

HONG KONG / JUDGMENT

# NICS ENGINEERING LTD v. THOMAS SEELEN

## COURT

Court of First Instance

## DECIDED

8 May 2007

## CASE / FILE NUMBER

HCB5559/2006

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bjbj HCB 5559/2006 IN THE HIGH COURT OF THE HONG KONG SPECIAL ADMINISTRATIVE  
REGION COURT OF FIRST INSTANCE BANKRUPTCY PROCEEDINGS NO. 5559 OF 2006

Between NICS ENGINEERING LIMITED Petitioner THOMAS SEELEN Debtor

Before: Hon Barma J in Court Date of Hearing: 12 January 2007 Date of Judgment: 8 May 2007

## J U D G M E N T

This was the trial of a bankruptcy petition presented by NICS Engineering Limited ( the Petitioner ) against Thomas Seelen ( the Debtor ). The petition is based on alleged debts of US\$140,000.00 and US\$77,451.20, plus interest, which are said to be due from the Debtor to the Petitioner pursuant to a Deed of Guarantee dated 1 November 2005 to which they (and a company called Pacific Smart Consumer Products (HK) Limited ( PSCP ), of which the Debtor was formerly the managing director and chief executive officer) were parties. A statutory demand in respect of these amounts dated 20 April 2006 was served on the Debtor, but went unanswered. Thereafter, on 16 June 2006, the petition was presented. The background to these proceedings can be summarised as follows. The Petitioner is a member of the Nikko group of companies, which is headquartered in Japan. It, or other companies within the Nikko group, had entered into a number of projects for the development and manufacture of toys with PSCP. One such project related to a toy that was to be called Jaws Panic , which was based on the film Jaws . It consisted of a mechanical shark toy, with a computer device which the parties referred to as the IC Board (an integrated circuit board) which contained the computer programmes which made the toy function, and also produced sound effects. The Debtor says that the Jaws Panic project was first

discussed in about June 2004, and that eventually it was agreed that PSCP would develop this toy for the Nikko group. According to the Debtor, the Petitioner was the company within the Nikko group that eventually placed orders for the toy with PSCP. The Debtor says that from PSCP's previous dealings with the Nikko group, a standard method of production had developed. This started with PSCP receiving instructions to produce a prototype of the end product, which was to be submitted to whichever Nikko group company PSCP was dealing with for approval. After approval of the prototype (which could take some months) was received, tooling of the moulds for the production of the end product would take place. This would commence on receipt of a deposit from the customer for the tooling costs, and would also take some months. On completion of tooling, the balance of the tooling costs would be paid to PSCP, and an order for the finished product would be placed. The tools would also be submitted for approval. This approval would also take some time to obtain, especially if there were licensing matters involved (as might be the case where the toy was based on characters in a film, which would require a licence to be obtained from the owner of the relevant intellectual property rights). Thereafter, materials would be ordered for production, and a sample IC chip would be produced for approval. On approval of the IC chip, it would be inserted into a demo board (a device that would play the music stored in the IC chip). This also required the customer's approval. At about the same time, the other parts of the toy would be manufactured. Thereafter, a final sample would be assembled, and submitted for approval. Only after that would mass production start. On 15 August 2005, the Petitioner and PSCP entered into an agreement which they called the Basic Agreement. This set out general terms governing the relationship between them. It envisaged, however, that individual orders would be placed for specific toys to be manufactured for the Petitioner. Although it contained many detailed terms, it does not appear to have dealt with a number of the matters set out above. The Debtor says that there were a number of delays in the development of the Jaws Panic toy, and orders were not placed until mid September 2005, some four months behind the original target date. There were a total of four orders calling for shipments of a total of 24,000 pieces of the toys to the Petitioner between 15 November 2005 and 10 December 2005. The Debtor says that PSCP had nonetheless commenced tooling in August 2005 despite not receiving the deposit for tooling costs until some time later. In mid-October 2005, however, a mould for the toy was accidentally damaged. PSCP informed the Petitioner of this by e-mail on 14 October 2005, indicating that it expected that the mould would be repaired by about 10 November 2005. On 22 October 2005, PSCP sent a demo board containing an IC chip for the sound to be made by the Jaws Panic toy to the Petitioner by courier, asking, by an e-mail message of the same date, for approval of the demo board. The production of the chip had been contracted to a supplier called Ying Leung International Limited ( Ying Leung ), and it seems that the documentation seeking the approval may have been on Ying Leung's letterhead or forms. On 26 October 2005, the Petitioner's solicitors wrote to PSCP, alleging that notwithstanding that the Petitioner had paid deposits in respect of the tooling costs for the Jaws Panic toy, and for each of the four orders that had been placed on 13 September 2005, PSCP had failed repeatedly to fulfil [its] legal obligations under the [Basic Agreement] and that the Petitioner accordingly was entitled to treat the Basic Agreement as having been repudiated by PSCP. The letter demanded repayment of the deposits paid, which amounted to a total of US\$77,451.20. The letter did not,

however, identify the respects in which PSCP was alleged to have breached the Basic Agreement. On 1 November 2005, the Petitioner's solicitors sent a revised purchase order and a document described as a draft Deed of Guarantee to PSCP, indicating that the Petitioner would only be prepared to withdraw the notice of termination contained in the letter of 26 October 2005 if these were entered into. The revised orders were for a total of 12,000 pieces of the Jaws Panic toy, to be delivered by two shipments, the first between 9 and 14 December 2005, and the second between 12 and 16 December 2005. The draft Deed of Guarantee contained terms requiring strict compliance with the revised delivery schedules, and provision for payment of liquidated damages of US\$140,000.00 and refund of the deposits (amounting to US\$77,451.20) that had been paid, in the event that the revised delivery dates were not adhered to. It also contained a term by which the Debtor undertook to guarantee the performance by PSCP of its obligations thereunder, including the obligations to make the payments to which I have just referred. By its reply dated 2 November 2005, PSCP protested that it was not in breach of any of its obligations, and that the draft Deed of Guarantee was unacceptable in that it sought a personal guarantee from the Debtor. The next day, a revised draft Deed of Guarantee, said to incorporate changes that had been agreed between the Petitioner, the Debtor and PSCP, was sent by the Petitioner's solicitors to the Debtor and PSCP. The amendments provided some flexibility as to the amount of goods to be shipped in each of the two shipments that were to be made, and imposed what appear on their face to be more onerous terms on PSCP and the Debtor, entitling the Petitioner to reject the goods delivered after inspection if the Petitioner was not satisfied with their quality or quantity, in which event the payments stipulated for would have to be made. Although PSCP was permitted to dispose of any rejected goods, this was only against a promise by PSCP and the Debtor not to infringe any product licenses or intellectual property rights of the Petitioner or the Nikko group by such disposal. On 4 November 2005, the amended draft Deed of Guarantee was executed by the parties. On 7 November 2005, PSCP sent an e-mail asking for the demo board to be approved. No reply having been received, a further e-mail message to similar effect was sent on 9 November 2005. On 10 November 2005, a further message was sent pointing out that no reply had been received, notwithstanding that the demo board had been sent to the Petitioner some two weeks earlier, and that the production schedule might be affected as a result. On 11 November 2005, the Debtor also took up the matter by communicating by e-mail with more senior management at the Nikko group. This prompted a reply from the Nikko group to PSCP's staff the same day, in the following terms:- We are sorry to reply you late. We confirmed the receipt of the IC and checked it. However, because of unsettled matters among us, we are not unable [sic] to sign the confirmation sheet at this moment. On 14 November 2005, a number of e-mails were exchanged. At around noon, PSCP informed the Petitioner and the Nikko group that the IC supplier had stopped production because of the delay in obtaining approval, and would only provide a revised production schedule after approval had been obtained. In the course of the afternoon, Mr Ban, a more senior member of Nikko group's management, wrote to the Debtor to say that he believed that contact had been made with a view to progressing the question of approval, which prompted the Debtor to respond that all that had been indicated was that due to internal reasons, it had not yet been possible to give the approval sought. Eventually, at about 6 p.m., Nikko group sent PSCP an e-mail accepting the IC, but requesting the sound volume to be increased. The debtor replied

indicating that it was now too late for the production schedule to be adhered to so as to achieve shipment by mid-December 2005 as called for in the revised orders. There were further exchanges of e-mails and correspondence between the parties, but these led nowhere, and the end result was that no goods were produced or shipped. Thereafter, the Petitioner commenced an action in the High Court against PSCP and the Debtor, claiming payment of the amounts provided for in the Deed of Guarantee and damages. After the commencement of that action, in which both PSCP and the Debtor filed defences, the statutory demand was served on the Debtor, followed by the petition. At the hearing, it was common ground that for the Debtor to successfully resist the making of a bankruptcy order, it would be necessary for him to demonstrate the existence of a bona fide dispute as to the debt on which the petition was based. Mr Shum, who appeared for the Debtor, contended that the debts alleged, which were based on the Deed of Guarantee, were the subject of a bona fide dispute in two respects:-

- (1) There had been no breach of the Deed of Guarantee by PSCP, because the Petitioner was in breach of its implied obligation to provide its approval for the demo board within a reasonable time so as to enable production and delivery of the Jaws Panic toy to proceed according to the revised orders. The consequence of the Petitioner's alleged breach was said to be that PSCP was either entitled to treat the contract as at an end, or at least to be excused from its inability to meet the revised delivery dates.
- (2) The Deed of Guarantee was unenforceable against the Debtor, because it had been entered into by him under duress. Mr Shum contended that there had been economic duress applied as against the Debtor because the Petitioner had unjustifiably purported to terminate the originally agreed arrangements by its solicitors letter of 26 October 2005, and had used this improper termination to force the Debtor to agree to the revised arrangements which included his personal guarantee. Mr Shum also relied on the Debtor's allegation that he and PSCP had invested very substantial amounts (said to be in the region of US\$3 million) in another project (known as the Digiblast project) that was being developed with the Petitioner or the Nikko group, and that the Petitioner had threatened to withdraw from that project if the Deed of Guarantee was not signed, a course of action that would result in severe losses for PSCP and the Debtor. Although the Debtor had suggested in his affirmations in opposition to the petition that the fact that the Petitioner had commenced proceedings against him and PSCP was a ground for dismissing the petition, Mr Shum did not pursue this point, recognising that it could not be conclusive in the Debtor's favour. So far as the first argument is concerned, Mr Haddon-Cave, for the Petitioner, contended that the alleged dispute was neither bona fide nor substantial. Although he accepted that it was arguable that there was an implied obligation on the Petitioner to give its approval to PSCP for the demo board within a reasonable time, He contended that:-
  - (1) There had been no breach of the obligation because the necessary approval had in fact been given many months earlier, in February and/or April 2004, and there was no obligation to give the approval again in October 2004;

- (2) The approval that was sought in October 2004 was to be given in favour of Ying Leung, not PSCP, and there was no basis for implying an obligation on the part of the Petitioner to give its approval to a third party, with whom it had no contractual dealings;
- (3) The seeking of approval in October 2004 was not genuine, but was part of a ploy by PSCP and the Debtor to divert attention from their own inability to perform their obligations to the Petitioner; I think that Mr Haddon-Cave was right to accept that the existence of an implied obligation on the part of the Petitioner to cooperate in the production process by giving its approval where needed on a timely basis was one which is well arguable. The Debtor's evidence as to the process by which a new product was developed was not really challenged. In any event, it seems to me to be at least arguable that where, as here, where a customer enters into arrangements with a manufacturer to develop and manufacture a product, which involve the manufacturer in producing prototypes and models prior to actual production through a process that calls for the input of the customer, there is an implied obligation on the customer of the nature contended for by the Debtor. I am also satisfied that in this case the Debtor has demonstrated the existence of a bona fide dispute as to the debt claimed, on this ground. As to Mr Haddon-Cave's first point, while there is evidence in the form of e-mail messages that certain approvals were given at an earlier stage of the process, it remains the case that a demo board was sent by PSCP to the Petitioner for approval on about 22 October 2005, and that the approval requested was not apparently given until at least 14 November 2005. The Petitioner has not put forward any evidence to suggest that what was sent for approval in October 2005 was no different from what had already been approved. Moreover, at no time up to and including 14 November 2005 did the Petitioner suggest to PSCP that the approval sought was unnecessary, as it had already been given. These matters do, in my view, raise a question as to whether or not the earlier approvals allegedly given were such as to obviate the need for the further approval sought in October 2005. As to Mr Haddon-Cave's second point, there is again nothing in the correspondence between the Petitioner and PSCP between 22 October 2005 and 14 November 2005 that suggests that the Petitioner was not prepared to give the approval sought because it was regarded as being not an approval to be given to PSCP, but to a third party. This point, if it is otherwise a good one, does not appear to have been communicated to PSCP by the Petitioner. Further, whatever form the documentation accompanying the demo board may have taken, it does not follow that PSCP was not seeking such approval on its own behalf, albeit with a view to passing it on to Ying Leung so that Ying Leung would have the comfort of knowing that what it was to produce met with the Petitioner's approval. Moreover, as Mr Shum pointed out, the terms of the e-mails sent from the Petitioner's side, apart from not conveying either of the points which are now taken, are in fact consistent with the existence of an obligation to give the approval sought, and appear to recognise that there had been some delay on the Petitioner's part in furnishing such approval to PSCP. Mr Haddon-Cave countered that while the terms of the Petitioner's e-mails might seem mildly apologetic, this was merely a reflection of the tendency of the writers, who were Japanese, to express themselves in polite terms. That may prove to be the case, but it does not seem to me to be possible at this stage to reject outright

the case being advanced by the Debtor. As to Mr Haddon-Cave's third point, it seems to me that for the reasons which I have already given, and particularly in the light of the correspondence which was placed before me, that it cannot at this stage be said that the position taken by PSCP and the Debtor was obviously a put up job so that their dispute as to their liability to the Petitioner must be regarded as other than bona fide and substantial. The Petitioner's position is that it was PSCP that was constantly falling behind schedule. The Debtor's case is that the party guilty of delay throughout the process of developing the Jaws Panic toy was the Petitioner. I do not think that it is possible, on the evidence presently available, to come to a firm view one way or other as to this. Further, insofar as it was suggested by the Petitioner that the tooling for the moulds needed to product the toys was not complete, I note that PSCP appears to have voluntarily informed the Petitioner of the damage to the mould, and indicated that it anticipated that the mould could be repaired by 10 November 2005. According to the Debtor, this would have given sufficient time for the toys to be produced by the revised deadlines. There is little in the correspondence which has been put in evidence for these proceedings to indicate that the Petitioner ever suggested to PSCP that it would be unable to meet its obligations prior to 26 October 2005, when the Petitioner purported to terminate the arrangements for the manufacture of the toy. As I have noted, even at the time of termination, no details as to the respects in which PSCP was allegedly in breach were provided. Thus, I think that it is, in the circumstances, arguable that PSCP was not in breach in failing to deliver the goods in accordance with the revised orders, and that therefore no liability attaches to the debtor under the Deed of Guarantee. It follows that the Debtor has, in my view, demonstrated the existence of a bona fide dispute of substance as to the debt on which the petition is based, with the consequence that the petition should be dismissed, and the Petitioner left to establish its right to recover from the Debtor by action in the ordinary way. That is not to say, of course, that the Petitioner will not ultimately succeed in establishing its claims following a trial of the matter. In the light of my conclusion on the first ground relied on by the Debtor, it is not necessary for me to come to a concluded view on the alternative argument based on economic duress, and in the light of the fact that the dispute between the parties will have to be resolved by action, I do not propose to say more about this point here. I shall therefore dismiss the petition. So far as costs are concerned, I see no reason why these should not follow the event, and I make an order nisi that the Petitioner is to pay the Debtor his costs of these proceedings, inclusive of any reserved costs, such costs to be taxed on the party and party basis if not agreed. (Aarif Barma) Judge of the Court of First Instance High Court Mr Francis Haddon Cave, instructed by Leland Chu & Co., for the Petitioner Mr Edward Shum, instructed by Wat & Co., for the Debtor Attendance excused for the Official Receiver

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