BUDDLE FINDLAY

Court of Appeal delivers Mainzeal decision: significant implications for insolvent trading

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This update deals with the significant appeal judgment released yesterday by the Court of Appeal in the proceedings brought by the liquidators of Mainzeal Property and Construction Ltd (in Liq) (Mainzeal) against its directors. Our previous legal updates on the High Court decisions can be found here and here. This update is longer than usual: it represents our attempt to condense the Court of Appeal's 186 page judgment into something that is digestible in five minutes. If you have any questions arising from the appeal judgment, or this update, please get in touch with one of the authors (listed below) to discuss.

For ease of reference, the relevant Companies Act 1993 (Companies Act) provisions under appeal were ss 135 and 136 Companies Act, set out in full below. Importantly, as the Companies Act provides, ss 135 and 136 are duties owed to the company, and not to shareholders.

"135 Reckless trading

A director of a company must not—

(a) agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or

(b) cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

136 Duty in relation to obligations

A director of a company must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so."

To summarise the Court of Appeal's findings:

- Consistent with the High Court, the Court of Appeal found that the directors had breached s 135 of the Companies Act. However, in contrast to the High Court, the Court of Appeal found that the breach did not cause loss to Mainzeal.
- Contrary to the findings in the High Court, the Court of Appeal found the directors to be in breach of s 136 of the Companies Act, and adopting the 'new debt approach', found that the directors ought to be liable for new obligations entered into from the date of insolvency until the date of liquidation.

The net result of the Court of Appeal's judgment is likely significantly to increase the quantum of the damages award in favour of the liquidators. The exact quantum of the award is a matter for determination by the High Court, as the Court of Appeal did not have sufficient evidence before it to determine the issue.

The lead up to liquidation

Given the significance of this decision, it is worth recapping the history leading up to the liquidation of Mainzeal along with a brief overview of the High Court's findings, before turning to consider the Court of Appeal's findings.

Both the High Court and Court of Appeal dealt in considerable detail with the factual background leading up to liquidation of Mainzeal, as well as the company structure, and various restructures. Mainzeal was a large construction company, with a significant presence across New Zealand.

From the Court's recitation of the company's history over the 8-10 years prior to liquidation, it was clear that Mainzeal was reliant on parent company support and that it became less reasonable over time for the directors to rely upon that support. The support came in the form of periodic letters of support, which had no contractually binding effect, from differing entities within the group,

By early 2011, the directors had received advice clearly demonstrating that Mainzeal was operating from a position of balance sheet insolvency, and the provision of parent company support through letters of support was inadequate. There was various

ancillary management and structural issues, including a restructure which had left Mainzeal without a parent company with substantial assets. Importantly, the advice also identified a significant issue with the recoverability of intercompany loans and receivables originating from Mainzeal and flowing out to related companies within the wider group. Notwithstanding the advice, the directors continued to trade, in part in reliance on the promise of support from the parent company.

Cashflow came under increasing pressure throughout 2012, and Mr Yan cited significant difficulties in obtaining and transferring funds from China to support Mainzeal. Mainzeal went into receivership in early February 2013 and into liquidation in late February 2013. Whilst secured and preferential creditors were repaid in full, unsecured creditors were owed $110m with little prospect of significant recovery.

High Court findings

The High Court found the directors of Mainzeal liable for reckless trading under s 135 of the Companies Act, leading to losses of $110m (not all of which the High Court found ought to be recovered). Three important factors led to the Court's conclusion:

- Mainzeal was trading while balance sheet insolvent because its intercompany debt was not in reality recoverable.
- There was no assurance of group support on which the directors could reasonably rely if adverse circumstances arose.
- Mainzeal's financial trading performance was generally poor and prone to significant one-off losses, which meant it needed a strong capital base or equivalent backing to avoid collapse.

The Court found that the directors breached s 135 by:

- Relying on assurances from Mr Yan when such assurances were not legally binding, and when the reliance on such assurances was not reasonable for reasons including that the applicable Chinese foreign exchange laws would not allow the Richina Pacific group to send the funds out of China to make the payments required.
- Failing to obtain independent legal advice, which would have led to the discovery that the assurances from Mr Yan were not legally enforceable and that Mainzeal was trading while insolvent.
- Presiding over poor corporate governance standards, such as record keeping and the failure to ensure that any assurances of financial support that were relied on by the directors were in writing.

Court of Appeal overturns the High Court; adopts 'new debt' approach to loss

The Court of Appeal did not take issue, in the main, with the High Court's findings of fact. It did not disturb the High Court's finding that the directors were in breach of their obligations under s 135. The Court of Appeal disagreed that the breach led to any recoverable losses. It found that the 'entire deficiency', 'net deficiency' and 'new debt' approaches supported by the liquidators were inappropriate in the circumstances.

The 'entire deficiency' approach adopted in the High Court was inappropriate because the breaches did not cause the insolvency of Mainzeal. Put another way, the losses from liquidation could not be attributed to a breach of s 135. The liquidators did not satisfy the Court of Appeal that there had been any net deficiency between the date of the breach in early 2011 until the date of liquidation. Finally, the Court rejected the application of the 'new debt' approach to breaches of s 135.

The Court of Appeal overturned the High Court on the question of whether s 136 had been breached. It also found that it was appropriate to apply the 'new debt' approach to the determination of losses for a breach of s 136.

On whether s 136 was breached, the Court found the Judge was wrong to confine s 136 to specific obligations. Instead, the Court of Appeal held that liability can apply under s 136 to all new obligations undertaken in the ordinary course of a company's business as a result of directors agreeing to continuing to trade without having reasonable grounds to believe the company can meet those obligations, whether those obligations were expressly approved by the board or by executives acting under delegated authority from the board. Accordingly, the directors of Mainzeal should not have agreed to enter into new obligations from 31 January 2011 onwards.

Furthermore, whilst it might have been the case that the directors believed the obligations could be met at the time they were incurred, the directors did not have reasonable grounds for that belief, at least for Mainzeal's relevant liabilities at issue.

The 'new debt' approach applied by the Court provides that directors ought to be required to compensate Mainzeal for new debts incurred from the date of breach. Significantly for the directors of Mainzeal, the new debts incurred, or obligations entered into, amounted to almost $64m – and that figure may increase once the High Court reconsiders the question of quantum.

The new debt approach is a novel analysis of losses arising for breach of s 136 and is significant for that reason alone.

Goddard J, who delivered the Court of Appeal's judgment, was critical of the legislation governing insolvent trading in New Zealand, finding it to be "unsatisfactory in a number of respects". His Honour recommended that it be reviewed "to ensure that it provides a coherent and practically workable regime for the protection of creditors where directors decide to keep trading in circumstances where a company is insolvent or near-insolvent".

Implications

Cases involving breach of directors' duties are inherently fact specific, but there are several important points to note from this judgment:

- **Quantifying insolvent trading claims**: There are now three potential ways to quantify loss in insolvent trading claims, which will depend on the nature of the breach, which we summarise as the 'net debt', 'whole debt', and 'new debt' approach:
  - **net debt (net deficiency)**: A director ought to be liable for the deterioration in the company's financial position between the date trading should have ceased and the date of the actual liquidation. This method of quantification will be relevant when the complaint is that the company continued to trade after a liquidation should have occurred and the company is worse off as a result. It will ordinarily be the appropriate starting point in most cases under s 135 of the Companies Act.
  - **whole debt**: A director ought to be liable for the entire deficiency on liquidation. This method of quantification will be relevant when director's breach of s 135 of the Companies Act causes the insolvent liquidation of an otherwise solvent company.
  - **new debt**: A director ought to be liable for the gross value of the obligations incurred by the company from the date of the director's breach of s 136 of the Companies Act which the company failed to perform. This is the harm suffered by new creditors, which is treated as a 'deemed harm' to the company, for which no allowance for benefits obtained by the company as a result of incurring the relevant obligations would normally be appropriate. It appears that the 'new debt' approach will be the presumptive approach to quantification in s 136 cases.
- **Section 136 applies broadly**: Section 136 can apply to obligations undertaken in the ordinary course of a company's business as a result of directors agreeing to continuing to trade, whether those obligations were expressly approved by the board or were approved by executives acting under delegated authority from the board. That is important for two reasons. First, the suggested distinction between the 'capital account' and 'revenue account', and the notion that s 136 of the Companies Act only applies to the former, has now been authoritatively dismissed. Second, it makes clear that boards of directors retain responsibility for all obligations incurred by the company – and illustrates the need for boards to exercise heightened supervision when a company nears insolvency.
- **Section 136 may have significant implications for directors**: The Court of Appeal's interpretation of s 136 of the Companies Act provides a reasonably potent method of recovery against directors in insolvent trading cases. However, there remains room for debate about director liability under s 136 for short term obligations incurred after a company is insolvent, which the Court of Appeal did not have to resolve definitively on the facts before it (because the most historic short-term liabilities were in fact paid, while the directors did not have reasonable grounds for believing the company would be able to meet the new short-term liabilities that remained outstanding at liquidation). The Court of Appeal suggested, however, that s 136 would be breached when the directors' belief that the company will meet its obligations is predicated on a trading strategy that involves breaching their obligations under the Companies Act and merely postpones the risk of failing to meet obligations without addressing underlying solvency problems. How lower courts apply that guidance will be important: read one way, it can be taken to imply a guarantee of solvency from directors under s 136, which would create a strong disincentive for directors of companies of marginal solvency to attempt to trade out of their positions. Further, it is questionable whether losses under s 136 should properly be awarded on a new debt basis by reason of a parasitic breach of s 135, in circumstances when s 135 would not respond to the losses sought under s 136 (as was the case in Mainzeal). In our view, it is best to follow the Court's analysis on the narrow ground on which it decided the issue, which is to identify whether, as a matter of fact, there were reasonable grounds for believing that the relevant obligations (short or long term) would be performed when due.
- **Court's discretion under s 301 of the Companies Act uncertain**: The Court's discretion under s 301 of the Companies Act, which is usually understood to be a procedural remedies section, remains uncertain. Kós P and Miller J provisionally considered that the Supreme Court's decision in *Madsen-Ries v Debut Homes Ltd* (in liquidation) [2020] NZSC 100 (which we covered here) authoritatively determined that the discretion under s 301 of the Companies Act is a broad one, to be exercised having regard to all the circumstances of the breach including concepts of causation, culpability, and duration of any breach. However, Goddard J provisionally considered that *Debut Homes* did not determine that question, and that it remains arguable that the discretion under s 301 is relatively confined, only to be exercised in cases in which there are factors that justify a reduction in the amount of compensation to be awarded against one or more directors (for instance, knowledge on the part of a creditor). For now, the Court of Appeal has remitted that question to the High Court, to determine with the benefit of full argument from the parties.

It is expected that the Court of Appeal's judgment will be appealed.

A copy of the Court's decision can be found here.

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