IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

CIV-2001-404-2403
CP665-SD01

UNDER	the Companies Act 1993, sections 56, 135, 136 and 301
IN THE MATTER OF	DML RESOURCES LIMITED (IN LIQUIDATION)
BETWEEN	J L VAGUE AND G G MCDONALD AND DML RESOURCES LIMITED (IN LIQUIDATION) Plaintiffs
AND	C W MCCARTHY AND OTHERS Defendant
AND	CHAPMAN TRIPP SHEFFIELD YOUNG Third Party

CIV-2001-404-2403
CP166-SD01

AND	
IN THE MATTER OF	DML RESOURCES (ASIA) LIMITED (IN LIQUIDATION)
BETWEEN	DML RESOURCES LTD (IN LIQUIDATION) Plaintiff
AND	M J BOLTON AND ANOTHER Defendant
AND	CHAPMAN TRIPP SHEFFIELD YOUNG Third Party

Hearing: 3 July and 29 August 2003

Appearances: J A Farmer QC, D M Connor and S A Litchfield for Third Party (in support)
K W Fulton for Plaintiff (to oppose)
P Courtney and N Hay for Defendants (abiding decision of Court)

Judgment: 18 September 2003

JUDGMENT (NO. 2) OF HEATH J

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Introduction

[1] This is an application to strike out part of a claim by which DML Resources Ltd [DML] sues three of its former directors under s56 of the Companies Act 1993 [the Act]. Mr Fulton, for DML, submits that valuable assets of DML were transferred out of that company for the benefit of its shareholders. He submits that two of the transactions amount to a "distribution" for the benefit of shareholders. Further, he submits that the distributions are recoverable from the directors under s56(4) of the Act. The transactions giving rise to the claim were part of wider re-structuring arrangements for a group of companies of which DML formed part.

[2] The Act requires the board of directors of a company to determine whether it is solvent before returning wealth to its shareholders. As shareholders stand behind creditors in the priorities in which they are paid on insolvency, it is inappropriate for a shareholder to receive benefits, ahead of creditors, at a time when the company is insolvent. The need for a company to be solvent before distributions are made to shareholders is underscored by provisions in the Act by which a company may seek recovery of amounts distributed from shareholders and directors: see s56(1), (2) and (4) of the Act.

[3] The Act requires directors of a company to turn their minds, individually and collectively, to the question whether the company will, immediately after a distribution to shareholders, satisfy the solvency test set out in s4 of the Act: s52(1). Each director who votes in favour of a distribution must sign a certificate stating that, in his or her opinion, the company will satisfy the solvency test immediately after the distribution is made; the grounds for that opinion must also be stated: s52(2). In this case it is agreed that no such process was undertaken by the directors in respect of the two challenged transactions.

[4] Sometimes directors will make a deliberate decision to distribute funds to shareholders without following the statutory process laid down by s52 of the Act. On other occasions a net transfer of wealth from a company to creditors may be authorised by the board of a company in ignorance of the need to comply with s52. Ignorance of the need to comply may result from a lack of comprehension of the legal requirements or from a misunderstanding of the character of the proposed transaction. The reason for the failure to comply may be relevant as, under s56(4) of the Act, only a director who fails "to take reasonable steps to prevent the distribution being made" may be personally liable to repay so much of the distribution as cannot be recovered from shareholders.

Background to the distribution claims

[5] In 1996-1997 DML was part of a group of companies known as the Skellerup Group of Companies. Those companies comprised a charging group. Each member of the charging group gave security in favour of a syndicate of lenders over its individual undertaking and executed cross guarantees in respect of indebtedness owed by other members of the group.

[6] A decision was made to re-structure the affairs of the charging group. The re-structuring was undertaken to provide further working capital. DML asserts that the re-structuring took place at a time when it was insolvent. Further, DML asserts that it was removed from the charging group so that secured lenders and shareholders of DML could realise value from its good assets.

[7] A series of transactions were entered into on 8 August 1997 to effect the re-structuring. The order in which component transactions of the re-structuring were to be completed was set out in a detailed document headed:

> MAINE RE-STRUCTURING
>
> Completion Memorandum
>
> 8 August 1997

I refer to this document as the "Completion Memorandum". The Completion Memorandum (which is four pages long) is annexed to the Second Amended Statement of Claim. It is a document on which DML relies to prove its case.

[8] The Completion Memorandum explains a number of preliminary steps, including incorporation of companies, the acquisition of assets by or from existing members of the group and assignment of debts from existing members of the group. Some new companies were incorporated in Australia; others in New Zealand. The Completion Memorandum also details the transactions to be effected on settlement in order to facilitate the injection of additional working capital. On settlement DML and its subsidiaries were to be released from the charging group.

[9] My summary of the Completion Memorandum is necessarily brief and incomplete. The transactions involved are complex. For the purposes of this judgment it is unnecessary to refer to the re-structuring arrangements in greater detail. I shall, however, outline particular aspects of the re-structuring when discussing the challenged transactions.

[10] Between 1 March 1986 and 7 August 1987 there were 12,001,000 issued shares in DML. Skellerup Group Ltd owned 11,999,999 ordinary shares. Skellerup Trustee Share Co Ltd owned one. In addition, there were 1000 preference shares which carried the right to receive dividends. While there is a dispute as to whether, at material times, those shares were owned by Maine Investments Ltd or Maine Industries Ltd, DML's pleading alleges that the impugned transactions were entered into "for the direct or indirect benefit of DML's shareholders [Skellerup Group Ltd] and/or [Maine Investments Ltd] in relation to shares held by" those shareholders. For

the purposes of this strike out application it is unnecessary for me to resolve the question whether Maine Investments Ltd was a shareholder of DML at material times.

[11] The Completion Memorandum makes it clear that Maine Investments Ltd was to become the overall holding company for the group. Both DML and certain Australian subsidiaries (DML Resources Pty Ltd [DML Pty] and DML Resources (WA) Pty Ltd) entered into transactions as part of the re-structuring. A new DML company (DML Resources (1997) Ltd [DML 97]) was incorporated to acquire shares in DML. The majority shareholder in DML 97 was an entity called Vermont Investments Ltd [Vermont]. That company had a role in the provision of fresh working capital to the Skellerup Group.

[12] DML's claims focus on two of the transactions involved in the re-structuring arrangements. They are called the Maine Indemnity and Armadillo transactions respectively. DML claims $A19,449,000 on the Maine Indemnity transaction and $NZ20,601,292 on the Armadillo transaction. I refer to these claims as the distribution claims.

[13] DML seeks recovery of the value of each distribution from the three former directors it sues. The directors acknowledge that they did not comply with s52 of the Act. They say that the two challenged transactions do not fall within the definition of the term "distribution" in s2(1) of the Act.

[14] The claims form two causes of action in a complex civil proceeding brought by DML and its liquidators against former directors of DML. It is unnecessary, for present purposes, to refer to other aspects of the claims. They are contained in the Second Amended Statement of Claim of 20 February 2003, a formidable document running to 709 paragraphs and a number of appendices.

[15] The three directors against whom the distribution claims are made seek contribution or indemnity from Chapman Tripp Sheffield Young [the solicitors] in respect of any amounts for which they may be held liable. The solicitors were engaged to advise on re-structuring arrangements involving the Skellerup Group of Companies. The directors allege that the solicitors ought to have realised that their

advice to DML and associated entities, in relation to the re-structuring, would also have been relied upon by the directors in committing DML to the transactions under attack in this proceeding.

[16] The solicitors seek an order striking out DML's distribution claims against the directors. Although the solicitors have not been sued directly by DML, the claims for contribution or indemnity made by the directors can only succeed if DML succeeds in its claims against the directors. I am satisfied, therefore, that the solicitors have standing to bring the strike out application in respect of DML's substantive claim against the directors. The directors abide the decision of the Court.

[17] As the substantive hearing is scheduled to commence before me on 9 February 2004 over six sitting weeks, a prompt decision is required. In the time available it is not possible for me to discuss fully the able arguments developed by counsel. Instead, I focus on those issues which, in my view, determine the application.

[18] I analyse the issues in the following sequence:

a) First, I consider the principles applicable on a strike out application.

b) Second, I explain the nature of the two challenged transactions.

c) Third, I outline the competing submissions of counsel on the issues I have identified as being determinative of the strike out application.

d) Fourth, I review the statutory framework in which the "distribution" provisions of the Act are found. I also consider the policy underpinning the statutory provisions.

e) Fifth, I analyse the two claims and determine whether they ought to be permitted to go to trial.

f) Sixth, I express my conclusions.

Strike out application: principles and issues

[19] On an application to strike out, the Court must proceed on the assumption that the facts as pleaded are capable of being proved unless, exceptionally, evidence is adduced which demonstrates that an allegation of fact is plainly wrong. It is well settled that before the Court may strike out proceedings the causes of action must be so clearly untenable that they cannot possibly succeed: see *Attorney-General v Prince and Gardner* [1998] 1 NZLR 262 (CA) at 267.

[20] The exceptional use of evidence to disprove a pleaded fact was put in the following way by McKay J, delivering the judgment of the Court of Appeal in *CED Distributors (1988) Ltd v Computer Logic Ltd (In Receivership)* (1991) 4 PRNZ 35 at 41:

> There will be occasions when brief affidavit evidence may assist a proper understanding of a pleading, may exhibit a pleaded document, or may deal with factual material that is undisputed. This is appropriate. But the Court on an application to strike out a pleading for failure to disclose a causes of action will not attempt to resolve genuinely disputed issues of fact or consider evidence inconsistent with the pleading.

[21] Applying the observations of McKay J in *CED Distributors* I have had regard to two affidavits sworn by Mr Hagen on behalf of DML on the basis that his evidence assists a proper understanding of the relevant causes of action. I have had regard to the affidavit of Mr Strowger, filed by the solicitors, to the extent that the pleaded documents have been annexed in full. I have not, however, drawn on Mr Strowger's affidavit on matters of fact which are inconsistent with allegations contained in DML's Second Amended Statement of Claim.

[22] In *CED Distributors*, at 46, McKay J added a word of caution applicable to cases in which counsel sought to resist an application to strike out on the ground that a pleading could be amended to overcome any objection. McKay J said:

> As a matter of practice counsel seeking to resist an application to strike out a pleading on the ground that it can be amended to overcome the objection should attempt to formulate the proposed amendment for consideration in the course of argument. There will be occasions when the need for amendment emerges only in the course of argument, but in many cases it will be apparent much earlier that amendment will be necessary if the pleading is to be retained. The argument will then be better concentrated if a draft is available.

[23] The directors agree that the process envisaged by s52 of the Act was not embarked upon by the board of the company before the two challenged transactions were entered into by DML. Rather, the issue is whether, as a matter of law, the challenged transactions fell within the definition of a “distribution”. That question turns on whether the transactions resulted in DML (directly or indirectly) transferring wealth to, or incurring a liability for the benefit of, its shareholders “in relation to shares held by” the shareholders. The question for my determination is whether the pleadings, as presently formulated, give rise to an arguable case that an unlawful distributions were made.

[24] DML alleges that, at material times, it was insolvent. That allegation must be accepted as capable of proof for the purpose of the present application.

[25] Mr Fulton also resisted the strike out application on other grounds. First, he submitted that the delay in bringing the application was sufficient to justify its dismissal. Second, he relied upon other discretionary matters: in particular an earlier ruling, on an interlocutory application, by a Master who indicated the need for a broad factual inquiry at trial as an integral feature of disposition of the claim. I am not persuaded that any of those factors are determinative of the application. The application raises a fundamental issue as to whether a claim in the form made by DML is capable of being regarded, at law, as a distribution. Accordingly, I proceed to consider the application on its merits.

The two challenged transactions

(a) The nature of the challenge

[26] The case for DML relies on the proposition that the two transactions amounted to a distribution by DML to its shareholders, but, particularly to its majority shareholder Skellerup Group Ltd. Affidavits sworn by a distinguished chartered accountant, Mr Hagen, have drawn together various strands of the claim to articulate them in their commercial setting. I refer, in what follows, to Mr Hagen’s second affidavit.

[27] A summary of Mr Hagen's analysis is set out below:

a) As at 21 February 1996, Skellerup Group Ltd was the majority shareholder of DML.

b) On 21 February 1996, Maine Investments Ltd acquired the majority shareholding in, and therefore controlled, Skellerup Group Ltd. Maine Investments Ltd was the company used to facilitate the take-over of the Skellerup Group as part of a leveraged buy out.

c) The take-over was financed by a banking syndicate led by the Bank of New Zealand. A series of debentures and cross guarantees were entered into by various members of the Skellerup Group, including DML. Maine Investments Ltd was the principal borrower. The remaining companies in the group executed debentures in favour of the lender to support guarantees given. Members of the group, below Maine Investments Ltd, comprised the charging group.

d) Problems arose. Maine Investments Ltd made a proposal to the banking syndicate on 25 June 1997. A proposal to restructuring the charging group was made. That proposal was subsequently carried into effect by the transactions effected on 8 August 1997.

e) At para 13 of his affidavit, Mr Hagen deposes:

> *It appears to me that the whole set of transactions* within which the two challenged transactions took place *were designed to remove the DML Group from the Charging Group, but to allow the bank funding to be maintained by a reduced and additionally capitalised charging group and to be re-organised.* Assets belonging to DML seen as having real value were dealt with in such a way that they could be held as security for the obligations by [Skellerup Group Ltd], [Maine Investments Ltd] and others. [my emphasis]

[28] Mr Hagen opines that a benefit to Skellerup Group Ltd and Maine Investments Ltd arose from the two transactions because:

a) A capital injection of $30m (by Vermont) would not have been made had the transfer of DML assets not taken place. Without that capital injection the re-structuring could not have occurred.

b) Had the DML assets not been transferred it is likely that more capital would have been required to allow the DML Group to exit from the charging group.

c) The transactions occurred in response to insolvency issues and "seemingly in the face of threats to the very survival of the entire Charging Group".

(b) The Maine Indemnity transaction

[29] Paragraph 663 of the Second Amended Statement of Claim alleges that a Deed of Indemnity was executed by Maine Investments Ltd in favour of DML on 1 October 1996. Clause 2.1 of that deed provided:

> 2.1 Maine covenants with DML to indemnity DML from all losses that DML will suffer in the event that amounts owing to DML and described in this Deed as Receivables are not paid in full to DML by the parties owing the said amounts to DML.

[30] The receivables to which the indemnity deed refers were valued at $A19,449,000. The debt in question was owed by Hunter Valley Coal Corporation Pty Ltd. That debt was the subject of legal proceedings in the Supreme Court of New South Wales in which Hunter Valley Coal Corporation sued DML Pty (a subsidiary of DML) for damages arising out of mining work carried out by DML Pty for Hunter Valley Coal Corporation at Mt Owen, New South Wales. That is made clear an agreement of assignment between DML Resources Pty Ltd and Maine Investments Ltd dated 8 August 1997 which records, in its second preamble, that:

> Due to a corporate group re-structuring, [DML Pty] proposes to assign the benefits of the [New South Wales] litigation to Maine on the terms and conditions set out in this agreement.

On 8 August 1997 a Deed of Assignment of Indemnity was also executed between DML (as assignor) and Maine Investments (as assignee) in respect of the same receivable. In consideration of Maine Investments agreeing to assume $5,569,063 indebtedness due by DML Resources Pty Ltd to Skellerup Group (Australia) Pty Ltd DML assigned to Maine absolutely "all DML's right, title and interest under the indemnity": cl 1 of the Deed of Assignment of Indemnity.

[31] DML pleads that the transaction was entered into for the direct or indirect benefit of Skellerup Group Ltd in relation to shares held by that company in DML. Particulars of the transaction, for the purpose of the distribution claim, are set out in para 672(a) of the Second Amended Statement of Claim. I summarise the effect of those particulars as follows:

a) The transaction enabled (or required) related transactions to take place which (*inter alia*) allowed Skellerup Group Limited to gain an increase in working capital of $10,000,000.

   The related transactions are expressly pleaded to have occurred in the manner stipulated by the Completion Memorandum to which I referred in para [7] above.

b) The transaction enabled Skellerup Group Ltd to borrow more than $95,000,000 from the Bank of New Zealand and other lenders and to secure that borrowing against the underlying claim that DML Pty had against BHP [the parent of the Hunter Valley company] in respect of which the indemnity was given – which was, at the same time, transferred to Armadillo Asset Holdings Limited [Armadillo].

c) The transaction saw Armadillo acquire a debt due by Skellerup Group Ltd to DML and thereby ensure that no demand would be made. This was done in circumstances tantamount to a release of Skellerup Group Ltd indebtedness.

d) As part of completing the Maine Indemnity transaction, Skellerup Group Ltd on 8 August 1997 transferred its shares in DML to DML 97 for $6,000,000. The majority of the shares in DML 97 were owned by Vermont.

e) Vermont also acquired the majority of the shares in Maine Investments Ltd, which continued to own the majority of shares in Skellerup Group Ltd. Accordingly, immediately after the transaction, both DML and Skellerup Group Ltd were ultimately owned by Vermont.

f) Notwithstanding that the Maine Indemnity transaction was documented as an assignment, it was in substance a "distribution" as defined in s2(1) of the Act. It was made in circumstances where DML was insolvent and under which DML received no, or grossly inadequate, consideration.

[32] DML asserts that the transaction was undertaken without compliance of s52 of the Act. It therefore seeks to recover the value of the indemnity.

(c) The Armadillo transaction

[33] The Armadillo transaction was another part of the wider re-structuring arrangements documented in the Completion Memorandum.

[34] A DML directors' resolution of 8 August 1997 included the following statement:

> The Board resolved that the Company shall enter into and execute an agreement for sale and purchase of shares in Diesel Propulsions NZ Limited an (sic) assignment of a receivable owing by Skellerup Group Limited between the Company (as vendor) and [Armadillo] (as purchaser), in the form produced to the Board, pursuant to which the Company agrees to sell all the issued share capital of Diesel Propulsions NZ Limited and assign indebtedness of $4,601,292 due to it by Skellerup Group Limited in consideration of the purchaser assuming $12,343,074 indebtedness due by the Company to Maine Investments Limited and $8,258,218 indebtedness due by [DML Pty] to Skellerup Group (Australia) Limited (the Board being satisfied that the consideration is fair and reasonable).

[35] On the same day DML resolved to enter into a Deed of Novation involving DML , Maine Investments Ltd and Armadillo pursuant to which Armadillo was to assume $12,343,074 indebtedness owing by DML to Maine Investments Ltd, in return for Maine Investment Ltd releasing DML from any further obligations or liabilities.

[36] Documentation was executed to give effect to those resolutions.

[37] The pleaded effect of the transactions is that DML disposed of shares owned by it in Diesel Propulsions NZ Ltd for the direct or indirect benefit of DML's shareholders, particularly Skellerup Group Ltd.

[38] I summarise below the effect of the Armadillo transaction as pleaded in para 687 of the Second Amended Statement of Claim:

a) The transaction enabled (or required) related transactions to take place which (*inter alia*) allowed Skellerup Group Ltd to gain an increase in working capital of $10,000,000.

   The related transactions are expressly pleaded to have occurred in the manner stipulated by the Completion Memorandum to which I referred in para [7] above.

b) The transfer of property enabled Skellerup Group Ltd to borrow more than $95,000,000 from the Bank of New Zealand and others and to secure that borrowing against the asset acquired by Armadillo. Armadillo guaranteed Skellerup Group Ltd's obligations to its lenders. Skellerup Group Ltd provided a cross guarantee in respect of Armadillo's obligations also.

c) The transfer of the property was designed to enable Skellerup Group Ltd (and the other companies in its group) to reduce borrowings by at least $20,000,000 over the next year.

d) As part of completing the Armadillo transaction, Skellerup Group Ltd, on 8 August 1997, transferred its shares in DML to DML 97 for

$6,000,000. The majority of the shares in DML 97 were owned by Vermont.

e) Vermont also acquired the majority of the shares in Maine Investments Ltd, which continued to own the majority of shares in Skellerup Group Ltd. Accordingly, both DML and Skellerup Group Ltd were ultimately owned by Vermont.

f) Notwithstanding that the Armadillo transaction was documented as a sale and purchase agreement, it was in substance a "distribution" as defined by s2(1) of the Act. It was a "distribution" because it was not an arm's length transaction: Armadillo being owned by DML's shareholder Maine Investments Ltd. It was made in circumstances where DML was insolvent and under which DML received no or grossly inadequate consideration.

g) The proposal that led to the Armadillo transaction and agreed with Lenders dated 25 June 1997 specifically recorded that the "Rationale behind DML plan – allows banks and shareholders to realise value from good assets…"

[39] DML asserts that the directors failed to ensure compliance was met with s52 of the Act before the transaction was entered into, the value of the distribution to DML is said to be $20,601,292. DML seeks recovery from the three directors.

Competing submissions

[40] Mr Fulton submits that the transfer of valuable assets out of DML (through the Maine Indemnity and Armadillo transactions with the consequential release of Maine Investments Ltd as a direct borrower within the charging group) provided a benefit to the shareholders of DML at a time when DML was insolvent. DML asserts that, notwithstanding the form of the transactions into which it entered, no, or at least grossly inadequate, consideration was received for the property transferred. DML alleges that the two transactions led to Skellerup Group Ltd gaining a net increase in working capital of approximately $10,000,000.

[41] The solicitors, on the other hand, view the transactions in a different light. Mr Farmer QC submits that the transactions were bilateral in nature. Mr Farmer QC raises two inter-related points. First, he submits that the transactions into which shareholders of DML entered as part of the re-structuring arrangements were not entered into in their capacity as shareholders. Second, he submits that DML gave and received value for the transactions into which it entered: exchange of value being inconsistent with the concept of a distribution which, necessarily, involves the return of wealth to a shareholder. For either of those reasons Mr Farmer QC submits that the two distribution claims ought to be struck out.

[42] In the context of his submission based on exchange of value, Mr Farmer QC refers to the benefit conferred on DML through the release of its obligations as a member of the charging group upon completion of the re-structuring arrangement. The total indebtedness from which it is asserted that DML was released from participation is approximately $300,000,000.

[43] Accordingly, Mr Farmer QC's fundamental submission is that a finding that these two transactions are, in law, capable of being regarded as distributions to shareholders would conflict with and, indeed, undermine the purpose of the distribution regime.

Distributions: the statutory framework and underlying policy

[44] The term "distribution" is defined by s2(1) of the Act as follows:

> Distribution, in relation to a distribution by a company to a shareholder, means—
>
> (a) The direct or indirect transfer of money or property, other than the company's own shares, to or for the benefit of the shareholder; or
>
> (b) The incurring of a debt to or for the benefit of the shareholder—
>
> in relation to shares held by that shareholder, and whether by means of a purchase of property, the redemption or other acquisition of shares, a distribution of indebtedness, or by some other means:

[45] Section 52(3) of the Act provides:

> **52. Board may authorise distributions**
>
> …
>
> (3) If, after a distribution is authorised and before it is made, the board ceases to be satisfied on reasonable grounds that the company will, immediately after the distribution is made, satisfy the solvency test, any distribution made by the company is deemed not to have been authorised.
>
> …

[46] The solvency test to which s52(3) refers is contained in s4 of the Act. Section 4 states:

> **4 Meaning of "solvency test"**
>
> (1) For the purposes of this Act, a company satisfies the solvency test if—
>
> (a) The company is able to pay its debts as they become due in the normal course of business; and
>
> (b) The value of the company's assets is greater than the value of its liabilities, including contingent liabilities.
>
> (2) Without limiting sections 52 and 55(3) of this Act, in determining for the purposes of this Act (other than sections 221 and 222 which relate to amalgamations) whether the value of a company's assets is greater than the value of its liabilities, including contingent liabilities, the directors—
>
> (a) Must have regard to—

(i) The most recent financial statements of the company that comply with section 10 of the Financial Reporting Act 1993; and

(ii) All other circumstances that the directors know or ought to know affect, or may affect, the value of the company's assets and the value of the company's liabilities, including its contingent liabilities:

(b) May rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

(3) Without limiting sections 221 and 222 of this Act, in determining for the purposes of those sections whether the value of the amalgamated company's assets will be greater than the value of its liabilities, including contingent liabilities, the directors of each amalgamating company—

(a) Must have regard to—

(i) Financial statements that comply with section 10 of the Financial Reporting Act 1993 and that are prepared as if the amalgamation had become effective; and

(ii) All other circumstances that the directors know or ought to know would affect, or may affect, the value of the amalgamated company's assets and the value of its liabilities, including contingent liabilities:

(b) May rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

(4) In determining, for the purposes of this section, the value of a contingent liability, account may be taken of—

(a) The likelihood of the contingency occurring; and

(b) Any claim the company is entitled to make and can reasonably expect to be met to reduce or extinguish the contingent liability.

[47] In applying the solvency test, for the purposes of both ss52 and 56 of the Act, the terms "debts" and "liabilities" have the extended meanings ascribed to them by s52(4) of the Act.

[48] The "distribution" provisions of the Act have their origin in comprehensive work undertaken by the Law Commission on company law reform in New Zealand: see *Company Law* (NZLC PP5, 1987), *Company Law Reform and Restatement* (NZLC, R 9, June 1989) and *Company Law Reform: Transition and Revision* (NZLC, R 16, September 1990). The regime for distributions created by the Act was intended

to be a radical departure from the old law on capital maintenance. The Law Commission based its recommendations on a North American model: see the references to the Model Business Corporation Act (US) and the Canada Business Corporations Act at paras 89 and 91 of the Law Commission's discussion paper *Company Law*. The definition of "distribution" as enacted in s2(1) of the Act appears to have been based on the definition of that term in the Model Business Corporation Act (US). That definition has been either adopted or adapted for use in many States of the United States of America.

[49] I compared the new statutory regime with pre-existing law in *Kitchener Nominees Ltd v James Products Ltd* (2002) 9 NZCLC 262,882. For convenience, I repeat my analysis of the relevant differences below. The argument in this case and academic comment on the *Kitchener* judgment has led me to modify my views slightly.

[50] In his original text, *Directors' Liability and Company Solvency - the new Companies Act* (CCH New Zealand Limited 1994) at pages 5-6, Associate Professor Ross (as he now is) said:

> A company is born as a hollow legal shell. Resources enabling the company to trade come from shareholders and creditors. These investors expect to earn a return on and/or recover their investment. Directors are charged with an obligation to take care in the management of company resources.
>
> A requirement that companies remain solvent was always implicit in the Companies Act 1955 and earlier companies legislation. The capital maintenance doctrine was intended to ensure that a buffer was maintained to protect creditors. The Companies Act 1993 requires, by comparison, that directors ensure that their company satisfy a statutory solvency test before returning company resources to shareholders [s4 of the 1993 Act]. This is novel.
>
> Under the 1993 Act, directors are required to have accounting records kept [s.194 of the 1993 Act], financial statements prepared [s.10 of the Financial Reporting Act 1993] and presented to shareholders [ss.210 and 211 of the 1993 Act]; they must expressly consider the company's solvency when making distributions [s.52 of the 1993 Act]; and they incur personal liability should the company trade while insolvent [ss.135, 136 and 300 of the 1993 Act]. Solvency is also relevant when making share repurchases [ss2(1) and 58 of the 1993 Act] and redemptions [ss2(1) and 70 of the 1993 Act] providing financial assistance for the purchase of shares [ss2(1) and 77(1) of the 1993 Act] and completing a merger or amalgamation of companies under Pt VIII of the Companies Act 1993.

Associate Professor Ross developed these ideas in a subsequent publication, *Corporate Reconstructions: Strategies for Directors* (CCH New Zealand Ltd 1999): see in particular his observations on the role of a director in a changing commercial environment at 1-4 (inclusive) and his comments on the statutory solvency test in Chapter 7 at 65 ff.

[51] Under the old law, the capital maintenance doctrine was underpinned by obligations cast upon shareholders to pay a nominated or par value for each share issued by a company. Various statutory provisions, when read together, were intended to provide a buffer which acted as a protection for creditors: see, in particular, ss 64, 65, 66 and 76 of the Companies Act 1955.

[52] Problems emerged when a distinction was drawn by the English Court of Appeal between distributions made to shareholders out of current trading profits (on the one hand) and return of capital (on the other): see *Verner v General and Commercial Investment Trust* [1894] 2 Ch 239 (CA). Associate Professor Ross described the problems in the following way:

> Any depreciation in the value of capital assets was sunk and lost. Dividends could be sourced from current trading profits, without the need to make good past trading losses. As long as there were sufficient assets to meet creditors' claims, there was no need to appropriate from current trading profits sufficient resources to maintain assets equal in value to the paid up capital. Creditors' interests were protected in that no distribution could be made to shareholders unless creditors' claims could first be met, but it was a fiction to consider nominal capital protected creditors. [*Directors' Liability and Company Solvency* at 6 and *Corporate Reconstructions* at 66].

[53] The reluctance of Courts to review commercial decisions made by directors to determine whether profits had been made in any particular period added to the problems caused by the capital maintenance doctrine. Indeed, prior to some legislative reforms in England in 1981, the rules which applied in England were regarded (by no less an authority on company law than Professor L C B Gower) as potentially nonsensical. Professor Gower said:

> Had companies taken full advantage of these rules (which fortunately most public companies did not) it would have made nonsense of the whole capital concept. [Gower's, *Principles of Modern Company Law* (Sweet and Maxwell), 5th ed, 1992) at 244.

The fifth edition was the last edition edited by Professor Gower.

[54] It is clear from the Law Commission's 1989 report that a deliberate decision was made to abolish the concept of par value for shares and to promote capital maintenance by ensuring that distributions to shareholders could only be made if the proposed solvency test was satisfied. At paras 400-402 the Commission said –

> 400. The solvency test in relation to distributions reflects two goals: avoidance of prejudice to creditors; and avoidance of prejudice to higher ranking shareholders with fixed entitlements, for example in preference shares.
>
> 401. The company must have sufficient funds to be able to meet its debts to outside creditors as they fall due and its realisable assets must exceed its liabilities, including contingent liabilities. The test is designed to be a rigorous one, as is discussed above in paragraph 333.
>
> 402. Shareholders with fixed entitlements cannot be prejudiced by distributions to shares which rank after them. For this purpose, therefore, the fixed entitlement is treated as if it were a debt. [*Company Law Reform and Restatement* (NZLC R 9 at p 97)]

[55] The rigorous test to which reference is made in para 401 must be read in conjunction with para 333 of the Law Commission Report. Paragraph 333 states:

> The draft Act follows United States precedent in using the concept of "realisable value" in the assets over liabilities limb of the test. The Canadian reliance upon a concept of "stated value" (being the sum of all value received on issue of shares) seems to us simply to reinstate under a different name the concept of nominal capital for the purposes of distributions and is insufficient protection for creditors at risk. We realise that in making a determination whether to make a distribution in marginal cases the directors will not be able to rely upon the historic values of assets in their accounts. We think in those marginal cases it would be wrong to permit the accounts to be sheltered behind to the prejudice of creditors. In those circumstances prudent directors will require reassessment of the value of the company's assets. The test is designed to be a purposive one for the protection of creditors. [*Company Law Reform and Restatement* (NZLC R 9 at p 79)]

[56] Viewed in that context, the definition of the term "distribution" ought not to be construed in a narrow manner. Reform of the capital maintenance doctrine would be undermined if the definition was interpreted narrowly. Yet, interpretation of the definition must also accord with the underlying purposes of the distribution provisions read in light of the Act as a whole: s5 Interpretation Act 1999. The main purpose of enacting the legislative change was to strengthen the capital maintenance doctrine to

avoid prejudice to creditors and higher ranking shareholders: see para 400 of the Law Commission's report set out in para [54] above.

[57] Section 52(3) of the Act (set out in para [45] above) reinforces this view; as does the Long Title to the Act. Section 52(3) draws a distinction between the time at which a distribution is "authorised" and "made". If, before the distribution is *made,* the board of the company ceases to be satisfied, on reasonable grounds, that the company will, immediately after the distribution is made, satisfy the solvency test the distribution is deemed not to have been authorised. The policy underpinning s52(3) has a firm foundation in the rule that shareholders rank after creditors on insolvency. The Long Title to the Act emphasises definition of the relationships between companies, their directors, shareholders and creditors and the need to encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment. At the same time the Act provides protection for shareholders and creditors against the abuse of management power.

[58] In *Kitchener Nominees Ltd,* at para [53] (at 262,892), I expressed the view that s52(3) effectively cancelled, retrospectively, the authority to distribute moneys which had been given at an earlier time. On reflection, the concept of cancellation is inapt. Rather, the ability to distribute is suspended until such time as the company is solvent. Suspension of the authority to distribute is all that is necessary to give effect to the policy underpinning s52(3). There can be no objection to distribution once the status of solvency is regained. A contrary interpretation of s52(3) may give rise to unintended consequences if insolvency intervenes between the date of making and payment of the distribution: query, whether it would require a fresh authority to distribute.

[59] If a distribution to shareholders is not made in conformity with the statutory process both the shareholder to whom the distribution was made and any directors who authorised it are at risk of being held liable to restore the lost value to the company. A company may seek recovery of any distribution from the shareholder under s56(1) of the Act. Recovery may be sought from a director in the circumstances disclosed by s56(2), (3) and (4). In this particular case the company seeks recovery from directors under s56(4) of the Act which provides:

56. Recovery of distributions

…

(4) If, by virtue of section 55(5) of this Act, a distribution is deemed not to have been authorised, a director who failed to take reasonable steps to prevent the distribution being made is personally liable to the company to repay to the company so much of the distribution as is not able to be recovered from shareholders.

…

[60] Section 56(5) empowers the Court, in an action brought against a director or shareholder under s56, to allow the shareholder to retain, or to relieve the director from liability in respect of, an amount equal to the value of any distribution that could properly have been made. That power stems from the proposition that so much of a distribution as would have been proper (because the company could pass the solvency test, after it was made) ought not to be impugned.

[61] In *Kitchener Nominees Ltd* I expressly left open the question whether a transaction between a company and a shareholder would be caught by the definition of "distribution" if it could be demonstrated affirmatively that the debt arose out of a genuine arm's length transaction in which the shareholder was involved solely *qua* creditor or *qua* employee. I did, however, express a provisional view that such transactions would not be caught by the definition: see para [57] at 262,893.

[62] In *Corporate Reconstructions*, Associate Professor Ross put forward the following propositions:

a) Company resources are often made available to shareholders as part of a corporate reconstruction: this can be by way of transfer of assets, use of company resources as collateral for shareholder borrowing, forgiveness of shareholder debts owed to the company and re-purchase or redemption of shares on issue. Associate Professor Ross opines that each of these transactions is a "distribution" as defined by the Act: 175.

b) The definition of "distribution" implies that a benefit is provided by the company to a shareholder "in relation to shares held by that shareholder". A plain reading of this phrase suggests that only benefits received by shareholders in their capacity as shareholders are to be treated as a distribution; benefits received in any other capacity are not distributions: 176.

c) In a "closely-held" company it could be argued that any receipt of company resources by a shareholder ought to be treated as a distribution regardless of the capacity in which the benefit was received. If it were intended the distribution be limited to benefits received by shareholders in their capacity as shareholders the Act could have stated this. Section 15 of the Companies Reregistration Act 1993 defined the distribution as a "benefit received in his or her capacity as a shareholder in the company on its re-registration". That provision dealt with any reduction in shareholders' liability arising on re-registration of a 1955 Act company: 176-177.

Those propositions were adopted, in argument, by Mr Fulton for DML. They represent a refinement of views expressed in the Associate Professor's earlier work: cf *Directors' Liability and Company Solvency* at 14, to which I referred in *Kitchener* at para [49], 262,891-262,892.

[63] In this particular case Associate Professor Ross' first and third propositions (see para [52] (a) and (c) above) come under scrutiny. DML could be described as a "closely-held" company as it was controlled by Maine Investments Ltd through Skellerup Group Ltd: details of the shareholding are set out in para [10] above.

Analysis of "in substance" distribution issue

[64] The definition of the term "distribution" is set out in para [44] above. There are three cumulative elements to a "distribution" as defined. They are:

a) the direct or indirect transfer of money or property (or the incurring of a debt) by a company

b) to or for the benefit of the shareholder and

c) in relation to shares held by that shareholder.

The concepts captured by those elements are the transfer of property (or the incurring of a debt) by the company; the corresponding provision of a benefit to or for its shareholders and receipt of the benefit by, or on behalf of, the shareholder in its capacity as a shareholder. A link must be established between the out-flow of wealth from the company and the benefit received by or on behalf of a shareholder.

[65] The use of the expressions "direct or indirect" and "to or for" the benefit of the shareholder serve to confirm the necessary link between the negative impact on the net value of the company and the positive impact on the net value of the shareholder. They also emphasise that the inquiry is one of substance rather than form. An analysis based on the substance of the transaction lessens the likelihood of a shareholder using its influence, as an insider, to mask the true nature of the transaction to avoid compliance with the distribution rules.

[66] A distinction must be drawn between the transfer of wealth to a shareholder in its capacity as a shareholder and a *bona fide* transfer of wealth to that shareholder in some other capacity. Failure to draw that distinction would, in my view, undermine the purpose of the reforms made by enactment of the distribution provisions of the Act because those reforms were focussed squarely on the protection of creditors or higher ranking shareholders: see para [56] above.

[67] I am satisfied that the provisional view I expressed in *Kitchener Nominees Ltd* (that a distribution does not occur if the shareholder receives benefits from the company as part of a genuine arm's length transaction for which valuable consideration is given) was correct. If a genuine loan contract has been entered into between a shareholder (as lender) and company (as borrower) repayment of that loan cannot be impugned unless challengable, on liquidation, under other provisions of the Act: for example under either s292 or s297 of the Act) or on some other legitimate basis (eg as a sham). As the North American cases demonstrate, the fraudulent conveyance provisions of s60 Property Law Act 1952 may also apply. Similarly, if a shareholder is employed by the company and receives wages, provided the services rendered are genuine any payments made to the shareholder, *qua* employee, could not

be impugned under the distribution provisions. See also the factors mentioned in paras [57] and [58] of *Kitchener Nominees Ltd* at 262,893-262,894.

[68] If DML had put its case squarely on the effect of the individual Maine Indemnity and Armadillo transactions and had not relied upon the inter-related transactions to prove the flow of a benefit to shareholders, I would have been loathe to exercise jurisdiction to strike out the claims because, clearly, evidential issues would have assumed primacy. But, that is not the way in which DML puts its case. Instead, DML seeks to rely on the individual transactions to establish the transfer of wealth out of DML and on the inter-related transactions to establish a benefit to shareholders. In failing to take account of the inter-related transactions to determine the value of assets transferred out of DML the necessary link between loss (to DML) and benefit (to shareholders) is not made. The question for my consideration is whether the approach taken by DML can be justified as a matter of law.

[69] An approach which compares net losses and gains has the advantage of according with commercial reality. Such an approach reflects economic reality as the group was clearly treated as an economic enterprise for the purpose of re-structuring. Indeed, unless constrained by the Constitution of DML (the terms of which I am, presently, unaware) directors of DML may have been entitled to take account of the interests of the company's holding company in determining whether to enter into a particular transaction: see s131(2) and (3) of the Act. In legal terms, however, an issue arises as to whether such an approach is permissible given the need to treat companies as distinct legal entities since *Salomon v A Salomon & Co Ltd* [1897] AC 22 was decided by the House of Lords.

[70] This raises an issue of interpretation of the terms "transfer" and "incurring of a debt" in the definition of "distribution". Both terms employ the singular. Is the definition intended to apply to a combination of transfers, or the incurring of more than one debt, or a mix of both? In my view the purposes of the distribution provisions (see para [54] above, in particular para 400 of the Law Commission report) would be undermined by a restrictive interpretation concentrating on the singular form of the terms. A wider interpretation is justified by s33 of the Interpretation Act 1999 which provides:

33 Numbers

Words in the singular include the plural and words in the plural include the singular.

[71] Mr Hagen acknowledges that the transactions entered into on 8 August 1997 were "carefully set up to allow the release of DML from the Charging Group, allow the bank funding to be maintained, and the $10m of additional working capital to be available to [Skellerup Group Ltd]." Yet, on its pleadings DML do not take account of any benefit flowing to DML from its release from the charging group. That is significant in the context of an assertion by the solicitors that the amount secured (from which DML was released from participation in the event of default) was something in the order of $300,000,000.

[72] The starting point for analysis is the definition of distribution in s2(1) of the Act. A company seeking relief against a director under s56(4) of the Act must be able to point to a benefit gained by a shareholder, in its capacity as a shareholder, arising out of either the transfer of an asset (or the transfers of assets) from the company or the incurring of a liability (or liabilities) by the company on behalf of the shareholder. Only if a company parts with an asset or incurs a liability with a corresponding benefit to a shareholder will the definition of "distribution" be met. It follows that Mr Farmer QC must be right when he submits that transactions involving broadly equal consideration are not intended to fall within the distribution provisions. The protections for creditors inherent in ss52 and 56 of the Act are unnecessary if transactions are entered into between company and shareholder for broadly equal consideration.

[73] Mr Fulton submits that it is permissible for the liquidator to choose particular transactions into which DML entered as part of the re-structuring arrangements without bringing to account any benefits flowing to DML from other transactions into which it entered as part of the re-structuring arrangements.

[74] Mr Fulton draws support for that submission from American authority interpreting distribution statutes adopted by States from the Model Business Corporation Act in similar terms to the distribution provisions of the 1993 Act.

[75] In particular, Mr Fulton embraces aspects of the Official Comment on the Model Business Corporation Act: see para 3 of the commentary which concerns the definition of "distribution" in s1.40(6) of the Model Act. The commentary states:

> … a "distribution" includes the declaration or payment of a dividend, a purchase by a corporation of its own shares, a distribution of evidences of indebtedness or promissory notes of the corporation, and a distribution in voluntary or involuntary liquidation. If a corporation incurs indebtedness in connection with a distribution (as in the case of a distribution of a debt instrument or an instalment purchase of shares), the creation, incurrence, or distribution of the indebtedness is the event which constitutes the distribution rather than the subsequent payment of the debt by the incorporation.
>
> *The term "indirect" in the definition of "distribution" is intended to include transactions like the repurchase of parent company shares by a subsidiary whose actions are controlled by the parent. It also is intended to include any other transaction in which the substance is clearly the same as a typical dividend or share repurchase, no matter how structured or labelled.* [my emphasis]

[76] I agree that the definition of "distribution" in s2(1), being based on the United States' Model Act, is intended to apply to any transaction which, in substance, returns wealth to a shareholder. But that begs the real question: namely, how is the substance of the transaction to be assessed?

[77] Mr Fulton submits that American authority supports a purposive interpretation of the term "distribution" to include returns of wealth to shareholders which, in substance, ought to be regarded as distributions. Mr Fulton has referred me to a number of authorities to support that view. A number of the authorities to which I have been referred by Mr Fulton deal with issues arising out of leveraged buy-outs.

[78] Unsurprisingly, the case law is more developed in North America. But even in North America it appears that little attention has been given to the question whether the transactions involved in a leveraged buy-out should be considered collectively or individually.

[79] In *United States of America v Gleneagles Investment Co Inc* 565 F Supp 556 (1983) at 584-585 a District Court was confronted with a submission that payment of a stock purchase price could be likened to an improperly declared dividend or distribution by a company to its shareholders. Judge Muir said:

> As to the argument that the payment of the stock purchase price should be likened to an improperly declared dividend or distribution, the directors of the corporation who declared payment of the same can be held liable to creditors of the corporation injured thereby. *West v Hotel Pennsylvania*, 148 Pa Super 373, 25 A 2d 595, 595 (Pa Super 1942). The director who allegedly declared the improper dividend or distribution was James Durkin, Sr and he was put in the position to make the distribution by the Gillens and Clevelands as part of the whole transaction. Because the Raymond Group's capital was impaired on November 26, 1973, the declaration of the distribution or dividend was clearly illegal under Pennsylvania law. See *Levin v Pittsburgh United Corp*, 330 Pa 457, 199 A 332 (1938). Therefore, the Gillens and Clevelands can be held accountable for the amount of the dividend or distribution.

[80] In *Wieboldt Stores Inc v Schottenstein* 94 BR 488 (1988) at 510-512, Judge Holderman noted that part of the claim was made under the distribution provisions of Illinois Business Corporations Act 1983, a statute based on the Model Act. It was argued that the Illinois statute did not contemplate a transfer in which no corporate assets passed directly from the corporation to its shareholders. At 511-512 the Judge said:

> Although the Illinois Legislature did not incorporate the [Model Acts] definition of "distribution" into the [Illinois Act], the Legislature's failure to adopt this definition does not indicate an intention to restrict the section to a narrow category of direct transfers. The predecessor to the [Illinois Act] … contained three provisions which regulated the directors' power to distribute corporate assets to shareholders. By enacting s9.10 for the express purpose of superseding the prior Act, the Illinois Legislature adopted a more general description of prohibited corporate distribution. In the absence of contrary authority, it appears likely that the Illinois Legislature contemplated a broad range of transfers, including indirect transfers such as the exchange of cash and shares between [corporation] and shareholders.

An application to dismiss that cause of action was refused.

[81] In *C-T of Virginia Inc v Barrett* 958 F 2d 606 (1992) the United States Court of Appeals for the Fourth Circuit considered the definition of the term "distribution" in the Virginia Stock Corporation Act 1989 in the context of an arm's length agreement effecting a leveraged acquisition in the form of a reverse triangular merger. At 610-613 the Court considered whether the transaction could be brought under the umbrella of a "distribution". The Court held that a distribution had not been made. Its reasons were:

a) Payment of the merger consideration to former shareholders of the corporation did not fit within the plain language of the definition: the key language is the requirement that the transfer of value be by a corporation to its shareholders.

b) The financing of the merger was not the incurring of indebtedness by a corporation. The finance for the merger was negotiated by the new owners and directors rather than the pre-merger directors. The focus of the new owners and directors was on the benefit flowing to the corporation rather than its pre-merger shareholders.

c) The transaction at issue represented an arm's length purchase of the corporation by another. The distribution statute is aimed at actions taken by a corporation to enrich unjustly its own shareholders at the expense of creditors and to the detriment of the continuing viability of the company. It does not apply to transactions for value and cannot be used to obstruct an arm's length acquisition by new owners with their own plans for commercial success.

The reasons given by the Fourth Circuit were based, predominantly, on the involvement of new owners and directors in the transactions which created the merger. Such arm's length transactions cannot, on any view, be regarded as falling within the legitimate purview of a provision designed to protect creditors from unilateral distributions of property by a company (operating through existing management) to shareholders who have appointed the directors.

[82] In *C-T of Virginia Inc,* at 611, Judge Wilkinson, delivering the judgment of the Court, said:

> Distribution statutes … derive from the regulation of corporate dividends and traditionally apply to situations in which shareholders, after receiving the transfer from the corporation, retain their status as owners of the corporation. Distribution statutes have not been applied to wholesale changes in corporate ownership, as is the case here, and [the company] has presented no evidence that the Virginia legislature intended the statutory definition to expand the applicability of distribution restrictions beyond their traditional scope.

[83] In *Re Munford Inc* 97 F 3d 456 (1996) the United States Court of Appeals for the Eleventh Circuit considered the Fourth Circuit's judgment in the Virginian case. Construing the terms of the Georgia statute (also based on the Model Act) Chief Judge Hatchett, delivering the judgment of the Court, said:

> In *C-T of Virginia*, the Fourth Circuit held that the LBO [leveraged buy-out] merger did not constitute a distribution within the meaning of Virginia's share repurchase and distribution statutes reasoning that Virginia's distribution statute [was] not intended to obstruct an arm's-length acquisition of an enterprise by new owners who have their own plans for commercial success. The reason for this distinction is simple: a corporate acquisition, structured as a merger, is simply a different animal from a distribution. (at 459)

[84] In *Munford*, at 460 the Chief Judge continued:

> We note that the LBO transaction in this case did not merge two separate operating companies into one combined entity. Instead, the LBO transaction represented a "paper merger" of Munford Inc and AMC, a shell corporation with very little assets of its own. To hold that Georgia's distribution and repurchase statutes did not apply to LBO mergers such as this, while nothing in these statutes precludes such a result, would frustrate the restrictions imposed upon directors who authorise a corporation to distribute its assets or to repurchase shares from stockholders when such transactions would render the corporation insolvent. We therefore affirm the district court's ruling that Georgia's restrictions on distribution and stock repurchase apply to LBO.

The distinction drawn between the transactions under review in *C-T of Virginia* and *Munford* in this passage highlights the need to analyse transactions to determine whether, in substance, a distribution has occurred. The Court must, in my view, look to the substance of the arrangements rather than to the form used to achieve an end result. It would be contrary to the policy underlying the distribution provisions for the form of a transaction to override the substance.

[85] The common theme of the American decisions is the need to apply the distribution provisions if wealth is passed from a company to its shareholders, without adequate consideration, at a time when the company is insolvent: see *Munford* at 460, *C-T of Virginia Inc* at 610-613 and *Wieboldt Stores Inc* at 510-512.

[86] In my view the definition of "distribution" ought to be given a wide meaning to facilitate the purposes of the distribution provisions of the Act: namely, protection of the interests of creditors and higher ranking shareholders once insolvency intervenes.

[87] Whenever a claim is made that relies upon an inter-connected series of transactions to prove a benefit flowing to a shareholder, it is incumbent on a plaintiff to demonstrate that wealth was lost by the particular company and provided to or for the benefit of the relevant shareholder. It is not possible to determine whether there has been a distribution to a shareholder unless both sides of that equation are calculated in the same manner.

[88] The need to calculate net out-flow of wealth and net benefit to a shareholder by reference to the same transaction (or combination of transactions) is inherent in the link between the elements identified in para [64][a] and [b] above. It must also be proved that any net benefit conferred on the shareholder by the company has been received by the shareholder in its capacity as a shareholder. The capacity point, once pleaded, will rarely be capable of resolution on a strike out application as the capacity in which the shareholder receives the benefit may only be capable of determination after evidence has been tested at trial.

[89] I return to the three propositions identified from *Corporate Reconstructions* at para [62] above. Whether each of the transactions identified in para [62][a] above amount to a distribution as defined by the Act will depend upon whether the transactions confer a net benefit or a net loss to the company and a corresponding increase in value to the relevant shareholder.

[90] Further, I respectfully disagree with the proposition that in a "closely-held" company any receipt of company resources by a shareholder ought to be treated as a distribution regardless of the capacity in which the benefit was received. The phrase "in relation to shares held by that shareholder" in the definition of "distribution" in s2(1) of the Act can refer only to capacity. The same concept is captured in s15 of the Companies Reregistration Act 1993 to which Associate Professor Ross refers. I see no point of distinction between the two definitions. They convey the same concept – albeit in slightly different language. As long as the substance of the transaction (or transactions) is the focus of analysis no problems should arise from this approach.

[91] If DML were permitted to select transactions which involved a disparity of consideration without taking account of any additional benefits conferred by other

simultaneous transactions into which DML entered as part of the re-structuring only half the picture would be available. That would be unfair to directors who, no doubt, viewed the transactions (at the time at which they were entered into) in their entirety as well as through the eyes of the particular companies they directed. Accordingly, benefits to DML arising from those transactions (within the series of transactions in question) into which it entered must be brought to account to determine whether a distribution has been made.

Conclusions

[92] The solicitors have established to my satisfaction that the two causes of action under s56(4) of the Act, based on the Maine Indemnity and Armadillo transactions, cannot succeed in the form in which they are pleaded.

[93] Ordinarily, I would have adjourned the application to strike out to enable DML to reformulate its claim based upon the entirety of the transaction, if it wished to do so. Notwithstanding McKay J's observations in *CED Distributors* (see para [22] above) I am satisfied that this is a case in which the real differences between the parties emerged, in a more refined form, during the course of argument. It is, therefore, appropriate to give time to DML to amend its claims if it wishes to do so. However, given the impending trial of the claim and the need for appeal rights in respect of this judgment to be exercised promptly, I propose both to grant the application to strike out and to grant leave to DML (should it wish to do so) to amend its Statement of Claim to re-plead the causes of action based on the entirety of the re-structuring arrangements.

[94] The formal orders of the Court are:

a) The application to strike out the two causes of action relating to the Maine Indemnity (paras 662-679 of the Second Amended Statement of Claim) and Armadillo (paras 680-692 of the Second Amended Statement of Claim) transactions is granted. Those parts of the Second Amended Statement of Claim are struck out.

b) Leave to amend the Statement of Claim is granted to DML on the basis that a Third Amended Statement of Claim containing any amendments must be filed and served by 5pm on 8 October 2003. That is the same date by which witness statements on behalf of the plaintiffs are to be served: see para [4] of my Minute (16) of 29 August 2003. Evidence in support of those amended allegations will need to be included in the witness statements to be served if DML elects to amend its claim.

c) Any Statement of Defence to the Amended Statement of Claim and any amended claim by the Defendants against the Third Party shall be filed and served by the defendants, contemporaneously with service of its witness statements, by 5pm on 12 November 2003.

d) Any Statement of Defence to any amended claim by the defendants shall be filed and served by the Third Party, contemporaneously with service of their witness statements, by 5pm on 17 December 2003.

e) The Third Party is entitled to costs on the application to strike out. If those costs have not been agreed by the conference to be held during the week of 13 October 2003 I will hear from counsel then as to the appropriate orders to be made.

[95] For the assistance of counsel I indicate that proper particularisation of a claim of distribution must identify discretely:

a) Those transactions entered into by DML from which it is alleged that wealth was transferred out of DML. The pleading must also specify the value of the wealth allegedly lost.

b) Identification of the claimed benefit to each shareholder of DML arising out of the net out-flow of wealth from DML.

c) A calculation demonstrating that a net benefit was conferred by DML to or for the benefit of relevant shareholders, with the quantum of the distribution being separately identified.

[96] There are two further matters which I note:

a) There is an issue as to whether the 1000 preference shares in DML were owned by Maine Investments Ltd or Maine Industries Ltd. The liquidators of DML will be aware of a potential exposure for costs should any issue be joined on the basis of Maine Investments Ltd being a shareholder if that status cannot be proved affirmatively by evidence.

b) An issue arises as to whether the Maine Indemnity transaction is a transaction which involved a transfer of property from DML. The solicitors contend that the appropriate entity was DML Pty. I do not comment on this issue as it may be that this aspect is brought to account in the more general way I have indicated: namely, through an in substance distribution calculated by reference to a diminution in value of DML caused by a diminution in value of its subsidiary.

[97] I thank counsel for their assistance in a difficult case, particularly having regard to the time constraints involved.

P R Heath J

Delivered at 2.20pm on 18 September 2003

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