Neutral Citation Number: [2007] IEHC 55

THE HIGH COURT

[2005 No. 306 COS]

IN THE MATTER OF PINEROAD DISTRIBUTION LIMITED (IN VOLUNTARY LIQUIDATION) AND

IN THE MATTER OF SECTION 150 OF THE COMPANIES ACT, 1990 AND SECTION 56 OF THE COMPANY LAW ENFORCEMENT ACT, 2001

BETWEEN

JAMES STAFFORD

APPLICANT

AND

JOHN JOSEPH FLEMING AND MARIA FLEMING

RESPONDENTS

Judgment of Mr. Justice Hanna delivered on the 7th day of March 2007

1. In these proceedings, the applicant is the liquidator of Pineroad Distribution Limited ("the Company") appointed as such on 10th June, 2004. The respondents, John Joseph Fleming and Maria Fleming, were, respectively, an executive director and a non executive director and company secretary of the said company. It is accepted by all parties that the company is insolvent within the meaning of s. 214 of the Companies Act, 1963. The applicant brings this application pursuant to s. 150 of the Companies Act, 1990, as amended, seeking an order of this court restricting the respondents from acting as company director or secretary for a period of five years.

2. The company was involved in the haulage industry. The first respondent had operated a number of companies under the business name "Fleming Transport" since 1975. The company was incorporated in 1986 and the business of Fleming Transport was channelled through this company from October, 1988. The company appears to have traded quite successfully over the years with shareholders funds amounting to €1,023,446 according to the audited accounts for the year ending 30th September, 2001. By that time the company had approximately fifty five staff as well as a large fleet of in the order of seventy lorries and trucks, all of these under lease. There were approximately six leasing companies involved in the leasing arrangements.

3. A central figure in the day to day operation of the business was one Mr. Patrick Farrell, the company's operation manager. According to the first respondent, Mr. Farrell was an essential figure in the operation of the company, both in terms of the day to day running and contact with the company's customers. Mr. Fleming, therefore, was somewhat taken aback when, in the summer of 2001, Mr. Farrell tendered his resignation. Mr. Fleming says that apart altogether from the significant blow of losing such a central senior employee, there was a risk that Mr. Farrell would set up on his own and would entice customers to him, given the fact that he had such close and regular personal contact with them. The applicant does contest whether the potential to poach company customers was realistically there, but Mr. Fleming maintains that it was and in a somewhat terse supporting affidavit, Mr. Farrell agreed with him. How then to retain Mr. Farrell's services?

4. The respondents say that protracted negotiations followed in which it was determined, *inter alia*, that Mr. Farrell would be given a 10% stake in a new company ("Euroute"). Put simply, Euroute would be given the use of the company's employees, vehicles and other equipment in return for which it was intended that Euroute would pay the company's costs. The arrangement commenced in or around the month of October, 2001. It should be observed that no provision was made in the agreement between the respondent and Mr. Farrell for payment for the goodwill of the company and this is one of the features which causes concern to the applicant and causes him to apprehend that the deal between Mr. Fleming and Mr. Farrell was improvident as far as the shareholders' and creditors' interests were concerned. On the other hand, Mr. Fleming, asserts that the goodwill was not a matter of great import to him and that as of the time of entering into the arrangement with Mr. Farrell failure to provide for payment for the goodwill was a justifiable "call" in the circumstances which then obtained.

5. The statement of affairs prepared by the respondents shows a deficit of €1.424million. Of this, the Revenue Commissioners are preferential creditors in the amount of €380,704, such debts arising in the year previous to the commencement of the winding up. Further, in addition, the Revenue Commissioners account for the overwhelming preponderance of unsecured/non-preferential creditors. Out of the estimated liabilities of €592,967, the Collector General is owed sums of €513,526 in respect of VAT and €69,352 in respect of PAYE/PRSI, in total €582,878. Thus, the total revenue debt amounts to something in the order of 98% of the unsecured creditors. No money is owed to either of the respondents. Euroute is said to be owed €25 and a company called J.J. Fleming & Co. is said to be owed €403.

The Law

6. Counsel for both the applicant and the respondents had no difficulty in agreeing the relevant principles of law. The leading case on s. 150 of the Companies Act, 1990 is *Re Squash Ireland Limited* [2001] 3 I.R. 35. At pp. 39 to 40, McGuinness J. says in reference to directors:-

> "The question before the court is whether they acted responsibly and this, as was correctly stated by counsel on behalf of the respondent, must be judged by an objective standard. In the case of all companies which have become insolvent it is likely that some criticisms of the directors may be made. Commercial errors may have occurred; misjudgments may well have been made; but to categorise conduct as irresponsible I feel that one must go further than this."

7. Quoting a passage from the judgment of Browne-Wilkinson V.C. in *Re Lo-Line Motors Limited* [1988] Ch. 477 at p. 485 -6 McGuinness J. adopted the following:-

> "What is the proper approach to deciding whether someone is unfit to be a director? The approach adopted in all the cases to which I have been referred is probably the same. The primary purpose of the section is not to punish the individual but to protect the public against the future conduct of companies by persons whose past record as directors of insolvent companies have shown them to be a danger to creditors and others... Ordinary commercial misjudgment is in itself not sufficient to justify disqualification. In the normal case, the conduct complained of must display a lack of commercial probity, although I have no doubt that in an extreme case of gross negligence or total incompetence disqualification could be appropriate."

8. McGuinness J. then went on to adopt the test set out by Shanley J. in *La Moselle Clothing Limited v. Soualhi* [1998] 2 I.L.R.M. 345 which sets out five criteria to which the court should have regard. They are as follows:-

> 1. The extent to which the director has or has not complied with any obligation imposed on him by the Companies Acts,

1963 to 1990.

2. The extent to which his conduct could be regarded as so incompetent as to amount to irresponsibility.

3. The extent of the directorate responsibility for the insolvency of the company,

4. The extent of the directorate responsibility for the net deficiency in the assets of the company disclosed at the date of the winding up or thereafter.

5. The extent to which the director, in his conduct of the affairs of the company, has displayed a lack of commercial probity or want of proper standards.

9. McGuinness J. goes on to state that the entirety of the tenure of the director should be considered and not just the few months in the run up to the liquidation.

10. Since the decision in *Squash Ireland* [2001] 3 I.R. 35 there have been a number of important decisions of the High Court which greatly assist the consideration of s. 150 cases. In *Re. Tralee Beef and Lamb* (Unreported, High Court, 20th July, 2004) Finlay Geoghegan J. says:-

> "In *re Vehicle Imports Limited (in liquidation)* (Unreported, High Court, Murphy J., 23rd November, 2000) Murphy J. cited with approval the relatively recent formulation of those duties by Jonathan Parker J. In *re Barings plc. and Ors*. (No. 5) *Secretary of State for Trade and Industry v Baker and Ors*. [1999] 1 BCLC 433. I would also respectfully agree with the general formulation of the duty of an individual director as stated by Jonathan Parker J. at p. 435:-
>
> > 'Each individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them.'
>
> Later at p. 436 Jonathan Parker J. derives three general propositions from earlier authorities in relation to duties of directors which appear helpful:-
>
> > (i) 'Directors had, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.
> >
> > (ii) Whilst directors were entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation did not absolve a director from the duty to supervise the discharge of the delegated functions.
> >
> > (iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, depended on the facts of each particular case, including the director's role in the management of the company.'"

11. In the more recent case of *Re Swanpool Limited* (Unreported, High Court, Clarke J., 4th November, 2005), he says at p. 9:-

> "In broad terms there would seem to me to be three types of situation which the court is typically required to consider in such applications. They are:-
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> > 1. Issues involving compliance by the company with its formal obligations under the Companies Acts including keeping books and records, making returns, holding meetings and the like;
> >
> > 2. The commercial management of the company most particularly at the period when the company was insolvent or heading in that direction; and
> >
> > 3. Compliance by the directors with the obligations identified in the *Frederic (sic) Inns* to ensure that once the company was facing insolvency its assets were dealt with in a manner designed to ensure the proper distribution of those assets in accordance with insolvency law."

12. Turning to tax deficiencies in *Re Digital Channel Partners* [2004] 2 I.L.R.M. 35, Finlay Geoghegan J. dealing with tax failures for a period of some four to five months between November, 2001 and March, 2002 said as follows:-

> "There are, I think, two ways of looking at the failures to make tax returns. The failures to make tax returns are clearly in breach of the relevant Taxes Act. Similarly the failure to make the payments are in breach of the Taxes Acts. The mere fact that a company is in breach for, as in this case, a relatively limited period will not of itself, it seems to me, indicate that the directorate of the Company have acted either dishonestly or irresponsibly in such a way as to preclude my concluding that overall they acted responsibly and honestly in relation to the conduct of the affairs of this Company. Unfortunately and inevitably where companies under significant financial pressure this may occur.
>
> It appears to me that in relation to tax liabilities there must be something more than a limited failure over a period to indicate that the directors have acted irresponsibly. This has been put in a number of different ways and certainly insofar as there may be evidence that there either has been selective distribution or selective payment of liabilities of a company or indeed a total disregard of obligations to the Revenue or even a decision to effectively seek to use taxation liabilities for the purpose of financing a company, that of itself will normally be indicative of the fact that the directors have been acting at least irresponsibly."

13. It seems to me that two further important guiding principles must be highlighted in the consideration of this case. Firstly, one must have regard to the words of Murphy J. in *Business Communications v. Baxter* (Unreported, High Court, 21st July, 1995) where he says:-

> "Of course one must be careful not to be wise after the event. There must be no 'witch hunt' because a business failed as businesses will."

14. On a similar theme, in *Re The Computer Learning Centre Limited; O'Ferrall v. Gill* (Unreported, High Court, 7th February, 2005), Finlay Geoghegan J. states:-

> "In considering whether or not the respondent directors have established that they acted responsibly notwithstanding continuing to trade until late 2002 counsel on their behalf urged that the court should avoid considering the actions of the directors with the benefit of hindsight and referred to prior judicial statements to that effect. I accept that the court in considering an application under s. 150 of the Act of 1990 and actions of directors prior to winding up must be extremely careful to avoid considering same with the benefit of hindsight."

15. Finally, referring to s. 150 in *Re. Usit World plc* (Unreported, High Court, 10th August, 2005) Peart J. says:-

> "… I find the link between the conduct of the directors and the collapse of the companies in question to be one which requires the most careful scrutiny. It follows in my view that the burden on a director seeking to satisfy the Court as to his/her behaviour in relation to conduct in the affairs of the company for the purposes of escaping from an order under the section, includes if necessary, establishing that where there are matters about which they can be rightly the subject of criticism, there is in reality no causal link between those culpable matters and the insolvency. This would certainly apply in my view in relation to irresponsibility, since irresponsibility can be a matter of degree. Where honesty is at issue and the Court has not been satisfied that the director has acted honestly, that dishonesty is more fundamental and goes to the core of a person's integrity. I say that even though the section draws no distinction between honesty and responsibility. But it is significant that both words have been used in the section."

Matters Which Concern the Liquidator

16. In seeking to discharge the onus cast upon them to establish that they should not be restricted, the respondents must confront four issues which have caused the Liquidator concerns. The first two I will deal with together at numeral 1.

> 1. The arrangements and dealings between the company and Euroute including the transfer of the goodwill of the company.
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> 2. Whether the company used revenue monies to stay afloat.
>
> 3. How long was the company insolvent?

17. I will deal with each of the matters in turn.

> 1. The applicant says that the statement of affairs as at 10th June, 2004, prepared by the first named respondent shows that the company was insolvent to the extent of €1,426,372. However, the applicant says that this statement of affairs is incorrect as a result of the failure by the Board of Directors properly to estimate the revenue liabilities. The statement of affairs shows a VAT shortfall of €787,389 and a shortfall in PAYE/PRSI of €176,193. No provision is made in it for interest and arrears. According to the statement of affairs, the revenue liabilities amounted to €963,582. The actual liabilities, according to the applicant, were €1,131,330 for VAT, €267,877 for PAYE/PRSI, interest calculated at €477,313 making a total of €1,876,520, a difference of €912,938.
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> The Liquidator points to the contrasting fortunes of Euroute. In 2001, it made profits of €90,535, in 2002, €3,347 and in 2003, €140,998. How can it be responsible, he posits, for directors to enter into an arrangement in which the company incurs very significant and mounting losses and moves from solvency to insolvency while the transferee reaps the benefits and makes profits? The Liquidator submits that the arrangement favoured Euroute to the cost of the creditors of the company, almost exclusively the Revenue Commissioners. The Liquidator says that there is no evidence that any of the profits made by Euroute in the three year period of 2001 to 2003 were returned to the company.
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> The respondents contend, that all of the company's costs in return for the use of employees and equipment were met by Euroute but that the shortfall arose because much of the monies received were used to meet the company's historic liabilities.
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> I find the respondents' explanation difficult to accept. Looming large on every aspect of this application is the historic revenue liability. When one compares and contrasts the fates of both companies, it is difficult to escape the conclusion that the respondents simply did not have regard to the relatively enormous tax liability in structuring the new company arrangement with Mr. Farrell. Further, insofar as any monies were directed back into the company from Euroute, even if I were to accept the respondent's explanation, it would appear obvious that the level of charges agreed between the company and Euroute fell dramatically short of what was required to meet the company's liabilities.
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> Turning to the question of the absence of goodwill, the Liquidator argues that this was an improvident arrangement as far as the company was concerned. The effect of the arrangement was that the entire workforce and in the order of seventy trucks were transferred to Euroute which had no setup costs and carried on the business of the company which had done well for a period of some thirteen years. The goodwill of the company was a valuable asset. Relying on *Aveling Barford v. Perion* [1989] B.C.L.C. 626, the Liquidator contends that such a transfer should be done only out of profits properly available for distribution or alternatively by a reduction of capital duly made. He does, however, concede that this is a matter for argument.
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> The respondents argue that goodwill was not a matter which concerned them greatly. The haulage industry, the first named respondent asserts, is highly price sensitive and client loyalty counts for little. His over arching concern as a director was, in a positive sense, to retain Mr. Farrell's highly valued services and in a negative sense to prevent Mr. Farrell setting up on his own and raiding the respondents' client base. Mr. Fleming argues that he took advice (the advisor is not specified) and understood that what was done was perfectly legal and answered Mr. Farrell's concerns about his potential tax liability on coming into a 10% share of the business.
>
> Whereas, I understand the concerns of the Liquidator on this point it seems to me that I should attach considerable weight to Mr. Fleming's knowledge and experience of the haulage industry. He had been trading successfully for years and would, no doubt, be acutely aware of the potential downside of the business.
>
> Again, the entire arrangement must be seen in the context of what was an aggressive campaign to recruit new business

in which several highly lucrative contracts were being sought. What were the reasonable expectations of the respondents and indeed, of Mr. Farrell at the time. Absent the proportions of the Revenue debt, I do not think one could necessarily criticise the arrangement entered into. Taken in isolation, the failure to make any provision for payment for the goodwill might be justified in the overall scheme of things given the legitimate expectations of the respondents and Mr. Farrell. The fact that those expectations did not materialise is no fault of theirs and I am sure that every effort was made to bring the contracts in. As has already been observed, businesses do fail and plans, however realistic, fall unfulfilled.

However, even allowing generous latitude for the exercise of business decisions one cannot escape the fact that the Revenue debt here was of such large proportions, that it had built up over a period of years prior to the inter company arrangements and that trade continued for a period of approximately two years during which time the company's taxation liabilities were not meaningfully addressed.

2. Having observed that the Revenue debt in this case represents in the order of 98% of the secured and unsecured sums outstanding from the company it is, clearly, a fundamental question to ask why this is so. I accept the evidence of the applicant that this problem goes back as far as 1994 and, further, I see no reason to doubt the Liquidator's figure, in the order of €1.8 million as representing the level of Revenue debt as opposed to the lesser sum of approximately €900,000 identified in the statement of affairs.

When the company entered into an arrangement with the Revenue Commissioners whereby a portion of the VAT liability was discharged by direct debit with a balance to be discharged at the end of each year, referred to in the course of the hearing as a VAT 3 Return, it was contended on behalf of the respondents, that at all times, they relied upon "financial advisors" to attend to these matters for them. Notwithstanding this, over the years a very substantial VAT liability grew. In addition to this, PAYE/PRSI liabilities to an amount of €267,877 also fell into arrears. This occurred during the years 2003 and 2004.

In the company's 2001 accounts creditors and accruals are shown as €982,762, up from €937,350 the previous year. It would, therefore, appear to be the case that the seeds of the insolvency were sown back in 1994 and these in turn were nourished over the years by, culpable ignorance on the part of the respondents. It is surprising to say the least that the Revenue Commissioners did not themselves become involved over the years given that what was clearly a major concern seemed to be making relatively modest VAT returns and failing to make VAT 3 returns on a continuous basis.

In any event, it is clear as of the 2001 accounts that there was a major problem with regard to the amount of Value Added Tax owed. In my view, given the proportions of the problem, what otherwise might have been in far less serious circumstances, an understandable and indeed, laudable attempt to trade out of the difficulty in a short term fashion became an act of irresponsibility. If the dimensions of the tax problems were not clear to the respondents as directors by 2001 then they ought to have been. Furthermore, not only were insufficient steps taken to address the problem but it would seem apparent in view of the PAYE/PRSI liabilities, that the company traded using these monies and in this regard I prefer the Liquidator's analysis. I find myself in agreement with the views of McCracken J. in *Duignan v. Stephen Arthur Carway and Others* (Unreported, High Court, 23 January 2002) where he says at p. 7 of his judgment:-

> Indeed it is clear that at least from the beginning of 1993 this Company was being kept alive by the fact that it was in effect trading on monies due to the Revenue, and allowing huge arrears to build up, together with the attendant interest. Quite astonishingly Dr. Forde SC attempted to justify this situation by arguing that if a company is temporarily short of funds, it may be justified in not paying the Revenue and in effect taking a loan on interest to keep the company going. P.A.Y.E. and P.R.S.I. are monies which a company pays to the Revenue on behalf of its employees, and constitutes its employees tax and its employees social insurance. To try to justify trading by using what is in effect its employees money without their knowledge or consent, is to me a quite bizarre and totally irresponsible attitude. This appears to have been a policy of the Board of Directors, and is not something which can be attributable to any one particular director. On this ground alone I have no doubt that the directors must be restricted under s. 150."

It seems to me that the respondents here, being at best culpably ignorant of the company's tax affairs, acted irresponsibly. They failed to acquaint themselves with the company's tax affairs and, when in 2001, they commenced the new arrangement I am satisfied that they continued to trade and used Revenue monies in so doing. The result of this is borne out by the final figures in which, in a small list of creditors both secured and unsecured, nobody is owed more than €2,000 apart, of course, from the Revenue Commissioners.

Much is made by the respondents of the fact that the first named respondent personally paid a sum of €1.1 million to the Revenue Commissioners between 2003 and 2004. He offers this as a token of the confidence that he had in the company's prospects in the protracted and ultimately unsuccessful negotiations to enter into trading arrangements with various companies. Whereas I have no doubt that Mr. Fleming did pay this money I have substantial doubts that the monies were paid for that reason. Firstly, the monies were channelled through Euroute and would have the appearance to me of the discharge of the inter company debt from Euroute to the company. Secondly, the statement of affairs of the company does not refer to Mr. Fleming as a creditor. Thirdly, it appears that of the monies paid, in excess of €600,000 was paid by bank draft under the threat of seizure of the company's assets including its vehicles by the Revenue Sheriff. It was not disputed by the respondents that such were the circumstances which preceded the payment. Accordingly, the first respondent has not satisfied me that I should regard his €1.1 million payment in the manner in which he asserts.

3. As I have already observed, the seeds of the company's problems were sown as far back as 1994. By 2001, as I have already stated, at the very least the respondents ought to have been aware of the historic VAT liability problem. Notwithstanding this, the respondents continued to trade and into the pool of debt was now thrown the PAYE/PRSI money. Given the fact that new arrangements were being agreed with Mr. Farrell in order to keep him onside and even allowing for a "head in the sand" approach to the company's Revenue debt, it is difficult to believe that the respondents were not aware as and from 2001 onwards of the serious and mounting revenue problem. To extend to them the benefit of wilful ignorance of the company's parlous state would, in my view, still amount to recklessness of the highest order. The respondents have sought to rely on the judgment of Lynch J. in *Re Hefferon Kearns Limited (No. 2)* [1993] 3 I.R. 191, a decision dealing with the interpretation of s. 33 of the Companies Amendment Act, 1990. In that case, as the respondents rightly argue, it is not always inappropriate to continue to trade in circumstances where directors reasonably believe that they can trade out of their difficulties. But that case deals with a period of some one or two months during which the trading carried on. In this case, the period was greater than that, approximately two years.

Conclusions

18. I am of the view that although the respondents did not act in a consciously dishonest way nevertheless they acted in a grossly irresponsible way in the first instance, in shutting their eyes to a long standing and greatly increasing debt and, ultimately, at a point when they must have been aware of that debt, in continuing to trade for a period far beyond what could reasonably be excused having regard to the enormous scope of their tax problems. In so doing, they acted with gross recklessness and contrary to the interests of the creditors of the company. As it happens, the vast bulk of the debt was a Revenue one.

19. In the circumstances I feel I have no option but to restrict the respondents for a period of five years pursuant to s. 150 of the Companies Act, 1990 as amended.