of determining the liability of directors for

negligent misstatement. For any individual to be liable for negligent misstatement, there must be an assumption of responsibility by that person. When the person is a director of a company the statement will be taken to have been made on behalf of the company (with the director acting as the mouth piece of the company) unless the director assumes responsibility. This will be a question of fact and will ultimately depend on whether, objectively, the tort victim could have reasonably relied for the accuracy of the statement on the director rather than (or as well as) the company. In *Williams*, the director was not liable because one of the elements of the tort, an assumption of responsibility, was missing.

The difficulty that the courts have found determining when the words and actions of a company director should be separated from those of the company is illustrated in the second case, *Standard Chartered Bank*.¹² Mr Mehra, the managing director of Oakprime Ltd, knowingly made a false statement to Standard Chartered Bank (SCB) that enabled Oakprime Ltd to obtain payment under a letter of credit. SCB sued Mr Mehra and two others for deceit and was successful against all these defendants at first instance. PNSC and Mr Mehra appealed. In the Court of Appeal, Mr Mehra was successful and SCB appealed.

Mr Mehra had successfully argued in the Court of Appeal that he had made the fraudulent representation on behalf of Oakprime Ltd and not personally. He was identified as the company and therefore not considered to be liable separately. The Court of Appeal judges considered that they were following the approach of the House of Lords in *Williams*. In fact the House of Lords considered that the Court of Appeal had misinterpreted both *Williams* and the principles governing tort liability of directors.

Lord Hoffmann analysed the discussion of the *Williams* case in the Court of Appeal as follows:

“[The] decision had nothing to do with company law. It was an application of the law of principal and agent to the requirement of assumption of responsibility under the Hedley Byrne principle. Lord Steyn said it would have made no difference if Mr Williams’s principal had been a natural person. So one may test the matter by asking, whether, if Mr Mehra had been acting as manager for the owner of the business

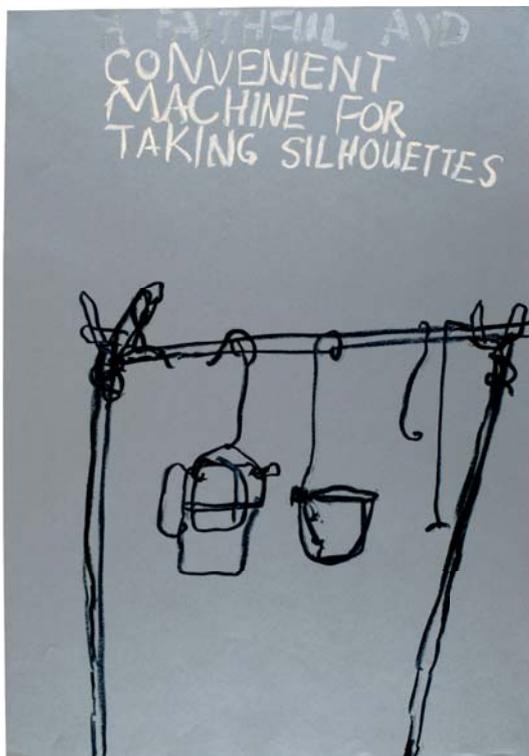
who lived in the South of France and had made a fraudulent representation within the scope of his employment, he could escape personal liability by saying that it must have been perfectly clear that he was not being fraudulent on his own behalf but exclusively on behalf of his employer.”

If directors who act on behalf of a company are viewed like any other agents of the company, their liability for tortious acts can be determined accordingly. If the director is viewed as an agent then, following agency law principles, the director will be normally liable for all of his or her torts (in addition to any liability that may fall on the company). Some

regard this as disastrous, arguing that exposing directors to personal liability for all torts negates the purpose of carrying on business using a limited liability company, especially in closely held companies. This is because the directors of closely held companies are almost always shareholders in the companies as well. Although one of the main functions of limited liability is to protect shareholders, not directors, the imposition of liability on directors in closely held companies would effectively take away the limited liability of the shareholders. Shareholders could not be directors without exposing themselves to personal liability for torts they commit, intentional or otherwise, while acting as directors of the company.

However, imposition of liability on directors in these circumstances can be viewed as legally distinct from the limited liability of shareholders. In cases involving intentional torts, like *Standard Chartered Bank*, where the intentional act was done by the direc-

tor in the course of the director’s duties, all the elements of the tort will be provable against the director. The director will therefore be held to be personally liable. (The company may also be found to be personally or vicariously liable). However, directors may not always be liable in cases involving non-intentional torts, such as negligent misstatement where one of the required elements for the tort is an assumption of responsibility by the director. That element may often be absent when company directors give advice on behalf of the company. Therefore, if a director personally assures a creditor that payment will be forthcoming, the director may incur liability under common law tort of deceit if the director knows that the statement is not true; or negligent misstatement if the statement was made carelessly and the creditor by words or conduct assumes responsibility for the statement. Trade creditors might well consider tort actions to be worthwhile with more certainty in this area likely in the future.



John Reynolds, *Epistomologies* (13), 2001, Oil stick on metallic paper, Auckland Art Gallery Toi o Tamaki, Gift of the Patrons of the Auckland Art Gallery and the artist 2002

Making company directors liable for their negligent or false advice has proved difficult recently. However, if, as the recent English authorities show, the liability of a director is assessed in the same way as any other agent who acts on behalf of a company, sheeting home liability to the director becomes more straightforward.

Reckless trading and incurring obligations that cannot be performed

Finally, and equally significantly, directors can be liable for reckless trading and for causing the company to enter into obligations that they cannot believe on reasonable grounds the company will be able to perform. The point might be made that there is little incentive to operate through a limited liability company, or indeed operating a business at all, if liability will be imposed as a matter of course in the event of company failure. Certainly, those were the comments made by many when the Companies Act was passed in 1993 and the duties set out in sections 135 and 136 (which ironically existed in only a slightly different form in the 1955 Act) were debated. However, the fact that there has been a dearth of actions brought under the provisions (less than ten), whilst perhaps largely reflecting perceived high litigation costs, would seem to suggest that sections 135 and 136 do not fetter entrepreneurial activity.

Section 136 says that a director 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. The courts have treated the basis of liability under the provision as objective, i.e., based on what a court determines a director would reasonably believe rather than a subjective test based on evidence of what the director actually believed. For example, in *Fatupaito v Bates*,¹³ even though the Judge accepted that the director honestly believed that continuing to trade would generate income in excess of the expenditure to be incurred, he took into account the director's knowledge that the company was insolvent and therefore decided that the decision to enter into further obligations was not reasonable. There is therefore an element of subjectivity in applying the test in that what the director actually knew in making the assessment under the section is taken into account. What the director can be shown to have intended at the time therefore is also relevant. For example, a director arranging for the company to enter into an obligation which the director has no intention that the company will perform will incur liability. Section 136 requires active agreement to entering into the obligation by a director before liability is imposed. Passive or inactive directors with no knowledge of the transaction will not be caught.

Section 135 deals with reckless trading. It states that a director must not "(a) agree to the business of the company being carried on in a manner likely to create a substantial risk or 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." The cases so far have involved situations where the directors have allowed the company to continue trading when it should have been obvious to any reasonable director that such a course would inevitably cause loss to the creditors of the company. This is both because the creditors might continue to extend credit to a hopelessly insolvent company and because there would be fewer assets remaining to pay creditors when the company eventually ceased trading and was liquidated.

Action is brought against directors pursuant to the provisions of the Companies Act 1993. The disadvantage of this remedy is, however, that an unsecured creditor either has to persuade the liquidator to take such action, or fund and bring the action on behalf of all the unsecured creditors. The amount recovered may not be the full amount owed to all the unsecured creditors. There has been no consistency in the cases decided so far in determining the extent of remedies payable to creditors by reckless directors. Whatever sum is awarded must be shared out pro rata amongst all the unsecured creditors. The courts also have no ability in the legislative provisions to take into account the conduct of creditors. Creditors who have taken steps to mitigate their losses are left in no better position than those who continued to advance money to a company knowing that it was in a hopeless position. The unpredictability and inconsistency of the Companies Act remedy may go some way to explain why it is so under-utilised. There are no such limits on the Fair Trading Act and common law tort remedies. A High Court judge has recently stated that the existence of the remedy in the Companies Act 1993 does not preclude the bringing of the other actions by unsecured creditors. Nevertheless in all the section 135 and 136 cases decided so far the unsecured creditors have been successful, with some substantial awards been made against company directors. Despite the drawbacks, the actions for reckless and insolvent trading remain effective weapons in the armoury of an unsecured creditor.

Conclusion

In New Zealand, companies can be set up online by an individual who needs only to pay the modest incorporation fees. Virtually no capital need be injected into the company and it is simple for anyone to take advantage of the limited liability structure. Preserving the integrity of the limited liability corporate structure is important. Part of the long title to the Companies Act 1993 states that it is intended "to reaffirm the value of the company as a means of achieving economic and social benefits through the aggregation of capital for productive purposes, the spreading of economic risk, and the taking of business risks." Limited liability is important as a protection for those who invest in companies as shareholders.

Almost as important is the presumption, affirmed in the late nineteenth century in *Salomon*, that companies are legally distinct and separate from their shareholders, directors and employees. It is important that directors do not auto-

Suggested further reading

For a more full analysis of the issues discussed in this article see Noonan, C and Watson, S, "Standard Chartered Bank : The Restoration of Sanity [2004] Journal of Business Law 539; Noonan, C and Watson S, "Rethinking the misunderstood and much maligned remedies for reckless and insolvent trading" (2004) 21 NZULR 26

Readers interested in the details of registration and liquidation of companies could refer to: www.companies.govt.nz and www.insolvency.govt.nz

The current leading text books on company law, tort law and the Fair Trading Act in New Zealand are Morison's Company and Securities Law, Lexis Nexis, 2004; Todd, S, et al, The Law of Torts in New Zealand, Brookers, 3rd ed, 2001; and Gault on Commercial Law, Brookers, 1994-

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matically incur personal liability if a business fails. But the presumption of separate legal entity should not and does not operate to protect the dishonest and the incompetent. In the period 1996/1997 to 2000/2001 there were 4,299 court-ordered liquidations. Very often directors of failed companies have behaved in a responsible manner and done everything possible to run the company effectively. But some have not. Either due to high litigation costs or a perception that there was no remedy available, only a tiny proportion of the directors of those insolvent companies were pursued through the courts. Companies were never intended to and do not act as a shield for those company directors who put their heads above the parapet and incur personal liability or those who recklessly cause or allow the company to trade on past the point of irrecoverable insolvency. Failure to sheet home liability to such individuals may not be caused so much by an inadequate company law regime but rather by an inadequate understanding by unsecured creditors and their advisors of the remedies that are available to them.

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