Directors' duties in the face of risk to creditors – *Mainzeal* concludes

Yan v Mainzeal Property Construction Limited (in liq)
[2023] NZSC 113

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At a glance

+ On 25 August 2023, the Supreme Court released its highly anticipated decision in *Mainzeal*.
+ It addressed the scope and application of directors' duties where a company is financially distressed, and how breaches of those duties should be compensated.
+ This is an important decision for D&O insurers and their insureds as it includes some helpful commentary on liability under ss135 and 136, and confirms the measures of loss.
+ In the wake of *Mainzeal*, both the Court of Appeal and the Supreme Court have suggested the Companies Act be reviewed.

Background

Mainzeal, one of New Zealand's major construction companies, was placed into receivership and liquidation in February 2013. When receivership ended, the appointing secured creditor and preferential creditors were paid in full. Unsecured creditors in the liquidation, however, were owed around $110 million.

The liquidators then brought claims against the directors for breaches of ss135 and s136 of the Companies Act – alleging from 31 January 2011 they carried on the business in a manner likely to create substantial risk of serious loss to creditors (s135) and they caused the company to incur obligations to creditors when they did not believe on reasonable grounds that the company could perform those obligations when required to do so (s136).

The High Court dismissed the s136 claim, but upheld the s135 claim. The directors had been in breach of s135 no later than 31 January 2011. Compensation was assessed at $36 million with apportionment amongst the directors based on their respective culpability.

The directors appealed to the Court of Appeal, challenging the finding on breach and assessment of compensation. The liquidators cross-appealed, seeking a larger sum and challenging the s136 claim's dismissal.

The Court of Appeal upheld the findings on the breach of s135, though it disagreed on the compensation payable – the proper measure of loss was the net deterioration of the company's financial position between the breach date and the date of liquidation. That deterioration had not been proved, so no compensation was awarded. The Court, however, disagreed with the High Court's dismissal of the s136 claim: the directors had no reasonable grounds to consider the company could meet its obligations when due for four major projects commenced after 31 January 2011, and similarly for all obligations from 5 July 2012 onwards. The proper measure of loss was the new debts incurred that remained unpaid at liquidation, though the Court was not satisfied it could not quantify this and remitted it back to the High Court.

The directors sought and obtained leave to appeal to the Supreme Court, seeking to overturn the findings of liability under ss135 and 136. They also, in the alternative, say the liquidators failed to establish loss for which compensation could be awarded. The liquidators sought to uphold the findings on liability, and cross-appealed on the measure of loss under s135. The liquidators also invited the Supreme Court to fix compensation rather than remitting the issue back to the High Court.

The directors breached their duties under ss135 and 136 in the manner determined by the Court of Appeal; they were ordered to pay $39.8 million plus interest to the liquidation.

Outcome

The Supreme Court unanimously dismissed the directors' appeal and allowed (in part) the liquidators' cross-appeal. The directors breached their duties under ss135 and 136 in the manner determined by the Court of Appeal; they were ordered to pay $39.8 million plus interest to the liquidation.

The directors allowed Mainzeal to trade in a manner that was likely to, and did create, a serious risk of substantial loss to creditors. If the directors had acted with reasonable skill and diligence, this would have been apparent to them. Mainzeal had traded while balance sheet insolvent for many years, with significant amounts of money extracted from it for the benefit of its parent company without practical prospects of recovery. The directors received external advice on the need for additional capital but did not pursue this. From 2008, Mainzeal generated little, if any, operating profit. The directors were aware of this precarious position; the best they did was obtain assurances of support from other companies in the group, however these assurances were not legally or practically enforceable.

The directors then caused the company to incur obligations in those four major construction projects, for which they had no reasonable grounds to believe Mainzeal could meet its significant obligations when due. From 5 July 2012, Mainzeal's financial position was so precarious that grounds for believing it could meet its short-term obligations ceased to reasonably exist.

The proper measure for damages here in breaching s135 is the net deterioration of the company's financial position. This reflects the loss to creditors as a whole, consistent with the language of s135 directing the risk of serious loss to creditors generally rather than individually. As the liquidators had not proved that net deterioration (as overall there was no material difference between financial positions at the date of breach and date of liquidation), no compensation could be awarded.

The measure of damages for breaching s136 is, however, the gross amount of debt taken on in breach of s136 and remaining unpaid at the date of liquidator – referred to as the "new debt" approach. In contrast to s135, s136 is focused on particular creditors so the most logical basis for assessing loss is that loss suffered by those creditors. The Supreme Court considered it had adequate information to quantify losses associated with the s136 breaches, and assessed them at $39.8 million.

The Supreme Court held that it has flexibility under s301 to assess compensation payable, with that assessed loss of $39.8 million as both the starting point and maximum compensation. There was no reason to depart from the High Court's assessments of culpability, so that the most culpable director was liable for the entire sum with remaining directors' liability capped: respectively $39.8 million and $6.6 million, plus interest.

Takeaways

Liability

Mainzeal includes some helpful commentary on liability under ss135 and 136:

- Directors have a continuing obligation to monitor the performance and prospects of their company. If they do not do so, they will be in breach of their duty to exercise the care, diligence and skill of a reasonable director.
- Directors should squarely address the future of the company if such monitoring reveals that by reason of the company's solvency position, or other adverse factors, there is (a) potential for substantial risk of serious loss to creditors; or (b) doubt as to whether there is continuing reasonable basis for belief that obligations to be incurred will be able to be honoured.
- If there is potential for risk of loss to creditors or doubt as to whether there is a reasonable basis for belief that new obligations will be honoured, the directors must decide how the potential for breaches of ss135 and 136 can be avoided. This can include taking professional or expert advice, for which the courts will allow a reasonable time for the directors to decide what course of action to take.
- That course of action should directly address the issues that have given rise to the concern. The directors should determine whether the associated risks can be eliminated or sufficiently managed and mitigated under a plan for continued trading that offers reasonable basis for concluding that there is not a substantial risk of serious loss to creditors and that the directors can be confident that obligations incurred will be honoured.
- Generally, a long-term strategy of trading while balance sheet insolvent is not acceptable. There might be circumstances in which this is a legitimate strategy, for example, where there are reasonably reliable assurances of support from parent or sister companies or third parties.
- The courts must apply a standard of reasonableness when assessing the decisions of directors – these likely involve the exercise of business judgment, for which the court should recognise that directors are often required to make complex decisions under pressure of time and events, often with incomplete knowledge.

Where a director does not do so, they will breach ss135 and/or s136.

Measure of loss and quantum

To the extent a director breaches s135, the loss is generally assessed on the company's net deterioration of its financial position; for s136, it will be the new debts incurred from the date of breach. Net deterioration may not always be the most appropriate assessment for breach of s135 though – as made clear by the Supreme Court. Others may be necessary or appropriate, for example, if:

- the breach of s135 is itself the cause of the company's failure, in which case the entire deficiency may be the basis of the award
- the records of the company do not enable its affairs at the breach date to be adequately reconstructed, in which case the entire deficiency may be the measure of loss, or
- the director derived a benefit from breaching s135, in which case compensation can be calculated by reference to the value of the benefit illegitimately obtained.

The Supreme Court's general approach to quantifying loss may be more widely applicable. The Court was satisfied that it could quantify the loss notwithstanding some evidential queries and refined inquiries outstanding. Those queries and inquiries likely favoured the directors and, against the sums claimed by the liquidators, meant the Court had a considerable margin of comfort in its final figure. *Mainzeal* might, therefore, provide some support in future cases for arguments for an appellate court to determine quantum and not remit a case back to a lower court.

Legislative reform

These findings on ss135, 136 and 301 create some tension, which was recognised by the Supreme Court. The Court's discretion to award payment under s301 is premised on liability and compensation accounting for debts owed to individual creditors, where that compensation will be shared by all creditors. Like the Court of Appeal, the Supreme Court accordingly suggested the Companies Act be reviewed.

Comparison

In terms of wider comparison, *Mainzeal* puts New Zealand into a different position than the United Kingdom, as expressed in *Sequana* and *Stanford*.[1] The Supreme Court consciously differed in its approach, relying on the higher threshold for director knowledge establishing liability in s214 of the Insolvency Act (UK) and the express need in ss135 and 136 to have at least substantial regard for creditors' interests.

As a result, it may be that in New Zealand, director liability for financially distressed companies has a lower threshold than (at least) the United Kingdom. Given the involvement of litigation funders, and their high profile success here, there may continue to be increasing scrutiny of directors when companies collapse.

[1] *BTI 2014 LLC v Sequana SA* [2022] UKSC 25, [2022] 3 WLR 709; *Stanford International Bank Ltd (in liq) v HSBC Bank plc* [2022] UKSC 34, [2023] AC 761.

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