IN THE COURT OF APPEAL OF NEW ZEALAND

I TE KŌTI PĪRA O AOTEAROA

CA113/2019
CA373/2019
[2021] NZCA 99

BETWEEN	RICHARD CILIANG YAN Appellant
AND	MAINZEAL PROPERTY AND CONSTRUCTION LIMITED (IN LIQUIDATION) First Respondent
	KING FAÇADE LIMITED (PREVIOUSLY KNOWN AS RICHINA LAND LIMITED) (IN LIQUIDATION) Second Respondent
	MAINZEAL GROUP LIMITED (IN LIQUIDATION) Third Respondent
	ANDREW JAMES BETHELL AND BRIAN MAYO-SMITH Fourth Respondents
	PETER GOMM Fifth Respondent
	JENNIFER MARY SHIPLEY Sixth Respondent
	CLIVE WILLIAM CHARLES TILBY Seventh Respondent
	PAUL DAVID COLLINS Eighth Respondent
	RICHINA GLOBAL REAL ESTATE LIMITED (IN LIQUIDATION) Ninth Respondent

ISOLA VINEYARDS LIMITED (PREVIOUSLY KNOWN AS WAIHEKE VINEYARDS LIMITED) (IN LIQUIDATION)
Tenth Respondent

CA119/2019

BETWEEN	PETER GOMM First Appellant
	JENNIFER MARY SHIPLEY Second Appellant
	CLIVE WILLIAM CHARLES TILBY Third Appellant
AND	MAINZEAL PROPERTY AND CONSTRUCTION LIMITED (IN LIQUIDATION) First Respondent
	ANDREW JAMES BETHELL AND BRIAN MAYO-SMITH Second Respondents
	RICHARD CILIANG YAN Third Respondent

Hearing:	27–31 July 2020 (further submissions received on 30 October 2020)
Court:	Kós P, Miller and Goddard JJ
Counsel:	D J Chisholm QC, T P Mullins and C I Hadlee for Appellant in CA113/2019 and CA373/2019 and Third Respondent in CA119/2019 M D O'Brien QC, Z G Kennedy and M D Pascariu for First to Fourth Respondents in CA113/2019 and CA373/2019 and First and Second Respondents in CA119/2019 J E Hodder QC, M D Arthur and J Marcetic for Fifth to Tenth Respondents in CA113/2019 and CA373/2019 and First to Third Appellants in CA119/2019
Judgment:	31 March 2021 at 10.00 am

JUDGMENT OF THE COURT

A The appellants' application in CA113/2019 and CA119/2019 for leave to adduce further evidence is declined.

B The appeals are allowed.

C The cross-appeals are allowed.

D The orders made in the High Court are set aside.

E The appellants must pay compensation to the first respondent under s 301 of the Companies Act 1993 on the basis set out at [534]–[539] of this judgment. The proceedings are referred back to the High Court to determine the amount of compensation payable on that basis.

F Costs in the High Court are to be determined in that Court.

G The appellants must pay one set of costs for a three-day complex appeal on a band B basis to the liquidators, with usual disbursements. We certify for second counsel.

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REASONS OF THE COURT

(Given by Goddard J)

Introduction

[1] Mainzeal Property and Construction Ltd (Mainzeal) was one of New Zealand's most significant construction companies. It was placed in receivership on 6 February 2013. Liquidators were appointed on 28 February 2013. The secured creditor that appointed the receiver, Bank of New Zealand (BNZ), was repaid in full. The receivers also paid the preferential creditors. On completion of the receivership the liquidators received approximately $8 million from the receivers, to meet liquidation expenses and some $110 million of outstanding claims by unsecured creditors.

[2] The liquidators brought claims against the directors alleging (among other things) that they had:

(a) agreed to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to creditors, in breach of s 135 of the Companies Act 1993 (the Act); and

(b) agreed to the company incurring obligations to creditors at a time when they did not have reasonable grounds for believing that the company would be able to perform those obligations when required to do so, in breach of s 136 of the Act.

[3] The s 135 claim was successful in the High Court. The s 136 claim failed. The High Court awarded a total amount of compensation for the s 135 breach of $36 million. This award represented a proportion of the entire deficiency in the Mainzeal liquidation of approximately $110 million.

[4] The directors appealed. The liquidators cross-appealed, seeking an increased award of compensation under s 135. They also sought a finding that the directors had breached s 136, and compensation for that breach.

[5] We agree with Cooke J that the directors of Mainzeal breached s 135 of the Act by no later than 31 January 2011. They exposed the company's creditors to a substantial risk of serious loss.

[6] But, focusing on the creditors and the business as a whole, that risk did not materialise. As the Judge held, there was no net deterioration in the company's position between 31 January 2011 and the date of liquidation in early 2013. We consider that is the relevant approach to assessing compensation for breach of s 135 in this case. The "entire deficiency" approach is not relevant on the facts as the breaches that were the subject of these proceedings did not cause the company to become insolvent: the liquidators did not establish on the balance of probabilities that liquidation would have been avoided if the directors had not breached their s 135 duties. Nor was this an approach pursued by the liquidators in the High Court: we consider it would not be fair to impose liability on the basis of an entire deficiency approach in circumstances where that approach to quantifying the claim was not pleaded, and was not the subject of relevant fact and expert evidence.

[7] We have also concluded that the liquidators' preferred approach, under which compensation would be quantified by reference to "new debt" incurred after 31 January 2011, is not available in the context of a breach of s 135.

[8] It follows that no compensation is recoverable in respect of the directors' breach of s 135. On the only relevant measure, the breach did not cause loss.

[9] We have however reached a different view from the Judge in relation to the liquidators' claim under s 136 of the Act. We consider that the directors breached s 136 by entering into certain obligations: four significant construction contracts entered into after 31 January 2011, certain obligations to subcontractors on those projects, and all obligations entered into from 5 July 2012 onwards. The appropriate measure of compensation for the directors' breaches of s 136 is the amount of those new obligations to the extent that they remain unsatisfied after allowing for any dividends in the liquidation.

[10] We remit the proceedings to the High Court to quantify this compensation, as we do not have all the information required to assess the amount of the directors' potential liability under s 136. The High Court will also need to consider whether there is good reason to reduce the amount awarded against any of the directors below that level, in the exercise of the discretion conferred by s 301 of the Act.

[11] The directors' appeals succeed in relation to the orders for compensation made in the High Court. The liquidators' cross-appeals succeed in part: they are entitled to orders for payment of compensation assessed on the new debt approach outlined above.

[12] The legislation governing insolvent trading in New Zealand is unsatisfactory in a number of respects. The Act should 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.

Background

[13] In order to understand the circumstances that led to Mainzeal's demise it is necessary to review in some detail the way in which the company operated over the preceding 10 years. The Judge heard extensive evidence about Mainzeal's history and operations in the course of a trial that lasted just over eight weeks. The Judge's factual findings are set out at length in the High Court judgment.[1] Those findings were largely unchallenged on appeal, with the exception of an issue about the net movement of funds between Mainzeal and related entities in 2011 and 2012 which we discuss below at [192]–[194]. Our account of the facts is largely drawn from the High Court judgment.

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1 *Mainzeal Property and Construction Ltd (in liq) v Yan* [2019] NZHC 255 [High Court Judgment No 1] at [7]–[149].

Richina Pacific acquires Mainzeal

[14] Mainzeal was incorporated in 1987.[2] At that time, Mainzeal's holding company, Mainzeal Group Ltd (Mainzeal Group), was listed on the New Zealand Stock Exchange. The parent company had interests in a number of sectors. The group's construction business was carried on through Mainzeal.

[15] In 1995 a majority interest in Mainzeal Group was acquired by an investment consortium subsequently known as REH Capital Ltd (REH Capital), which was controlled by Mr Richard Yan. REH Capital represented a group of mostly North American private equity investors. Mr Yan's family had a substantial equity interest in REH Capital. He also held non-equity shares that gave him effective control of the day-to-day management of REH Capital's investments. In evidence, he described his position as a "benevolent dictatorship".

[16] REH Capital was primarily interested in investing in China. The main reason for purchasing a stake in Mainzeal Group was that it owned Mair Astley Holdings Ltd, an entity involved in the leather industry. REH Capital's main objective was to acquire this interest to associate it with an interest it already had in the leather industry in China. The acquisition of Mainzeal was an incidental consequence of this strategic objective. Mr Yan explained in evidence that many of the investors in REH Capital did not like the idea of owning a construction company, but were willing to trust him "in making the best deal for them".

[17] The Act came into force on 1 July 1994. Existing companies were required to reregister under the Act. Mainzeal reregistered in June 1996. The constitution it adopted on reregistration contained provisions of the kind contemplated by s 131(2) of the Act, authorising a director of Mainzeal as a wholly owned subsidiary to act in the best interests of its holding company, even if that was not in Mainzeal's best interests. The Mainzeal constitution also provided for its holding company to exercise, as sole shareholder, any of the powers which would otherwise fall to be exercised by the board.

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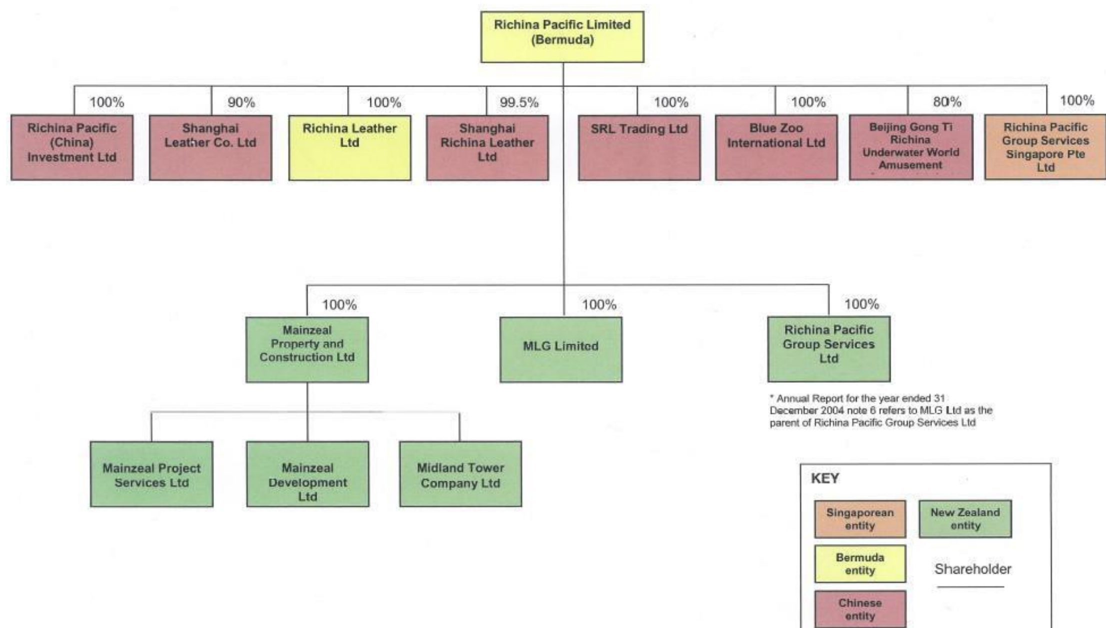
2 A precursor company had been established as long ago as 1968.

[18] In September 1996 the listed parent company, Mainzeal Group, was renamed Richina Pacific Ltd. In December 2003 that company was removed from the New Zealand Companies Register, and a new company with the same name — Richina Pacific Ltd (which we will refer to as Richina Pacific) — was incorporated in Bermuda. That company continued to be listed on the New Zealand Stock Exchange. The investment consortium represented by Mr Yan continued to own a majority interest in Richina Pacific. Mainzeal became a wholly owned subsidiary of Richina Pacific.

[19] In the Richina Pacific annual report for the financial year ending 31 December 2003, Mr Yan's statement as Chief Executive Officer (CEO) identified the issue whether it was desirable for Richina Pacific to own a construction company in New Zealand. One of the reasons for doing so, Mr Yan said, was that the company did not require much equity capital given the significant cashflows involved in the construction industry, which operated as a kind of working capital. The critical factor was how to "contain as far as possible the downside risk in this business".

[20] Following the 2003 restructuring, the Richina Pacific group structure was as follows:



Mainzeal board membership

[21] In the course of the 2003 restructuring of the Richina Pacific group, the Richina Pacific board decided that it was desirable for certain subsidiaries to be administered for operational purposes by a separate board of directors. In April 2004, a new independent board was established for Mainzeal.

[22] Dame Jenny Shipley (Dame Jenny) was appointed Chair of the newly established independent board. She was also appointed to the Richina Pacific board. Dame Jenny had been approached to join the Richina Pacific and Mainzeal boards in late 2003 or early 2004. Following a lengthy career in politics, including serving as Prime Minister between 1997 and 1999, Dame Jenny was an independent consultant and served on the boards of a number of companies.

[23] Mr Clive Tilby was also appointed as an independent director of Mainzeal in 2004. Mr Tilby was a consultant with significant governance experience in the construction industry.

[24] Mr Yan was a director of Mainzeal in April 2004, but he resigned from the Mainzeal board in November 2004. In 2006, he and his family came to live in New Zealand, and he again became a Mainzeal director in April 2009. Throughout the relevant period, Mr Yan was also a director of Richina Pacific.

[25] Mr Peter Gomm joined Mainzeal as its Chief Operating Officer in May 2007. He became CEO in April 2009 and joined the board in June 2009.

[26] In April 2012 Sir Paul Collins (Sir Paul) joined the Mainzeal board.[3]

Relationship between Mainzeal and Richina Pacific

[27] In 2004 the Richina Pacific board adopted a document referred to as the "Charter" which set out the intended relationship between Richina Pacific and Mainzeal, and the way in which the new Mainzeal board would operate.

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3 See [153] below.

[28] The Charter described its objective as “to set out in a permanent form the powers the Board can exercise as of right, by identifying the powers that are not as of right entitled to be exercised”. It set out the authority of the Mainzeal board in the following terms:

> **AUTHORITIES:**
>
> The appointed Board of [Mainzeal] will have the authority and obligation to do such things as are necessary to ensure appropriate governance in the best interests of the Company and, if directed, the Parent [Richina Pacific], as permitted by law and the Constitution, except as to matters involving:
>
> - equity raising
> - capital expenditures (in excess of limits to be from time to time agreed)
> - appointment and remuneration of CEO and CFO
> - taxation matters
> - dividends and loan account to/from the parent and its subsidiaries
> - investigation (other than preliminary) of major or outside of ordinary course of business transactions
>
> In respect of matters for which no direct authority is provided, the Board is expected, from time to time, to make representations/recommendations to the [Richina Pacific] Board on these matters, which the [Richina Pacific] Board, in its absolute discretion, may approve or reject, with or without explanation.

[29] The inaugural meeting of the newly established Mainzeal board took place on 13 April 2004. At that meeting Dame Jenny sought comments in relation to the Charter, and the relationship between Richina Pacific and Mainzeal. In light of the Mainzeal directors’ comments, Richina Pacific sent a further letter dated 10 June 2004 to the Mainzeal directors providing further details about the intended relationship between the two companies. The letter advised the Mainzeal board that:[4]

> 10. Within any [Richina Pacific] policy, [Mainzeal] should determine its own policies and procedures to best utilise the equity it has, plus from time to time new equity it has been allocated by the [Richina Pacific] board. To the extent that it requires more capital, it will have to compete with other demands from other subsidiaries or from initiatives within the [Richina Pacific] corporate group. Allocations may need to be made, and if that is the case, the basis would be need, and expected return on investments. [NB: Any safety, health and

[4] Typographical errors in this passage, and in other quoted passages, have been corrected.

> environmental issues usually need to take precedence and be fixed first - these also being matters on which each director can be personally liable.] The Directors of the [Mainzeal] board who are also on the [Richina Pacific] board would be expected to promote any reasoned requests for equity at the [Richina Pacific] board level once they are satisfied as to the appropriateness of those requests, and funding cannot otherwise be secured.

[30] The minutes of the Mainzeal board meeting on 28 June 2004 record that the general principles in this letter were understood and accepted.

[31] It was clear from the Charter that Richina Pacific would retain control over dividends to be paid by Mainzeal and advances between Richina and Mainzeal. Mr Yan made clear on more than one occasion that he saw all funds held by Mainzeal as shareholder money, with Richina Pacific having the ability to determine where in the wider group those funds should be deployed from time to time. If Mainzeal sought further capital, it would need to compete for that capital with other group companies. Richina Pacific would determine whether dividends would be paid. And, critically, Richina Pacific would determine whether Mainzeal would make (or receive) inter-company advances.

Funds extracted from Mainzeal for use in China

[32] In 2004 and 2005 Richina Pacific drew on funds held by Mainzeal to assist it with a major acquisition made by the Richina Pacific group in China. Richina Pacific acquired the Shanghai Leather Co Ltd (SLC), a former Chinese state-owned enterprise that held extensive land use rights in Shanghai. Mainzeal advanced USD 2.37 million to MLG Ltd (MLG), a New Zealand company that was also owned by Richina Pacific. The loan document described the advance as a "floating rate debenture loan", though it did not involve Mainzeal taking security over any assets held by MLG. The advance was repayable in seven years' time, with interest accruing and capitalising at 10 per cent of the consolidated profit of SLC. The funds borrowed by MLG were then made available to other companies within the Richina Pacific group to enable the acquisition of SLC to proceed. Those further transfers were structured in a way that did not give MLG any enforceable rights of repayment from the companies in China

in which the valuable assets were held.[5] Nor did MLG have any other assets of substance out of which it could fund repayment of the advance. It appears that the Mainzeal directors did not take any independent legal advice in relation to entry into this transaction.

[33] The acquisition of SLC was a very significant transaction for Richina Pacific. In the Richina Pacific 2004 Annual Report, Mr Yan's statement as CEO said that he had "little doubt that 2004 will be recorded in the history of [Richina Pacific] as the pivotal turning point for its future success". He compared the acquisition of SLC to the Louisiana Purchase because, by purchasing SLC, Richina Pacific acquired substantial land use rights around Shanghai which would become valuable property as the city expanded. As the Judge recorded, this was plainly a very valuable investment for Richina Pacific, though there was no evidence providing a precise estimate of its current value.[6]

[34] On 15 November 2005 Mainzeal and MLG entered into a further funding facility. This facility was described as a "current account loan". It appears the sum initially advanced was USD 5 million. This advance was repayable by MLG in instalments on specified dates in 2006. The advance attracted interest at 9.5 per cent per annum. These funds also appear to have been used to support acquisitions of substantial assets in China by Richina Pacific.[7]

[35] Over this period additional funds were extracted from Mainzeal by Richina Pacific without any further documentation. The minutes of the Mainzeal board meeting on 7 December 2004 refer to Richina Pacific needing to borrow additional money from Mainzeal in 2005 to fund Richina Pacific corporate expenses. Mainzeal's financial statements for the year ended 31 December 2005 record the amount outstanding under the MLG floating rate debenture as NZD 3,470,303, and record other advances to MLG, including the current account loan, of NZD 16,789,916.

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5 The MLG accounts for the year ending 31 December 2005 record that MLG had bought back shares from Richina Pacific for NZD 19 million.

6 High Court Judgment No 1, above n 1, at [27].

7 At [29].

[36] The Judge recorded a suggestion by the directors at trial that the structure for making these advances via MLG may have been adopted for tax reasons. But the structure also meant that Richina Pacific itself had no legal obligation to pay Mainzeal. Nor for that matter did it have an obligation to pay MLG, as a result of the way in which the funds were passed on to Richina Pacific.

[37] By the end of 2005 Mainzeal's accounts included related party advances totalling some NZD 34 million, mostly to a related company, MLG, that did not have any significant assets out of which the advances could be repaid. MLG did not have any enforceable rights against Richina Pacific or any other company of substance. The recoverability of these Mainzeal advances was wholly dependent on the ability and willingness of Richina Pacific to put MLG in funds to meet its obligations.

Construction bond support from Richina Pacific

[38] Throughout this period Richina Pacific provided Mainzeal with significant support for its on-going operations by providing, or guaranteeing, construction bonds. Significant construction contracts of the kind that Mainzeal entered into often required the head contractor to provide a construction bond: a form of security that the principal can call on if the construction company fails to perform its obligations. The bonds are usually issued by a bank or an insurance company for a percentage of the total construction contract price (typically 10 per cent). For many construction projects Mainzeal's bond provider — referred to as a "bondsman" — was Vero Insurance (Vero). In turn, Vero required the bonds to be backed by a guarantee from a party of substance. Richina Pacific provided that guarantee for numerous Mainzeal construction bonds. On some occasions Richina Pacific itself provided the construction bond. This did not involve Richina Pacific providing funds to Mainzeal, but it did involve taking on significant contingent liabilities for the benefit of Mainzeal.

RGREL introduced as holding company

[39] The structure adopted in 2003 continued largely unchanged for the next five years or so, except that a new company was introduced as Mainzeal's immediate holding company in 2006. That company was initially called Richina Land (NZ) Ltd,

but was subsequently renamed Richina Global Real Estate Ltd (RGREL). Richina Pacific also used RGREL as a vehicle through which to channel funds from Mainzeal to the entities in China. It appears that although RGREL was of more financial substance then MLG, it also was not in a position to repay the Mainzeal loans that were made to it.[8]

Chinese foreign exchange controls

[40] Another factor that had a significant bearing on the ability of Mainzeal to obtain repayment of advances made to other group companies, and to receive support from its parent, was the foreign exchange control regime that applied in China throughout the relevant period. Various government authorities, and in particular the State Administration of Foreign Exchange (SAFE), administered stringent controls on removing funds from China — more specifically, on buying foreign currency with Chinese currency. The rules governing transactions that had the direct or indirect effect of transferring funds out of China changed on a number of occasions over the relevant period. A number of witnesses gave evidence on this topic. Various techniques could be used to enable money to leave China, but each had significant limitations. These are addressed, where relevant, below.

[41] The key point is that once funds had been extracted from Mainzeal and used by Chinese entities in the Richina Pacific group to make investments in China, it was difficult to get the money back out again, even where the assets acquired with that money had increased considerably in value. It was not legally possible for Richina Pacific to transfer funds from China to Mainzeal at any time, and in any amount, that Richina Pacific desired. Nor was it possible for Richina Pacific to enter into legally binding agreements to transfer funds out of China, without prior approval from the relevant authorities.

Mainzeal financial performance 2005–2008

[42] Mainzeal's financial performance for the years 2005 to 2008 was uneven, with a reported loss for the 2005 year of approximately $7.5 million, a reported profit for

[8] High Court Judgment No 1, above n 1, at [33].

the 2006 year of $14.8 million, a reported profit for the 2007 year of $11.1 million and a reported loss for the 2008 year of $5.2 million. Those figures included substantial amounts in respect of capitalised interest on inter-company debts. Operating profit for those four years, excluding capitalised interest income, interest costs, and tax was:

(a) 2005 — loss of $12.1 million;

(b) 2006 — profit of $12.2 million;

(c) 2007 — profit of $2.5 million;

(d) 2008 — loss of $2.4 million.

[43] Mainzeal's financial statements for the year ending 31 December 2008 reported net assets of $21,228,000. However that figure was arrived at on the basis that inter-company debts of approximately $35.3 million owed by MLG and RGREL were current assets that were recoverable in full, and the "debenture loan" to MLG of approximately $4.1 million was a non-current asset that was expected to be recoverable in full. If these entries, which total some $39.4 million, are disregarded then Mainzeal would have had a balance sheet deficit of approximately $18 million. So the recoverability of these amounts was highly material to any assessment of Mainzeal's balance sheet solvency.

[44] Despite the importance of these assets for Mainzeal's financial position — actual and reported — it appears that the directors did not seek any advice on that issue, or address the need for any provision in the company's financial statements to reflect a risk that the advances would not be recovered. Mainzeal's auditors, who at that time were PriceWaterhouseCoopers (PwC), gave an unqualified audit opinion in respect of Mainzeal's 2008 financial statements.

[45] The notes to the 2008 financial statements recorded an undertaking from Richina Pacific to provide financial assistance to Mainzeal if necessary. Note 15 read as follows:

> **15. Continued parent support**
>
> The considered view of the Directors of [Mainzeal] is that, after making due enquiry there is a reasonable expectation that the Company had adequate resources to continue operations at existing levels for the next 12 months from the date of the audit report. [Richina Pacific], the ultimate Parent, has undertaken to provide financial assistance to the Company, if necessary, to ensure that the Company will meet its debts as they fall due.

[46] This note was based on a formal letter of support provided by Richina Pacific for the 2008 year which acknowledged to the directors of Mainzeal that Richina Pacific undertook to provide sufficient financial assistance as and when it was needed to enable the company to continue operations and fulfil all financial obligations for at least the next 12 months. Similar letters had been provided in earlier years. The orthodox view is that such letters of comfort, particularly when provided in connection with an annual audit, may be taken into account by directors but are not legally enforceable.[9]

[47] The reason that letters of support of this kind are not seen as legally enforceable is that they are invariably expressed in a manner that does not exhibit an intention to create legally binding relations. In particular, they are not expressed as a legally binding undertaking or guarantee that may be enforced by the company or its creditors. There may be room for argument about the legal consequences of such letters in particular cases, including under the Fair Trading Act 1986. But in this case it was not suggested that the letters of support given by Richina Pacific were legally enforceable.

Restructuring in 2008–2009

[48] A further restructuring of the Richina Pacific group took place in 2008–2009. Mr Yan explained that it arose from differences of view among the shareholders in

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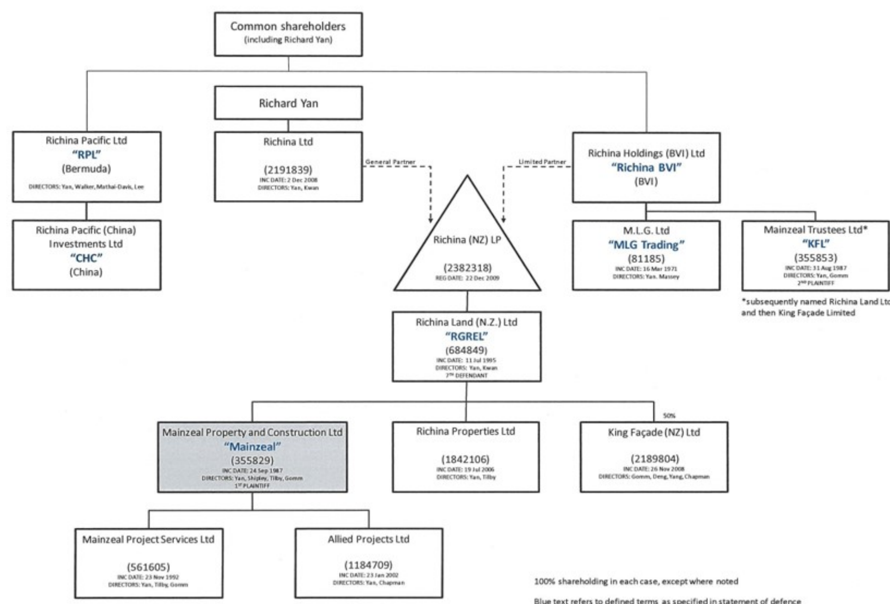
[9] See *Kleinwort Benson Ltd v Malaysia Mining Corp Bhd* [1989] 1 WLR 379 (CA); *Carillion Construction Ltd v Hussain; Re Simon Carves Ltd* [2013] EWHC 685 (Ch); *Bank of New Zealand v Ginivan* [1991] 1 NZLR 178 (CA) at 180; and *Genos Developments Ltd v Cornish Jenner & Christie Ltd* HC Auckland CP556/90, 10 July 1990.

relation to the investments held by Richina Pacific. Some did not want to have investments in New Zealand, in particular in a construction company. They wanted to concentrate their investments in China. Others were more interested in the New Zealand investment. Mr Yan said that the overall purpose of the restructuring was to divide the group into separate divisions, with the shareholders then having a choice as to where they wished to hold their investments. In essence, the restructuring was intended to separate out the New Zealand companies from the Chinese companies. The plan involved Richina Pacific delisting from the New Zealand Stock Exchange and buying back all the publicly held shares in that company.

[49] The proposed arrangements were set out in an investment statement sent to the public shareholders. It explained that a new Richina Pacific entity would be created as a private company. That entity would no longer be the ultimate holding company of Mainzeal. New entities would be put in place as holding companies of a New Zealand division. A limited partnership, Richina (NZ) LP, would own RGREL and, through RGREL, Mainzeal.

[50] The implementation of the restructuring began in late 2008, including the delisting of Richina Pacific. However the restructuring did not proceed in the manner originally contemplated, and was not completed until late 2009. Following completion of the restructuring, the new structure was as follows:



[51] The most important consequence of the restructuring for present purposes is that the relationship between Mainzeal on the one hand, and Richina Pacific and the entities in China that held assets of substance on the other hand, became more remote. Mainzeal did not have any parent company with substantial assets. The delisting of Richina Pacific also reduced that company's connection with New Zealand, and the transparency of its financial position so far as the New Zealand public was concerned.

[52] REH Capital's interest in Richina Pacific increased as a consequence of the acquisition of minority shareholdings, to something in the order of 70 per cent. Mr Yan's family's equity interest in Richina Pacific also increased. The Judge recorded that the evidence about Mr Yan's equity interest in Richina Pacific was not entirely clear, but it appeared that his family's equity interest increased to at least 25 per cent.[10] And he retained effective control of Richina Pacific by virtue of his non-equity shareholding in REH Capital.

[53] It was initially proposed that as part of the separation of the Chinese and New Zealand divisions, the New Zealand entities would be capitalised to a level that would enable them to operate independently of Richina Pacific, and in particular, without Mainzeal needing bonding support from Richina Pacific. A preference share issue by RGREL was contemplated as a mechanism for increasing the New Zealand division's capital by around USD 13.5 million. In a report that accompanied the investment statement issued to shareholders in connection with the delisting of Richina Pacific, PwC explained the proposal as follows:

> **The New Zealand Division**
>
> 15. The New Zealand Division will essentially comprise Mainzeal. Mainzeal's balance sheet is in a deficit position (excluding its intercompany advance) and it requires the support of the [Richina Pacific] Group to operate in the short term. Consequently, to enable it to operate as a stand-alone division, it requires a cash injection from the Group. We are advised that this will be affected through the issue of preference shares by the Investments Division to the New Zealand Division which are intended to qualify for treatment as equity of [RGREL] and the New Zealand Division. Following the investment in preference shares, it is intended that the New Zealand Division will be able to operate independently from the remainder of [Richina Pacific].

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10 High Court Judgment No 1, above n 1, at [46].

> 16. The issue of preference shares should be undertaken prior to amalgamation and be sufficient to deal with Mainzeal's deficit.

[54] The investment statement also advised shareholders that:

> [Richina Pacific] will ensure that each Division is appropriately capitalised …

[55] The Mainzeal board were aware that Richina Pacific was not intending to provide additional capital to Mainzeal by any other mechanism, and that there was a solvency issue for Mainzeal given the issues surrounding recoverability of the intercompany loans. A January 2009 report to the Mainzeal board from its Chief Financial Officer (CFO), Mr Reegan Pearce, stated:

> It is not anticipated that any further cash support will come from the [Richina Pacific] parent directly to Mainzeal other than potentially a cash injection to the new parent of the NZ division as disclosed in the [Richina Pacific] notice of meeting to get to a solvent position.

[56] This note reflects a realistic assessment of the position at that time: the proposed capital injection was necessary to put Mainzeal in a solvent position.

[57] However this capitalisation did not ultimately take place. It appears the redeemable preference shares were issued, but never called up. As a consequence, the capital injection that PwC had advised was necessary for Mainzeal to operate as a stand-alone entity, and to address the deficit position in Mainzeal's balance sheet, never occurred.

[58] It appears that one of the reasons the capitalisation did not proceed was that the institutions that were providing construction bonds for Mainzeal's construction contracts were not willing to accept substitution of RGREL for Richina Pacific as guarantor of those bonds, even if RGREL was capitalised as proposed. Mr Yan explained that the bondsman, Vero, indicated that it would be necessary for RGREL to have more capital than the proposed USD 13.5 million (at the time, approximately NZD 20 million) in order to be acceptable as a guarantor. Any New Zealand entity replacing Richina Pacific as guarantor would need to have capital of NZD 40 million.

[59] Mr Yan's evidence was that the figure of NZD 20 million had originally been recommended by PwC. It appears that a United States investor had inquired about

how much capital was required to separate the New Zealand and Chinese assets, and was prepared to provide this amount of capital in order to ensure the separation. But Mr Yan went on to explain that the global financial crisis in 2008 intervened, and the investor was not able to provide the funds. In any event, the PwC assessment of the amount of capital required was not sufficient in light of Vero's stance.

[60] In those circumstances Richina Pacific decided not to proceed with the proposed capitalisation of the New Zealand division. The minutes of the audit and governance committee of Richina Pacific for 26 May 2009 record that Richina Pacific "determined that it would not be prudent to put [USD] 13.5 million cash in [RGREL] in order to create a cash positive stand-alone entity".

[61] The result was that a complete financial separation of the Chinese and New Zealand divisions was not achieved. The restructuring that created a new Richina Pacific was completed, but the shareholders of Richina Pacific did not make a choice about which division to invest in. Instead, they all continued as shareholders of both Richina Pacific, which ultimately owned the Chinese investments, and Richina Holdings (BVI) Ltd (Richina Holdings (BVI)), which ultimately owned the New Zealand investments through a limited partnership, Richina (NZ) LP, in which it was the limited partner. The general partner in Richina (NZ) LP was an investment company owned by Mr Yan.

[62] The Mainzeal directors were conscious of the significance of the separation, even in its more limited form, and the greater independence of the New Zealand entities contemplated by that separation. The minutes of the board meeting held on 28 April 2009 record:

> **3.7 Bonding Availability** **RP/RY**
>
> Note – Generally positive meeting held with the Bondsman based on [Mr Yan]'s representation that [Richina Pacific]'s support will be ongoing. The Bondsman is seeking the group's consolidated audited accounts for 2008 and ongoing 2009 [Mainzeal] management accounts.

> **3.8 Support of Mainzeal by [Richina Pacific]**
>
> [Mr Yan] reaffirmed that the support of Mainzeal is ongoing, however the directive is for Mainzeal to be self-sufficient and to grow to become a much stronger stand-alone viable entity.

[63] This was reported to the Richina Pacific board in the following terms the next month:

> The principles of operation now adopted by the Mainzeal senior management team, is that Mainzeal is a standalone business entity which has to be financially self-sufficient from [Richina Pacific]. There is one exception, the need for the [Richina Pacific] Parent Company Guarantee to support the availability of performance bonds from Vero required by the typical New Zealand public and private clients.
>
> [Richina Pacific] has confirmed that consistent with this mandate, Mainzeal will retain all profits and cash-flow to rebuild the company's balance sheet and net worth.

[64] The restructuring does not appear to have resulted in any change to the way in which intercompany cashflows were managed. As discussed below, the movement of cash between Mainzeal and Richina Pacific and other entities continued to be managed on a day-to-day basis by Mr Yan and Richina Pacific executives on what Mr Yan described as a "centralised basis".[11]

PwC raises concerns

[65] In the years ending December 2007 and December 2008 PwC were the auditors of both Richina Pacific and Mainzeal. One of the auditors who was involved in PwC's 2008 advice about the need to capitalise Mainzeal, Mr Michael Schubert, gave evidence at the trial. He explained that the failure to capitalise the New Zealand division as indicated in the information provided to the public shareholders of Richina Pacific caused him considerable concern. An associated promise to provide greater financial disclosure following delisting, particularly concerning related party transactions, also was not implemented: that also caused him concern.

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[11] See [98] below.

[66] On 22 May 2009 PwC raised its concerns in the draft audit report for Richina Pacific for the financial year ending 31 December 2008. PwC noted that the redeemable preference shares had not been called upon, and the greater transparency concerning related party transactions had not occurred. PwC also raised an issue about whether Richina Pacific itself was a going concern. A response from Mr John Walker, the Chair of the Richina Pacific board,[12] recorded the concern in the following terms:[13]

> PwC has raised the question of whether [Richina Pacific] is a going concern, specifically with respect to the ability of [Richina Pacific] to access funds to support its non-China entities, particularly Mainzeal, and to repay [a loan] from Siam Commercial Bank ("SCB") when due.

[67] The letter from Mr Walker responded to PwC's concerns. He advised that Richina Pacific did not plan to subscribe for the RGREL preference shares until the restructuring was completed.

[68] Mr Schubert also explained in his evidence that advice was obtained from the law firm Russell McVeagh in relation to his concern that the suggested failures involved a breach of securities laws, in light of representations made to the public shareholders. He said that Russell McVeagh advised that there was no such breach. This was accepted by PwC, and ultimately PwC signed off the audit reports.

[69] Mr Schubert nevertheless said that he lost confidence in his ability to rely on assurances given to him by Mr Yan, and that he also:

> … lost confidence that the boards of [Richina Pacific] and Mainzeal were readily able to impose any constraint on the decisions made or authority exercised by Mr Yan, despite Dame Jenny also being a director on both [Richina Pacific] and Mainzeal boards.

Mr Schubert said he was grateful when PwC was subsequently advised by Mr Walker that they would no longer be required as auditors. Messrs Walker and Yan disagreed that that was Mr Schubert's view at the time, but the Judge said he had no reason to doubt that this was Mr Schubert's position.

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[12] Mr Walker was also a director of the Chinese Holding Company (CHC) from 2009 to 2011, and of RGREL from August 2010 to November 2011.

[13] PwC's original letter and report is no longer in existence, and only a draft of this reply has been found. But Mr Schubert confirmed it was similar in terms to the final letter.

Developments in 2009

[70] The restructuring process continued through 2009. The Mainzeal CFO's report to the Mainzeal board in January 2009 noted that it was not anticipated that any further cash support would come from Richina Pacific directly to Mainzeal, other than potentially a cash injection to the new parent of the New Zealand division "as disclosed in the [Richina Pacific] notice of meeting to get to a solvent position". This reflects the comments made in the PwC report of November 2008.

[71] There was no evidence of letters of support being provided by any related entity in 2009 for the benefit of Mainzeal, MLG or RGREL. The period covered by Richina Pacific's letter of support for Mainzeal given in May 2008 ended in May 2009. It does not appear to have been replaced. Despite this, as noted above at [43]–[44], Mainzeal's audited financial statements for the year ending 31 December 2008 were approved by the directors and received an unqualified opinion from PwC.

[72] MLG's audited financial statements for the year ending 31 December 2008 showed it remained effectively insolvent. It had negative equity of $44.8 million. This included debts to Mainzeal of $28.6 million and to RGREL of $9.4 million, neither of which it had the means to repay. Despite this, Dame Jenny said in evidence that she regarded Mainzeal's receivable from MLG as "sound". The basis for this was the expectation, recorded in the MLG accounts, that Richina Pacific had "undertaken measures to provide financial assistance to the company, if necessary, to ensure that the Company will meet its debts as they fall due".

[73] Dame Jenny said in evidence that there was "no question that Mainzeal was reliant on its parent in balance sheet terms" and that Mr Yan and Richina Pacific were "open and clear with Mainzeal directors and demonstrated to the Mainzeal directors' satisfaction that the parent could and would support Mainzeal".

[74] The decision by Richina Pacific in May 2009 not to provide the proposed redeemable preference share capitalisation for the New Zealand entities does not appear to have triggered concerns at Mainzeal board level. There are no references to the issues this raised for balance sheet solvency of Mainzeal in the board papers in 2009. There were passing references to the issue of balance sheet solvency.

For example, a Mainzeal board report in October 2009 discussing a proposed tax defeasance read as follows:

> **Tax Defeasance and Review**
>
> A "scaled down" version of this is now being agreed with [Ernst & Young] with one of the resulting outcomes being to move "paper equity" into the NZ division (and out of the China division) which will assist with the technical solvency issues the division currently faces.

[75] As the High Court judgment explains in more detail, the "paper equity" transfer proposal did not proceed.[14]

[76] Although Richina Pacific had decided not to proceed to capitalise RGREL using the redeemable preference share mechanism, the subscription agreement for the redeemable preference shares between RGREL and Richina Pacific entered into in November 2008 remained in existence. It appears the agreement was never cancelled. Instead, Richina Pacific's obligations under the agreement were assigned first to Richina Holdings (BVI) and then from that company to Richina (NZ) LP. The shares were recorded in RGREL's accounts for the 2009 to 2011 years. The value of the shares was not taken into RGREL's balance sheet, but the accounts recorded that RGREL had the right to call on the subscription agreement. The Judge accepted that those rights continued to be recorded in RGREL's accounts for the 2009 to 2011 years in order to make it appear that RGREL had a stronger balance sheet than was in fact the case.[15]

[77] The concerns expressed by PwC in mid-2009, and PwC's subsequent removal as auditor of Mainzeal, do not appear to have been discussed at Mainzeal board meetings in 2009. It appears that PwC had only been the auditor of Mainzeal for some two years at the time it was removed. It is not clear whether the Mainzeal board members were aware of the concerns expressed by PwC to Richina Pacific. If they were, the absence of any discussion at board level about PwC's departure would be surprising.[16] And if they were not, we would have expected the directors to seek an

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[14] High Court Judgment No 1, above n 1, at [69].

[15] At [70].

[16] Mainzeal did not have an audit committee, so any consideration of this issue would necessarily have taken place at a full board meeting.

explanation from PwC so they could satisfy themselves that there was nothing amiss. There is no record of this happening.

[78] When PwC's expressions of concern about Mainzeal being balance sheet insolvent at this time were put to the directors in cross-examination, they explained that that was not how they saw it, as Mainzeal was part of a wider group and the wider group had repeatedly provided assurances of support. Mr Gomm also explained in evidence that balance sheet solvency did not concern him because Mainzeal always had the cashflow to pay its debts. That is a feature of the way in which construction companies operate, as explained above at [19]. Payments from principals are usually received some time in advance of the date on which subcontractors are paid. There can be very substantial amounts of money passing through the company. These provide a form of working capital. But the greater a company's reliance on this form of working capital, the greater the attention the directors need to pay to ensuring compliance with ss 135 and 136 of the Act, as we explain below.

[79] Dame Jenny stepped down from the Richina Pacific and MLG boards in late 2009. She explained that the delisting and separation of divisions was under way and that, in that context and given her other commitments, she agreed with Messrs Yan and Walker to resign from the boards of Richina Pacific and MLG, but to stay on the board of Mainzeal.

[80] Mainzeal's financial statements for the year ended 31 December 2009 reveal a slender operating profit of $853,560. The overall profit for the year of $3,284,384 included accrued (and capitalised) interest income from related companies of $3.214 million. If this interest income is disregarded, Mainzeal's profit for the year largely disappears.

[81] The notes to the 2009 financial statements referred to continued shareholder support:

> **15. Continued shareholder support**
>
> The considered view of the Directors of [Mainzeal] is that, after making due enquiry there is a reasonable expectation that the Company has adequate resources to continue operations at existing levels for the next 12 months from the date of the audit report.

> The shareholders of [RGREL], the immediate parent of the Company, have undertaken to provide financial assistance to the Company, if necessary, to ensure that the Company will meet its debts as they fall due.

[82] The auditor's report from Ernst & Young, who had replaced PwC as Mainzeal's auditor, included an "emphasis of matter" drawing attention to this note:

> **Emphasis of Matter**
>
> We draw attention to Note 15 of the financial statements which describes the continued support of the shareholders of [RGREL], the immediate parent company. The financial statements have been prepared on the going concern basis, the validity of which depends upon the continued financial support by the shareholders of the immediate parent company. The financial statements do not include any adjustments that would result should the support of the shareholders of the immediate parent company be discontinued. Our opinion is not qualified in respect of this matter.

[83] In connection with the audit of the 2009 financial statements, a letter of support was provided by Richina (NZ) LP, signed by Mr Yan as "Director for the General Partner, Richina Limited". The letter acknowledged to the directors of Mainzeal and RGREL that Richina (NZ) LP accepted responsibility for providing, and undertook to provide, sufficient financial assistance as and when it was needed to enable them to continue operations and fulfil all financial obligations "now and in the future", with the undertaking "provided for a minimum period of twelve months from May 31, 2010". The wording was essentially the same as the letters provided in earlier years by Richina Pacific. As noted above at [46]–[47], such letters are not generally regarded as legally enforceable. And the limited partnership that was now providing the letter of support did not itself have the resources to meet the assurance given in the letter. None of this would have been obvious to a potential creditor reading Mainzeal's financial statements.

[84] As the Judge concluded, from the end of 2009 Mainzeal was in a vulnerable position. It depended for its solvency on informal expressions of support.[17]

[85] Despite the restructure, and the decision not to proceed with capitalisation of the New Zealand division, Dame Jenny gave evidence that she remained confident

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[17] High Court Judgment No 1, above n 1, at [76].

about Mainzeal's prospects in reliance on oral expressions of support given by Messrs Yan and Walker. She said:

> 94 Richard Yan and John Walker made clear to the Mainzeal directors that the restructure did not change the group's support of Mainzeal. At no stage was there any conversation, or any indication, that group support was no longer available. I pressed [Mr Walker] and [Mr Yan] on this point extensively at various times and they confirmed to me that until such time as the NZ limited partnership and the future New Zealand group had sufficient assets in a balance sheet of its own (including the proposal for a proposed new arm of the group, holding a banking licence in New Zealand, which went on to be called Richina Finance), the directors could completely and utterly rely on the support of the group. …

[86] Dame Jenny acknowledged that the inter-company receivables from RGREL and MLG, which were in total some $42 million, exceeded Mainzeal's total equity of approximately $24.5 million "so clearly underpinned Mainzeal's balance sheet solvency". In her evidence she addressed this issue as follows:

> 136 From our perspective, the receivables effectively sat with [Richina Pacific], backed by the China assets and companies. We knew that [Richina Pacific] had the ability to support Mainzeal, including by repaying those debts if required. We also had confidence that Mainzeal could perform in the market and we did not anticipate this call would be required. Beyond the receivables themselves, [Richina Pacific] was continuing to support Mainzeal through providing security for bonds to be issued and providing cash when required.
>
> 137 On that basis, the board agreed that Mainzeal could continue to meet its obligations for the next 12 months.

2010 — Increasing expressions of concern

[87] The Mainzeal board's first meeting in 2010 took place on 22 January. By this time Mr Gomm was Mainzeal's CEO. His report to the board referred to the balance sheet solvency issue as follows:

> **KPI 8 – Mainzeal Balance Sheet**
>
> - Negative circa US$10m.
> - The market perception as being driven by competitors and feedback from clients, is that we are totally dependent upon the support of [Richina Pacific]. Any matter that is perceived to be a negative outcome for [Richina Pacific] is also a major issue for Mainzeal. The health of both entities is very closely linked.

- The plans to strengthen the Mainzeal balance sheet are welcomed, and from a strategic point of view, the communication to the market needs to be managed to achieve positive support.

…

[88] The reference to "[n]egative circa US$10m" is almost certainly a reference to the net asset position disregarding receivables from MLG and RGREL: a deficit of around NZD 18.3 million, which at that time was approximately USD 10 million. The board knew that there was a large hole in Mainzeal's balance sheet, and that the company's balance sheet solvency was entirely dependent on the ability and willingness of Richina Pacific — which was no longer the parent company of the New Zealand division — to support the New Zealand entities in meeting their obligations.

[89] The minutes of the January 2010 meeting do not record any specific actions to be taken in relation to this issue. However at the next meeting, held on 16 February 2010, the board discussed the implications of the 2008–2009 restructuring in more detail. Under the heading "Cashflow" the minutes of the meeting record the following:

> It was noted that the Board required a schedule of all cash movements with relevant dates and explanations between [Richina Pacific] and Mainzeal to be presented at each board meeting and are making all payments on the basis that Richina Holdings (BVI) or [Richina Pacific] have approved the payments under an authorisation and governance framework presented and agreed by those Boards.
>
> The [Mainzeal] Board needs to have a full understanding between the respective Boards so that all directors are aware of their obligations. We need to come to an agreement as to what this framework will involve and how the respective Boards will interact.

[90] The board also considered the question of which company would provide support for construction bonds in the future: Richina Pacific or Richina Holdings (BVI) or neither. The minutes continued:

Whose overall duty is it to make sure that the NZ division is operating while solvent going forward, Directors of [Richina Holdings (BVI)]? [Dame Jenny/Mr Tilby] to seek a briefing from [Mr Yan] on what are the financial obligations, reporting or otherwise of the NZ division and Mainzeal.	**JS/CT/RY**

[91] Dame Jenny followed these issues up in an email dated 19 February 2010 to Messrs Yan and Walker headed "NZ separation and related issues". The email noted that "[a]t a recent board meeting for [Mainzeal] a number of important governance and management issues were raised". Dame Jenny expressed the hope that "the Richina [Pacific] Board and exec staff may be able to formally respond to these issues so that we can all be clear about our roles and responsibilities".

[92] After raising some issues in relation to cashflows, the email went on to note that the board required a schedule of all cash movements between Richina Pacific and Mainzeal to be presented at each board meeting, with relevant dates and explanations. She recorded that the Mainzeal board "are making all payments on the basis that Richina Holdings (BVI) or [Richina Pacific] have approved the payments under an authorization and governance framework presented and agreed by those Boards".

[93] Under the heading "Mainzeal Accounts" Dame Jenny said:

> Mainzeal has an ongoing need to present accounts to confirm financial strength for various project related submissions. We seek the [Richina Pacific] Board's guidance on what accounts can be presented given Mainzeal is now a subsidiary of [Richina Holdings (BVI)], yet as I understand it we still enjoy the support of [Richina Pacific] for Bonding purposes at this stage. …

[94] The email raised some questions about reporting requirements under the new structure. It then went on to deal with the question of bonding, asking whether Richina Pacific or Richina Holdings (BVI) would provide bond support going forward, and what accounts would be available in order to confirm the assets supporting the guarantees. The email went on to make two important observations:

> Mainzeal Directors wish to clarify whose overall duty is it to make sure that the NZ division is operating while solvent going forward on who are the Directors who carry this obligation? Both [Mr Tilby] and I feel we need a full understanding of this in terms of meeting our legal obligations.
>
> …
>
> We would appreciate it if as part of the finalizing of the separation of the NZ interests from the China interests that the matters above can be cleared up in writing so that we are clear about how inter company arrangements will occur and who has director responsibilities in each of these cases.

[95] The email was signed off "Jenny Shipley on behalf of the Mainzeal Directors".

[96] Mr Walker responded the following day with a short email saying the issues would be "fully address[ed]". But no substantive response was provided in the following week. Dame Jenny followed up with an email on 27 February 2010, saying that some of the issues were "very important and do need our attention as I am personally not comfortable with things as they are". In her evidence she explained why she raised those matters, including:

> 103 … I wanted to be very clear as to whose overall responsibility it was to support the New Zealand division of the wider Richina group so that the board could be confident that Mainzeal could meet the solvency test. Both [Mr Tilby] and I, as the independent directors of Mainzeal, wanted to be extremely clear about our obligations. Of course, we knew we had responsibility as directors of Mainzeal, but I wanted it recorded that, despite the restructure, the New Zealand division still had the benefit of the China assets.

[97] Some months passed without any substantive response to Dame Jenny's email. The minutes of the board meeting on 24 May 2010 record that Dame Jenny would follow up with Mr Walker again.

[98] A response had still not been received on 12 August 2010 when the directors received email advice from Mr Pearce, the Mainzeal CFO, that Richina Pacific had requested an additional NZD 1.2 million advance to be paid the following day, in addition to rolling over an advance made the previous month of NZD 1.2 million. Mr Pearce sought the board's approval for these transactions. Mr Yan responded to this email advising Dame Jenny and Mr Tilby that:

> We are simply managing the group's cash now on a centralised basis and will formalise this arrangement by working with BNZ to have group treasury within this coming month so we will permanently eliminate any "related party" issues going forward and all cash will be managed by [Richina Pacific], rather [than] at Mainzeal although [Richina Pacific] will guarantee sufficient cash for all its operating businesses.

[99] As this email confirms, Mr Yan continued to treat cash within Mainzeal as a group asset which Richina Pacific could deploy as it saw fit. Mainzeal's directors do not appear to have exercised any control over the way in which Mainzeal's cash was managed, and in particular over flows of funds between Mainzeal, Richina Pacific and other entities controlled by Richina Pacific.

[100] Dame Jenny replied by email expressing her concern about the request in the following terms:

> I am very concerned by this request and would prefer not to approve the additional amount requested until the matters outlined below are resolved.
>
> The Mainzeal Board has asked on a number of occasions for the matter to be clarified as to the accountability and responsibility surrounding related party transfers of funds from Mainzeal to other entities in the Group. As you know, as Mainzeal Directors we are all responsible for the contracts we sign and our ongoing ability to meet our obligations to fund those contracts. As we have no formal arrangements in place to cover the guarantee of these requested transfers and despite the fact that we are recording these as part of our Mainzeal Board reports I know the Directors have real concerns around this issue. I have raised this with yourself and John Walker on a number of occasions and the matter is still not clear despite assurances that the issues would be dealt with.
>
> While I note your desire to run a central treasury function for the NZ interests it is unreasonable to ask Mainzeal Directors to approve the associated related party transfers without the clear understanding if we are liable for these decisions and the associated obligation or if other persons or Directors are legally responsible. We are not informed as to the purpose of these transfers and would not need to be so if we had a clear indication from those responsible for the group that the request had been approved. We have asked that you and [Ernst & Young] or other advisors make the appropriate arrangements and accountabilities clear to safe guard us all. I believe it is essential that at our Board meeting on the 26th of this month this matter is clarified in writing from John Walker and yourself so that everyone can have confidence and be clear about our responsibilities.

[101] Mr Tilby then sent an email echoing this concern and referring to "the lack of governance structure and procedures as it relates to the link between Mainzeal and the wider group, and of course Mainzeal's security going forward". He said:

> We appear to be in an overly flexible situation right now and I am somewhat uncomfortable as an independent director without the clear documented understanding on governance/responsibilities/accountabilities which we thought John [Walker] would have provided by now.

[102] Mr Yan replied by email the same day to say that a board paper was being prepared for the next board meeting. He went on to say:

> Mainzeal has always operated and continues to operate under a shareholder/parent guaranty and all the cash are shareholders' cash. There is no issue of independent director liability as Mainzeal is a wholly owned subsidiary and NOT an independent company as such. Under the guarantee, the group has always been willing and so far able and will only be more able going forward to guarantee all its obligations.

> As I have repeatedly explained in the past [Richina Pacific] does have issues of taking money out of China but it did large amounts last year when Mainzeal needed them so now Mainzeal [has] the cash and we have found a solution for taking cash out through King Façade, we are simply dealing with a time issue.
>
> Again, there are no independence issues here as it is ultimately the shareholders who are on the hook for everything. Mainzeal is in no way compromised and [Richina Pacific] has always supported it to the full extent even during its more dire situations.

[103] The directors appear to have agreed to the request for further funds to be advanced, as the cashflow register provided at the board's next meeting records a further advance of $1.2 million made on 16 August 2010.

[104] Mr Yan's 13 August 2010 email sheds considerable light on his thinking at that time. It reflects a number of significant misunderstandings about his role and the role of the other directors, and more generally about the position of Mainzeal.

[105] First, and most important, Mr Yan describes "all the cash" in Mainzeal as "shareholders' cash".[18] This plainly was not true at that time. As the board knew, there was a large deficit in shareholders' funds. Mainzeal was using creditors' funds as working capital. The cash that was being withdrawn from Mainzeal was not shareholder equity in the company.

[106] Second, Mainzeal was a company in its own right, and its directors had all the obligations that attach to directors of a company under the Act. Those duties had been modified in certain respects by Mainzeal's constitution. But Richina Pacific was no longer Mainzeal's holding company for the purposes of those provisions in Mainzeal's constitution. And, most importantly for present purposes, those modifications did not affect the directors' duties under ss 135 and 136 of the Act.

[107] Third, there was no legally enforceable guarantee from other group companies. The debts recorded in Mainzeal's balance sheet from other group companies were owed by entities without the means to pay them. The entities with significant assets in China had no legally enforceable obligations to Mainzeal, or to its debtor

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18 This theme that the cash was not Mainzeal's money, but Richina Pacific's shareholders' money, was reiterated by Mr Yan in the course of cross-examination at trial.

companies. Indeed by this time the entities of substance in China were no longer even providing (unenforceable) letters of support in connection with Mainzeal's audit.

[108] Fourth, the email records the issues Richina Pacific faced in moving money out of China, as a result of the foreign exchange regulations referred to above. Mainzeal's ability to access support depended on the continuing goodwill of the Chinese companies, and on their ability to find legally and practically workable methods of transferring cash to New Zealand.

[109] Drawing those threads together, the statement that "the shareholders … are on the hook for everything" was not accurate. Nor for that matter were the Chinese entities with significant assets "shareholders" of Mainzeal in 2010, following the restructuring. The entities in China with significant assets were not "on the hook" for anything except the construction bonds provided by Richina Pacific.

[110] Some clarification about these issues was provided by Mr Walker by email dated 26 August 2010, finally responding to Dame Jenny's inquiries from February of that year. His email described in some detail the new wider group structure. It set out a proposed resolution of the audit committee of Richina Holdings (BVI), the general partner of Richina (NZ) LP, approving transactions between Mainzeal and the Richina Pacific entities subject to a restriction that the transactions must be approved by the board of directors of Mainzeal, and in the aggregate in the course of a calendar year should not exceed USD 3 million. The resolution also provided that the Richina Holdings (BVI) audit committee must receive a quarterly register and report of all transactions authorised by those resolutions.

[111] Mr Walker's email advised the Mainzeal directors that Mr Walker periodically received separate registers, one prepared in Auckland by the Mainzeal CFO and the other prepared in Kuala Lumpur by the Richina Pacific team, reporting cashflows between Mainzeal on the one hand, and RGREL and other companies on the other hand. He advised them that he and another director of Richina Pacific had reviewed the most recent registers of cashflows for the period from 1 January to 13 August 2010 and believed that each of these cashflows "which constitute either intercompany fund

transfers or related party transactions, are for appropriate business and operating purposes. Accordingly, we have approved these cash flows."

[112] Mr Walker advised that if it was necessary in order for Mainzeal to win business, the audited financial statements of relevant entities in the wider group could be made available to appropriate parties on a confidential basis.

[113] The email concluded with the following significant observations:

> **Reporting Expectations of [Richina Holdings (BVI)]'s Board**
>
> As a result of the corporate restructuring, reporting that the Mainzeal Board previously made to the [Richina Pacific] Board should now be directed to the [Richina Holdings (BVI)] Board. Going forward, Wallace and I would like to receive the materials that are prepared for the Mainzeal Board meetings. At appropriate and convenient occasions, Wallace and I would like to have conversations with the two of you to learn first-hand your views regarding Mainzeal and its businesses and management. *However, we believe that it is the role and responsibility of the Mainzeal Board to make going concern, solvency and similar determinations with respect to Mainzeal.*
>
> I hope the above is a helpful step toward addressing the issues you have raised. Of course, I am happy to discuss any of this further with you. Richina's corporate structure continues to evolve, and it is most important that appropriate governance procedures accompany the restructuring.
>
> (Emphasis added.)

[114] Any illusions that might have been created by Mr Yan's email about the responsibility of the directors of Mainzeal to make going concern and solvency determinations in relation to that company were expressly dispelled by Mr Walker's email.

[115] Nor did that email provide any reassurance about the support available from other group companies. It gave no additional comfort to the Mainzeal directors when making decisions about whether Mainzeal was a going concern, and whether it was solvent. In particular, the question posed by Dame Jenny about whose responsibility it was to make sure the New Zealand division was operating while solvent was not squarely addressed. The Mainzeal directors were, as Mr Walker's email correctly recorded, required to determine whether or not the company was solvent. But if it was not solvent, the question of responsibility for remedying that problem remained unanswered. Nor was any short-term response provided in relation to the concerns

expressed by Dame Jenny and Mr Tilby about the cashflow issues that Mainzeal was facing, and the "overly flexible situation" that Mr Tilby considered the company was in.

[116] In the course of 2010 the Mainzeal board did begin to receive a register of cashflows between Richina Pacific companies and Mainzeal as part of the CFO's report to each board meeting. A copy of the last of these cashflow registers provided to the board before Mainzeal went into receivership, which runs through to the end of April 2012, is attached as Appendix A. It shows that in the course of 2010 some $2.1 million flowed out of Mainzeal to Richina Pacific entities, until the last entry of the year in which $5.3 million flowed the other way. However in the course of January 2011 approximately $4.6 million flowed back out again. It is difficult to escape the impression that the $5.3 million repaid to Mainzeal on 31 December 2010, which was largely withdrawn again in the following weeks, was window dressing to improve the appearance of Mainzeal's 2010 financial statements. We return to this below.

[117] The Mainzeal board met on 26 August 2010. The CEO's report referred to the importance of a strong balance sheet. In place of the note found in some earlier reports referring to a USD 10 million deficit, the CEO's comment in relation to the balance sheet Key Performance Indicator read as follows:

> **KPI 8 – Mainzeal Balance Sheet**
>
> - Subject to parental support letter.
>
> - The plans to strengthen the Mainzeal balance sheet via the progressive winding out of the related party loans by [Richina Pacific] paying for the Chinese imported materials and Mainzeal retaining the cash payments as equity, is welcomed.

[118] The reference to the plan to strengthen the Mainzeal balance sheet appears to be a reference to the pre-paid materials agreement that was subsequently entered into. This is explained in more detail below at [145]–[150].

[119] The CFO's report also addressed balance sheet issues:

> **Balance Sheet Strength/Bonding**
>
> A key requirement in order to demonstrate Balance Sheet strength is either the repayment of related party balances or alternatively the build up of equity. If related party balances continue to grow as opposed to being repaid an impairment issue emerges given the sheer quantum and long term nature over which the advances have been given. This was raised in last year's audit.
>
> By demonstrating the ability to repay related party balances we validate the collectability and therefore it does not bring into question whether or not they are an impaired asset. Purchasing of King Façade materials in the manner demonstrated in the last Board meeting papers is one such way of achieving this.
>
> Centralising cash balances to [Richina Pacific] will not assist with this however as cash will be perceived as still residing with the [Richina Pacific] related party brand and will not assist the Mainzeal brand. If equity is built up that equity or reduction in related party balance would need to remain either as cash or non-cash assets e.g. fixed assets, buildings, investments etc in order to strengthen the Mainzeal balance sheet as it moves towards becoming a stand-alone business.
>
> We have specifically just had these very questions surrounding ability to recall related party loans asked of us as part of the due diligence for the Auckland City Council Tepid Baths Project conducted by a local Chartered Accounting firm. Given our ability to produce a "clean" audit report that represented no impairment in the value of related party loans was a key factor in getting through the due diligence phase.
>
> For Mainzeal to be a stand-alone brand and show it is moving towards business independence from [Richina Pacific] some form of liquidity should be demonstrated in a market which is more and more focused on stress testing entities they want to enter a long term relationship with.

[120] The register of cashflows attached to the CFO's report showed the July 2010 rollover of $1.2 million and the further advance of $1.2 million on 16 August 2010, with an approximate balance of cash out from January 2009 to August 2010 of $4.4 million.

[121] Neither the papers presented nor the minutes of that meeting suggest that there was any significant discussion at that meeting of the role and responsibilities of Mainzeal's directors, or the balance sheet solvency of the company.

[122] The next Mainzeal board meeting took place on 13 October 2010. The minutes record a discussion about governance as follows:

> **Governance ([Mr Yan] on teleconference)**
>
> - [Mr Yan] discussed his views on the governance issues and the fact that nothing has changed.
>
> …
>
> - Board agreed that the governance structure had to be formalised prior to Christmas in conjunction with [RGREL]. **RP/RY/PG**
> - [Mr Pearce] to track down the original Mainzeal Board charter to review and update as necessary **RP**
> - Authority limits need to be circulated as a refresher.

[123] Following that meeting, on 24 October 2010, Dame Jenny emailed Messrs Yan and Walker identifying certain matters that "need attention". The first was that the "[g]overnance relationship needs to be addressed and finalised prior to Christmas (not reflected in the [board] papers)". In response, Mr Walker said this was being worked on, and he attached proposed resolutions of RGREL and Mainzeal. No proposed Richina Pacific letter or resolution was provided. The proposed Mainzeal resolution read as follows:

> That pursuant to the delisting of [Richina Pacific] the concept of independent directorship has become irrelevant in the context of [Richina Pacific] and [Mainzeal].

[124] It is difficult to know what was meant by the suggestion that the concept of independent directorship had become irrelevant in the context of Mainzeal. It may be that it was a reference to the ability of the board to act in the best interests of Mainzeal's parent company. But as discussed in more detail below, that is not the position where there is a significant balance sheet deficit and the capital that is supporting the company's continuing trading is creditors' capital, not shareholder capital. In any event, there is a large gulf between the modification of certain duties under s 131 of the Act, and the concept of independent directorship being "irrelevant". If the Mainzeal directors had sought external legal advice about this proposed resolution, the many difficulties with the approach it reflected would have been readily identified.

[125] At around the same time, it appears that the Richina Pacific board gave some thought to the provision of letters of support for the benefit of Mainzeal. On 5 October 2010 a series of resolutions and letters relating to the issue of support were prepared by Richina Pacific staff and sent to Messrs Walker and Yan. They included letters of support from Richina Pacific (China) Investment Ltd (an entity which held substantial assets in China and was often referred to as the "Chinese Holding Company" or "CHC" (CHC)) to RGREL, and from RGREL to Mainzeal. Although such letters are not generally the source of legally binding obligations, as noted above at [46]–[47], the proposed letters would have put in place a chain of expressions of support from the CHC to Mainzeal via RGREL.

[126] However it appears that a decision was made not to provide these formal expressions of support. Before the High Court, Mr Walker (and with less certainty, Mr Yan), said that these resolutions had been passed and the supporting letters signed. Dame Jenny also gave evidence that this was her recollection, and said they were very important documents for Mainzeal's directors. But the High Court Judge did not accept that these documents were signed, or that the resolutions were passed (a finding that was not challenged before us). No executed versions were produced. There is no record of the resolutions being passed or such letters signed. Subsequent emails make no reference to their existence. There is no record of the draft documents being sent to Mainzeal. Perhaps the clearest evidence that these letters of support were not signed is that the letters of support relied on by the auditors for going concern purposes from this time onwards came from Richina (NZ) LP. It seems clear that a decision was made that Richina (NZ) LP would provide the letters of support for Mainzeal, and that there would be no chain of letters of support from the CHC to Mainzeal via RGREL. We agree with the Judge that this cannot be the consequence of an oversight. There must have been a conscious decision made by Richina Pacific that the commitment would not come from the CHC. Rather, any letter of support would be provided by Richina (NZ) LP, an entity without substantial assets.[19]

[127] The apparent belief of Dame Jenny and Mr Yan that this chain of support letters was in place, when that was plainly not the position, is consistent with their focus on

[19] High Court Judgment No 1, above n 1, at [98]–[99].

informal oral assurances of support. The directors failed to ensure that Mainzeal had clear assurances of support in writing from an entity that was able and willing to provide such support, despite Mainzeal's dependence on that support.

[128] The failure to address governance issues and directors' obligations under the new structure was, by this time, causing Mr Pearce significant concern. In an email following the board meeting on 13 October 2010 Mr Pearce provided a confidential update about the meeting to Mr Walker. He raised a number of concerns, including in relation to Mr Yan's comment that "nothing has changed". Mr Pearce said:

> The main point that continues to require agreement is what exactly are the directors obligations and duties under the new structure that you have previously addressed in an email.
>
> …
>
> As you know governance is all about transparency and my fear (as with the Waiheke winery potential purchase) is that if this is not adequately sorted out and agreed then [Dame Jenny] and [Mr Tilby] may ultimately resign which [Mr Gomm] and I certainly don't want to happen.

[129] He went on to note that it would be "interesting" whether Ernst & Young would regard the related party balances as impaired, and reported that Mr Yan wanted to handle this issue himself with Ernst & Young during the audit and did not want others involved.

[130] When Mr Pearce did not receive a substantive response from Mr Walker, he followed up in a further email dated 12 November 2010. He said that he remained "deeply concerned about the activities that are happening down here". Referring to continuing cashflows out of Mainzeal and the lack of control over these, he said "as CFO this is alarm bell material for me" and "I know this is blunt but I find the whole thing nothing short of frightening".

[131] Mr Walker responded on 13 November 2010. He said that it was "important for the Mainzeal Board to have a full and frank discussion with [Mr Yan] regarding the concerns from Mainzeal's perspective, including from the perspective of Directors' obligations". He said that a discussion paper prepared by Mr Pearce, referred to as the "White Paper", could be very helpful in moving this issue forward. Mr Walker

reported that he had discussed the position with Mr Yan, who had agreed that the issue needed to be taken seriously.

[132] There is no record of any serious engagement with these issues in the correspondence or minutes of board meetings for the remainder of 2010.

January 2011

[133] It does however appear that in late 2010 Mainzeal sought advice from Ernst & Young on certain corporate governance issues. A draft of the report was provided to Mainzeal in January 2011. It recorded that Ernst & Young had been asked to undertake the following work:

> - Assess the current corporate governance framework in terms of how the company operates with the immediate parent and ultimate shareholders;
> - Assess the current corporate governance framework in terms of how practices may be perceived by customers of [Mainzeal];
> - Consider the effectiveness of current practices through discussion with board members and executives;
> - Evaluate current corporate governance practices against leading practices; and
> - Identify typical public sector procurement evaluation assessment criteria to assess your financial capacity and capability to be considered as a contracting partner for an exemplar public sector construction project.
>
> In addressing the corporate governance framework consideration has been given to:
>
> - the nature of [Mainzeal] and its shareholding structure, its immediate group structure and ultimate group structure;
> - the "central treasury facility" that is operated; and
> - The balance sheet (financial statements) of [Mainzeal].

[134] The draft report highlighted the lack of transparency in the relationship between Mainzeal and other group companies and in Mainzeal's balance sheet, the

effect on Mainzeal of intra-group cash transfers, and the absence of an audit committee. It set out the following "Specific high-level findings":

- The independent directors of [Mainzeal] are not directors of the parent company, [RGREL] (or other NZ group companies). This may raise the perception that the independent directors of [Mainzeal] are unable to exercise any effective influence of the operations of [Mainzeal], its structure or its balance sheet due to the influence of its shareholder. This may be exacerbated by the external perception that the current group structure is "too hard to understand". We note there is one independent director (Mr Wallace Mathai-Davis) at the parent company level.

  Under the constitution of [Mainzeal], directors may, when exercising powers or performing duties as a director, act in a manner he or she thinks is in the best interests of the parent, even though it may not be in the best interests of [Mainzeal]. As the independent directors are not directors of the parent or any other group company, this may place them in a position where they are not able to independently assess what is in the best interests of the parent and therefore may be at risk of being compromised in their actions.

  Recommendation: Consider the structure of the NZ Group ([RGREL] group) thereby enabling all NZ operations to be transparent to the independent directors. This would enable all NZ operations to be viewed externally in a more holistic manner.

- All assets of [Mainzeal] and the NZ Group are not independently verifiable or transparent. The NZ Group, through [Mainzeal], has significant related party loans with a sister company, MLG. The auditor's report for the group and for [Mainzeal] has an emphasis of matter regarding future parent company support, primarily due to the inability to independently verify the collectability of these loans. In this regard we note that MLG is not audited.

  Recommendation: Consider the financial structure of the NZ Group, bringing all assets under the control of the audited group. This may require a review of the mechanism utilised for transferring cash reserves via the centralised treasury, i.e. utilisation of dividend payments rather than inter-company transfers.

- The above related party loans have arisen due to inter-group cash transfers. Beyond the immediate NZ Group there is no clear visibility of these transfers. We understand that these loans arise through the operation of a centralised treasury function. The circumstances set out above arise due to the manner of the operation of this function, i.e. once the monies leave [RGREL] group all visibility is lost.

  Recommendation: As above.

- Kunshan Richina Hotel Limited, a Chinese subsidiary, is consolidated by the NZ Group. The major asset of this subsidiary is land rights. The net assets of the subsidiary are off-set by an intercompany payable, which results in no increase in equity of the NZ Group.

Recommendation: Undertake a review of the group structure to determine the need for Kunshan Richina Hotel Limited to remain within the NZ Group.

- The current board charter for [Mainzeal] was last updated in February, 2004. At this time the group structure was different to that which now exists. The continued relevance of the charter needs to be considered.

  Recommendation: Undertake a review of the [Mainzeal] board charter in conjunction with a review of the group structure.

- There is currently no audit committee specifically constituted to consider financial matters, particularly the annual financial statements of [Mainzeal] or the NZ Group. Whilst the board fulfils the role of the committee, the operation of a specific committee in our view raises the significance of the process of considering the financial statements. Further, the [Mainzeal] independent directors do not have formal visibility of the group financial statements. This could have an impact where a [Mainzeal] customer wishes to consider the NZ Group financial position.

  Recommendation: Constitute a formal audit committee at a NZ Group level. Note this committee may operate as an extension of board procedure, however it should be a formal process operating under a specific audit committee charter.

- No formal risk management framework is in place for [Mainzeal] (or the NZ Group). We understand that plans are in place to formalise a risk committee for projects.

  Recommendation: The plans for the risk committee for projects should be continued with. Further, oversight of risk at a board level should be considered.

[135] Referring to the "centralised treasury function", the report said:

> The centralised treasury function originates from [Mainzeal]. Transfers of cash occur for the most part from [Mainzeal] to other group and cross-group companies (where the ultimate ownership is not clear and the ultimate utilisation of the cash is not known). The issue however is not with the transfer or the authorisation of the transfer. The issue is that the resultant receivable held by [Mainzeal] is NOT collectible when demanded.

[136] The report also set out a Mainzeal "self-assessment" prepared by the CEO and CFO in relation to certain matters, including Mainzeal's relationship with its parent companies. It records "[c]onfusion as to what is the 'ultimate' parent company." In response to a question about the financial strength and capacity of the parent company, the self-assessment notes "[p]arent company relies on sister company in China" and "conditional on getting funds out of China".

[137] Mr O'Brien QC, counsel for the liquidators, confirmed in the course of argument that one of the reasons that the liquidators had selected 31 January 2011 as a relevant breach date was the receipt by the board of this draft Ernst & Young report in January 2011. He said that although the directors ought to have been aware well before this point of the balance sheet insolvency of Mainzeal, and difficulties in relying on support from the CHC, the draft report clearly spelled out the key issues of concern. It should have triggered a careful appraisal by the directors of Mainzeal's financial situation, and the need for additional capital or formal expressions of support from the CHC if Mainzeal was to continue to trade.

[138] On a more positive note, the board papers for the first meeting of the year, held on 7 February 2011, recorded strong cashflow and a "normalised" Earnings Before Interest and Taxes (EBIT) in management accounts of just over $4 million. However after allowing for legacy costs this reduced to a slender $109,000. The management accounts suggested that after taking into account capitalised interest on inter-company loans, earnings before tax would be just under $4 million. This figure reduced substantially in the final audited accounts, as discussed in more detail below. But the picture presented to directors in relation to the immediate financial outlook in early 2011 was relatively positive.

Further developments in 2011

[139] Mainzeal's audited financial statements for the year ending 31 December 2010 were signed off by the directors, and by Ernst & Young as auditors, in April 2011. The financial statements recorded an operating loss of $1,020,553. They also recorded a profit before tax of $1,758,186 after taking into account the accrued and capitalised interest on inter-company loans of $2,778,739. Excluding that interest accrual, the company made a loss.

[140] The financial statements recorded net assets of some $26.3 million. Inter-company receivables of some $44.5 million included debts of approximately $30 million owed by MLG, and approximately $12 million owed by RGREL. If the inter-company obligations owed by related companies are disregarded, there was a deficit in shareholder funds of approximately $18.2 million.

[141] Note 14 to the financial statements read as follows:

> **14. Continued shareholder support**
>
> The considered view of the Directors of [Mainzeal] is that, after making due enquiry there is a reasonable expectation that the Company has adequate resources to continue operations at existing levels for the next 12 months from the date of the audit report. The shareholders of [RGREL], the immediate parent of the Company, have undertaken to provide financial assistance to the Company, if necessary, to ensure that the Company will meet its debts as they fall due.

[142] The auditors' report included the same emphasis of matter in relation to this as in the previous year:

> **Emphasis of Matter**
>
> We draw attention to Note 14 of the financial statements which describes the continued support of the shareholders of [RGREL], the immediate parent company. The financial statements have been prepared on the going concern basis, the validity of which depends upon the continued financial support by the shareholders of the immediate parent company. The financial statements do not include any adjustments that would result should the support of the shareholders of the immediate parent company be discontinued. Our opinion is not qualified in respect of this matter.

[143] As in 2010, the letter of comfort came from Richina (NZ) LP. It read as follows:

> Dear Directors,
>
> In order for the directors of [Mainzeal], to be in a position to support the use of the going concern basis in preparing the financial statements of [Mainzeal], which means that [Mainzeal] is able to meet its debts as and when they become due in the normal course of business, continue in operation without any intention or necessity to liquidate or otherwise wind up its operations, and the value of the company's assets is greater than the value of its liabilities, including contingent liabilities, and
>
> - to give assurance to the directors and officers of [Mainzeal] of the firm intention of Richina (N.Z.) LP to financially support [Mainzeal] in the future,
>
> we hereby acknowledge to the directors of [Mainzeal] that:
>
> - Richina (N.Z.) LP accepts responsibility of providing and undertakes to provide sufficient financial assistance to [Mainzeal] as and when it is needed to enable [Mainzeal] to continue its operations and fulfil all of its financial obligations now and in the future.

> This undertaking is provided for a minimum period of twelve months from 28 April 2011.

[144] A letter in essentially identical terms was provided by Richina (NZ) LP to RGREL. There was no letter of comfort from the CHC or any other entity with substantial assets to either Mainzeal or RGREL.

[145] In the course of 2011 a proposal was developed to reduce the inter-company balances, despite restrictions on removing funds from China, by Richina Pacific supplying building materials to Mainzeal from China. This proposal was called "Project Citron". On 24 August 2011 Ernst & Young provided a report on Project Citron. The report referred to the $42.4 million in related party receivables on Mainzeal's balance sheet, which it described as the "result of historical extraction of funds from [Mainzeal] for utilisation within the broader Richina Group". The report recorded that MLG did not have sufficient funds to repay the inter-company balance if it was called on to do so. The report suggested a "recapitalisation plan" under which a Richina Pacific entity would purchase building materials in China, and then supply them to Mainzeal. The MLG debt to Mainzeal would be reduced by the value of the materials received.

[146] These proposals were ultimately implemented on 31 December 2011. A series of transactions was entered into that was collectively referred to as the "Pre-Paid Goods Agreement". In summary, MLG's debt to Mainzeal of some $33 million was restructured so that it no longer accrued interest, and was repayable in 10 years' time, subject to MLG's profitability. The CHC was assigned the right to receive the repayments. In exchange the CHC would supply building materials to Mainzeal under a forward purchase agreement. A schedule prepared at the time contemplated an effective elimination of the debt through the supply of these materials over a three-year period ending in 2014.

[147] As the Judge noted, this arrangement had two advantages.[20] First, it was a mechanism that appeared to address the foreign exchange restrictions in China: an obligation to pay money to Mainzeal was replaced by an arrangement for supply of

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[20] High Court Judgment No 1, above n 1, at [116].

goods. Second, it was consistent with Mainzeal's plans to take greater advantage of the supply of Chinese building materials, in particular in relation to building facades (the exterior cladding of buildings). Mainzeal had developed a business plan to become a supplier of building products of this kind through a related company known as King Façade Ltd (King Façade), and had already been receiving some materials in accordance with that plan. It had used these facades on a development for Baradene College in Auckland.

[148] However as the Judge went on to explain, the arrangement also had considerable disadvantages.[21] Mainzeal's balance sheet solvency issue would continue until sufficient profits had been generated from the use of the materials supplied to make good the approximately $18 million deficit in Mainzeal's net asset position. Meanwhile, no interest would be earned. The arrangement tied Mainzeal to a single supplier of the relevant building materials. The Project Citron report also referred to the risks inherent in a supply chain from China for building materials. These risks materialised over the next two years: the supply of building materials through King Façade became a significant problem which caused substantial losses for Mainzeal.

[149] Another significant consequence of this arrangement was that it depended on Mainzeal continuing as a going concern, with a need for supply of building materials. There was no right to seek a cash payment in lieu of the materials, if Mainzeal ceased operating as a construction company.

[150] A further disadvantage which was not appreciated by the Mainzeal board at the time was that, as a matter of Chinese law, the agreement was unlawful and not enforceable. The shared view of the Chinese law experts called by the parties was that because the agreement sought to circumvent prohibitions on moving funds out of China it would be treated as "arbitrage", which was unlawful. The Mainzeal board did not appreciate this because it did not take any independent advice on this substantial transaction.

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21 At [117].

2012 — Cashflow difficulties

[151] In the course of 2012 Mainzeal experienced increasingly acute cashflow difficulties. These arose primarily as a result of issues encountered with a significant construction contract that Mainzeal had entered into with Siemens (N.Z.) Ltd (Siemens). Siemens was the head contractor for the upgrade of the electricity transmission link between the North and South Islands, which is owned and operated by Transpower. Mainzeal won a contract with Siemens to do the construction work for this upgrade at locations in the North and South Islands. There were substantial cost overruns, and disputes about payment arose between Siemens and Mainzeal.

[152] On 26 April 2012 Mr Pearce advised the directors that Mainzeal should meet its cashflow projections through to 20 May 2012, but there could be a shortfall of $9 million if Siemens refused to make an interim payment. At the board meeting on 23 May 2012, the board recorded there was a $7 to 7.5 million gap in the company's cashflow as a result of Siemens not paying. BNZ, Mainzeal's bank, was not prepared to extend Mainzeal's facilities to bridge this gap. Richina Pacific agreed to fund this cashflow gap. It did so by using a new technique it had identified for providing funds to Mainzeal: Standby Letters of Credit (SBLCs). Put simply, Chinese banks could make facilities available that allowed offshore banks to give credit that could be used offshore. The Chinese government did not need to approve individual SBLCs. Rather, it placed restrictions on the overall ability of each Chinese bank to provide such facilities and transferred responsibility to each bank to ensure that the SBLCs it granted complied with relevant conditions and overall limits.

[153] As mentioned above, in April 2012 Sir Paul joined the Mainzeal board. He represented a group of investors in Richina Pacific through an investment vehicle known as Active Equities Ltd. It appears there was a plan for him to succeed Dame Jenny as Chair of the Mainzeal board. Almost immediately after joining the board, he identified the significant balance sheet issues described above. He was conscious that without support from China, Mainzeal would not have survived in the past, and advised Mr Walker and others that a significant cash injection was desirable. Shortly afterwards, he suggested that additional capital should be introduced as

preference shares or in the form of subordinated debt, ideally in the region of $20 million.

[154] A board meeting was held on 23 May 2012. There was discussion of a further restructuring which was initially called "Project Shutter", and subsequently renamed "Project New Blue". The general idea was to build up New Zealand entities outside Mainzeal with assets that would provide a stronger capital base within New Zealand. A new entity would continue the construction business, with the benefit of those assets. This strategy was seen as having two related advantages. First, it would mean that Mainzeal was less of a target for leaky building claims because its assets would be shifted into these new entities. Second, those other entities would be more attractive counterparties for other industry participants and funders, including the bondsmen and Chinese banks, because they would not be vulnerable to the leaky building claims and other legacy claims that posed a significant and continuing problem for Mainzeal.

[155] The Siemens dispute continued to put pressure on Mainzeal's cashflow. At a board meeting on 27 June 2012 Mr Pearce advised that cashflow remained critical. In addition to the Siemens dispute, there were serious delays with another project (the "Geyser Building" in Parnell) as a result of difficulties with the delivery of materials by King Façade. The impact on cashflow from that issue was described in Mr Gomm's report as "serious when coupled with the slow progress being made with Siemens". The legacy issues were also of increasing concern. Mr Yan presented a revised version of the restructuring proposal, which was summarised by Dame Jenny as "putting Mainzeal's good assets into a new company and isolating legacy claims in the 'old' Mainzeal, while at the same time creating a holding company for all Richina's Mainzeal companies, to be called Mainzeal Group Limited". The board agreed to give further consideration to the restructuring.

[156] The next board meeting took place on 5 July 2012. The growing cashflow problem was discussed. In an email prior to that meeting Sir Paul observed that Mainzeal was in a "precarious position to say the least". BNZ had put a revised proposal to Mainzeal for continued funding of working capital needs, but this required a personal guarantee from Mr Yan supported by a second mortgage over his Remuera property. Mr Yan was unenthusiastic about giving the guarantee, but eventually did

so. In an email about BNZ's requirements Sir Paul advised Mr Yan that given BNZ's security over other assets, Mr Yan was not truly at risk. Sir Paul said that BNZ "would always get their money out — it's all the unsecured creditors who are seriously exposed". Sir Paul's observation was correct: by this time existing and new unsecured creditors of Mainzeal were seriously exposed, though of course there was nothing to alert them to this significant risk. Further funding was necessary to enable Mainzeal to pay debts as they fell due, and enable Mainzeal to survive.

[157] Further short-term funding was obtained from BNZ and from Richina Pacific. BNZ agreed to increase Mainzeal's facility to $12 million, made up of an $8 million core facility and a $4 million excess. The facility would be reviewed monthly. As one of the conditions of providing the facility, BNZ required Mainzeal to provide it with daily cashflow information. In addition, Richina Pacific agreed to make a further $1 million available to Mainzeal immediately, a further $5 million the following week, and $2.7 million the week after: a total of $8.7 million.

[158] Mr Yan said in evidence that he personally had no real concerns about Mainzeal's solvency at this time. However that was not a level of confidence shared by Sir Paul. In an email to Mr Yan sent on 10 July 2012, Sir Paul said:

> I would have to say I'm at my wits end.
> I joined the board under the impression Mainzeal was solvent - I accept Siemens came from left field but equally I accepted all your representations re support and more recently redomiciling in NZ later this year and taking out the BNZ.
> As you will well appreciate I have dealt with a lot of bad news stories over the years and have found that matters can be worked through when you have all the cards on the table. I don't have that confidence here.
> …

[159] In his evidence Sir Paul suggested that this email had been written with a degree of emphasis because he was seeking to make a point. He said that he believed that Mainzeal was solvent in April 2012 when he joined the board, and that, whilst Mainzeal was always relying on the group's balance sheet and its significant Chinese assets for solvency, he believed the group "could financially support Mainzeal when necessary". He sought to explain his email exchanges over the period as being influenced by the particular circumstances, and the emphasis he was trying to give. Be that as it may, his emails throughout 2012 demonstrate a growing concern

regarding Mainzeal's reliance on expressions of support, and the absence of support at the level needed to ensure Mainzeal could continue to operate.

[160] The dispute with Siemens remained unresolved. Mainzeal was unsuccessful in adjudications under the Construction Contracts Act 2002 that took place in September 2012 and October 2012. Richina Pacific was struggling to find ways to transfer additional funds to Mainzeal. In an email to Sir Paul on 13 September 2012, Mr Yan said:

> We can fund the [King Façade] exports in China but we can't find any bank willing to lend to any NZ entity foreign cash even against our cash deposits in China because of the extremely poor financial results and the huge misses of budgets/forecasts for the past two years in a [row] by a wide margin. There is no other magic solution unfortunately! Our China businesses are already drained of all their cash possible for offshore use and our licenses are now at stake.

[161] Mainzeal began selling assets to deal with the cashflow difficulties it faced. Two properties were identified for sale: a property at Carbine Road, thought to be worth approximately $5 million, and Mainzeal House, thought to be worth approximately $15 million.

[162] In November 2012, as a condition of continuing to provide facilities to Mainzeal, BNZ required Mainzeal to appoint PwC to undertake a high-level independent assessment of Mainzeal's financial position, funding requirements and on-going viability. PwC provided an interim report on Mainzeal's financial position and funding requirements on 29 November 2012.

[163] In parallel with these events, work continued on the Project New Blue concept.

[164] On 1 December 2012 Sir Paul emailed the directors to say that specialist advice on solvency was urgently required. He expressed the view that if Mainzeal did not have BNZ's support, the company was insolvent and a receiver should be appointed. He said that Mainzeal needed additional equity of not less than $10 million. Shortly before this, Mr Pearce had emailed the directors to say that he was getting complaints daily about bills not being paid by Mainzeal.

[165] The directors sought independent legal advice from Chapman Tripp, which was provided by email and discussed at a board meeting on 4 December 2012. Mr Michael Arthur of Chapman Tripp attended the meeting. The minutes record the discussion as follows:

> **4. INDEPENDENT LEGAL ADVICE**
>
> - [Mr Arthur] addressed the meeting in his role as independent legal advisor to the Board. His advice to Directors was to attend to the responsibilities laid out in his email of 3 December (4 items listed below):
>
>   1. Obtain, and critically consider, good and reliable information and advice.
>
>   2. Monitor closely, and with increased frequency, performance of the company against cash-flow projections. Essentially, the same question (whether on-going trading is prudent) should be asked repeatedly, as all new information becomes available.
>
>   3. Ensure that any third party commitments, on which the Board is relying, are documented in a legally binding way.
>
>   4. Consider very carefully any significant new obligation. Specifically, does the Board reasonably consider that the obligation will be met when it falls due?
>
> - In addition to the above, [Mr Arthur] provided further clarification with respect to solvency considerations and any plans to trade out established for Directors.
>
> - These are summarised as follows:
>
>   • The Courts are sympathetic to Directors' rights to trade out of difficult business situations; that they should be given reasonable time to do so (months generally, not days or years). Normally trading out required committing more equity to the company.
>
>   • In deciding to trade further, Directors had to consider the risk of injury to the "body" of creditors but do not need to base key decisions on the needs of individual creditors.
>
>   • Ask always, "Do I/we have the information that I need, do I trust it?"
>
>   • Have more regular meetings and ask the right questions.

- If other members in the group are being required to support, the interests of those Boards need to be considered and their approval obtained.

(Note: this seems not to be an issue in our situation).

- With regard to email item 3 above, all commitments from the shareholder or others need to be legally structured and specific to each pledge made. Frank Chan (FC) will draft the necessary commitments for Board approval.

- [Mr Arthur] stressed how important it was to get PwC validation of any plan going forward.

[166] The advice underscored the importance of appropriately specific and legally effective commitments from shareholders and other related entities to support a decision to trade further.

[167] We return below to two elements of this advice: the ability of directors to trade out of difficult business situations, and whether the obligation of directors to consider creditors is limited to the risk of injury to creditors collectively, rather than individual creditors.[22]

[168] On 8 December 2012 Sir Paul emailed Dame Jenny and Mr Yan emphasising the need for a binding commitment of support. He put it as follows:

> - Solvency/Capital - while "cash is king" clearly solvency is also important - the suggested underwrite/indemnity/confirmation of support from the parent if appropriately worded and given the equity position in China will be adequate in my view. It should come from [Richina Pacific] and [Richina Holdings (BVI)] and be signed by [Mr Walker] and [Mr Yan].

[169] At the board meeting on 11 December 2012, the board received an update on key issues including the asset sale programme, settlement with Siemens and other issues affecting cashflow. As a condition of continued support BNZ had required Mainzeal to reach an overall settlement with Siemens by accepting an offer made by Siemens to pay final amounts bringing the total paid under the contract to $86.5 million. The directors considered this was significantly less than should have been recovered. Mr Walker described this outcome in evidence as Mainzeal settling

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22 See [264]–[271] and [283]–[287] below.

with a gun to its head. He estimated that Mainzeal lost between $4 million and $16 million on the settlement. The settlement eased the immediate cashflow pressure the Siemens dispute had generated. But the company remained under significant financial pressure.

[170] At the 11 December 2012 board meeting Mr Yan said that he was committed to pursuing transfer of more capital to Mainzeal from China at dates in March and June 2013, but that the regulatory framework in China did not permit funds to be transferred earlier. He confirmed there was no capacity to bring further cash from China before 20 December 2012.

[171] On 18 December 2012 PwC provided a draft of stages two and three of their independent appraisal of Mainzeal. The draft report identified significant concerns about (among other matters) the reliability of Mainzeal's forecast cashflows, legacy claims, and the recoverability of debts owed by related entities. The outlook for the Mainzeal group over the next 12 months remained "very uncertain". Management's ability to execute the business plan over that period depended on a number of factors, including completion of certain asset sales, resolution of legacy claims, and "[a]n equity injection to recapitalise the Group to a level commensurate with its scale of operation".

[172] Mr Yan said in evidence that by Christmas 2012 he realised that Mainzeal might collapse. This caused him concern in relation to his personal guarantee. He approached both Dame Jenny and Mr Gomm in January 2013 and asked them to talk to BNZ and request that his wife be released from her personal guarantee. Dame Jenny gave evidence that Mr Yan told her that he could not continue to support Mainzeal unless the guarantee from his wife was waived. Dame Jenny said that she then told Mr Walker about that conversation, saying that unless Mr Yan resolved the issue concerning provision of further cash by way of equity there was "a real risk that I, and the other directors, would resign as we felt that undertakings previously given may not be able to be relied on".

[173] Some elements of the proposed Project New Blue restructuring were implemented at the end of 2012. A new company called Mainzeal Group Ltd (MGL)

was established as the immediate holding company for Mainzeal. The Mainzeal directors "migrated" to MGL with effect from 31 December 2012. Dame Jenny, Sir Paul and Mr Tilby resigned as directors of Mainzeal. Messrs Yan and Gomm continued as directors of Mainzeal. They were already directors of MGL. They were joined on the MGL board by Dame Jenny, Sir Paul and Mr Tilby.

2013 — Mainzeal's collapse

[174] An MGL board meeting was held on 21 January 2013. At that board meeting Mr Yan advised that discussions were progressing in China to provide a further $10 million of funds in addition to an expected $2 million from the sale of a property on Waiheke Island owned by another related company.

[175] In an email dated 22 January 2013 to Messrs Walker, Mr Yan, and the other Mainzeal directors, Dame Jenny recorded the view reached at the board meeting that progress was being made in addressing the many challenges faced by Mainzeal and that those issues were "within the range of what can be resolved by good leadership and management by Mainzeal executive and also, if necessary, what will be negotiable with the Bank if required". The email referred to advice from Mr Yan that genuine progress was being made in arranging for cash to come in from China. She recorded that the directors:

> … specifically addressed the issue of whether we have a genuinely held belief that the company is a going concern not withstanding that there are still a set of very significant issues that are works in progress as laid out in our agreement with the Bank. The Board unanimously agreed that based on the performance and evidence we are a going concern.

[176] However the email then went on to record developments after the board meeting, and the concerns that those gave rise to as follows:

> An hour after the board meeting which [Mr Yan] and [Mr Yan's wife] participated in, [Mr Yan] called me to say that he and [his wife] had a problem with a condition of the guarantee which was entered into in the middle of last year and was refreshed in Dec. There have been lengthy conversations with [Mr Yan] concerning this issue since then which has led to the position where he has informed me that unless he can get the guarantee varied he will withdraw his support for the company. I have urged [Mr Yan] to take advice on this point and to make clear to him that in my view that is not a personal choice he has. It is my view that it is the responsibility for the [Richina Pacific] board to make such a decision.

The [Richina Pacific] Board has over many years provided undertaking both specifically and generally that [Richina Pacific] stands behind the undertakings it has given to the market and in particular to Mainzeal Directors and others. As recently as December I have emails from [Mr Yan] on behalf of the [Richina Pacific] Board as I prepared to make presentations to the BNZ that Richina [Pacific] was and remained “100%” behind [Mainzeal] and that the new company was established on the basis of that confidence in these undertakings. Directors of Mainzeal agreed to migrate to MGL on this basis and with confidence in these undertakings.

Please note on the 13th of Dec [Mr Walker] and [Mr Yan] “for and on behalf of [Richina Pacific]” gave undertakings to the Board of Directors of [Mainzeal] re asset sales and on the 19th Dec [Mr Yan] on behalf of [Richina Pacific] gave the Board of Directors of [Mainzeal] undertakings re [the Waiheke property] and the cash injections from [Richina Pacific] on or by the 31st March and the 30th June.

REQUEST
I seek on behalf of the Mainzeal Directors confirmation in writing from the Board of [Richina Pacific] that the undertakings given in relation to
a] funding of materials from China as reflected in the business plan and cashflows for 2013 and
b] the equity {cash injection} to be provided by 31st March and 30th June consistent with the undertakings as was presented to and approved by the BNZ as part of the negotiation in Dec which led to the current arrangement with the BNZ, will both be honoured. If this is not the case please notify us immediately so we may consider our position, our obligations and the associated implications for the company.

Further, I am very concerned based on discussions that have been held in my presence that [Mr Yan] has indicated his intention to move to withdraw [Richina Pacific] support if he can’t get agreement from [BNZ] concerning the guarantee. He has indicated that it is his intention that the timing of such a decision would be solely related to when he believes he is least exposed to the personal guarantee, that is when we have a peak inflow of funds not withstanding that we have outgoing obligations for those funds which are directly related to subcontractors etc on those projects. In doing so I believe he is knowingly seeking to disadvantage sub-contractors and others who are due to be paid as a result of the funds in hand and the working capital arrangements that the company has in place. While I understand his interest I don’t agree that it is in the best interests of the company and further I believe it is inconsistent with our obligations and undertakings we have previously entered into. It is important that I remind us all that we have legal obligations as Directors to act in the best interests of the company and the business undertakings we have made. This obligation also involves the receivables as outlined on the balance sheet and the associated undertakings reflected in them in my view and this point should not be overlooked. PwC has expressed a very clear view on this matter in their reports!

[177] Mr Yan responded by email on 23 January 2013 to confirm that “the shareholder support has NOT changed from what [Richina Pacific] undertook in December”. The email emphasised the difficulties in relation to getting cash out of

China. One possible avenue had been identified but many conditions were attached that needed to be worked through. The proposed timing was $2 million at the end of March 2013 (assuming the Waiheke property sale settled or $4 million if not) and $6 million at the end of June 2013. But it would not be until after Chinese New Year — around 20 February 2013 — before there could be written confirmation of this facility.

[178] In their evidence Messrs Yan and Walker said that discussions about providing funds to Mainzeal then took place with a Mr Jian Guo Huo who had recently been appointed as Chair of the CHC. He had previously been the CHC's CEO. Mr Yan said that Mr Huo advised him that the CHC could not give assurances on funding Mainzeal until it demonstrated profitability.

[179] On 29 January 2013 Mr Yan sent a letter to the directors of MGL and Mainzeal to report that he had been formally told that the CHC was unable to provide the assurances sought by Richina Pacific for the benefit of Mainzeal. He said that unfortunately he was "forced to conclude that this means that each of [Mainzeal] and MGL will not be able to pay its debts as they fall due, will be unable to meet the solvency test under the Companies Act and is therefore no longer a going concern".

[180] Mr Yan formally requested an urgent board meeting to consider a resolution to inform BNZ and request the appointment of a receiver to the Mainzeal group. The letter went into considerable detail in relation to the difficulties that had been encountered in obtaining funds to transfer to New Zealand, and in continuing to provide building materials in the absence of foreign currency held by the CHC with which to pay for those materials.

[181] Mr Yan concluded by setting out his view of the support that had been provided to Mainzeal:

> **Commitment of the [Richina Pacific] shareholding interests**
>
> The [Richina Pacific] shareholding interests and myself personally have done everything in our power to assist the Mainzeal group and in particular over the past 6-8 months. We have provided comfort letters and more recently equity undertakings to help ensure that Mainzeal group is a going concern. We have committed and delivered additional equity as requested by the [Mainzeal]

> Board and BNZ. At the critical time of [Mainzeal]'s negotiations with BNZ in July last year, I personally gave my support by giving securities in the form of a personal guarantee of $8M and my wife also provided a guarantee of $8M. I have subsequently increased my exposure under my personal guarantee to $19M. We have also given security over personal property. Assets outside the Mainzeal group were also committed to be sold. As of last Friday, we successfully ensured that the sale of [the Waiheke property] was unconditional in principle. We have done what has been expected and asked of the shareholding interests and more in my personal capacity. It is with deep personal regret and sadness that I am not able to do any more. I am keenly aware that these events will have wide reaching and immediate commercial and human consequences, including for my own family. CHC and myself personally have exhausted all avenues for finding funding for the payment for [King Façade] NZ materials and for equity funding in China and elsewhere. After taking urgent professional advice on the events of late yesterday, I have been advised that I must immediately inform the Board in the terms above.

[182] All of the directors gave evidence of their surprise at this turn of events, and the collapse of Mainzeal that followed. Even at this late stage, Mr Walker considered that the position might be salvageable. He considered that Mr Yan was too pessimistic. He resumed negotiations with Mr Huo and, after making further progress, obtained further commitments of support from the CHC. On 31 January 2013 a letter from the CHC signed by Mr Huo was sent to the board of Richina Pacific. It provided assurances in relation to further support subject to certain conditions, including Mainzeal providing a three-year business plan and pro forma financial statements based on which the CHC could reasonably conclude that Mainzeal going forward would be a viable and profitable business and would be able to service its debts. The letter also indicated that the CHC would seriously consider the sale of certain assets to generate profits of up to NZD 10 million which could be remitted out of China, subject to certain regulatory restrictions. The proceeds of those remittances would be made available to Mainzeal to support its on-going business operations.

[183] In turn, a letter from Richina Pacific signed by Mr Walker to the Mainzeal directors and to BNZ set out the support that would be available from the Chinese companies, if BNZ was willing to continue to support Mainzeal.

[184] Meanwhile, however, Mr Yan's 29 January 2013 email had been communicated to BNZ. By letter dated 31 January 2013 BNZ advised that it was suspending any further drawings on its facilities. This triggered Mainzeal's demise.

The independent directors all resigned on 5 February 2013. Receivers were appointed on 6 February 2013. Mainzeal was placed into liquidation on 28 February 2013.

[185] One result of Mainzeal's collapse was that the construction bonds guaranteed by Richina Pacific were called on by a number of principals. Mr Walker's evidence described the steps that were taken to deal with that situation. The difficulty facing Richina Pacific was that it had considerable assets in China, but did not have much liquidity, and was constrained by Chinese foreign exchange regulations. It was therefore not able to meet the obligations arising under the bonds immediately. In order to manage that situation, and in order to minimise the extent of its obligations, Richina Pacific was put into voluntary provisional liquidation in Bermuda in March 2013. Negotiations then took place with the bondsmen in relation to Richina Pacific's obligations. Ultimately Richina Pacific reached a settlement involving a payment of $19 million over a period of time. Richina Pacific then came out of provisional liquidation in December 2013.

[186] On 10 February 2013, shortly after receivers were appointed, Dame Jenny sent an email to the former directors, Mr Walker and others, indicating that she was concerned about the position of creditors and that the related party receivables and undertakings provided were assets that should be realised for their benefit. On 14 May 2013 she emailed Messrs Walker and Yan saying that she hoped they would be making it clear to the Richina Pacific shareholders that "the undertakings that [Richina Pacific] has given on many occasions in audit letter signings to [Ernst & Young] and other Directors that the receivables outstanding to [Mainzeal] and in particular the money owed to staff and sub-contractors will be honoured". On 11 June 2013 she emailed Mr Walker saying that as far as she was concerned the receivables on Mainzeal's balance sheet remained an obligation.

[187] However none of the related company debtors were entities with assets available to meet those obligations, and the undertakings referred to by Dame Jenny

had not been provided in a legally enforceable form. Unsurprisingly in those circumstances, no further funds were forthcoming.

[188] In the year leading up to the failure of Mainzeal a total of approximately $11.7 million had been provided to Mainzeal using the SBLC mechanism. This had been structured as advances by other Richina Pacific entities to Mainzeal. Those entities executed deeds abandoning their claims and did not prove in the liquidation for this sum.[23]

Overview of Mainzeal's finances in the relevant period

[189] A table prepared by the liquidators summarising Mainzeal's net asset position from 2005 to 2012 is attached as Appendix B. This table helpfully traces the inter-company receivables over time, and the impact of their recoverability on the reported net assets position of the company. At the end of 2011 reported net assets were some $19.1 million. But after excluding obligations of related companies, there was a deficit of some $36.6 million. The management accounts for December 2012 indicated that by that time the deficit had grown to some $61.3 million.

[190] A table showing the financial performance of Mainzeal from 2005 to 2012 is attached as Appendix C. It traces the uneven operating profit achieved by Mainzeal over this period and shows the impact on Mainzeal's reported results of the accrued "finance income" attributable to the related party receivables, none of which was ever received by Mainzeal.

[191] Reference has already been made to the register of cashflows in Appendix A. The register of cashflows records net payments out of Mainzeal in 2011 of $3.8 million. The liquidator's analysis based on the 2010 and 2011 financial statements suggested a larger net outflow of funds in 2011 of some $7.5 million.

[192] We had some difficulty in deriving a clear picture from the evidence before us of the net amount received by Mainzeal in 2011 and 2012 through the use of SBLCs and other forms of support. At the hearing of the appeal we asked the parties to clarify

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[23] A proof of debt was initially filed by Richina Finance Ltd for $6.017 million, but this claim was subsequently abandoned.

the net movement of funds into Mainzeal from 1 February 2011 onwards, so far as possible. Counsel filed a joint memorandum dated 15 September 2020 in which they confirmed that:

> 3. In summary, the evidence shows a net inflow of funds into Mainzeal from Richina companies of approximately $8.56 million in the period between 01 February 2011 and 31 December 2012, comprised of:
>
> (a) net outflow of $406,260 from Mainzeal to the Richina companies between 1 February 2011 and 30 April 2012, as per the register of cashflows;
>
> (b) net inflow to Mainzeal of $8.968 million through SBLCs from 1 May 2012 to 31 December 2012.
>
> (Footnote omitted.)

[193] The figure of $8.56 million excludes the value of building materials provided to Mainzeal under the Pre-Paid Goods Agreement during this period. Mr Bethell's evidence was that Mainzeal received $6.1 million of building materials in 2012. Cash was also paid by Richina Pacific and its related entities to other companies in the group in a manner which ultimately benefited Mainzeal and King Façade: a benefit which, the directors say, is reflected in recent payments of $3.027 million to Mainzeal from the liquidators of the eighth defendant, Isola Vineyards Ltd (Isola), reducing the deficit in the liquidation. In addition, Richina Pacific provided direct bonding support, and guaranteed other bonds provided by Vero.

[194] Overall, it is clear that there was a substantial net inflow of funds and building supplies from related entities into Mainzeal over the 2011/2012 period. This inflow substantially offset the operating losses made in those years: $10.1 million in 2011, and (based on management accounts) some $13.2 million in 2012. We return to this below at [510]–[518], when we consider whether there was a net deterioration in the financial position of Mainzeal over the period from 31 January 2011 to the date of liquidation some two years later in early 2013.

The statutory regime governing insolvent trading — an overview

Overview

[195] The policy goals of New Zealand's companies legislation are concisely summarised in the long title of the Act:

> (a) to reaffirm the value of the company as a means of achieving economic and social benefits through the aggregation of capital for productive purposes, the spreading of economic risk, and the taking of business risks; and
>
> (b) to provide basic and adaptable requirements for the incorporation, organisation, and operation of companies; and
>
> (c) to define the relationships between companies and their directors, shareholders, and creditors; and
>
> (d) to encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management power; and
>
> (e) to provide straightforward and fair procedures for realising and distributing the assets of insolvent companies

[196] As the Law Commission observed in its 1989 Report that led to the enactment of the Act, the economic and social benefits of the company form are derived from five main characteristics: recognition of the company as an entity distinct from all its shareholders (legal personality); the flexibility and adaptability of the company form; ease of transferability of investor interests by dividing those interests into shares; limited liability for investors; and specialised management, separate from ownership, in larger companies.[24] The benefits of limited liability lie not only in the limitation of risk to individual investors (which is an incentive for aggregation of capital) but also in enabling risk-taking. The taking of business risks is central to the success and social utility of the company.

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[24] Law Commission *Company Law: Reform and Restatement* (NZLC R9, 1989) [Law Commission 1989 Report] at [22].

[197] These five characteristics of company law are essential to its operation. They confer economic and social benefits. But they also give rise to a risk of abuse. As the Law Commission went on to observe:[25]

> Company law is largely concerned with containing the risk of abuse within acceptable bounds while not undermining the substantial benefits for investors and for society in general which these five characteristics provide.

[198] At the heart of this case is the question whether the way in which the directors of Mainzeal managed the company's affairs was within the sphere of legitimate business risk-taking, or whether they stepped outside the acceptable bounds of business risk-taking and should be responsible for some or all of the losses suffered by Mainzeal's creditors. Viewed from the perspective of those creditors, the issue is whether the losses they suffered when Mainzeal collapsed are simply a manifestation of the ordinary risks of dealing with a limited liability company, or whether unlawful conduct on the part of Mainzeal's directors exposed them to abnormal and unacceptable risks, with the result that the directors are liable for some or all of the losses suffered by those creditors.

[199] Before turning to the detailed provisions that govern the liability of directors for insolvent trading, it is helpful to sketch the wider statutory framework within which those provisions operate.

[200] Part 2 of the Act provides for the incorporation of companies. A company must have one or more shares; one or more shareholders; and one or more directors.[26] Section 15 sets out the fundamental principle of separate legal personality: a company is a legal entity in its own right separate from its shareholder(s). Part 3 provides for the capacity and powers of a company. The 1993 reforms swept away the complex restrictions on corporate capacity that were a feature of New Zealand's earlier companies legislation. A company has full capacity to carry on or undertake any business or activity, do any act, or enter into any transaction. It has full rights, powers and privileges for the purpose of doing so. The constitution of a company may restrict its capacity and powers, but such restrictions do not affect the validity of any act of

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25 At [23].
26 Companies Act 1993, s 10.

a company: they are, broadly speaking, enforceable internally but not against outsiders dealing with a company.[27]

[201] Part 5 provides for company constitutions. A company may have a constitution, but is not required to do so.[28]

[202] Part 6 contains detailed rules in relation to the rights and obligations attaching to the shares of a company. It also governs distributions to shareholders (including dividends and share repurchases). A fundamental plank of the 1993 reforms is found in s 52, which permits the board of a company to authorise a distribution only if the board is satisfied on reasonable grounds that the company will, immediately after the distribution, satisfy the solvency test. The solvency test is set out in s 4:

> **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), 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 are prepared under this Act or any other enactment (if any); and
>
> (ia) the accounting records of the company; 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:

27 See in particular ss 16 and 17.
28 Section 26.

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

[203] The requirement in s 4(1)(a) that the company is able to pay its debts as they become due in the normal course of business is generally referred to as "trading solvency". The requirement in s 4(1)(b) that the value of the company's assets must be greater than the value of its liabilities, including contingent liabilities, is generally referred to as "balance sheet solvency".

[204] The 1993 reforms abandoned the former "capital maintenance" doctrine, which required a company to have a notional capital and precluded distributions that would impair that notional capital. That approach was seen as artificial and ineffective to address concerns about the risks posed by undercapitalised companies.[29]

[205] Rather, the 1993 legislation adopted a two-pronged approach to address the risks that undercapitalised companies pose to those dealing with them. First, the restriction on distributions by a company by reference to the solvency test. A company can return funds to shareholders provided that there are reasonable grounds for thinking that shareholders — as residual claimants taking after creditors — are entitled to the benefit of those funds. But the company must not return funds to shareholders where doing so would impair either the immediate or long-term ability of the company to meet its obligations to creditors. Those are the risks at which the two limbs of the solvency test are aimed.

[206] Second, as the Law Commission explained, the risks caused by undercapitalised companies can be addressed by imposing appropriate duties on directors:[30]

> 226 The Law Commission considers that the dangers of undercapitalisation are better faced up to by imposing obligations upon directors who incur liabilities in the name of the company in such circumstances. The duties imposed upon directors in the draft Act in section 105 are an attempt to face up to this problem directly.

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29 Law Commission 1989 Report, above n 24, at [84] and [223]–[228].

30 Law Commission 1989 Report, above n 24.

[207] The Law Commission's draft s 105 was the precursor of ss 135 and 136 of the Act, to which we return below at [212]. It read:

> **105 Solvency**
>
> (l) A director of a company must not agree to the company entering into a contract or arrangement or acting in any other manner unless he or she believes at that time on reasonable grounds that the act concerned does not involve an unreasonable risk of causing the company to fail to satisfy the solvency test.
>
> (2) A director of a company must not agree to the company incurring an obligation unless he or she believes at that time on reasonable grounds that the company will be able to perform the obligation when required to do so.

[208] Part 8 of the Act is concerned with directors and their powers and duties. Section 128 provides that the business and affairs of a company must be managed by, or under the direction or supervision of, the board of the company. The board has (subject to the Act and the company's constitution) all the powers necessary for managing, and for directing and supervising the management of, the business and affairs of the company.

[209] One of the central goals of the 1993 reforms was to improve the accessibility of company law. Before 1993, the duties of directors were for the most part established by case law. Some duties of directors were established by, or recognised in, companies legislation: but the relevant provisions were scattered through the legislation. Part 8 of the Act seeks to set out all the significant duties of directors in a clear, coherent and accessible manner.

[210] The core fiduciary duty of directors is set out in s 131(1):

> **131 Duty of directors to act in good faith and in best interests of company**
>
> (1) Subject to this section, a director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company.
>
> (2) A director of a company that is a wholly-owned subsidiary may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of that company's

holding company even though it may not be in the best interests of the company.

…

[211] Section 133 provides that a director must exercise a power for a proper purpose. Section 134 provides that a director of a company must not act, or agree to the company acting, in a manner that contravenes the Act or the constitution of the company.

[212] Sections 135 to 137 are at the heart of this appeal. They read as follows:

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.

137 Director's duty of care

A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation,—

(a) the nature of the company; and

(b) the nature of the decision; and

(c) the position of the director and the nature of the responsibilities undertaken by him or her.

[213] Section 138 addresses the important question of the extent to which, when exercising their powers, directors may rely on information supplied by others.

[214] Directors are, unless the constitution provides otherwise, appointed by the shareholders by ordinary resolution.[31] And (subject to the company's constitution) a director can be removed from office by an ordinary resolution of shareholders.[32] In essence, directors are appointed by the shareholders to manage the company on their behalf and for their benefit. The Act provides a number of mechanisms through which directors are accountable to shareholders, including the provision of financial statements and annual reports, and a requirement to hold annual meetings.[33] But the most fundamental mechanism by which accountability of directors to shareholders is secured is the ability of the shareholders to appoint and remove the directors.

[215] Part 9 sets out the basic machinery for enforcement of obligations under the Act, including the obligations of directors. Because the company is a separate legal person, claims in relation to duties owed to the company must be brought in the company's name. The board's power to manage the affairs of the company includes the power to decide whether or not to bring proceedings, and to manage those proceedings. Part 9 contains a group of provisions enabling derivative actions to be brought by a shareholder or director in the name of, and on behalf of, the company in certain circumstances, with the leave of the court. A shareholder is not otherwise entitled to bring or intervene in any proceedings in the name of, or on behalf of, a company.[34]

[216] A shareholder or former shareholder can however bring an action against a director for breach of a duty owed to them as a shareholder.[35] It is therefore necessary to identify which duties of directors are owed to the company, and which are owed to shareholders. That distinction is drawn by s 169(3), which provides as follows:

> **169 Personal actions by shareholders against directors**
>
> …
>
> (3) Without limiting subsection (1), the duties of directors set out in—

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31 Companies Act, s 153(2).
32 Section 156.
33 See pts 11 (accounting records and financial reporting) and 12 (disclosure by companies); and ss 120–124 (meetings of shareholders).
34 Section 165(6).
35 Section 169(1).

> (a) section 90 (which relates to the duty to supervise the share register); and
>
> (b) section 140 (which relates to the duty to disclose interests); and
>
> (c) section 148 (which relates to the duty to disclose share dealings)—
>
> are duties owed to shareholders, while the duties of directors set out in—
>
> (d) section 131 (which relates to the duty of directors to act in good faith and in the best interests of the company); and
>
> (e) section 133 (which relates to the duty to exercise powers for a proper purpose); and
>
> (f) section 135 (which relates to reckless trading); and
>
> (g) section 136 (which relates to the duty not to agree to a company incurring certain obligations); and
>
> (h) section 137 (which relates to a director's duty of care); and
>
> (i) section 145 (which relates to the use of company information)—
>
> are duties owed to the company and not to shareholders.

[217] As s 169(3) makes clear, the duties of directors set out in ss 135 and 136 are duties owed to the company and not to shareholders. An individual shareholder cannot bring a claim in their own name against a director for breach of the director's duties under ss 135 and 136. Nor can an individual shareholder bring such a claim on behalf of the company, unless leave to bring a derivative action is obtained under s 165.

[218] At the risk of stating the obvious, the duties under ss 131–137 that are owed to the company are not owed to the company's creditors personally, any more than they are owed to shareholders personally. A creditor cannot bring a claim for breach of those duties in the name of, and on behalf of, the company. Nor is it open to a creditor to seek leave to bring a derivative action on behalf of a company. For so long as the company is solvent, control of the company rests with the board, and with the shareholders who appoint the board. The interests of creditors are protected through other mechanisms: the two mechanisms referred to above at [205]–[206], and the

ability to apply to put the company into liquidation under pt 16, discussed below at [222]–[228].

[219] Part 11 sets out the core obligations in relation to accounting records and financial reporting that apply to companies registered under the Act. A company such as Mainzeal that is a "large" company under s 45 of the Financial Reporting Act 2013 is required to prepare financial statements and to have those financial statements audited.[36]

[220] The financial statements of certain companies must be delivered to the Registrar of Companies for registration. Not all companies are required to make their financial statements publicly available in this manner. The relevant filing obligations are set out in the Financial Reporting Act and in s 207D of the Act. It appears that from 2010 onwards Mainzeal was not required to make its financial statements publicly available.

[221] The Act contains a number of mechanisms designed to enable a company that faces financial difficulties to resolve those difficulties and continue trading. Part 14 provides for compromises with creditors. Part 15 provides for court approval of certain arrangements, amalgamations and compromises. Part 15A, which was inserted into the Act with effect from 1 November 2007, establishes a voluntary administration regime that is intended to maximise the chances of the company (or as much as possible of its business) continuing in existence or, if that is not possible, that results in a better return for the company's creditors and shareholders than would result from an immediate liquidation of the company.[37] An administrator can be appointed by the board of a company, a liquidator, a secured creditor with a charge over the whole or substantially the whole of the company's property, or the court.[38]

[222] Part 16 provides for liquidation of companies. A liquidator may be appointed by shareholders by special resolution. A liquidator may also be appointed by the court, on the application of certain persons including a shareholder, a director or a creditor.

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36 Sections 200, 201, 206 and 207. A large company may, in certain circumstances, opt out of the audit requirement: s 207J.
37 Section 239A.
38 Sections 239H and 239I.

Section 241(4) sets out the grounds on which a court can appoint a liquidator. The usual trigger for an insolvent liquidation is an application to the court by a creditor to appoint a liquidator on the grounds that the company is unable to pay its debts.[39]

[223] The principal duty of a liquidator of a company is to take possession of, protect, realise, and distribute the company's assets or their proceeds to the creditors of the company in accordance with the regime prescribed by the Act. If there are surplus assets remaining, the liquidator must then distribute them in the manner prescribed by the Act. This must be done in a reasonable and efficient manner.[40]

[224] The court has a broad power to supervise the conduct of a liquidation.[41] A liquidator is required to act independently and fairly as between relevant stakeholders in the performance of their duties. A current or former shareholder, creditor, director, auditor or receiver of the company cannot act as liquidator.[42]

[225] Secured creditors are of course able to exercise their security rights outside a liquidation. Alternatively, they can prove as secured creditors in the liquidation. Unsecured creditors may also prove in the liquidation. The liquidator decides which proofs to admit and must then apply the proceeds of realisation of the company's assets to meet claims in the statutory order of priority set out in pt 16. The costs of the liquidation (including debts incurred by the liquidator) are met first. Certain unsecured claims have preferential status and are met next.[43] After those preferential claims have been paid, the liquidator applies the assets of the company in satisfaction of all other claims. Those claims rank equally among themselves and must be paid in full, or if the assets are insufficient to meet them, rateably among all claims.[44] After creditors have been paid in full, any remaining assets are distributed to shareholders in accordance with their entitlements under the constitution.

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39 Section 241(4)(a) and (2)(c)(iv).
40 Section 253.
41 Section 284.
42 Section 280(2).
43 Section 312 and sch 7.
44 Section 313. Section 313(3) provides for subordinated debt.

[226] Part 16 contains a number of provisions that are designed to ensure that the pari passu regime for payment of unsecured creditors is not circumvented by payments made, and securities granted, in the period prior to liquidation.[45]

[227] Sections 300 and 301 make provision for claims to be brought by a liquidator against directors, and against certain other persons involved in the administration of a company, where duties to the company have been breached. Section 300 applies where proper accounting records have not been kept, or proper financial statements have not been prepared:

> **300 Liability if proper accounting records not kept**
>
> (1) Subject to subsection (2), if—
>
> (a) a company that is in liquidation and is unable to pay all its debts has failed to comply with—
>
> (i) section 194 (which relates to the keeping of accounting records); or
>
> (ii) section 201 or 202 (which relates to the preparation of financial statements or group financial statements) or any other enactment that requires the company to prepare financial statements or group financial statements; and
>
> (b) the court considers that—
>
> (i) the failure to comply has contributed to the company's inability to pay all its debts, or has resulted in substantial uncertainty as to the assets and liabilities of the company, or has substantially impeded the orderly liquidation; or
>
> (ii) for any other reason it is proper to make a declaration under this section,—
>
> the court, on the application of the liquidator, may, if it thinks it proper to do so, declare that any 1 or more of the directors and former directors of the company is, or are, personally responsible, without

[45] Section 292 provides that certain "insolvent transactions" are voidable by the liquidator. Section 293 provides that certain charges are voidable by the liquidator. Section 297 enables the liquidator to bring a claim where a transaction was entered into with a third party at an undervalue, in certain circumstances. Section 298 provides for claims in relation to transactions for inadequate or excessive consideration with directors and certain other persons connected with the company and its controllers. Section 299 provides that a liquidator may apply to the court for an order setting aside securities and charges in favour of certain persons connected with the company and its controllers.

limitation of liability, for all or any part of the debts and other liabilities of the company as the court may direct.

…

[228] Section 301, under which the liquidators claim in this proceeding, reads as follows:

301 Power of court to require persons to repay money or return property

(1) If, in the course of the liquidation of a company, it appears to the court that a person who has taken part in the formation or promotion of the company, or a past or present director, manager, administrator, liquidator, or receiver of the company, has misapplied, or retained, or become liable or accountable for, money or property of the company, or been guilty of negligence, default, or breach of duty or trust in relation to the company, the court may, on the application of the liquidator or a creditor or shareholder,—

(a) inquire into the conduct of the promoter, director, manager, administrator, liquidator, or receiver; and

(b) order that person—

(i) to repay or restore the money or property or any part of it with interest at a rate the court thinks just; or

(ii) to contribute such sum to the assets of the company by way of compensation as the court thinks just; or

(c) where the application is made by a creditor, order that person to pay or transfer the money or property or any part of it with interest at a rate the court thinks just to the creditor.

(2) This section has effect even though the conduct may constitute an offence.

(3) An order for payment of money under this section is deemed to be a final judgment within the meaning of section 17(1)(a) of the Insolvency Act 2006.

(4) In making an order under subsection (1) against a past or present director, the court must, where relevant, take into account any action that person took for the appointment of an administrator to the company under Part 15A.

[229] Against that general backdrop, we turn to consider in more detail the specific provisions under which this proceeding has been brought by the Mainzeal liquidators.

Insolvent trading — the policy concerns that underpin ss 135 and 136

[230] Directors are, as explained above at [214], almost invariably appointed by, and accountable to, the shareholders. The shareholders can choose how much risk they will allow the directors to take with the funds the shareholders have invested in the company. Creditors, on the other hand, have no role in appointing the directors and no voice in the level of risk they take. Nor, unless they expressly seek it, do creditors have access to much (if any) information about the financial position of the companies with which they deal. There are significant information asymmetries between the directors of a company and its creditors. Usually that is not a problem. For most creditors, it is not rational to invest time and money in making inquiries about the financial position of the companies with which they deal. A creditor contemplating a significant exposure to a company can make provision of financial information a condition of extending credit, or seek security for the obligations owed to them: this then becomes a matter for negotiation between the creditor and the company. If the creditor is not satisfied with the information and/or security on offer, they can decline to deal with that company. But for most creditors, the time and cost involved is not worthwhile. And in many markets, especially those in which companies enjoy some market power, the strategy of seeking more information and/or security may also be problematic because the company will be able to find another counterparty to deal with that does not impose such requirements.

[231] The directors of a company that is insolvent, or on the threshold of insolvency, may face perverse incentives in relation to risk-taking. So may the shareholders who appoint them (who, in small companies, are also often directors). Once the shareholders' funds are depleted, the downside of a business risk will be borne by the creditors, not the shareholders. But the upside, if the risk pays off and the company makes gains that bring it back into positive territory, will be enjoyed by the shareholders. So the worse the position of the company, the greater the incentive for directors and shareholders to "gamble on the doorstep of insolvency".[46]

[46] John C Coffee *Court Has a New Idea on Directors' Duty* 1992 NAT'L LJ 18 (2 March 1992).

[232] Directors (and shareholders) may also face perverse incentives to trade on where they are personally liable for some of the company's obligations: for example, where they have guaranteed advances to the company. There are many reported cases in which directors of a company have traded on with a view to reducing the company's exposure to a lender who holds a guarantee from the directors or related persons, or in order to reduce debts owed to related persons.

[233] Seen from the perspective of creditors, there are two broad types of harm that may be caused by a decision by directors to continue trading while a company is insolvent, or near insolvent:

(a) *Harm to existing creditors*: where a company trades on, but shareholder funds are exhausted, the company is in effect trading on capital provided by the company's existing creditors. If the company makes losses, those losses will be borne by the existing creditors who would otherwise have received a higher dividend in the company's liquidation, had it stopped trading earlier. The loss they suffer is the difference between the payment they would have received in an earlier liquidation, and the payment they receive in the eventual liquidation.

(b) *Harm to new creditors*: new creditors, who would not have been exposed to the company if the company went into liquidation at an earlier date, may deal with the company and suffer losses in the eventual liquidation. And existing creditors may extend further credit, increasing their exposure to the company. For these creditors, the loss caused by the company trading on is the whole of their new exposure to the company, less any payments received before liquidation or in the eventual liquidation.

[234] Some creditors will suffer both forms of harm: they incur a new exposure to the company, and after they become creditors, the assets available to meet their claims are further eroded.

[235] The picture is further complicated by the fact that during a period of insolvent trading it is likely that some creditors will be paid in whole or in part, and are better off than if liquidation had occurred earlier. Some payments to creditors may be recovered by the liquidator under the insolvent transaction regime.[47] But not all such payments will be recoverable, especially where insolvent trading continues over an extended period.

[236] So far as the first of these two forms of harm to creditors is concerned, the objection to the directors' decision to continue trading is that the assets of the company are in effect the assets of the creditors: continued trading risks depleting those assets at the creditors' expense. The concern in relation to the second form of harm to creditors is that the directors have permitted the company to obtain credit from new creditors in circumstances where dealing with the (insolvent) company involved a significant risk for those creditors. If the company is already insolvent, and the directors know this but the creditors do not, extending credit to the company falls outside the normal range of risks that creditors accept when they deal with limited liability companies. In effect, the directors mislead the new creditors by failing to disclose to them that dealing with the company involves a substantial — and abnormal — level of risk.

[237] Speaking generally, there is no policy reason for concern about the position of a creditor who has adequate information about the company's financial position and the risks they are taking on by extending credit to the company. They can bargain for terms that reflect this risk. A policy concern arises in relation to new creditors if, and only if, the risk that those creditors face in dealing with the company is outside the normal and acceptable range, and the relevant creditors are not aware of this.

[238] The way in which the law has responded to the perverse incentives for directors and shareholders to trade on while a company is insolvent or near-insolvent, and to the policy concerns identified above in relation to the risk to creditors in that scenario, has evolved over time. Sections 135 and 136 of the Act are the latest iteration of those developments. They have their origins in the 1926 Greene Report in England, which

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47 See [226] above.

recommended the introduction of a provision making directors liable for fraudulent trading.[48]

[239] The particular concern identified by the Greene Report was the scenario where a person in control of the company holds a floating charge and, knowing that the company is on the verge of liquidation, "fills up" their security by means of goods obtained on credit, then appoints a receiver. This Report led to the enactment of a prohibition against fraudulent trading in the Companies Act 1929 (UK).[49] New Zealand followed suit, enacting a corresponding prohibition on fraudulent trading as s 268 of the Companies Act 1933 (1933 Act). When the 1933 Act was replaced by the Companies Act 1955 (1955 Act), that provision was carried forward as s 320 of the 1955 Act. Section 320(1), as enacted in 1955, read as follows:

> **320.** (1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court, on the application of the Official Assignee or the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct. On the hearing of an application under this subsection the Official Assignee or the liquidator, as the case may be, may himself give evidence or call witnesses.

[240] This provision was drafted in a manner that enabled targeted relief to be provided for the benefit of a subset of creditors who were harmed by the fraudulent trading. For example, directors could be made responsible for the debts owed to new creditors who had dealt with the company after a specified date and without disclosure of the company's financial difficulties. Orders providing for an amount awarded under s 320 to be distributed among a subset of creditors have been made by the New Zealand courts.[50]

[241] However s 320 of the 1955 Act only dealt with a narrow subset of the situations where directors abused their powers by continuing to trade while the company was

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48 Board of Trade *Company Law Amendment Committee Report* (Cmd 2657, 1962) at [61]–[62].

49 Now repealed. The current provision now appears in s 214 of the Insolvency Act 1986 (UK): see [243] of this judgment.

50 See for example *Re South Pacific Shipping Ltd (in liq)* (2004) 9 NZCLC 263,570 (HC) at [3], [161] and [165]–[166], upheld on appeal in *Löwer v Traveller* [2005] 3 NZLR 479 (CA).

insolvent, causing prejudice to creditors of the two kinds described above at [233]. In 1962 the Jenkins Committee Report in England noted "widespread criticism" of the English provision, which did not "provide a sufficient deterrent to dissuade directors from continuing the business of a company which they know to be hopelessly insolvent".[51]

[242] The Jenkins Committee recommended that the legislation:[52]

> … should be extended to make directors and others, who have carried on the business of the company in a reckless manner, personally responsible without limitation of liability, for all or any of the debts or other liabilities of the company.

[243] In England the current version of the provision that was enacted to give effect to that recommendation appears as s 214 of the Insolvency Act 1986 (UK). Similar provisions were enacted in Australia. In New Zealand the 1973 Macarthur Report recommended enacting a provision in relation to reckless trading that followed the Australian model.[53]

[244] This recommendation was implemented in 1981 by replacing the former s 320 of the 1955 Act with a new provision that preserved the prohibition on fraudulent trading and added two further limbs. The new version of s 320(1) read as follows:

> **320 Responsibility for fraudulent trading of persons concerned**
>
> (1) If in the course of the winding up of a company it appears that—
>
> (a) Any person was, while an officer of the company, knowingly a party to the contracting of a debt by the company and did not, at the time the debt was contracted, honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due for payment as well as all its other debts (including future and contingent debts); or
>
> (b) Any person was, while an officer of the company, knowingly a party to the carrying on of any business of the company in a reckless manner; or

51 Board of Trade *Report of the Company Law Committee* (Cmd 1749, 1962) at [499]. See also [496]–[503], in particular [497]–[499].

52 At [503(b)].

53 Ian Hannay Macarthur *Final Report of the Special Committee to Review the Companies Act* (March 1973) at [325]–[329].

> (c) Any person was knowingly a party to the carrying on of any business of the company with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose,—
>
> the Court … may, if it thinks it proper to do so, declare that the person shall be personally responsible … for all or any part of the debts and other liabilities of the company as the Court may direct. …

[245] The legislation remained in that form until enactment of the 1993 Act. As with the original version of the provision, the courts could award targeted relief for the benefit of the relevant subset of creditors who had been harmed by the directors' conduct.

[246] Section 320 provided for new liabilities on the part of directors of an insolvent company over and above their liabilities for breach of the existing duties they owed to the company. A companion provision, s 321 of the 1955 Act, provided a procedural mechanism for liquidators to pursue claims against directors (among others) for breach of those other duties they owed to the company:

> **321.** (1) If in the course of winding up a company it appears that any person who has taken part in the formation or promotion of the company, or any past or present director, manager, or liquidator, or any officer of the company, has misapplied or retained or become liable or accountable for any money or property of the company, or been guilty of any misfeasance or breach of trust in relation to the company, the Court may, on the application of the Official Assignee, or of the liquidator, or of any creditor or contributory, examine into the conduct of the promoter, director, manager, liquidator, or officer, and compel him to repay or restore the money or property or any part thereof respectively with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance, or breach of trust as the Court thinks just.
>
> (2) The provisions of this section shall have effect notwithstanding that the offence is one for which the offender may be criminally liable.
>
> (3) Where an order for payment of money is made under this section, the order shall be deemed to be a final judgment within the meaning of paragraph (*f*) of section twenty-six of the Bankruptcy Act 1908.

[247] Section 321 was amended in 1980 by broadening the scope of subs (1) to apply where a director or other officer was guilty of any "negligence, default, or breach of duty or trust in relation to the company".

[248] In parallel with these statutory developments, a series of decisions of the courts in New Zealand and elsewhere recognised the responsibility of directors to take account of the interests of creditors where a company was insolvent or near-insolvent. In *Walker v Wimborne* the High Court of Australia rejected the proposition that directors could act in the interests of other companies in a group in circumstances of insolvency or near-insolvency.[54] Mason J observed:[55]

> In this respect it should be emphasized that the directors of a company in discharging their duty to the company must take account of the interests of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them.

[249] Some 10 years later this Court considered the responsibilities of directors of an insolvent or near-insolvent company in *Nicholson v Permakraft (NZ) Ltd*.[56] This Court emphasised that although the duties of directors are owed to the company, not directly to its creditors, some circumstances will require the directors to have regard to the interests of creditors. Cooke J said:[57]

> The duties of directors are owed to the company. On the facts of particular cases this may require the directors to consider inter alia the interests of creditors. For instance creditors are entitled to consideration, in my opinion, if the company is insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency.

[250] Shortly afterwards the issue was considered by the New South Wales Court of Appeal in *Kinsela v Russell Kinsela Pty Ltd (in liq)*.[58] The Court endorsed what had been said in *Walker v Wimborne* and *Nicholson v Permakraft (NZ) Ltd*.[59]

[251] Following some initial controversy, it became generally accepted that these duties of directors were owed to the company, not to creditors directly. That proposition was reaffirmed by the Law Commission in its 1989 Report and is reflected in the structure of the current Act. As noted above, s 169(3) of the Act expressly provides that the duties of directors under ss 131, 133 and 135–137 are

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54 *Walker v Wimborne* [1976] HCA 7, (1976) 137 CLR 1.
55 At 7.
56 *Nicholson v Permakraft (NZ) Ltd (in liq)* [1985] 1 NZLR 242 (CA).
57 At 249.
58 *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 (NSWCA).
59 At 732.

duties owed to the company and not to shareholders. They are not enforceable by shareholders or by creditors. The Law Commission, addressing the responsibilities of directors in relation to creditors, wrote:[60]

> 217 In particular, we are of the view that it is wrong in principle to impose fiduciary duties upon directors which are owed directly to creditors of the company. Any such extension of directors' duties would unacceptably dilute the scheme of director accountability under the draft Act.
>
> …
>
> 219 Directors owe a specific duty to the company not to take unreasonable risks of breaching the solvency test (section 105). Where that duty is breached, liability is owed to the company and may be enforced by the company or by a shareholder suing derivatively or, after insolvency, by the liquidator. Creditors will not have standing to obtain a remedy for breaches of the solvency duties owed to the company. To provide such a remedy would be to undermine the statutory system for liquidations. …
>
> 220 This is an area of law which has recently been considered in New Zealand and Australia in *Nicholson v Permakraft (NZ) Limited* [1985] 1 NZLR 242 and *Kinsela v Russell Kinsela Pty Limited* 1986 4 CLC 215. The draft Act is consistent with these cases but in so far as they may suggest that in cases of near insolvency creditors are owed and can enforce duties directly against directors, the draft Act would depart from them.
>
> …
>
> 222 The draft Act would set the duties owed by directors to the company in cases of near insolvency at the standard of unreasonable risk provided for in section 105.

[252] As this Court observed in *Madsen-Ries v Petera*, not all of the recommendations of the Law Commission were carried over into the new Act. But the overall scheme of the directors' duties provisions, and their relationship to the interests of creditors as reflected in the above passages, is very much as envisaged by the Law Commission.[61]

[253] The current insolvent trading provisions that were enacted in 1993 do however differ in a number of significant respects from the specific provisions that were recommended by the Law Commission in 1989. The focus of the Law Commission's draft s 105(1) was on whether the director believed, when authorising the company to enter into a contract or arrangement or act in some other manner, that doing so would

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60 Law Commission 1989 Report, above n 24.

61 *Madsen-Ries v Petera* [2016] NZCA 103, [2018] 2 NZLR 500 at [21].

not “involve an unreasonable risk of causing the company to fail to satisfy the solvency test”. Section 135, on the other hand, focusses on whether the director has agreed, caused or allowed 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. It has been suggested that the language of s 135 omits any balancing of risk and reward, contrary to the underlying philosophy of the legislation, and contrary to the way in which the Law Commission’s draft s 105(1) was framed.[62] However, subsequent decisions have read s 135 in light of the long title of the Act, and have proceeded on the basis that it is concerned with a level of risk to creditors beyond what is normal, acceptable and legitimate.[63] We return to this issue below at [261].

[254] The other significant difference is that the Law Commission did not recommend any equivalent of the current s 301. The substantive content of the obligations found in s 320 of the 1955 Act had been carried forward into the Law Commission’s draft s 105, which as noted above appears in the current Act as ss 135 and 136. The Law Commission considered that these (and other) duties owed to the company could be enforced by the liquidator by bringing proceedings against a director in the name of the company, so there was no need for a separate enforcement mechanism along the lines of the former s 321. But in the course of the parliamentary process the current s 301, which is closely modelled on the former s 321, was added back into the legislation. There is no record, so far as we are aware, of the rationale for restoring this additional procedural mechanism: it may well have been out of an abundance of caution. However as discussed in more detail below, that gives rise to some difficult issues about the operation of s 301 and the extent of the discretion it confers.

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[62] *Fatupaito v Bates* [2001] 3 NZLR 386 (HC) at [63].

[63] See for example *Re South Pacific Shipping Ltd (in liq)*, above n 50, at [121]–[123] and [129]–[130]; *Mason v Lewis* [2006] 3 NZLR 225 (CA) at [49]; and *Grant v Johnston* [2016] NZCA 157 [*Grant v Johnston* (CA)] at [37].

[255] Before turning to the detail of the requirements of ss 135 and 136 we make the following observations about the scheme of the current Act in relation to directors' duties and claims for breach of those duties:

(a) The duties imposed by ss 131, 135, 136 and 137 are all, as noted above, duties owed by directors to the company, not to individual shareholders or creditors.

(b) Claims for the benefit of shareholders in relation to breach of these duties are mediated through the company. They can be pursued by the board, or through a derivative action brought in the name of the company. In a solvent liquidation, a liquidator could also bring such a claim against the former directors for the benefit of the shareholders. Where a claim is brought for breach of any of these duties by a solvent company, it is clear that the remedies for the breach relate to the harm suffered by the company. That is, any compensation awarded will be paid to the company and shareholders will benefit from that compensation according to their interest in the company at the time the compensation is received.

(c) Similarly, claims for the benefit of creditors in relation to breach of these duties are generally mediated through the company. They may be initiated by the board, by means of a derivative action initiated by a director or a shareholder, or by a liquidator who brings a claim for breach of the duty or a claim under s 301.

(d) Section 301(1)(c) expressly provides for claims to be made by a creditor of a company in liquidation, and contemplates relief being provided direct to the creditor bringing the claim. The circumstances in which relief can be provided direct to a creditor who brings a s 301 claim, rather than to the company, have yet to be considered by the courts.[64]

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[64] See *Madsen-Ries v Cooper* [2020] NZSC 100, (2020) 29 NZTC 24-088 [*Debut Homes*] at nn 159 and 179.

(e) The duties owed by directors under ss 131, 135, 136 and 137 remain duties owed to the company regardless of who subsequently initiates proceedings for breach of those duties, and regardless of the procedural mechanism used to bring those proceedings.

(f) Where a claim is brought in relation to a breach by a director of the fiduciary duty in s 131, or the duty of care in s 137, it seems clear that any compensation that is recoverable is compensation for harm suffered by the company as a result of the breach of the duty owed to it. That is plainly the case where the claim is brought by the company, and it is difficult to see any justification for a different result if the claim is pursued by a liquidator under s 301. If the company is solvent, the benefit of the claim will flow to the shareholders. If the company is insolvent, the creditors will benefit from that compensation according to their entitlements in the liquidation. Unsecured creditors will benefit from that compensation only after payment in full of the claims of any secured creditor(s) whose security extends to rights to bring such claims — for example, a creditor with a general security over all the assets of the company — and claims of preferential creditors.

(g) More difficult issues arise in relation to ss 135 and 136. One of the central issues in this case is whether compensation for breach of those duties should be assessed by reference to the loss to the company, quantified by reference to the net deterioration in the company's financial position as a result of the breaches, or the loss suffered by creditors generally, or the loss suffered by some subset of creditors. We discuss that issue in more detail below at [290]–[297].

[256] At the risk of stating the obvious, directors do not have a duty to capitalise a company adequately. In particular, they do not have a duty to provide, or procure the provision of, additional capital where a company becomes insolvent.[65]

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65 *Sojourner v Robb* [2007] NZCA 493, [2008] 1 NZLR 751 at [24].

[257] Nor do directors have a duty to avoid the loss caused by an insolvent liquidation, unless the insolvency is itself the result of a breach of duty on their part. Directors do not breach their duties by resigning, even if this triggers liquidation, or by taking other steps to trigger a liquidation: for example, resolving to appoint a liquidator under s 241(2)(b) of the Act if the constitution provides for them to do so, or applying to the court to appoint a liquidator under s 241(2)(c) of the Act. It is a necessary corollary of this that directors have no duty to avoid losses to creditors caused by an insolvent liquidation, unless they have brought about that insolvency by some other breach of duty. Although this point may seem obvious, it is of some importance in this case. The liquidators did not argue that the directors would have been liable for the large losses to the company and its creditors that would have resulted from a decision to put the company into liquidation in January 2011, or from a decision to resign at that time — a step which could well have triggered a liquidation. The implications of this are explored in more detail below at [486]–[491].

The obligations of a director under s 135

[258] We turn to discuss the duties of directors under s 135 in more detail. The obligations of a director under s 135 of the Act must be ascertained from the text of the provision and from its purpose.[66] In a claim for breach of s 135 the first question is whether the business of the company was being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors. If so, the second question is whether the director agreed to the business of the company being carried on in that manner, or caused or allowed it to be carried on in that manner.

[259] The first question can in turn be broken down into the following elements:

(a) The loss to which the creditors are exposed must be a *serious* one. The risk of minor losses is not enough to trigger s 135.

(b) The risk must be *substantial*. That word is capable of a wide spectrum of meanings, but it is well established that in this context it means

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[66] Interpretation Act 1999, s 5.

"large". There must be a large, or significant, risk of serious loss to creditors.

(c) The way in which the business of the company is being carried on must be *likely* to create that large risk of serious loss. Again, the term "likely" can have a range of meanings. But in the context of s 135, it must mean "more likely than not". Other meanings of "likely" that invoke lesser degrees of probability (for example, a real and substantial risk) would make little sense in conjunction with the reference to creation of a large risk of serious loss to creditors.

[260] Drawing those threads together, the question is whether the business of the company is being carried on in a manner that is more likely than not to create a large or significant risk of a serious (not minor) loss to the company's creditors.

[261] The purpose of s 135 can be described at a number of levels. At the most general level, we accept Mr Hodder QC's submission that s 135 must be read in a manner consistent with the overall purpose of the Act, as set out in its long title. The Act, including s 135, should be read in a way that facilitates the taking of business risks and the exercise of business judgment by creditors. But "at the same time", as the long title of the Act says, protection for creditors must be provided against the abuse of management power. More specifically, the interpretation of s 135 is informed by the purpose of that particular provision within the overall scheme of the legislation. The immediate purpose of s 135 is to deter directors from responding to the perverse incentives identified above at [231]–[232], and to protect creditors from the risks described above at [233]. It draws the boundary between legitimate risk taking and abuse of management powers at the expense of creditors. That line is drawn at the point where the way in which the company's business is being carried on is more likely than not to create a substantial risk of serious loss to creditors.

[262] Mr Hodder submitted that an assessment of whether a company is balance sheet solvent, and whether it is likely to be able to meet its debts as they fall due, is itself a matter of business judgement. That, he said, is especially so where making that assessment requires the exercise of judgement about the likelihood that assurances

of support from a related company can be relied on. The courts should be slow to second-guess the judgements made by the directors about these issues at the relevant time. That submission is difficult to reconcile with the objective nature of the s 135 test. Adopting that approach would create a risk that directors would be excused under s 135 because they had failed to adequately inform themselves about the state of the company's affairs and likely future trading results. We consider that s 135 sets an objective boundary, beyond which the scope for directors to take business risks is significantly curtailed. Whether that boundary has been crossed should be assessed by reference to the information that was available or should have been available to the director, acting reasonably. A failure to make inquiries that a reasonable director would have made, or seek advice that a reasonable director would have sought, will not protect a director from liability for breach of s 135. This approach leaves proper scope for the exercise of business judgment by directors who are acting reasonably in the performance of their responsibilities.

[263] Thus, as this Court said in *Mason v Lewis*, what is required when a company enters troubled financial waters is a "sober assessment" by the directors, of an on-going character, as to the company's likely future income and prospects.[67]

[264] The authorities do not speak with one voice on whether the reference to loss to the company's creditors is confined to a net loss to the creditors in aggregate, or extends to the risk of loss to certain categories of creditor — in particular, new creditors. But the Supreme Court has recently confirmed that it is sufficient that continued trading will result in a shortfall, whether or not some creditors would be better off and whether or not any overall deficit is projected to be reduced. If continued trading is expected to result in a deficit, it is not open to directors to trade on in the hope that the deficit will be reduced.[68]

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[67] *Mason v Lewis*, above n 63, at [51].
[68] *Debut Homes*, above n 64, at [72]–[73].

[265] In *Fatupaito v Bates* O'Regan J summarised the position in relation to s 135 when read together with s 301, as follows:[69]

- Section 135 imposes a duty which is owed by a director to the company rather than to any particular creditor;
- The test is an objective one;
- Although the law reform process makes it difficult to elicit any legislative intent in relation to the wording of s 135, it appears to impose a stringent duty on directors to avoid substantial risks of serious loss to creditors and does not appear to allow for such risks to be incurred, even in circumstances where the potential for great rewards exists;
- In situations where a company has little or no equity (as is the case here), directors will need to consider very carefully whether continuing to trade has realistic prospects of generating cash which will allow for the servicing of pre-existing debt and the meeting of commitments which such trading will inevitably attract. As Anderson J said, the reference to "substantial risk" and "serious loss" does appear to set a higher standard than simply any risk at all to creditors which must be inevitable where a company is operating at a loss and has few, if any, realisable assets;
- Where a breach of the duty is found, the assessment of the amount to be paid by a director under s 301 should be "neither more nor less than that [director's] just desserts" [sic].

[266] Mr Hodder also emphasised the difficult and complex nature of the decision facing directors considering whether or not to trade on. A decision to cease trading will, as William Young J observed in *Re South Pacific Shipping Ltd (in liq)*, inflict serious loss on creditors which may be unnecessary if there is a probability of salvage. William Young J described the responsibility of directors in this scenario as follows:[70]

> No-one suggests that a company must cease trading the moment it becomes insolvent (in a balance sheet sense). Such a cessation of business may inflict serious loss on creditors and, where there is a probability of salvage, such loss can fairly be regarded as unnecessary. The cases, however, make it perfectly clear that there are limits to the extent to which directors can trade companies while they are insolvent (in the balance sheet sense …) in the hope that things will improve. In most of the cases, the time allowance has been limited, a matter of months.

[69] *Fatupaito v Bates*, above n 62, at [67].
[70] *Re South Pacific Shipping Ltd (in liq)*, above n 50, at [125].

[267] And, as William Young J went on to say:[71]

> Directors of a company facing insolvency can be expected to address the reasons for the insolvency and, if they elect to trade, put in place carefully thought-through strategies for salvaging the situation.

[268] We accept Mr Hodder's submission that the decision on whether to trade on may be a difficult one, and that a decision to cease trading will often have a serious impact on creditors, employees and other stakeholders. But, as William Young J said, there are limits to the extent to which directors can keep trading while balance sheet insolvent in the hope that things will improve. It is not acceptable for directors to continue to trade with their creditors' money unless they have put in place carefully thought-through strategies, with a good prospect of success, to restore the company's solvency.[72]

[269] Drawing these threads together, it seems to us that where a company is in a precarious financial position:

(a) The directors must squarely face up to that financial situation and assess the risk of a serous loss to creditors.

(b) If continuing to trade in a "business as usual" manner is likely to create a significant risk of serious loss to creditors, trading on in that manner is not permitted.

(c) A decision to trade on should be made only after undertaking a sober assessment of the likely consequences of doing so. Unfounded optimism is not enough.

(d) A decision to trade on, rather than take immediate steps to cease trading, is likely to breach s 135 unless the manner in which the directors choose to trade on has realistic prospects of enabling the company both to service pre-existing debt and to meet the new commitments which such trading will inevitably attract. It is not enough that there is a realistic

71 At [150].
72 At [152].

> prospect that existing creditors will be paid by substituting new creditors, who in turn will face a substantial risk of serious loss. Section 135 does not condone a policy of robbing Peter to pay Paul, on condition that Peter's losses are exceeded by Paul's gains.

[270] If, following a sober assessment of the likely consequences of trading on, it appears that a return to solvency is unlikely, it is not open to the directors of a company to trade on while attempting to rescue all or part of the business. They must either cease trading or take steps to appoint an administrator under pt 15A of the Act to seek to rescue all or part of the company's business.

[271] In particular, as the Supreme Court emphasised in *Debut Homes*, it is not open to the directors of an insolvent company to trade on in order to conduct their own informal administration or liquidation, unless they obtain the consent of affected creditors and/or ensure that creditors who have not consented to that approach are paid in full.[73] To do so would be inconsistent with the scheme of the Act: the administration of an insolvent company, and any decision on whether all or part of the business should continue to trade, should be undertaken by an administrator, a receiver or a liquidator. That ensures both the necessary independence of decision-making, and — very importantly — appropriate priority for new obligations incurred in the course of the administration, receivership or liquidation.

The obligations of a director under s 136

[272] The same observations that we made in relation to the approach to interpretation of s 135 are equally applicable in relation to s 136. Section 136 must be applied having regard to its text, the wider purpose of the Act, and the specific purpose of the provision within the wider statutory scheme.

[273] Section 136 only applies to obligations that a director has agreed to the company incurring. In *Debut Homes* the Supreme Court observed, without deciding the issue, that it may be that this connotes a more active role than "allowing" and a more direct relationship to the particular decision than "causing"; terms that appear

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73 See *Debut Homes*, above n 64, at [47]–[48], [179]–[180] and [184].

in s 135 but not in s 136.[74] But in that case Mr Cooper had an active and direct role in the sales that gave rise to the relevant obligations, so it was not necessary to decide any nuances in the specific terms used.

[274] There is some authority that s 136 is only concerned with transactions on capital account, not transactions on revenue account. The High Court Judge did not accept that proposition.[75] The directors submitted the Judge was wrong to reject this limit on s 136, relying on observations made by this Court in *Peace and Glory Society Ltd (in liq) v Samsa*.[76] That was a case about a particular obligation incurred by the company in question to pay GST in connection with a property transaction. This Court referred to the view expressed by Professor John Farrar in *Corporate Governance: Theories, Principles and Practice* describing the purpose of s 136 as being to deal with obligations on capital accounts such as major investments: "[i]t focuses on a particular transaction rather than the general conduct of the company's business. By contrast, s 135 deals with the debts on revenue account."[77]

[275] The directors also relied on *Grant v Johnston*, where the High Court referred to *Peace and Glory Society Ltd* and treated s 136 as limited to transactions that were on capital account, or of a similar nature.[78]

[276] We do not consider that *Peace and Glory Society Ltd* and *Grant v Johnston* provide any real support for limiting s 136 to transactions of a capital account nature:

(a) The passage from Professor Farrar's text that was referred to in *Peace and Glory Society Ltd* was simply set out by way of introduction to the Court's discussion of s 136. The Court did not need to consider whether the distinction drawn by Professor Farrar was sound, in the context of a case focussed on a specific obligation. No argument appears to have been directed to the point. We do not read this Court's decision in *Peace and Glory Society Ltd* as adopting (even obiter) the distinction drawn by Professor Farrar.

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74 At [92].
75 High Court Judgment No 1, above n 1, at [300].
76 *Peace and Glory Society Ltd (in liq) v Samsa* [2009] NZCA 396, [2010] 2 NZLR 57.
77 At [44], quoting John Farrar *Corporate Governance: Theories, Principles and Practice* (3rd ed, Oxford University Press, Melbourne, 2008) at 174.
78 *Grant v Johnston* [2015] NZHC 611 at [134]–[137].

(b) The appropriateness of such a limit does not appear to have been argued in the High Court in *Grant v Johnston* and was not in issue on appeal before this Court.[79] It appears that counsel for the liquidators accepted that the High Court Judge's construction of s 136 was correct and that, in any event, the liquidators' allegations of breach of s 136 did not add materially to their case. In those circumstances it was not necessary for this Court to determine the point, and it did not do so.[80]

[277] The approach adopted by the Supreme Court in *Debut Homes* does not support drawing such a distinction. The Supreme Court found that Mr Cooper breached s 136 in relation to GST obligations incurred in the course of the company trading as a property developer.[81] The Court observed that he would also have breached s 136 in relation to any trade debts left outstanding at liquidation if those debts were incurred at a time when it was clear those debts would not be paid.[82]

[278] We agree with the High Court Judge that there is no support for such a distinction in the text of s 136 or in the wider statutory context.

[279] It has also been suggested in a number of cases that s 136 is concerned with specific transactions, not trading generally, based on the use of the verb "agree" and the reference to "an obligation" in the singular. But words in the singular include the plural.[83] And as a matter of ordinary language, where the directors of a company agree to a company undertaking a particular project, for example, they agree to the company undertaking all the obligations that would ordinarily be expected to form an integral part of that project. Thus where the directors of Mainzeal agreed to the company entering into a major construction contract, they agreed not only to the company entering into the obligations to the principal set out in that construction contract, but also to the company entering into associated obligations with subcontractors and suppliers. And where they agreed to continued trading, they agreed to the company incurring all the obligations that would normally result from such trading.

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79 *Grant v Johnston* (CA), above n 63.
80 At [43].
81 *Debut Homes*, above n 64, at [95].
82 At [96].
83 Interpretation Act, s 33.

[280] It is of course the case that s 136 can apply to a decision to enter into a specific obligation that the company is unable to perform when it falls due. But there is nothing in the text of s 136, or in the Act more generally, to suggest that the provision should be confined to decisions to enter into specific transactions. The purpose of the provision is to discourage directors from agreeing to the company incurring obligations where they do not believe the company will be able to perform the obligations when required to do so, or where there are no reasonable grounds for such a belief. In those circumstances the risk to the creditor(s) in question falls outside the normal and acceptable range of risks that creditors expect to face when dealing with a company. That concern may arise in relation to a specific obligation, or it may arise in relation to a specific class of transactions, or transactions generally.

[281] O'Regan J adopted this broader approach to the scope of s 136 in *Fatupaito v Bates*, equating the decision to keep trading with an agreement to incurring the obligations that were a consequence of that continued trading:[84]

> [86] While I accept that Mr Bates honestly believed that continuing to trade would generate income in excess of the expenditure to be incurred, I do not believe that the circumstances were such that this belief was a reasonable one taking into account:
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> - The company's trading history, which showed continued losses and failures to meet projected income targets;
> - The problems the company had had with Mr Moon involving funds being taken by Mr Moon on an apparently unauthorised basis;
> - The fact that, on Mr Bates' own assessment, the employees were "stressed people" and the fact that there had been a number of employees departing the company around Christmas 1997;
> - By the end of February Mr Bates knew or ought to have known, that there was significant difficulty in collecting the $16,050 debt owed by Mr P Collyns which ended up being part of a transaction involving the transfer to the company of a Mazda vehicle which was the subject of an ownership dispute (about which I will say more later).
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> [87] It also appeared that Mr Bates' decision was based on a likelihood that debts incurred after the date of the receivership by the company would be outweighed by income, but Mr Bates knew at the time of the commencement of the receivership that the company already had an excess of liabilities over assets of over $14,000. It should have been clear to him that creditors in existence at the time of the receivership would also need to be paid, and in

[84] *Fatupaito v Bates*, above n 62.

> view of the fact that many accounts from those creditors were already overdue, the pressure would come on for them to be paid first. The "aged payables" list which Mr Bates prepared at the commencement of the receivership showed that 56.8 per cent of creditors' accounts were 31 – 60 days old, and a further 9.3 per cent were older than 60 days. There was no basis on which Mr Bates could reasonably assume that existing creditors would continue to permit late payment – to do so would not be reasonable – see *Carrier Air Conditioning Pty Ltd v Kurda* (1993) 11 ACLC 773, cited by Wild J in *B M & C B Jackson Ltd*.
>
> [88] In the circumstances, I find that Mr Bates was in breach of s 136 from the beginning of March 1998 because he was, at that time, aware that the company was in an insolvent position and it was not reasonable for him to believe that from then on obligations incurred by the company would be able to be met as they fell due.
>
> [89] Looking at the position with hindsight, it is clear that the financial position of the company deteriorated significantly for a number of reasons which meant that the company did not in fact meet a number of obligations incurred during the receivership. The question I need to answer is whether Mr Bates could reasonably have believed that such obligations would be met. I find that he could not.

[282] The approach outlined above also derives support from the approach adopted by the Supreme Court in *Debut Homes*. As already mentioned, the Court expressly declined to decide any "nuances" in the difference between the s 136 reference to obligations that directors *agree* to the company incurring, and the s 135 references to directors who *agree* to the business of the company being carried on in the specified manner, or who *cause or allow* the company's business to be carried on in that manner.[85] But the Court went on to hold that the respondent director had agreed to the company incurring GST obligations that he knew would result from his decision to enter into certain agreements for sale and purchase.[86] And the Court proceeded on the basis that a decision by the director to trade on at a time when the company could not meet its debts as they fell due would breach s 136.[87] It is implicit in this approach that s 136 is not limited to specific transactions, and that by deciding to trade on, the director had agreed to incur the trade debts that the director knew would result from such trading.

[283] Thus a s 136 claim may relate to specific obligations, an identified class of obligations, or all obligations incurred by the company after a given point in time.

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85 *Debut Homes*, above n 64, at [92].
86 At [92].
87 At [96].

[284] The first step in applying s 136 is to identify the obligation(s) that are the subject of the claim, and ascertain whether the director agreed to the company incurring those obligations.

[285] The next step in applying s 136 involves asking:

(a) Whether the director believed that the company would be able to perform the relevant obligations when they fall due. This inquiry focuses on the (subjective) beliefs of the relevant director.

(b) If so, whether the director had reasonable grounds for that belief. This is an objective test. As with s 135, the focus will be on what the director knew or would have known if they had made the inquiries that a reasonable director would have made. A director cannot rely on certain matters known to them which suggest the obligations will be met if a reasonable director would have made further inquiries, and those further inquiries would have revealed that there was a substantial risk that the company would not be able to perform the obligation(s) in question when they fell due.

[286] This step in the s 136 inquiry requires some specificity in relation to the obligations or class of obligations in issue. It is necessary to identify:

(a) when the relevant obligations were incurred;

(b) when those obligations would fall due;

(c) what the director believed, at the time the obligations were incurred, about the ability of the company to meet the obligations at the future time when they would fall due; and

(d) the grounds for the director's beliefs.

[287] In some cases the position of a company will be so dire that there are no reasonable grounds for thinking that any obligations incurred by the company would

be met when they fall due, even in the very short-term. Failure could occur at any time, and it would be a matter of luck rather than reasonable expectation if the company survived long enough to meet any new obligations. In other cases the directors of a company may have reasonable grounds for expecting that the company will be able to keep trading for the immediate future and pay debts as they fall due for the next few months, but the longer term position of the company is uncertain and there is no reasonable basis for predicting that obligations will be met beyond that horizon: in those circumstances, any liability under s 136 would be confined to the longer term obligations that will fall due beyond that horizon.

Relief in claims for breach of directors' duties

[288] The appropriate approach to awarding relief for breach of a duty owed by a director to a company, where that claim is brought by the company, will of course depend on the provision breached and on the nature of the breach. If, for example, a director breaches the fiduciary obligations set out in s 131, the remedy will be assessed in accordance with the principles governing claims for breach of fiduciary duty. The remedy may be gain-based, or may take the form of compensation for loss assessed on a generous basis that takes as its starting point all losses that would have been incurred but for the breach, with the onus on the director to justify any reduction from that starting point.[88]

[289] If however a director breaches the duty of care set out in s 137, compensation will be assessed on the approach that is normally adopted in negligence cases. The loss recoverable will depend on the harm that the director had a duty to avoid. "But for" causation is a necessary but not sufficient requirement when assessing the loss that is caused by, and fairly attributable to, breach of a duty of care.[89]

[290] Where a company brings a claim under ss 135 or 136, the appropriate approach to assessing compensation will depend on the nature of the breach. Counsel for the directors submitted, and the liquidators accepted, that the loss recoverable from

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[88] See Andrew Butler (ed) *Equity and Trusts in New Zealand* (2nd ed, Thomson Reuters, Wellington, 2009) at [31.1], [31.3], [32.1], [32.5] and [32.6].

[89] Susan Watson and Lynne Taylor (eds) *Corporate Law in New Zealand* (Thomson Reuters, Wellington, 2018) at [23.2.4].

directors for a breach of ss 135 and 136 must have been caused by the relevant breach. That is plainly correct.[90]

[291] The net deterioration approach adopted in *Mason v Lewis* — an approach that focuses on the deterioration in the company's financial position between the date trading should have ceased and the date of actual liquidation — will be relevant in s 135 cases where the complaint is that the company continued to trade after a liquidation should have occurred, and the company is worse off than it would have been if trading had ceased at an earlier date.[91] As the Supreme Court observed in *Debut Homes*, the appropriate starting point in most s 135 cases is net deterioration "because the section looks at the creditors and the business as a whole".[92]

[292] But even in the context of s 135 claims, the net deterioration approach is not a straitjacket. If for example a breach of s 135 brings about the insolvent liquidation of an otherwise solvent company, the loss to the company may well include the entire deficiency on liquidation and the costs of the (otherwise avoidable) liquidation. That appears to be the basis on which compensation based on the entire deficiency in the liquidation was awarded in *Barring Horticulture New Zealand Ltd (in liq) v Barring* and *FAF Holdings Ltd (in liq) v Bethune*.[93]

[293] In *Debut Homes* the Supreme Court explained that a different approach will generally be needed in assessing compensation for breaches of s 136:[94]

> [165] We do not, however, consider that the [net deterioration] measure of compensation would necessarily respond adequately to breaches of s 136. The breach of duty under s 136 is the incurring of obligations without a reasonable belief that they will be met. This section therefore concentrates on individual creditors. Section 136 is, however, like s 135 and others, framed as a duty to the company. It follows that Parliament must have considered any

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90 For the approach to causation in s 135 claims, see *FXHT Fund Managers Ltd (in liq) v Oberholster* [2010] NZCA 197 at [28]–[31].

91 *Mason v Lewis*, above n 63, at [109]–[110].

92 *Debut Homes*, above n 64, at [164].

93 *Barring Horticulture New Zealand Ltd (in liq) v Barring* [2016] NZHC 304, [2016] NZCCLR 17 at [43]–[49] where the director was liable for the full loss to creditors of $219,184; and *FAF Holdings Ltd (in liq) v Bethune* [2017] NZHC 2796, [2019] NZCCLR 6 at [169] where the director was liable for the total loss on liquidation of $538,213.28 (which included a preferential claim for court liquidation costs: [28(a)]). See also High Court Judgment No 1, above n 1, at [410]–[411], referring to *Re South Pacific Shipping Ltd (in liq)*, above n 50, at [164]; and *Löwer v Traveller*, above n 50, at [78]–[79] and [90].

94 *Debut Homes*, above n 64 (footnotes omitted).

> breach of the duty would harm the company. It is therefore appropriate that any relief ordered should operate to reverse that harm and thus be restitutionary in nature.
>
> [166] In cases where the breach is of s 136, limiting compensation to the net deficiency (the usual measure for s 135) would not respond to the breach and make good the harm, especially in cases where new obligations are incurred and used to pay other debts ("robbing Peter to pay Paul"). There is much force in the liquidators' submission that limiting compensation to the net increase in amounts owing would provide directors with the perverse incentive to continue to trade in breach of s 136 as long as they are careful to make sure that the net deficit remains constant. If relief under s 301 is calculated on a net deficiency basis in such cases, there would be no deterrent effect and directors would not properly be held to account. Nor would the harm to the company be reversed.

[294] It follows that where a director breaches s 136, the starting point for assessing compensation is likely to be the obligations that the director agreed to the company undertaking, in breach of s 136, and that the company failed to perform. This is the harm that is suffered by the new creditors, and on the approach to s 136 approved by the Supreme Court in *Debut Homes* this is the harm that the company must be treated as having suffered.

[295] On this approach no allowance would normally be appropriate for benefits to the company as a result of undertaking the relevant obligations: for example, the value of goods or services provided to the company on credit. If the focus was on the loss to the company caused by entry into the new obligations as a matter of fact, such an adjustment would be necessary. But then a typical breach of s 136 — where a company trades on while insolvent and obtains goods or services on credit that the company is unable to pay for — would not generally result in any claim on the part of the company, which will have received value for the debt it incurs. On that approach, most breaches of s 136 would not give the company any right of recovery for the benefit of creditors, or expose directors to any liability. If on the other hand incurring the obligations is treated as a form of "deemed harm" to the company in and of itself, as the Supreme Court evidently contemplated in the passages set out above, such an adjustment would not be appropriate.

[296] In our view, it follows from the Supreme Court's approach in *Debut Homes* that compensation for breach of s 136 will generally be assessed by adopting a "new debt" measure that focuses on the gross amounts of the unsatisfied obligations

undertaken in breach of s 136. This approach reflects the policy rationale underpinning s 136, and ensures that the provision is practically relevant in typical insolvent trading scenarios. That is the approach we adopt.

[297] We are conscious that this approach sits rather uncomfortably with the s 136 duty being described as a duty owed to the company, and the corresponding provision for enforcement of the duty primarily by (or through) the company. And there is a stark mismatch between the new debt approach to assessing compensation for breach of the s 136 duty and the identity of the stakeholders who will benefit from any award of compensation to the company. As we explain below, a claim for breach of these provisions is usually brought by a receiver or liquidator: in those circumstances any compensation will be paid to the company, and creditors will benefit from that award in accordance with their entitlements in a liquidation. So for example a secured creditor may benefit from an award that has been calculated by reference to an increase in net unsecured debt. Or all unsecured creditors may share pro rata in an award calculated by reference to new debt incurred after a given date: the new creditors who suffered the harm at which the provision is aimed, and by reference to whose loss the compensation is quantified, will share that compensation with pre-existing creditors. These difficulties are not sufficient to lead us to reject the new debt approach under s 136, which we see as consistent with the Supreme Court's approach in *Debut Homes*, and necessary in order to make the legislation work. But these difficulties underscore the need for a review of the post-1993 insolvent trading provisions, to ensure they are coherent and practically workable.

Relief under s 301

[298] Section 301 has been described as a "procedural short cut" by which a liquidator, creditor or shareholder may pursue the claims which a company in liquidation may have against, among others, its former directors.[95]

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[95] *Sojourner v Robb*, above n 65, at [53]. See also *Löwer v Traveller*, above n 50, at [50] which contrasts s 321 of the 1955 Act (the precursor of s 301 of the Act) with s 320 (the precursor of the current s 135); s 320 did create a new cause of action that could be pursued only once the company is in liquidation.

[299] A liquidator can bring a claim for compensation against a former director under s 301 only if that director has been guilty of negligence, default, or breach of duty or trust in relation to the company. Section 301 does not impose any new duty or create any new cause of action. Rather, the liquidator needs to identify some other duty owed by the director to the company and a breach of that duty. The courts have consistently described s 301 as essentially procedural in nature.[96] As Cooke P said in *Arataki Properties Ltd v Craig* in relation to the precursor of s 301 (s 321 of the 1955 Act):[97]

> I cannot think that [s 321 of the 1955 Act] was ever meant to create a wholly new cause of action as at the date of commencement of a winding up, which, subject only to the discretion of the Court, could expose non-fraudulent directors to examination into their conduct in years long past.
>
> The settled interpretation that the section provides a new way of examining into and enforcing an existing liability to the company should not be disturbed by judicial decision. Perhaps there are arguments of policy for extending the time scope of the section; but to say the least they are not overwhelming. If there is to be any change it is best left to the legislature.

[300] Thus, as this Court held in *Arataki Properties Ltd v Craig*, time runs in relation to a breach of duty by a director from the time that the company could bring a claim in respect of that breach.[98] Section 321 of the 1955 Act did not have the effect of giving the liquidator a new cause of action, in respect of which time started running when the liquidation began. There is no indication that the current Act was intended to produce a different result.

[301] A liquidator who brings a claim under s 301 in respect of a breach of duty by a director must establish all the elements of a cause of action for breach of that duty. Directors cannot be required to pay more under s 301 than could have been awarded against them in a direct claim by the company for breach of that duty.[99]

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96 See *Arataki Properties Ltd v Craig* [1986] 2 NZLR 294 (CA) at 297–298, citing *Re J E Hurdley and Son Ltd (in liq)* [1941] NZLR 686 (CA) at 723.

97 *Arataki Properties Ltd v Craig*, above n 96, at 298.

98 At 297–298.

99 *Sojourner v Robb*, above n 65, at [54]; *Löwer v Traveller*, above n 50, at [79]; and *Morgenstern v Jeffreys* [2014] NZCA 449 at [99]. See also *Cohen v Selby* [2001] 1 BCLC 176 (EWCA) at [20] for discussion on s 212 of the Insolvency Act 1986 (UK) which is equivalent to s 321 of the 1955 Act.

[302] The High Court Judge placed some emphasis on the references in s 301 to the court carrying out an "inquiry" into the conduct of the relevant director, and to payment of such sum by way of compensation "as the court thinks just". On its face, s 301 might be read as conferring a broad remedial discretion on the court. But considerable caution is required in relation to the apparent breadth of this language, given the clear authority that s 301 does not enable the court to impose a liability that would not otherwise exist, or to award more than the company could have recovered in a claim for breach of the relevant duty. That cap on s 301 liability makes sense as a matter of principle — it would be unsatisfactory and unjust for the use of a different procedural mechanism to pursue a claim for breach by a director of a duty owed to the company to result in an increase in the amount for which the director was liable in respect of that breach of duty.

[303] Can the court award less under s 301 than would be awarded in a direct claim for breach of duty brought in the name of a company? On the face of it, yes; the statutory language allows the Court to order such compensation as it thinks just. There are several decisions of this Court that proceed on the basis that s 301 confers a discretion on the court in relation to the amount to be awarded against a director.[100]

[304] But there are also authorities suggesting that the scope of the s 301 discretion is limited. As this Court observed in *Sojourner v Robb*, where a claim under s 301 is a proxy for a direct claim by the company against its former directors it is difficult to identify a reason for leaving stakeholders in the company's liquidation worse off under s 301 than they would have been if the company had sued the directors, recovered what was due and owing, and distributed the proceeds of the claims to creditors.[101] After all, the liquidator could simply sue in the name of the company without relying on s 301, or pursue a direct claim and a s 301 claim in the alternative. It would at first blush be surprising if the procedural mechanism chosen by the liquidator reduced the amount recovered for the benefit of creditors.

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[100] See for example *Mason v Lewis*, above n 63, at [55] and [110]; *Peace and Glory Society Ltd (in liq) v Samsa*, above n 76, at [48], [64] and [69]; and *Shaw v Owens* [2017] NZCA 315 at [17].

[101] *Sojourner v Robb*, above n 65, at [55].

[305] The existence of a broad discretion to reduce an award against a director on discretionary grounds under s 301 also is not easy to reconcile with another element of the 1993 reforms. Under the 1955 Act, the court had the power to relieve a director from liability where the director had acted honestly and reasonably, and ought fairly to be excused.[102] The Law Commission recommended that this power be carried forward into the new legislation.[103] But a deliberate decision appears to have been made not to include a dispensing power of this kind in the current Act. No such power is available where a solvent company brings a claim against a director, or where a receiver brings a claim on behalf of a company, or where a liquidator sues in the name of the company rather than applying under s 301. It would be anomalous for a dispensing power of this kind to be available where a claim relating to a breach of a duty owed by a director to the company is brought by a liquidator under s 301, but not in other circumstances.

[306] In *Debut Homes*, the Supreme Court proceeded on the basis that s 301 confers a discretion in relation to the amount to be awarded against a director, to be exercised by reference to concepts of causation, culpability, and duration of any breach.[104] That issue does not appear to have been in dispute before the Supreme Court: rather, it appears to have been common ground among the parties that s 301 confers a broad remedial discretion. No doubt for that reason, the Supreme Court did not consider whether the existence of a broad dispensing power can be reconciled with the scheme of the 1993 Act and its legislative history. The Supreme Court summarised the position as follows:

> [182] Where there have been breaches of duties, any relief ordered under s 301 must respond to and provide redress for the particular duty or combination of duties breached. Relief can be compensatory or restitutionary in nature and must take account of all of the circumstances, including the nature of the breach or breaches, the level of culpability of the director, causation, duration of the breach, holding the director to account and reversing the harm to the company.
>
> (Footnote omitted.)

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102 Companies Act 1955, s 468.
103 Law Commission 1989 Report, above n 24, at [575] and s 137 of its draft legislation.
104 *Debut Homes*, above n 64, at [158], [162] and [182].

[307] The argument before us did not squarely address the scope of the court's discretion in relation to relief under s 301, and the principles on which that discretion should be exercised, having regard to the issues identified above. In particular, the manner in which that power should be exercised in respect of a finding of liability for breach of s 136 was not canvassed in any detail before us. The provisional views of the panel hearing this appeal differ in relation to the breadth of the s 301 discretion. Kós P and Miller J provisionally consider that they are bound by *Debut Homes* to proceed on the basis that the discretion 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. Goddard J provisionally considers that this issue is not foreclosed by *Debut Homes*, and that it remains arguable that the discretion is relatively confined, reflecting the essentially procedural nature of s 301, and should only be exercised where there are factors such as knowledge on the part of a creditor that justify a reduction in the amount of compensation to be awarded against one or more directors. We all however agree that this difficult question is best resolved against the background of relevant factual findings, and with the benefit of full argument from the parties, in the context of the reference back to the High Court that we direct at [552] below. This Court will then have the benefit of the Judge's findings and analysis in the event of a further appeal.

[308] Where the court is satisfied that there has been a breach of a relevant duty by a director, the court may order that director to "contribute such sum to the assets of the company by way of compensation as the court thinks just".[105] On the face of the provision, the payment goes to the company and not to creditors, except in certain cases where the claim has been brought by a creditor under s 301(1)(c), discussed below at [309]. The court is not given any power to direct that the compensation be applied other than in accordance with the usual order of priority in a liquidation. In particular, the court does not appear to have the power conferred by s 300 of the Act (and by s 320 of the 1955 Act) to declare directors liable for a specified part of the debts of the company. The remedial powers conferred by ss 300 and 301 appear on their face to differ in this practically important respect. As noted above, and as this Court recognised in *Mason v Lewis*, that may mean that the benefit of any

105 Companies Act, s 301(1)(b)(ii).

recovery flows in whole or in part to a secured creditor, or (at least in part) to creditors other than those prejudiced by the continued trading.[106]

[309] Section 301(1)(c) does provide for an application under s 301 to be made by a creditor of the company. Where the application is made by a creditor, the court can order the defendant to pay or transfer money or property to the creditor under s 301(1)(c). It has been held in the High Court that this power is available where the defendant has misapplied or retained or become liable or accountable for money or property of the company, but not in relation to compensation for breaches of a duty owed by a director to the company.[107] However in *Debut Homes* the Supreme Court expressly left the question of when an award can be made to a creditor for decision in a case where the issue arises directly.[108] As the present proceedings were brought by the liquidators of Mainzeal, not by creditors, we also need not decide that issue.

The claim before the High Court

[310] One of the grounds on which the directors appealed is that the decision of the High Court finding them liable under s 135 of the Act for the entire deficiency in the liquidation was procedurally unfair, as a claim on that basis was not pleaded by the liquidators and was not advanced by them at trial. It was an integral step in the High Court's reasons for arriving at that result that, by 31 January 2011, the directors were required to put pressure on Mr Yan and Richina Pacific to provide additional capital, or to provide enforceable commitments to support Mainzeal. The directors submitted that it was also a necessary step in this line of reasoning that such pressure would have been effective, and would have prevented Mainzeal becoming insolvent and going into liquidation. If a claim along those lines had been pursued, the directors say, they would have filed both fact and expert evidence responding to it. Moreover the liquidators failed to put questions to the directors that were necessary if such a claim was being advanced.

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106 *Mason v Lewis*, above n 63, at [95]. See also Kristin Van Zwieten *Goode on Principles of Corporate Insolvency Law* (5th ed, Sweet & Maxwell, London, 2018) at [14-17] in relation to the equivalent provision in the United Kingdom insolvency legislation.

107 *Mitchell v Hesketh* (1998) 8 NZCLC 261,559 (HC) at 261,562.

108 *Debut Homes*, above n 64, at nn 179 and 191.

[311] Because this procedural fairness issue was a major plank in the directors' argument on appeal, it is necessary to describe in some detail the way in which the case was pleaded, and the way in which it developed at trial.

The liquidators' pleading

[312] The claim went to trial on the basis of the liquidators' third amended statement of claim filed in July 2018 (Third ASC). The relevant causes of action in the Third ASC for the purposes of this appeal are the first cause of action based on breach of ss 136 and 137 of the Act, and the second cause of action based on breach of s 135 of the Act.

[313] The claim is pleaded as a claim by Mainzeal (and other related companies that are also in liquidation). It is not pleaded as an application by Mainzeal's liquidators. But it is clear from the pleading read as a whole that it is a claim brought by the liquidators under s 301 of the Act.

[314] The Third ASC begins by identifying the parties and certain other relevant entities. It then sets out the factual background to Mainzeal's collapse, including the advances from Mainzeal to the related entities described above.

[315] The first cause of action pleads the duties owed by Mainzeal's directors to Mainzeal under ss 136 and 137 of the Act. The alleged breaches of those duties, and the loss caused by those breaches, are pleaded in paras 60–62 of the Third ASC. This pleading is central to the complaint made by the directors about the process in the High Court, so we set it out in full:

> 60. In discharging their duties pleaded in paragraph 59 above, [Mainzeal]'s directors were under a duty to consider the interests of [Mainzeal]'s creditors:
>
> (a) at all times after 31 December 2008 as:
>
> (i) from 2005, [Mainzeal]'s annual financial accounts were prepared on a going concern basis in reliance on the provision of financial support by:
>
> (aa) [Richina Pacific] between 2005 and 2008;

(bb) RGREL and/or [Richina (NZ) LP] between 2009 and 2012; and

(ii) [Mainzeal]'s liabilities exceeded its realisable assets;

…

(b) alternatively, at all times from January 2011, at which point it was or should have been apparent to [Mainzeal]'s directors, including from the *Corporate Governance* report provided by [Ernst & Young], that there was significant uncertainty over the collectability of related party debts and over leaky building claims and also that structural and governance issues affecting [Mainzeal] added further risk to the company;

(c) alternatively, at all times on or after 31 July 2011, by reference to the matters pleaded in paragraph 33 above.

61. [Mainzeal]'s directors breached the duties pleaded in paragraphs 59 and 60 above by agreeing to [Mainzeal] continuing to trade and incurring new obligations at a time when reasonable grounds did not exist for the belief that [Mainzeal] would be able to perform those obligations when required to do so as:

(a) [Mainzeal] was unable to:

(i) obtain financial support from [Richina (NZ) LP] because that company did not have the financial ability to provide such support; and

(ii) obtain repayment of debts due to it from related companies, including MLG; or

(iii) compel [Richina Pacific] and its subsidiaries to repay these related companies debts and/or provide [Mainzeal] with financial support;

(b) [Mainzeal]'s directors failed to make an ongoing and realistic assessment of:

(i) [Mainzeal]'s ability to tender for new work and perform its contractual obligations in circumstances where it had negative working capital and its cash reserves were limited or depleted;

(ii) the current and prospective financial position of [Mainzeal], including adequate provisioning for:

(aa) leaky building claims and other contingent liabilities of [Mainzeal]; and

(bb) non-recoverable related parties' debts;

(iii) the reliability of the supply of building materials from China and the quantum of the benefit which [Mainzeal] could be expected to receive; and

(iv) the risk to [Mainzeal]'s prospective creditors as a result of continuing to trade and incurring further obligations after 31 January 2011 or alternatively 31 July 2011.

62. As a consequence of the breach of duties by [Mainzeal]'s directors pleaded in paragraphs 59 and 60 above, [Mainzeal] incurred obligations to its creditors of:

(a) $75.348 m after 31 January 2011.

Particulars

(i) As to the obligations incurred, all those incurred after 31 January 2011 and not satisfied as particularised in Schedule 2.

(b) $69.427 m after 31 July 2011.

Particulars

(i) As to the obligations incurred, all those incurred after 31 July 2011 and not satisfied as particularised in Schedule 2.

[316] The relief claimed was an order under s 301 of the Act that the directors jointly and severally contribute to the assets of Mainzeal:

(a) $75.348 million as quantified in para 62(a) of the pleading;

(b) $69.427 million as quantified in para 62(b) of the pleading; or

(c) such other sum as the Court thinks just.

[317] The liquidators also claimed interest and costs.

[318] The second cause of action pleads the duty owed by Mainzeal's directors under s 135 of the Act. It pleads that in discharging that duty, Mainzeal's directors were under a duty to consider the interests of Mainzeal's creditors from 31 December 2008,

or alternatively from 31 January 2011, or alternatively from 31 July 2011 at the latest. The allegations of breach, and resulting loss, were pleaded as follows:

> 66. [Mainzeal]'s directors breached the duty pleaded in paragraphs 64 and 65 above and agreed or allowed [Mainzeal]'s business to be carried on in a manner that created or was likely to create a substantial risk of serious loss to [Mainzeal]'s creditors by:
>
> (a) engaging in the conduct, and allowing continued trading in the circumstances, pleaded in paragraph 61 above;
>
> (b) failing to ensure that:
>
> (i) [Mainzeal] was adequately capitalised, including by failing to:
>
> (aa) conclude the documentation of the capital call option provided in the Charter; or if such documentation was concluded,
>
> (bb) exercise the capital call option;
>
> (ii) they had adequate control over cash advances by [Mainzeal] to related companies;
>
> (iii) [Mainzeal]'s cash advances to related companies were able to be sustained by [Mainzeal] and properly documented;
>
> (iv) [Mainzeal] had the ability to:
>
> (aa) recover related parties' debts including those owed by MLG Trading (to 31 December 2011) and RGREL;
>
> (bb) call on and enforce [Richina Pacific]'s support, including by enforcing the Prepaid Goods Agreement against [the CHC] in a timely manner or at all;
>
> (v) an audit committee and appropriate risk assessment processes were established;
>
> (c) failing to adequately monitor [Mainzeal]'s financial position on a sufficiently regular basis;
>
> (d) failing to plan for the possibility that [Richina Pacific] would elect to withdraw its provision of support;
>
> (e) failing to ensure, or to take reasonable steps to ensure, that:
>
> (i) related company debtors were and would be able and willing to provide funds owed when due or required;

> (ii) related company promisors of support were and would be able and could be compelled both legally and practically to provide assured funds when required;
>
> (f) approving and allowing the Prepaid Goods Agreement;
>
> (g) approving and allowing the [Mainzeal] Debt Restructure; and
>
> (h) allowing [Mainzeal] to continue trading when they should not have done so.
>
> 67. [Mainzeal]'s financial position deteriorated by:
>
> (a) $44.494 m between January 2011 and February 2013.
>
> ...
>
> (b) $32.849 m between July 2011 and February 2013.
>
> ...
>
> 68. [Mainzeal] and its creditors have suffered loss as a result.
>
> 69. Alternatively, [Mainzeal] incurred obligations to creditors and those creditors suffered loss as pleaded in paragraph 62 above.

[319] The relief sought was the same as the relief sought in the first cause of action, with the addition of two further alternative sums by way of compensation: the alleged net deterioration of $44.494 million (between January 2011 and February 2013) or $32.849 million (between July 2011 and February 2013).

[320] A pleading, like any other document, must be read as a whole. Individual paragraphs cannot be read in isolation, divorced from the context in which they appear. Reading the Third ASC as a whole, it is clear that the case advanced by the liquidators was that:

(a) The directors breached their duties to the company under one or more of ss 135, 136 and 137 no later than 31 January 2011, or alternatively 31 July 2011.

(b) If they had not breached those duties, Mainzeal would have ceased to trade, or at least ceased to enter into new obligations, by either 31 January 2011 or 31 July 2011.

(c) The delay in Mainzeal ceasing to trade and/or ceasing to enter into new obligations caused loss either to the company itself, assessed on the basis of the net deterioration of the financial position of the company as a result of the delay, or to creditors, assessed by reference to the new debt incurred by trading on beyond the relevant breach date.

[321] There was no pleading that if the directors had performed their duties there would not have been an insolvent liquidation. Nor was there any pleading that either the company or its creditors had suffered loss quantified by reference to a "no liquidation" counterfactual.

[322] There are some paragraphs in the pleading — in particular, para 66 — which taken in isolation might be read as consistent with a "no liquidation" counterfactual. But when one reads each cause of action in the Third ASC as a whole, we accept the directors' submission that no claim of that kind was pleaded against them. It was reasonable for them to prepare for trial on the basis that the case they had to answer was that if they had not breached their duties, the company would have ceased trading, or at the least ceased entering into new obligations, at an earlier date: either some date before 31 January 2011, or alternatively some date before 31 July 2011. Both the nature of the alleged breaches and the consequences of those breaches fell to be considered on that basis.

[323] The liquidators' opening submissions reflected this approach. They said:

> 237. The directors should have ceased trading from January 2011 if not before. The plaintiffs' case is that by no later than that date, the directors allowed [Mainzeal] to carry on business (s 135) and agreed to incur specific obligations (s 136) that involved significant and illegitimate risks to the creditors.
>
> …
>
> 239. The directors' decision to permit [Mainzeal] to continue trading after the structural separation, but without the represented recapitalisation, falls squarely within the provisions of s 135. From this point, the directors failed to appreciate, or to recognise, that [Mainzeal] was insolvent despite PwC telling them so in plain terms in December 2008. They failed to comprehend the scale of [Mainzeal]'s growing leaky building liability and its deteriorating trading performance. [Mainzeal]'s related party liability then increased by a further $14 m during the 09, 10 and 11 years notwithstanding that structural

> separation had been predicted on [Richina Pacific] injecting capital of a similar amount into [Mainzeal].
>
> …
>
> 307. The plaintiffs contend that under s 135, the measure of loss is not limited to the *Mason v Lewis* approach which involves a comparison of the company's position between the actual liquidation date and a [notional] counterfactual representing the time at which the directors ought to have ceased trading earlier. The Court also has jurisdiction to determine loss based on the new debts incurred by the company at a time when the directors were trading illegitimately.
>
> …
>
> 317. Mr Apps has also calculated loss under s 136 utilising the 'new debt' method, that is, those creditors who acquired new debt after the counterfactual dates. (As noted, this approach may also be available under s 135 but is advanced by counsel in the Court as the better and right approach under s 136.)
>
> (Footnote omitted.)

[324] The liquidators did not suggest in opening that the directors should have threatened to resign or brought pressure to bear on Mr Yan and Richina Pacific in some other way, and that their doing so would have enabled Mainzeal to avoid liquidation. Nor, as a consequence, was it suggested that the directors might be liable for the entire deficiency on liquidation. At the risk of stating the obvious, there is a significant difference between a claim for up to $75.348 million based on an allegation that trading (or undertaking new obligations) should have ceased at an earlier date, and a claim for some $110 million based on an allegation that the company's failure could, and should, have been avoided. These are not minor questions of detail.

[325] As one would expect in light of the pleading and opening submissions, the expert evidence filed by the liquidators sought to quantify, in considerable detail, the amount that was claimed from the directors by reference to the net deterioration and new debt approaches. The deficiency on liquidation did of course need to be quantified in order to quantify the "net deterioration" figure claimed. But there was no suggestion that compensation in that amount was itself recoverable from the directors.

Developments during trial: the Judge's minutes

[326] On 24 October 2018, in the sixth week of the trial, the Judge issued a minute (Minute (No 5)) raising concerns about "a possible difference between the plaintiffs' case on liability, and their case on quantum".[109] By that date, the liquidators had closed their case and Mr Yan and Dame Jenny had given their evidence.

[327] In Minute (No 5) the Judge summarised the allegations of breach by the directors, and went on to say that those allegations differed in important respects from the standard reckless trading case:

> [4] Those allegations differ from the kind of reckless trading cases that more commonly arise where it is alleged that directors continue to trade a company that should have earlier ceased trading. The allegations here are not limited to an allegation that the directors should have ceased trading at an earlier point. Rather the allegations are that Mainzeal's directors continued to conduct the business of the company in a way that exposed the creditors to a substantial risk of serious loss because of the risk of failure arising from Mainzeal's alleged insolvent/undercapitalised state, and the reliance on expressions of support that could not be counted on.

[328] The Judge observed that the case on quantum reflected the approach that is normally applied in more conventional cases, with loss calculated on a counterfactual basis comparing the actual loss to the creditors on insolvency with the position the creditors would have been in at the earlier date when it is alleged that the directors should have ceased trading — in this case either January or July 2011. The Judge then explained the concern he had identified about this approach:

> [6] The award of compensation under s 301 is discretionary. In the present case it is possible that the Court could conclude that compensation should be assessed on a different basis - not one based on the loss arising from continued trading beyond a counterfactual date, but one based on risk to the creditors arising from trading Mainzeal in a vulnerable position arising from its alleged insolvent and undercapitalised state. It may be that the liquidation of Mainzeal was the very thing the directors had a duty to avoid. That could theoretically encompass the full loss to creditors on insolvency, albeit that the discretionary factors would need to be applied, and the object would be to assess the loss actually caused by the illegitimate risk the directors had exposed the creditors to.
>
> [7] I stress that I have not reached any conclusions on these issues. It is far too early to do so. But as the evidence has unfolded I simply see this

[109] *Mainzeal Property and Construction Ltd (in liq) v Yan* HC Auckland CIV-2015-404-1094, 24 October 2018 [Minute (No 5)] at [2].

> alternative approach as a possibility. In effect it would involve accepting the plaintiffs' argument that the directors breached their duties under s 135, but also accepting the defendants' argument that placing Mainzeal in liquidation in 2011 would have been unreasonable, and simply the cause of significant loss. Accepting both those arguments is not inconceivable.

[329] As the Judge noted, if the liquidation of Mainzeal was the very thing the directors had a duty to avoid, a different approach to compensation under s 301 might be appropriate.

[330] Minute (No 5) records that when the Judge raised this issue with Mr O'Brien, senior counsel for the liquidators, "he confirmed that the plaintiffs' case was based on the proposition that the directors should have placed Mainzeal into liquidation in 2011". The Judge flagged his concern that if the Court was to consider the award of compensation on a different basis, then in fairness to the defendants, this should be identified. Mr Chisholm QC for Mr Yan, and Mr Hodder for the other defendants, objected to the plaintiffs proceeding with any new allegation in relation to quantum. As the Judge recorded:[110]

> They explained that the cross-examination of the plaintiffs' witnesses, and the preparation of the defendant's case, had all proceeded on the assumption of the plaintiffs currently formulated allegation. I accept that this is so. Indeed that is one of the reasons why I raised this issue, as I can see that the case has a potential for being more complicated.

[331] The Judge indicated to Mr O'Brien that the matter needed to be further considered by the plaintiffs. The Judge recorded his agreement with Mr Hodder that the raising of any other basis for assessing loss should be considered on the same basis that would be applied if the plaintiffs were applying to amend their pleading. The Judge emphasised the importance of dealing with the matter promptly.

[332] The Judge concluded as follows:

> [12] Having considered the matter further since raising the issue, I am inclined to the view that should the Court decide that liability under s 135 arises it needs to make the assessment of quantum on the basis required by s 301, and accordingly on the basis the Court thinks is just. That is so even if this is not the basis the plaintiffs contend for. Section 301 needs to be applied in its terms. I am not sure that a formal amendment to the pleadings is strictly necessary, but I do think the defendants need to understand whether any

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110 At [10].

alternative approach is open, and to be given a fair opportunity to respond. This view is subject to at least two limitations. First it would not be appropriate for the Court to assess compensation on a basis expressly disavowed by the plaintiffs. Second it is necessary for alternative approach to be squarely raised, and for the defendants to have the right to respond to it, including through the ability [to] call any further evidence (and even recall witnesses) to ensure there is no unfairness.

[333] In response to Minute (No 5), the plaintiffs' counsel filed a memorandum dated 30 October 2018 which described the liquidators' s 135 claim as follows:

> 4. In respect of the s 135 claim the plaintiffs allege that from the dates pleaded in paragraph 65 of the third amended statement of claim (December 2008, January 2011 and July 2011), the directors allowed the business of Mainzeal to be conducted in a manner that created or was likely to create a substantial risk of serious loss to creditors. That is, the plaintiffs allege the directors should have caused the company to cease trading in the manner it was trading by, at the latest, January 2011 or July 2011.
>
> …
>
> 7. *The plaintiffs do not plead that the defendant directors had a duty to avoid the liquidation of Mainzeal.* The allegation is that the trading of the company as was occurring, and engaging in new contracts and business, should not have been allowed to continue as it was and should have been brought to an end. This would very likely have led sooner or later to a liquidation. (That is not to say, however, that a liquidation would have occurred suddenly and without the transitional arrangements that prudent planning might have allowed.)

(Emphasis added.)

[334] The memorandum then went on to deal with the question of relief. It confirmed that the liquidators contended that the new debt approach was the more appropriate means of calculating relief under s 301 in this case. The alternative approach pursued was the net deterioration approach.

[335] The liquidators did not seek to adopt the Judge's suggested approach, under which the directors' breaches of duty resulted in an otherwise avoidable liquidation, with the appropriate compensation falling to be assessed by reference to the entire deficiency on liquidation. However the liquidators did seek leave to amend the pleadings to raise an alternative approach to quantum based on the net deterioration in Mainzeal's reported net asset position, adjusted for irrecoverable related party balances, between December 2010 and December 2012. The December year end dates

were described as "close enough to be proxies for the January 2011/February 2013 dates".

[336] That is, rather than focusing on net deterioration in the position of the company in terms of proofs of debt in the actual liquidation as compared with a notional liquidation in January 2011, the alternative approach contended for focussed on the company's reported net asset position as at the relevant dates. On this basis, the amount claimed was $55.37 million.

[337] In order to reflect this shift in approach — a shift that was significantly less ambitious than the one foreshadowed by the Judge — the liquidators sought leave to amend the pleadings:

(a) to add a new sub-para 67(c) pleading the alternative approach to deterioration in Mainzeal's financial position and quantifying this as $55.37 million; and

(b) adding a new sub-para to the prayer for relief, referring to a claim for compensation of that amount.

[338] That application for leave to amend was opposed by the directors. They filed evidence from their accounting expert, Mr Grant Graham, identifying the further work that he considered he would need to carry out in order to review and respond to the amended claim. He said that substantial work would be involved. The liquidators filed evidence from Mr William Apps, their expert accounting witness who dealt with quantum, suggesting that although some additional analysis would be required, it would not be anywhere near as extensive as suggested by Mr Graham.

[339] The Judge heard argument on the proposed amendment on 1 November 2018. As the Judge recorded, it became apparent that, if the amendment was allowed, the defendants' accounting expert would need time to consider giving additional evidence, and the trial might need to be adjourned part-heard. As a result, near the end of that argument, Mr O'Brien indicated that the plaintiffs would not pursue the application.[111]

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[111] *Mainzeal Property and Construction Ltd (in liq) v Yan* HC Auckland CIV-2015-404-1094, 2 November 2018 [Minute (No 6)] at [2].

[340] Following that hearing, on 2 November 2018, the Judge issued a further minute (Minute (No 6)) reiterating his view that it was open to the Court to consider quantum on a basis other than that advanced by the plaintiffs. Because of the importance of the issue to the appeal before us, we set out the Judge's explanation of his approach:[112]

> [3] During the course of the argument Mr Hodder addressed the issue raised in my earlier Minute (No 5) in which I indicated that I considered it was open to the Court to consider quantum on a basis other than that advanced by the plaintiffs, and that no amendment to the pleading was required. I emphasised to both Messrs Hodder and Chisholm that I remained of that view. As I explained, should liability for breach of s 135 arise it would be open to the Court to assess compensation on the basis set out in paragraphs [3]–[6] of my earlier Minute. The alleged breach of s 135 may have given rise to a risk that Mainzeal would collapse, leading to the risk to creditors referred to in the section. But for the alleged breach, Mainzeal may not have failed at all. If that was established, some assessment based on that part of the total loss to creditors on insolvency arising from the breach might be involved, and subject to the application of the discretion under s 301.
>
> [4] The appropriate award of compensation follows from, and will depend on the findings in relation to liability. This necessitates a degree of uncertainty. The award is also discretionary. This was referred to in the judgment of William Young J in *Re South Pacific Shipping Ltd (in liq)*, including in the following way:
>
> > … precise calibration of remedy to the different circumstances of what may be hundreds or thousands of creditors is likely to involve exercises which are beyond what can practically and economically be implemented. So some element of rough justice may be called for. I am of the view that the section allows scope for this in that it requires exercise of a judicial discretion rather than what Mr Fardell dismissively referred to as a "mechanistic assessment".
>
> [5] I am not dealing with a conventional civil claim advancing a cause of action recognised at common law. Rather I am addressing provisions of a statutory scheme. The claim might be characterised as a statutory cause of action, but under s 301 under which compensation is awarded the Court's function is to conduct "an inquiry", and after conducting that inquiry to make such award of compensation as the Court thinks just.
>
> [6] I accordingly confirm the view expressed in paragraph [12] of my earlier minute. The plaintiffs have not disavowed any particular way the Court might assess compensation, and through my two Minutes and the discussions I have had with counsel the defendants are fairly informed of this possibility.
>
> [7] I raise this not only because it would assist me for this possibility to be addressed in closing, but also because, as I again stressed, it is appropriate that the case proceed with procedural fairness. If the defendants wish to call further evidence, or recall any witness given [that] have said that I regard this

112 Minute (No 6), above n 111 (footnote omitted).

approach as open to the Court, then they are able to apply to do so. I am highly likely to look on any such application favourably.

[8] I again reiterate that I have not reached any conclusions on any of the complex allegations in this case. This is just one aspect of one of the causes of action.

Liquidators' closing submissions

[341] In closing submissions the liquidators did seek to frame their claim more broadly. They said:

> 1.13 The plaintiffs have not claimed only that the company should have ceased trading in or before January 2011. That is one of several claims. A binary situation of either continuing on in the same way or stopping is the wrong way to frame the claim. The plaintiffs' case is that, by January 2011, a reasonable director would have ceased trading in the way that they had been up until then, possibly ceased to trade at all, or severely changed the way in which they did trade.
>
> …
>
> 3.4 The pleadings are broader than the defendants would have it. They are not focused on a liquidation and certainly not on a liquidation at a particular date. They are focused on the inadequacies in the manner in which the business of the company was allowed to continue and on the need for change and, absent that, cessation of trading in that manner or altogether.
>
> 3.5 The defendants wrongly but consistently seek to pigeon-hole the liquidators' case as being a claim that the directors should have 'pulled the plug' on [Mainzeal] in January 2011. As demonstrated, that is not the pleading and nor was it the evidence. The question was put to and addressed by Mr Bethell in cross examination:
>
> Q. And putting it in rather colloquial terms, your main claim is that the directors should have pulled the plug on Mainzeal by 31 January 2011?
>
> A. … no, I wouldn't use those terms, I would say should have stopped trading in the normal sense, in that they should have not started incurring new obligations without either appointing a liquidator or taking some other actions to improve the position such as recovery of the related party debts, obtaining actual funding from the shareholders and the like.
>
> (Footnotes omitted.)

[342] However, they acknowledged that the entire deficiency approach had not been pleaded by them, but rather emerged from the Judge's minutes issued in the course of the trial.

High Court Judgment No 1

Detailed findings of fact

[343] The High Court judgment sets out in considerable detail the factual findings made by the Judge in light of the extensive evidence, fact and expert, called by the parties. As noted above at [13], there was no real challenge to those findings of fact on appeal.

Section 135 of the Companies Act

[344] The Judge then turned to the claims under s 135 of the Act. After setting out the legislative history of the provision, and referring to relevant authorities, the Judge identified the following aspects of the wording of the provision that he saw as significant:[113]

> (a) The section is concerned with risks to *creditors*, not risks to the company. A risk to the creditors will only arise if the company fails leaving a deficiency on liquidation. Some risk to creditors of this kind is inherent in the normal business risks taken by a company. The section is not focused on such normal business risks that companies are established to take, however.
>
> (b) The section only refers to a *substantial* risk to the creditors. There is no requirement for it to be shown that it is more likely than not that that risk will materialise. But it means there must be a major or large risk. This means that there must be a major risk of the company failing with a deficiency on liquidation.
>
> (c) That risk must be one that will *create* — that is cause or give rise to — *serious loss*. This contemplates a serious deficiency in a liquidation. A minor or modest loss is not relevant. The loss in issue must be a significant or major one and must be caused by the risk arising from the conduct in issue.
>
> (d) The conduct in issue is the *manner* in which the business is being carried on. Thus, it is the way the business of the company is undertaken, and the decisions of the directors in relation to it, that must cause the substantial risk of serious loss. That is not limited to

[113] High Court Judgment No 1, above n 1, at [161] (emphasis in original).

the question of whether to continue trading and can encompass other modes of undertaking business.

(e) Finally, the way that the business is being undertaken must be *likely* to cause the substantial risk of serious loss to creditors. That is, it must be more likely than not that the substantial risk of serious loss will be created by the manner in which the business is being operated. This is an important causal link between the manner in which the business is conducted and the qualifying risk of loss to the creditors.

[345] The Judge observed that the section involves a reasonably high threshold for liability.[114]

[346] The Judge considered that using the concept of illegitimate risk as the touchstone of liability, by itself, sheds little light on when risk taking is illegitimate. But substantial risk of serious loss will arise only when potential insolvency is in issue. That includes one-off transactions that place the entire company at a substantial risk of failure causing serious loss to creditors, even when solvency was not previously an issue before the transaction. Directors who take risks when that is the case are really risking the creditors' money, not the shareholders' capital. If a company is insolvent, or close to insolvency, and the directors operate the company in a manner likely to create a substantial risk of serious loss to those creditors, that involves illegitimate risk taking.[115]

[347] The Judge observed that s 135 is not limited to decisions on whether to continue trading at all:[116]

> The "manner" in which the "business of the company" is "being carried on" also contemplates other ways the company is being traded that give rise to a substantial risk of serious loss to creditors. The test is an objective one, and there is no requirement to show that the directors knew that they were operating the business in a manner likely to give rise to a substantial risk of serious loss to creditors. But they must "cause" or "agree" or "allow" infringing trading. Given the requirements, it would be surprising if directors had failed to recognise that the qualifying risk had arisen. The bar is set quite high. Whilst the title of the section — reckless trading — is not by itself an interpretive guide, the standards set by the section seem to me to require more than negligence, but risk taking when potential insolvency is involved, and substantial risk of serious loss to creditors is likely. Reckless trading is a fair overall description.

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[114] At [162].
[115] At [163]–[166].
[116] At [168].

[348] The Judge discussed the importance of balance sheet solvency and noted that a systemic policy to trade while insolvent is particularly problematic.[117]

[349] An important issue in this case was the assurances given by shareholders that support would be provided, and the relevance of such assurances to the performance of the directors' duties under s 135. The Judge observed that extracting funds from a subsidiary can give rise to the subsidiary trading while insolvent, which puts the subsidiary's creditors at risk, potentially raising a breach of the duty under s 135.[118] Promises that the shareholders will nevertheless provide support where necessary need to be assessed carefully in light of the obligations arising under s 135, and the particular facts and circumstances of the case.[119]

[350] The Judge then turned to the application of s 135 to the present case. The Judge concluded that the directors had acted in breach of their duties under s 135. There were three key considerations that cumulatively led him to that conclusion:[120]

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

[351] The Judge considered that each of these three features was necessary to establish liability in the present case:[121]

> The policy of trading while insolvent is the source of the directors' breach of duties, however, such a policy would not have been fatal if Mainzeal had either a strong financial trading position or reliable group support. It had neither.

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117 At [173].
118 At [176], citing *Mountford v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 (HC) at [89].
119 At [179].
120 At [187].
121 At [188].

[352] The Judge then went on to examine each of these three factors in detail. He considered that Mainzeal had been insolvent on a balance sheet basis from as early as 2005.[122] This insolvency was not a transient or temporary state. It was continuous. Mainzeal had adopted a policy of insolvent trading.[123] Mainzeal was using the funds of creditors — in particular, sub-contractors — as its working capital.[124]

[353] The Judge went on to consider whether the directors were able to properly trade notwithstanding the company's balance sheet insolvency because of the expectation of group support. The Judge considered that the expressions of support from Richina Pacific were not sufficiently clear and reliable to mean the directors did not breach their duties.[125]

[354] First, the assurances were not clearly formulated, and were for the most part oral rather than written. The written letters of comfort provided by various entities in connection with the annual audit were provided for the purposes of audit only and were not legally binding. Following restructuring these letters did not come from Richina Pacific itself, but from Richina (NZ) LP, an entity that did not itself have significant assets.[126]

[355] Second, the expressions of support given by Richina Pacific were qualified and conditional. Mr Yan's evidence was that the intention to support Mainzeal was only while it remained a going concern. It was unreasonable for the directors to rely on support from group companies without understanding the limits of that support.[127]

[356] Third, the expressions of support were not in a legally binding form. Indeed the Judge considered that it appeared that the group had made efforts to ensure that any demands made on it by Mainzeal would not be legally enforceable.[128]

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122 At [193].
123 At [200].
124 At [203].
125 At [209].
126 At [210]–[211].
127 At [212]–[213].
128 At [214].

[357] Fourth, the expressions of support relied upon by the directors had to be understood in light of restrictions placed by Chinese law on the ability of the CHC and other Chinese entities to transfer funds out of China. The Judge considered that the directors needed to ensure that the expressions of support would be effective given the limitations of Chinese law. The directors failed to take steps to ensure that the CHC would be able to act on the assurances it was providing.[129]

[358] Fifth, the Judge did not accept the directors' submission that one of the reasons they could rely on support being provided in the future was that Richina Pacific had provided substantial support to Mainzeal in earlier years. In particular, the Judge did not accept that Richina Pacific had been providing financial support to the extent the directors appeared to believe was the case.[130] The Judge reviewed the evidence about cashflow movements between Mainzeal and the wider group, and concluded that it was incorrect to say that Richina Pacific was providing Mainzeal significant financial support during the years 2006–2011. It was generally the other way around. It was only in 2012 that significant funds flowed the other way.[131]

[359] On the other hand, the Judge accepted that there were two factors that supported the directors' case that financial support was provided, and that reliance on Richina Pacific support was reasonable:

(a) Richina Pacific had provided support for construction bonds, either by providing the bonds itself or by guaranteeing the bonds. This bonding support gave Richina Pacific a very strong incentive to continue to support Mainzeal.[132]

(b) Substantial financial support, in the order of $11.6 million, was provided by Richina Pacific during 2011/2012 in an attempt to assist Mainzeal.[133]

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129 At [215]–[216].
130 At [218].
131 At [218]–[220].
132 At [222].
133 At [224].

[360] The Judge considered that these two related factors supported the directors' case, but did not by themselves demonstrate that the directors had met their duties under s 135:[134]

> Without a legally binding commitment, or even a clearly articulated one, such support was always ultimately at the option of the Richina Pacific group. It was never assured.

[361] Sixth, the unreliability of group support became particularly acute after the 2008–2009 restructuring and separation. The Judge considered that it was at this point that reliance on informal expressions of support became unreasonable, in circumstances where there was much greater separation between Mainzeal and the Chinese entities; Richina Pacific was no longer listed on the New Zealand Stock Exchange; the annual audit letters of comfort no longer came from Richina Pacific; the companies that owed the intercompany receivables on which solvency depended were no longer subsidiaries of Richina Pacific, and could not by themselves repay; and Mainzeal itself was no longer a wholly-owned subsidiary of Richina Pacific. The fact that the promised capitalisation of Mainzeal following separation did not occur was also a significant factor in assessing whether the oral assurances of support could be relied on.[135]

[362] The Judge considered that the concerns raised by Mr Schubert of PwC in 2009 following this restructuring were the kind of concerns that should have arisen for the Mainzeal directors.[136]

[363] From at least 1 January 2010, the Judge found that Mainzeal was trading while insolvent in a highly material way. The Judge accepted the evidence of Mr Samford Maier, the liquidators' corporate governance expert, that the directors had failed to make the sober assessment required before deciding to trade on. Mr Maier considered that the directors of Mainzeal had never really properly appreciated the risks they were engaging in. He was prepared to give them the benefit of the doubt for a period of time through to the end of 2010, before expressing the view that the directors were acting improperly in continuing to trade Mainzeal in this way from the end of

[134] At [225].
[135] At [226]–[228].
[136] At [229].

January 2011. By that stage, he said, he would have been "climbing up on the [board] table" given the state of the risks facing the company.[137]

[364] Seventh, the Judge noted that the problems with group support were evident to the directors by early 2010 at the latest, as evidenced by the email exchanges between Dame Jenny and Messrs Yan and Walker beginning in February 2010. Dame Jenny sought, but never received, an adequate resolution of her concern that the directors of Mainzeal were responsible for the company's solvency and the position of creditors.[138]

[365] The circumstances necessitated that the directors insist upon the arrangements changing so that Mainzeal was no longer required to continue operating while balance sheet insolvent. Mainzeal could not legitimately be allowed to continue operating as it was.[139]

[366] The Judge considered that the White Paper produced by Messrs Pearce and Gomm, and placed before the board for its meeting on 19 November 2010, was a very clear further warning to the directors. But no meaningful discussion appears to have taken place at the board meeting concerning these issues.[140]

[367] The Judge then went on to consider Mainzeal's financial trading position. There may have been no substantial risk of failure if the company's trading performance was particularly good and dependable. But several features of Mainzeal's trading position demonstrated that its performance was unpredictable and generally very poor.[141]

[368] First, in the period 2005–2010 the company's trading position had been weak, with operating losses in three years. The results had been highly variable. There was some basis to hope for improvement in early 2011. But optimism, without more, was not enough.[142]

137 At [230].
138 At [231].
139 At [233].
140 At [234].
141 At [238].
142 At [240]–[243].

[369] Second, the nature of the construction business carried on by Mainzeal meant that there was a significant risk of large one-off losses. That was a recognised feature of the industry. The Judge considered that although the Siemens issue itself may not have been predictable, issues of this kind were predictable at a general level.[143]

[370] Third, by 2010 there was a growing problem with significant leaky building claims against Mainzeal.[144]

[371] Finally, the Judge said, it had become apparent by 2010 that Mainzeal's business model was not working. A revised business strategy was adopted.[145] That was not in itself problematic:[146]

> But, by its very nature, the new approach involved a recognition that Mainzeal's existing business strategy was not working. Given that Mainzeal was balance sheet insolvent, to put significant faith in a change of business strategy on the assumption that this would revolutionise Mainzeal's generally poor performance involved significant risk.

[372] The Judge considered that the factors identified above in relation to Mainzeal's financial trading position, in combination with the fact that Mainzeal was trading while insolvent without reliable group support, meant that Mainzeal's trading position made it vulnerable to failure with consequential substantial loss to its creditors.[147]

[373] The Judge then went on to address a number of additional factors that were relevant to the s 135 issue.

[374] First, the Judge referred to the directors' argument that they had relied on the auditors, Ernst & Young, in making their assessments in relation to Mainzeal's position. The Judge accepted that some comfort could be taken from the auditors' views. But there were limits to what the directors could reasonably take from those views.[148]

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143 At [244]–[245] and [248].
144 At [249].
145 At [254].
146 At [255].
147 At [258].
148 At [260]–[261].

[375] In particular, the directors could not take much comfort from the auditors' satisfaction that the going concern assumption was justified, as the audit standard did not involve a particularly high threshold. Mainzeal was properly classified as a going concern for financial reporting purposes unless it had "no realistic alternative" but to cease trading.[149] And even the auditors' acceptance that this low hurdle had been cleared was subject to the "emphasis of matter" paragraph in their audit reports. An "emphasis of matter" was required under the relevant auditing standard if there was a material uncertainty about the going concern assumption. The Judge considered that the inclusion of this emphasis of matter meant that the approval of the auditors did not provide significant comfort on the key issue the directors needed to confront:[150]

> In fact, it raised a question of possible concern about Mainzeal even continuing to operate for the next 12 months. … [T]his emphasised (literally) the importance of support for the directors' responsibilities. So the auditor's opinion begged the critical question.

[376] Second, the directors did not take external advice, in particular external legal advice, about their responsibilities even though a number of important issues had emerged. The failure by the directors to seek any external advice relating to their duties until just before the company failed reflected their failure to comply with their duties.[151]

[377] Third, Mainzeal's corporate governance arrangements were inadequate. The directors had no formal procedures for addressing risk. There was no audit and risk committee. Nor was there any formal risk register. These issues were highlighted by Ernst & Young in its January 2011 report. That would not have mattered if risks had otherwise been appropriately addressed. But the Judge accepted the evidence of the liquidators' corporate governance experts that they were not.[152]

[378] Fourth, the liquidators raised the question of the knowledge that the creditors would have had of Mainzeal's vulnerable state, and the substantial risks involved in dealing with it. The Judge found that the creditors would not have understood these matters. Mainzeal's accounts were not freely available, so many creditors would not

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149 At [261]–[262].
150 At [263].
151 At [265]–[269].
152 At [270]–[271].

have seen them. But they were presented as part of tendering for construction works. In any event, the accounts did not demonstrate the vulnerable position: Mainzeal would have appeared to those creditors to be solvent. And creditors would have generally understood that Richina Pacific stood behind Mainzeal. They would not have understood the extent to which Richina Pacific had limited its ultimate liability, including in relation to intercompany receivables.[153]

[379] The Judge said that for all these reasons, he found that s 135 was breached. Only one factor caused him to hesitate in finding that s 135 was breached:[154]

> … that Richina Pacific's contingent liability under the construction bonds gave it a strong incentive to prevent Mainzeal's failure. But in the end this incentive provided inadequate protection.

[380] He rejected the argument that there should be no liability under s 135 unless the insolvency of the company is imminent or unavoidable. Nor did he accept that the provision only applies to circumstances where directors should cease trading, but continue to trade, creating further loss to creditors. That is the usual reckless trading scenario, he said, but it is not the only situation contemplated by s 135.[155]

[381] The Judge considered that the risks taken by the directors could not be regarded as normal business risk-taking. On the contrary, the directors allowed Mainzeal to continue to trade in highly unorthodox circumstances which involved a very significant risk to the creditors. The directors were not taking the normal risks that are inherent in the operation of a company of Mainzeal's size.[156]

[382] The Judge then addressed the timing of the breach. He did not consider that the directors of Mainzeal should be held to have caused, agreed or allowed Mainzeal to conduct business in a manner that infringed s 135 before the effects of the 2008–2009 restructuring and the nature of on-going group support were finalised. The concerns they raised in early 2010 suggested they were not agreeing to or allowing, let alone causing, the manner of trading that led to the company's demise. But they did so

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153 At [274]–[276].
154 At [279].
155 At [281].
156 At [284].

during the following months. At the very least the directors allowed the company to conduct trade on an infringing basis by mid-2010. The 19 November 2010 board meeting "was perhaps the last occasion where the directors could reasonably have drawn a line in the sand. But nothing occurred of that kind".[157]

[383] The Judge concluded that the directors either agreed to, or allowed, the business of Mainzeal to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors from mid-2010. It was unnecessary to make a more precise finding on the time of the breach. The directors continually breached their duties under s 135 from this period. The liquidators' pleadings contended that the breaches occurred from 31 January 2011, or alternatively 31 July 2011. The Judge accepted that breaches occurred at those dates.[158]

[384] The Judge then explained the nature of the breach he had identified in an important paragraph that we set out in full, as it underpinned the Judge's approach to quantum:

> [293] It is not a matter of saying that the directors of Mainzeal should have placed the company in voluntary liquidation. Ultimately, the fate of Mainzeal was really in the hands of Mr Yan and the Richina Pacific group. The matter required direct resolution, and Dame Jenny, Mr Tilby and Mr Gomm needed to make it clear that the company could not continue to trade unless the arrangements changed to address the policy of insolvent operation. The position was that, almost literally, Mr Yan had to put up, or shut up. If Mr Yan refused to do so, they could properly have taken the stance that they would resign, with the decisions to be taken by Mr Yan (and anybody else appointed as directors in their place). Such resignation had been seen as a prospect by Mr Pearce in October 2010. I accept Mr Burt's evidence that raising resignation unless matters were resolved was an appropriate stance for the directors to take — in effect, a tactic to put the company back into a proper position. Continuing on as a director when there are serious issues can be highly detrimental to creditors. Given the reputation of the directors, including Dame Jenny's status as a former Prime Minister, such resignations would have been very significant to Mainzeal's reputation and Richina Pacific's reputation. The threat of resignation was, accordingly, a very powerful tool.
>
> (Footnote omitted.)

157 At [288]–[291].
158 At [291]–[292].

Section 136 of the Companies Act

[385] The Judge dismissed the claims under s 136 of the Act. He concluded that s 136 involves a materially different question from s 135. He did not see s 136 as based on directors taking risks. Rather:[159]

> It is based on the performance of specific obligations and the associated beliefs of the directors. To establish a breach of s 136, it must be established that, at the time the obligation was entered into, the director did not believe that the company would be able to meet its obligation; or, if it is established that the director did believe that the company would be able to meet its obligation, that his or her belief was not based on reasonable grounds.

[386] The Judge considered that in this case, s 136 required a focus on particular obligations under specific construction contracts that Mainzeal was entering into. Specific contracts considered by the directors needed to be identified. The first question was whether the directors subjectively believed that Mainzeal would be able to meet its obligations under those contracts. If they did have that belief, the question then arose whether the grounds they had for that belief were reasonable.[160]

[387] The Judge noted the reference in some authorities to s 136 being concerned with transactions on capital account rather than revenue account. The Judge did not see that distinction as reflecting the text or purpose of the provision. Nor did he consider that this distinction was helpful.[161]

[388] The Judge observed that the Third ASC did not identify specific obligations in the context of the s 136 claim. Rather, it alleged more broadly that by a certain stage (presumably 31 January 2011 or 31 July 2011) continuing to incur new obligations involved a breach of s 136. It appeared to be an allegation in relation to all obligations entered into by the company from that time onwards.[162]

[389] The Judge saw the failure to focus on specific transactions as fatal to the liquidators' s 136 claim. It had not been properly pleaded. In opening the liquidators had identified four major contracts entered into by Mainzeal during the relevant

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159 At [297].
160 At [299].
161 At [300].
162 At [303].

period: Manukau Institute of Technology (MIT), Ministry of Justice Manukau Precinct, ANZ Tory Street and Wigram Museum. This, the Judge said, at least identified particular obligations that could found a claim under s 136.[163] However, in order to pursue those obligations at trial:[164]

> … it would have been necessary for the [liquidators] to identify what the obligations under those four contracts were, identify when the directors agreed to incur those obligations by entering the contracts, and demonstrate why the directors either did not believe the company would meet those obligations, or did not have reasonable grounds for their beliefs.

[390] The relevant contractual documentation was not in evidence. The particular obligations arising from these construction contracts had not been put to the directors. Nor were the directors' reasons for believing the obligations under the contracts would be performed challenged at trial. In those circumstances, the Judge said, there had been a failure by the plaintiffs to provide the evidence needed to make out their case under s 136.[165]

[391] The Judge considered that even if the relevant obligations had been clearly identified, it was unlikely that a breach of s 136 would have been established. There was no reason to conclude that the directors either did not believe that those obligations would be fulfilled, or that the reasons for believing they would be fulfilled were unreasonable. It would not have been apparent to the directors that Mainzeal's failure would occur, or would likely occur immediately, or within a particular period of time, at least until very near to the point when Mainzeal failed — "[t]hat seems to be critical to establish liability under s 136 in these circumstances".[166]

Other causes of action

[392] The Judge then went on to consider a number of other causes of action and dismissed all but one. The claim that succeeded was a claim against the eighth defendant, Isola, another of the companies in liquidation, under s 298 of the Act alleging that King Façade had entered into a transaction with Isola for inadequate

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163 At [304]–[305].
164 At [306].
165 At [307]–[308].
166 At [309].

consideration. None of these other causes of action was in issue before this Court, so we need say no more about them.

Quantum

[393] The Judge then turned to consider whether orders for payment of compensation by the directors should be made under s 301 of the Act. As noted above at [320], the liquidators had advanced two alternative ways of assessing quantum:[167]

(a) the new debt approach, which focusses on the loss to new creditors arising after the relevant counterfactual date; and

(b) the net deterioration approach that is normally applied to reckless trading cases, set out in this Court's decision in *Mason v Lewis*.[168]

[394] The Judge accepted the directors' argument that the new debt approach should not be used in relation to a breach of s 135. In part, the Judge said, this is because the duties of the directors are owed to the company and not to the individual creditors. It is the loss to the company caused by the directors' breach that is the focus. That loss is represented by the claims of creditors overall.[169]

[395] But the key reason why the Judge considered that a new debt approach is not available in relation to a breach of s 135 is that a claim under s 301 cannot be brought for the benefit of an individual creditor or class of creditors, as opposed to creditors generally. A liquidator who recovers an amount under s 301 must distribute the proceeds to all creditors equally. The liquidator cannot pay some creditors at the expense of others. Nor can a creditor bring a claim for compensation for breach of s 135 for their own benefit.[170]

[167] At [382].
[168] *Mason v Lewis*, above n 63.
[169] High Court Judgment No 1, above n 1, at [386].
[170] At [387].

[396] The liquidators had calculated their claim based on a hybrid approach involving the following:[171]

> (a) for creditors whose debts increased from the counterfactual date, the amount of the increase was allowed in the loss calculation;
>
> (b) for creditors whose liability decreased, no deduction was made;
>
> (c) for creditors who were not creditors at all at the counterfactual date, the full amount of the debt was allowed; and
>
> (d) for creditors who existed at the counterfactual date, but not at liquidation, no deduction was made.

[397] The Judge considered that this "ungainly hybrid" did not provide a principled remedy. Nor did it confront the issue that the liquidator must distribute pari passu to all creditors, so the new creditors would not be fully compensated in any event. For those reasons, the Judge did not accept that this was an available approach to awarding compensation for a breach of their s 135 duty in an action brought under s 301. Nor was this approach appropriate in the present case on the facts: the loss caused by the directors' breach was not, the Judge said, identified by this calculation as this was not a case where the directors had improperly continued to trade a company destined to fail and created further losses to creditors in doing so.[172]

[398] The Judge also did not accept that the net deterioration approach was appropriate in this case.[173] The Judge's reasons for forming this view were central to his approach to quantum, so we set them out in full:

> [394] The *Mason v Lewis* assessment is directed to the situation where directors of a company continue to trade in circumstances where it was inappropriate to do so. In particular, where the courts have found the directors should have ceased trading at an earlier date, this being the counterfactual date. It is the failure to cease trading earlier that constitutes the breach of directors' duties. The loss caused in these circumstances is the deterioration of the company's financial position caused by trading on.
>
> [395] But that is not the nature of the directors' breach in the present case. I have accepted the plaintiffs' contention that the directors breached their duties by continuing to trade the company in a particular manner — by way of summary, by trading it while it was insolvent, while relying on what were informal assurances of group support that were not reliable. Given the

[171] At [388].
[172] At [390]–[391].
[173] At [393].

financial trading position, this exposed the creditors to the risk of loss arising from the company's failure, which is the very risk that came to fruition.

[396] But equally, I accept the strongly expressed views of the defendants that there was no reason for the directors to have put Mainzeal into receivership or liquidation at the January or July 2011 dates. Mr Yan described that suggestion as ridiculous, and he outlined the extensive projects that Mainzeal was working on at that stage, including in China. Mr Walker said that the idea was ludicrous and foolhardy. All the directors gave evidence consistent with these views.

[397] There is also the further related feature that may distinguish this case from many other reckless trading cases. At its insolvency, Mainzeal had existing trade creditors. But it also had significant construction contracts on foot. The very act of ceasing to trade would have created huge further losses arising from its failure to continue with these contractual obligations. As Sir Paul said, the consequences of liquidation would be "horrific". Ceasing to trade would have transformed assets into liabilities — turning profitable contracts into claims against the company. In the liquidation, there are claims of approximately $43.8 million arising from Mainzeal's failure to continue to perform its construction contracts. Other claims in the liquidation are likely to have arisen by the losses created by ceasing trade. The same applies to any earlier liquidation — indeed the defendants say that had Mainzeal been liquidated in January or July 2011, very significant losses would have been created by it ceasing to perform the contracts in existence at that time, which were then larger in number. That is why there is considerable force in the view of Mr Yan, and Mr Walker, that ceasing to trade would have been ridiculous/foolhardy. Liquidation was the very thing that reasonable directors would want to avoid.

[398] The breach of the directors' duties in this case did not arise because the directors failed to cease trade and put Mainzeal in liquidation or receivership in January 2011. The breach of directors' duties arose because they caused, agreed or allowed Mainzeal to engage in trade in a vulnerable state — being balance sheet insolvent, with a poor financial trading position, and depending on assurances of support in a way I have found to be unreasonable. As previously indicated, s 135 is directed to the "manner" in which the business of the company is being carried on. The manner in issue in this case involves trading in this vulnerable state. It is not focused on continuing to trade a company that was likely to fail in any event and thereby creating further losses.

[399] The plaintiffs themselves do not contend that the directors should have liquidated Mainzeal at the counterfactual date. But they contend that, had the directors decided not to continue to trade the company in a manner breaching s 135, this would ultimately have led to liquidation. This is their basis for contending that the *Mason v Lewis* approach should apply.

[400] I do not accept this. Mainzeal only collapsed because it traded in the vulnerable state created by the group, which the directors agreed to. This created a substantial risk of serious loss to the creditors, being the very loss that came to fruition. In effect, that was the defendants evidence. The receivership and liquidation arose because of immediate cash flow issues, and because the Richina Pacific group withdrew its support.

> Had Richina Pacific been legally committed to provide support, then in my view failure would not have occurred.
>
> [401] But the directors must face the ultimate responsibility for the vulnerable trading given that it is their responsibility to determine the manner of trading, and the directors have the duty not to trade in a manner causing a substantial risk of serious loss to creditors. If Mainzeal had not engaged in this vulnerable trading, for example if it had been properly capitalised, it would not have failed at all, even taking into account the poor performance over the years, and its vulnerability to significant one-off losses. Failure would not have occurred had the directors complied with their duties.

[399] The Judge went on to consider whether, in those circumstances, an alternative approach could be adopted. He focussed on the entire deficiency approach outlined in the minutes he issued in the course of the trial.[174] The Judge considered that it was open to him to do so:[175]

> [404] In my view, it is permissible for the Court to assess quantum on a basis other than on the basis contended for by the plaintiffs, particularly when the Court is exercising a statutory power, and where the statute contemplates the Court conducting an inquiry and then making an award of compensation as the Court thinks just. Caution needs to be applied if the Court is considering doing so, however. The Court needs to be satisfied it has the evidence required for assessing quantum on an alternative basis, and it is also necessary for the Court to be sure that it meets the requirements for procedural fairness.

[400] In order to explain the rationale for this approach, the Judge said, it was necessary to go back to first principles. The starting point is the loss to creditors caused by the breach. The Judge accepted the directors' submission that causation is critical: there must be a causal chain linking breach and loss.[176]

[401] The Judge also accepted the directors' submission that s 301 is not a provision that establishes a right of recovery. It simply provides a procedural mechanism for rights that arise elsewhere — in this case, as a result of a breach of s 135. So, the Judge held, a loss caused by the breach of s 135 must be established before recovery under s 301 is possible.[177]

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[174] Minute (No 5), above n 109; and Minute (No 6), above n 111.
[175] High Court Judgment No 1, above n 1.
[176] At [408].
[177] At [409].

[402] The Judge found support for his approach in *Re South Pacific Shipping Ltd (in liq)*:[178]

> [410] In *Re South Pacific Shipping Ltd (in liq)*, William Young J concluded that the starting point for the liability of a director was "the possibility of an order requiring him to meet all the debts of [the company] as at the date of liquidation". He then deducted from that amount the substantial losses to creditors that would have arisen had the company ceased trading at an earlier point because the director was "entitled to some sort of credit for the losses which would have been suffered if he had not acted in breach …" On appeal, the Court of Appeal accepted that the approach the Judge adopted was open to him, noting that the Judge had recorded there were a "number of different ways in which the assessment of loss could be approached and the approach he followed was not the sole basis for his decision". …
>
> (Footnotes omitted.)

[403] The Judge accepted that if directors breach their s 135 duty by continuing to trade a company that should be liquidated, the directors will only be liable for the additional loss to creditors that they cause by failing to cease trading. But, he said, "if the s 135 breach … arises by creating a substantial risk of failure for a company that should otherwise not fail, then the loss caused by the breach is the loss created by that failure".[179]

[404] In such a case, the Judge said, discretionary considerations may become more significant. The assessment of compensation must be rational, reasonable and, ultimately, just. He referred to the observation of this Court in *Löwer v Traveller* that when assessing compensation the Court should be both conservative and cautious, if there are uncertainties.[180]

[405] The Judge considered that the loss to creditors that materialised in this case — the $110 million loss on liquidation — was the very loss the directors exposed the creditors to by their conduct in breach of s 135. He considered the company only failed because of the manner in which it conducted business, which was the manner that gave rise to the breach of duties.[181]

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[178] High Court Judgment No 1, above n 1, quoting *Re South Pacific Shipping Ltd (in liq)*, above n 50.
[179] At [412].
[180] At [413], citing *Löwer v Traveller*, above n 50, at [80].
[181] High Court Judgment No 1, above n 1, at [415].

[406] The Judge considered that it was not necessary to conduct an elaborate analysis of what was likely to have happened if the directors had declined to agree to the business being conducted in the infringing manner. It was unnecessary to establish that the directors could successfully have stopped the group from procuring the illegitimate trading. Rather, it was sufficient to establish that the serious loss to creditors arose from the manner of trading that the directors had the duty not to engage in. Moreover, the Judge said, "to some extent asking whether the directors would have succeeded in persuading the group to change involves a degree of speculation, or at least considerable uncertainties".[182]

[407] However the Judge went on to say that if it was necessary to engage in that analysis, and determine whether the directors could successfully have forced the group to abandon the vulnerable trading approach, in his view they would have been successful in doing so.[183] It was unlikely that Richina Pacific would have taken steps to fully recapitalise Mainzeal by providing the necessary funds. The alternative would have been to provide a legally binding commitment of support. The Judge considered that it was "possible" that the directors' insistence on the arrangements changing could have led to Richina Pacific being prepared to provide such expressions of support in a form that was legally binding. Had that been done, Richina Pacific would not have been in a position to withdraw support as it did in early 2013 and liquidation would have been avoided.[184]

[408] The Judge found that to avoid resignation by the directors Richina Pacific would have been prepared to provide such legally binding support. But it was highly likely that Richina Pacific would have wanted to limit its liability: it would not have provided an unlimited legally binding commitment. The Judge considered that what would "most likely have happened had the directors acted in accordance with their duties" was that a legally binding obligation to repay the intercompany loans would have been put in place.[185]

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[182] At [416].
[183] At [417].
[184] At [422].
[185] At [423]–[424].

[409] The Judge then turned to consider discretionary factors under s 301: causation, culpability and duration of trading. The duration of the breach of duty was lengthy. That counted in favour of a significant contribution. In terms of culpability, Dame Jenny, and Messrs Tilby and Gomm had acted in good faith and with honesty throughout. Mr Yan was in a different position as he faced an inherent conflict of interest, but the Judge accepted that Mr Yan had also acted honestly and was genuinely committed to Mainzeal. Nevertheless, the Judge said, he led on the other directors in a way that contributed to their breach of duty. Mr Yan's responsibility and the level of compensation he should be ordered to pay should be different from the other directors.[186] Turning to causation, the Judge considered that a number of factors contributed to Mainzeal's failure including the problem with the Siemens contract, losses arising from the King Façade building supplies from China, and the decision by Richina Pacific not to continue the support previously promised.[187]

[410] The Judge concluded that he was required to decide what the just contribution should be under a statutory power. He asked what proportion of the deficiency to creditors on liquidation it was fair for the directors to contribute. Given the uncertainties and the need for caution, he applied a significant discount from the starting point of a deficiency of approximately $110 million. He considered an appropriate figure was one-third of that deficiency — expressed in rounded figures, $36 million.[188]

[411] The Judge also briefly set out an alternative way of assessing the position by reference to the amount that would have been received from Richina Pacific if it had become legally responsible to repay the inter-company advances. At the end of 2011, the inter-company liability was approximately $55.7 million. From that amount, the Judge said, the funds that Richina Pacific invested in Mainzeal during the course of 2012, being $11.6 million, might be deducted. This could be treated as repayment of the loans, in substance. In that scenario, the company and its creditors would have been better off by a figure of around $44 million. The Judge considered this provided "a further rational and reasonable assessment for a figure that it is just for the directors

186 At [430]–[432].
187 At [442]–[443].
188 At [445].

to contribute. It also would be the relevant figure if Mainzeal was to have failed in any event."[189]

[412] The Judge then moved on to consider whether the liability of the directors should be joint and several, or whether there should be some form of several liability only. He saw the considerations relevant to liability as different for different directors.[190] In particular, he saw the position of Mr Yan as being very different from that of the other three directors because of the following factors:[191]

> (a) Mr Yan's breach may have occurred from an earlier stage, and on the basis that he *caused* Mainzeal to conduct trade in a manner leading to a substantial risk of serious loss to creditors.
>
> (b) He was in a conflict of interest position. Given his own personal shareholding in Richina Pacific, and the interests of the shareholders he represented, it was not in his or their best interests to provide a legally binding commitment of support. This compromised the performance of his fiduciary duties.
>
> (c) He misled the directors by the manner in which he provided the assurances of support. He exaggerated what the support was and assured them that there was no need to worry. He failed to live up to his assurances. This was a significant factor in the breaches of duties by the other directors.
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> (d) Mr Yan and his fellow shareholders in Richina Pacific have benefited very substantially from using Mainzeal's funds to assist in acquiring the substantial assets in China, which are now worth a considerable amount.
>
> (e) The extent of the amount the directors are required to contribute is materially less than the value extracted from Mainzeal to assist in acquiring this wealth.

[413] The Judge held that Mr Yan should be liable for the full amount of $36 million. Each of the remaining directors should have their liability capped at $6 million each. He calculated that limit by taking half of the amount for which he had held the directors should be liable ($18 million) and dividing it equally between the three remaining directors.[192] In order to achieve this outcome, the Judge imposed

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[189] At [446].
[190] At [451].
[191] At [453].
[192] At [456].

a combination of joint and several liability. Mr Yan was liable for the full $36 million. Each of the remaining directors was liable for $6 million, jointly with Mr Yan.[193]

No net deterioration

[414] Finally, the Judge went on to analyse in some detail the amount for which the directors would have been liable if a net deterioration approach had been adopted. He did this against the prospect that he was wrong to find that it was inappropriate to adopt that approach to compensation.[194] He carried out this assessment using the earlier of the two counterfactual dates suggested by the liquidators: 31 January 2011.[195]

[415] The Judge carefully reviewed the expert accounting evidence on this issue. Mr Apps, the expert accountant called by the liquidators, compared the actual deficiency in the liquidation of $110 million with the likely deficiency in a notional liquidation in January 2011. His approach involved attempting to predict what proofs of debt would have been filed in that notional liquidation, in order to compare like with like. He did not seek to assess what the company's liabilities were at the time of the actual liquidation, and at the time of a notional liquidation, given the complexity of that task. Creditors that did not prove in the actual liquidation were disregarded. Mr Graham described this approach as unusual, but also undertook a quantification on this basis.

[416] Mr Apps' primary estimate of loss was $43.928 million. Mr Graham, on the other hand, considered that creditors were better off in the actual liquidation than they would have been in a notional liquidation by some $12.027 million.[196] The difference between these figures resulted from the different views they took on seven key issues. The Judge worked through each of those issues in considerable detail. The most significant difference related to principals' contract claims. This was also the most complex of the seven issues. The Judge's approach to this issue is discussed in more detail below at [513]–[515].

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193 At [459].
194 At [462].
195 At [463].
196 At [466]–[467].

[417] The Judge also analysed three further potential adjustments to these figures that were identified in the course of the trial.[197]

[418] The Judge's ultimate conclusion was that the creditors were better off than they would have been in the event of an earlier liquidation. So, on the net deterioration approach, there was no loss arising from the breach. The Judge did not consider that this outcome was surprising. Mainzeal made significant trading losses in the next two years of trade from January 2011, but Richina Pacific invested $11.6 million into Mainzeal prior to its collapse, and the Richina Pacific construction bonds were much higher at the liquidation than they were in the counterfactual. Importantly, the book of work was much larger at the counterfactual date. These factors largely cancelled one another out.[198]

Result

[419] The Judge made formal orders:[199]

(a) declaring that the directors were liable to Mainzeal on the basis, and in the amounts (totalling $36 million), set out at [413] above;

(b) declaring that Isola was liable to the Mainzeal liquidators in the amount of $2,164,474.09;[200]

(c) reserving leave to the parties to apply to the court in relation to certain aspects of the relief awarded; and

(d) awarding costs to the liquidators and providing for the determination of those costs.

197 At [532].
198 At [538]–[539].
199 At [550].
200 A correction to this limb of the orders was made under the slip rule in *Mainzeal Property and Construction Ltd (in liq) v Yan* [2019] NZHC 1637 [High Court Judgment No 2] at [109].

High Court Judgment No 2 — Applications to alter quantum and costs

[420] The Judge delivered a second judgment dealing with two matters arising from his first judgment:[201]

(a) The liquidators and the directors each applied for orders altering the amount of compensation awarded, pursuant to the leave reserved.

(b) The liquidators and Sir Paul each applied for costs. Sir Paul was named as a defendant in some of the unsuccessful claims, but by the time the matter went to trial, he was not named as a defendant in the ss 135 and 136 claims. So he was successful at trial on all the claims he faced.

[421] A further hearing took place on 8 May 2019. Supplementary memoranda were filed addressing certain issues that emerged at that hearing.

[422] The Judge accepted that the figure of $110 million that he took as the starting point for assessing the amount of compensation represented the total of proofs by creditors, but did not represent their likely loss. The companies in liquidation had assets which could be realised to partially offset the loss to those creditors. Because of the approach taken by the plaintiffs to quantum, the offsetting assets had been disregarded in the expert evidence of the accountants. But on the Judge's approach, the loss to creditors was the amount they were owed less the assets available to meet those claims. There was some debate about the level of expected recoveries, but based on the limited evidence before him the Judge concluded that the relevant figure was approximately $23.843 million, with the result that the starting point for assessing liability should have been $87 million rather than $110 million.[202]

[423] Conversely, the figures for creditors' loss used by the plaintiffs and the expert accountants focussed on amounts as at the date of liquidation. Those figures took no account of the further loss to creditors arising from being out of pocket from the date of liquidation in 2013 to the date of the Court's judgment in 2019.[203] The liquidators

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201 At [1].
202 At [10]–[13].
203 At [21].

submitted that the Court had erred by failing to address their claims for interest.[204] The Judge accepted that in exercising the s 301 discretion he had not taken into account the loss to creditors arising out of being held out of funds between liquidation and the date of judgment, and that it was appropriate to do so as this was a genuine loss to those creditors.[205]

[424] The Judge saw the two adjustments sought by the directors and the liquidators as interrelated. He reduced his starting point figure by $23 million to account for expected realisations. Adjusting the $87 million starting point upwards by $23 million was equivalent to compensating creditors for the time value of money at a simple rate of around 4.4 per cent for the six-year period. That was close to the prescribed rate under the Judicature Act 1908, which "provides a general guide for an amount that can be attributed to this factor under the Court's discretion under s 301". If both adjustments were made, the Judge said, the starting point would have been the same overall, meaning $36 million would be the appropriate compensation to award.[206]

[425] The Judge noted that the compensation ultimately awarded under s 301 is limited by the loss caused by the defendants, but is then subject to an overall evaluation. It is not an exact exercise.[207]

[426] The end result arrived at in the first judgment "still accords with the Court's findings". If the Judge reopened the issues addressed by the applications, and granted both of them, he would have reached the same result. So no adjustment was necessary and both applications were declined.[208]

[427] Finally, the Judge determined a number of issues in relation to costs claimed by the liquidators. The Judge agreed to a number of time band uplifts for certain steps,[209] but declined to apply a percentage increase in the costs award by way of increased costs.[210]

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204 At [23].
205 At [30].
206 At [31].
207 At [34].
208 At [35].
209 At [43]–[56].
210 At [66].

[428] The directors argued that there should be a reduction in the costs awarded to the liquidators because the liquidators failed on a number of claims, including the claim under s 136 and both of their preferred approaches to quantum. They contended for a reduction of 50 per cent. The liquidators said that a reduction of only 10 per cent was appropriate to reflect the aspects of the claim on which they had failed.[211] The Judge considered that a 10 per cent reduction was appropriate.[212]

[429] Costs were awarded to Sir Paul in relation to the claims he faced.[213]

[430] The Judge also dealt with a number of disputes in relation to disbursements.[214]

Issues on appeal

[431] The appeals and the cross-appeal raise the following principal issues:

(a) Did the directors breach s 135 of the Act?

(b) Did the directors breach s 136 of the Act?

(c) If the directors breached s 135, on what basis should compensation be assessed under that provision and s 301 of the Act? In particular, was it open to the Judge as a matter of law to adopt an entire deficiency approach to assessing compensation? If that approach is not open as a matter of law, do these provisions permit the court to adopt a net deterioration or new debt approach?

(d) If the entire deficiency approach is open as a matter of law, was there procedural unfairness in making an award of compensation on this basis, in circumstances where that approach was not pleaded and was not the basis on which the liquidators presented their claim at trial?

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211 At [82]–[83].
212 At [90].
213 At [76].
214 At [91]–[107].

(e) If it was open to the Judge to adopt an entire deficiency approach, should the amount awarded be modified?

(f) If a net deterioration approach should have been adopted, did the Judge err in finding that a net deterioration had not been made out?

(g) If a new debt approach should have been adopted, what amount should be awarded?

(h) If the directors breached s 136, on what basis should compensation be assessed under that provision and s 301?

(i) Was the Judge's apportionment of liability under s 301 appropriate?

(j) Did the Judge err in his approach to costs in the High Court? In particular, should there have been a greater reduction in the costs awarded to the liquidators in circumstances where neither of the approaches to compensation they advanced was successful?

Did the directors breach s 135?

The issue

[432] The first question is whether the Judge was right to find that the directors were causing or allowing the business of the company to be carried on in a manner that breached s 135 by no later than 31 January 2011. As noted above at [350], the Judge concluded that the s 135 duties were breached for three main reasons:[215]

> (a) Mainzeal was trading while balance sheet insolvent, because the intercompany debt was not in reality recoverable.
>
> (b) There was no assurance of group support on which the directors could reasonably rely if adverse circumstances arose.

[215] High Court Judgment No 1, above n 1, at [187].

(c) Mainzeal's financial trading performance was generally poor and prone to significant one-off losses, which meant it had to rely on a strong capital base or equivalent backing to avoid collapse.

Appellants' submissions

[433] The directors submitted that the Judge's application of s 135 was incorrect for four broad reasons:

(a) The Judge's analysis of the scope and purpose of the provision was wrong.

(b) The Judge's approach involved an inappropriate application of hindsight.

(c) The Judge inappropriately discounted or disregarded relevant evidence and circumstances.

(d) There was a disconnect between the Judge's findings and the liquidators' case as pleaded and advanced at trial.

[434] The directors emphasised that even if the company was vulnerable as a result of the 2008–2009 restructuring, and this was known to the directors by late 2010, it was necessary to ask whether s 135 required the directors to promptly cease trading in those circumstances. They submitted this is not necessarily required where a company is vulnerable: it depends on the available options and their consequences. In this case, there was no "soft landing" option. A decision to cease trading was likely to significantly increase the risk and magnitude of losses to creditors. Making this decision involved a difficult question of business judgement. A wide margin of appreciation should be afforded to directors, recognising the likely existence of various tenable options and the risk of hindsight-based challenges. Directors should be liable only if they take risks that they know or ought to know are abnormal and illegitimate risks which increase the likelihood or magnitude of an insolvent liquidation.

[435] The directors submitted that the Judge's approach was tantamount to finding that there was a statutory duty to resign or seek liquidation. However resignation is an inherently problematic course of action, which may well itself cause damage to a major trading company. Nor does it deal with the problem: it simply passes it on to successor directors. Section 135 should not be construed to seriously undermine the ability of companies to trade their way out of temporary difficulties.

[436] The directors also submitted that the Judge's reasoning was seriously affected by hindsight bias. In this case, the directors considered very carefully each year whether Mainzeal was a going concern when considering the company's on-going prospects and group support, before signing off the financial statements. That included active engagement by the directors with the auditors. There was no reason to criticise those judgments made by the directors as outside the acceptable range at the time they were made.

[437] Further, counsel argued, each of the three main planks of the Judge's conclusions was unsupported by the evidence. Mainzeal was not balance sheet insolvent. The directors had no reason in late 2010 to view the related party loans as unrecoverable. It was reasonably open to them to rely on assurances that the wider group would stand behind Mainzeal and each of the related companies that owed Mainzeal money.

[438] The directors submitted that they could reasonably rely on the clear and consistent assurances of group support that they received from the group's controllers. This was a matter of business judgement for the directors. The court should assess the reasonableness of that business judgement as at the time of the alleged breach (January 2011), based on what was known to the directors at that time. The conclusion reached by the Judge reflected hindsight reasoning. The ultimate (and unexpected) withdrawal of group support in the circumstances of early 2013 ought not to have been taken into account.

[439] The directors also submitted that the Judge erred in finding that Mainzeal's trading performance was generally poor and prone to significant one-off losses, and that the directors ought to have known this. That finding, they submitted, is

inconsistent with the Judge's finding (which they support) that "there was no reason for the directors to have put Mainzeal into receivership or liquidation at the January or July 2011 dates".[216]

[440] The directors accepted that, as this Court said in *Mason v Lewis*, they were required to engage in an on-going "sober assessment" of the company's likely future income and prospects.[217] The directors submitted that there was clear evidence that this was done in and around regular board meetings, as well as annually in the directors' and auditors' scrutiny of the Mainzeal financial statements and its going concern status, and in the development and discussion of the coming years' plans and forecasts.

Analysis

[441] We accept the directors' submission that hindsight must be avoided when assessing whether there has been a breach of s 135. The focus must be on what the directors knew or ought to have known at the time of the alleged breach.

[442] We also accept the submission that this inquiry requires identification of the courses of action that were open to the directors. But we do not accept the proposition that it is necessary to identify a course of action that would have been open to directors, and that would have avoided insolvent liquidation, in order to find that there was a breach of s 135. Sometimes it is necessary to bite the bullet and take steps that will trigger an administration or an insolvent liquidation, and failure to do so will result in liability under s 135.

[443] We agree with the Judge that Mainzeal trading on, in what was essentially a "business as usual" mode, involved a substantial risk of serious loss to creditors. By January 2011 at the latest, Mainzeal was in a very vulnerable state. It was seriously balance sheet insolvent, if the related company debts owed by MLG and RGREL were not recoverable. Those debts, though treated in the financial statements as current assets, were owed by entities that did not have the means to meet them. Their ability

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216 High Court Judgment No 1, above n 1, at [396].
217 *Mason v Lewis*, above n 63, at [48] and [51].

to pay depended on the willingness of the Chinese entities to provide substantial financial support to those New Zealand entities and on the ability of those entities to do so. Both the ability and the willingness of the Chinese entities to provide tens of millions of dollars to enable those obligations to be met were most likely to be in question in precisely those circumstances where the funds were needed to pay creditors because Mainzeal was under financial pressure. The approach adopted by the directors involved a large measure of wishful thinking; a failure to squarely address the risks that had been pointed out by (most recently) Ernst & Young; and a failure to seek external independent advice on the recoverability of the sums owed by related companies, in particular, in circumstances where Mainzeal might be under financial stress. We do not accept Mr Hodder's submission that this conclusion depends on the wisdom of hindsight: all of these matters would have been readily apparent to a reasonable director by January 2011 at the latest, and the most significant risk factors had been expressly drawn to the directors' attention by this time.

[444] We do not need to decide whether it was appropriate to include the related company assets in Mainzeal's financial statements without any provisioning, consistent with applicable financial reporting standards. Whatever the position might have been as a matter of financial reporting, by January 2011 it was not reasonably open to Mainzeal's directors to make decisions about continued trading on the assumption that these debts were recoverable in full.

[445] Similarly, by January 2011, against the backdrop of the large deficiency in Mainzeal's balance sheet, it was no longer reasonable for directors to proceed on the basis of oral assurances that financial support would be provided to Mainzeal as and when required. For some years the only written commitments in relation to support received by the directors of Mainzeal were the support letters provided in the audit context by Richina (NZ) LP, an entity which did not itself have the means to provide that support. These assurances were not expressed to be legally binding and the directors do not suggest they thought otherwise. In some cases it will be reasonable for directors to rely on informal assurances of support, but that will be very much fact

and context-dependent.[218] In this case, it was not a reasonable approach in light of the following factors:

(a) The deficiency in Mainzeal's balance sheet was very large.

(b) The entities with substantial assets that were in a position to provide the significant amounts of funding that were potentially required by Mainzeal were too distantly related to Mainzeal, carried on business in another country, and had no relevant trade relationship with Mainzeal that provided an incentive to act on assurances of support in circumstances where Mainzeal faced financial stress.

(c) The assurances from those entities were insufficiently clear and definite. They were not in writing. They were informal. Their parameters were unclear. Mr Yan at least considered that they were subject to the important qualification that they applied only while Mainzeal was a going concern. It appears that was not the understanding of the other directors. But it was precisely the failure to engage squarely with this issue that left room for this significant difference in understanding about the terms on which support would be available.

(d) The ability of the relevant entities to deliver on the assurances in a timely way was insufficiently clear. The directors were well aware of the constraints on transferring funds from China. There was no reason to think that large sums could be made available at short notice to support Mainzeal if it encountered significant cashflow issues.

(e) The risk of significant cashflow issues was always present for a construction company with high turnover, low margins, and significant project risks. Management forecasts had proven unreliable in the past. There was significant downside risk in relation to leaky building claims and other so-called "legacy issues". The directors

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[218] See for example *Morgenstern v Jeffreys*, above n 99, at [121].

could not reasonably proceed on the basis that Mainzeal would not encounter significant cashflow issues or significant legacy liabilities in excess of the modest provisions made. It was not reasonable for Mainzeal's directors to proceed on the basis that there would always be new projects, and revenue from those projects in excess of expenditure, to enable existing obligations to be met.

[446] Mainzeal had for many years adopted a deliberate policy of trading while balance sheet insolvent, using creditors' funds as working capital. The directors knew this. As O'Regan J observed in *Fatupaito v Bates*, where a company has negative shareholders' funds the decision to keep trading is a decision which necessarily involves risk for creditors. Directors must be very cautious before embarking on a course of continued trading, in the hope that this will enable the company to restore solvency.[219] In the present case, the directors were not cautious. There was no realistic prospect of addressing the substantial deficit in Mainzeal's balance sheet unless Mainzeal received new capital, or Richina Pacific took steps to put the related company debtors in a position where they could meet their obligations. It was necessary to press for this to happen. If it could not happen in January 2011, there was no reason to think it would happen at a later date: in other words, there was no reason to think that solvency could be restored.

[447] In those circumstances, the one thing that it was not open to the directors to do was to continue to trade on without taking urgent corrective action. There was no soft option available. A number of courses of action were open to them. They could have pressed for repayment of a substantial proportion of the debts owed to Mainzeal by related companies within a reasonable timeframe. They could have sought written assurances of support from entities with the means to provide that support, which clearly set out the parameters for that support. They could, and should, have pressed for those assurances of support to be in a legally binding form. If that was not achievable, they could and should have pressed for the clearest and most definite assurances that could be obtained, and then assessed the adequacy of those assurances bearing in mind all other relevant circumstances.

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219 *Fatupaito v Bates*, above n 62, at [77].

[448] If those strategies were unsuccessful, they could and should have undertaken a formal review of the appropriateness of continuing to trade. They should have looked at whether there was a realistic prospect of continuing to trade in a way that ensured new creditors would be paid and the position of existing creditors would not be prejudiced. For example, they could have explored ways in which new projects could be "ring-fenced" to protect new creditors. That may have been difficult to achieve given the dependence of the company on those new creditors to fund completion of existing projects. But that in itself would have been a significant warning sign to the directors that continuing trading involved a substantial risk of serious loss to creditors at some point in the not too distant future.

[449] We agree with the Judge that one weapon in the directors' arsenal was to convey the seriousness of their concerns to the controllers of the Chinese entities and indicate to them that if it was not possible to obtain repayments of inter-company debts and/or binding assurances of support, they would not be willing to commit the company to any new construction projects and would proceed to wind down the business. They could also indicate that if none of the various options outlined above was feasible, they would have little choice but to resign.

[450] Ultimately, if none of these courses of action bore fruit, the directors could have, and should have, resigned. We agree with the Judge that it would have been premature to leap to liquidation in January 2011 without exploring all the alternatives. The indications from Mr Yan and others that liquidation would have been a mistake in January 2011 suggest there was at least some prospect that a properly informed and determined approach to putting the company on a more stable footing could have succeeded. However as the Judge said, exactly what would have happened is speculative.[220]

[451] In this case, the directors did the one thing that was not reasonably open to them: they simply traded on while failing to engage in any meaningful way with the profoundly unsatisfactory financial position of the company and the risks this created for current and future creditors. The business of the company was being carried on in

[220] High Court Judgment No 1, above n 1, at [416].

a manner that created a substantial risk of serious loss to creditors. The directors allowed this and agreed to it. They were well aware of the extent of the risk. If they had made the further inquiries that a reasonable director should have made in those circumstances, that risk would undoubtedly have been brought home even more firmly to them. They cannot shelter behind their failure to seek independent legal advice. Nor can they shelter behind the vague and general assurances provided by Mr Yan by email in the course of 2010, or the much more limited comfort provided by Mr Walker in his email in August 2010.

[452] It was reasonable for the directors to take some time to explore all realistic alternative courses of action and endeavour to avoid an insolvent liquidation. If they were actively engaged in seeking advice and attempting to address these issues, they could not be criticised and would not be exposed to liability under s 135. It was their striking failure over an extended period to engage with the realities of the company's situation and take any meaningful action to address those issues that leads us to confirm the Judge's finding that they breached s 135 no later than 31 January 2011.

Did the directors breach s 136?

The issue

[453] The liquidators cross-appealed from the Judge's finding that there was no breach of s 136. They focused on the allegation that all obligations incurred by Mainzeal after 31 January 2011 were incurred in breach of s 136. The liquidators did not allege that the directors did not believe that Mainzeal would be able to perform the obligations it undertook after that date. But they argued that the directors did not have reasonable grounds for their belief that Mainzeal would be able to perform those obligations.

Submissions on appeal

[454] The liquidators submitted that the Judge was wrong to confine s 136 to specific obligations. The claim as it was advanced at trial related to all obligations incurred after the breach date, or alternatively, to the four specific construction contracts which were identified and put in issue in the liquidators' written evidence and opening

submissions: the head contracts in relation to Wigram Museum (entered into in November 2011), MIT (February 2012), ANZ Tory Street (October 2012) and Ministry of Justice Manukau Precinct (November 2012) . The Judge was also wrong to focus on whether it would have been apparent to the directors that Mainzeal's failure would occur, or would be likely to occur, immediately or within a particular period of time. It should have been apparent to the directors that failure could occur at any time and that timing was largely unpredictable. No proper assessment of Mainzeal's ability to complete the four projects was undertaken.

[455] The directors submitted that the Judge was right to reject the s 136 claim. They adopted the Judge's reasoning on that issue. In particular, they said that the focus of s 136 is on an individual obligation which the company undertakes. There needs to be a focus on what the directors believed in relation to that specific obligation and the grounds for that belief. Here, the s 136 claim was pleaded in relation to Mainzeal's general trading over an extended period of some two years.

[456] The directors also submitted that they had reasonable grounds for their belief that all contracts would be performed by Mainzeal as a going concern at all times until late January 2013, essentially for the reasons canvassed in relation to s 135.

[457] Mr Chisholm emphasised that the argument presented by the liquidators on appeal in relation to the four specific contracts was in effect an argument that the directors should not have allowed Mainzeal to enter into any construction contracts in the ordinary course of business over late 2011/2012. That decision could not be separated from the decision to continue trading, which is better evaluated under s 135. The High Court accepted the directors' view that there was no reason to have put Mainzeal into receivership or liquidation in January 2011. So it was reasonable for Mainzeal to continue to carry on business as a construction company, and therefore reasonable to continue to enter into construction contracts.

[458] The directors also submitted that the liquidators' failure to plead any specific obligation in their s 136 cause of action was fatal to their claim. A s 136 claim based on the four specific construction projects was not pleaded or properly put to witnesses in cross-examination. There was no focus on the particular obligations arising from

those contracts, the directors' reasons for believing Mainzeal could meet its obligations under those contracts, and the basis on which the liquidators alleged that their belief in Mainzeal's ability to perform those obligations was unreasonable. Indeed the contract documents were not even in evidence.

Analysis

[459] As discussed in more detail above at [279]–[283], we accept the liquidators' submission that s 136 is not concerned only with entry into one or more specific obligations. There is no good reason to read the provision as confined in this way.

[460] Plainly the directors of Mainzeal did agree to new obligations being taken on after 31 January 2011. Those obligations included the four new major projects referred to by the liquidators, which involved a significant number of obligations to principals, sub-contractors and suppliers. But it seems to us that the class of obligations to which the directors agreed was much broader than this: it extended to all new obligations undertaken in the ordinary course of Mainzeal's business as a result of the directors' agreement to Mainzeal continuing to trade on a "business as usual" basis, whether those obligations were expressly approved by the board or were approved by executives acting under delegated authority from the board.

[461] We proceed on the basis that the directors did believe that Mainzeal would be able to meet those obligations: as noted above at [453], that was not challenged by the liquidators. So the focus is on whether there were reasonable grounds for the directors to believe that those obligations would be met.

[462] In circumstances where directors trade on knowing that the company is vulnerable to failure at any time, and that if it stops trading there will be a serious deficiency to creditors, it seems odd to say that there were reasonable grounds for thinking that at any given moment obligations stretching out some months and years into the future would be met. We accept that as at 31 January 2011 the directors had no reason to think that the company would experience sudden failure in the coming months. The company had managed to continue to trade despite serious balance sheet insolvency for some years, and there were good reasons to think that this strategy could continue for the short-term at least. As noted above at [138], board papers for the

February 2011 meeting recorded strong cashflow and a relatively positive immediate financial outlook. But the writing was on the wall. Legacy obligations continued to erode the company's modest cash resources. The company's ability to generate cashflow from principals to meet its existing obligations to subcontractors and suppliers depended on incurring further obligations that would fall due in coming months: a strategy that did not resolve the underlying balance sheet issue, but simply deferred the risk of being unable to meet obligations when they fell due.

[463] In these circumstances, we consider that where significant obligations with a longer time horizon were undertaken — for example, the obligations to principals under the four major projects — there was a high risk that those obligations would not be performed. The ability to do so depended on the company receiving shareholder support as and when financial difficulties arose. The directors' belief that shareholder support would be forthcoming was not based on reasonable grounds, having regard to the factors identified above at [445].

[464] We therefore accept the liquidators' argument that the directors did not have reasonable grounds for thinking that the company would be able to perform the longer term obligations to principals that were assumed as a result of entry into the four contracts referred to above at [454]. It was not open to the directors to enter into those contracts without having put in place arrangements that provided a reasonable basis for believing that Mainzeal would be able to perform its obligations under those contracts through to completion.

[465] That does not mean that Mainzeal had to cease trading as at 31 January 2011. But it does mean that Mainzeal could only take on significant new long term commitments after that date if the directors first took steps to address the company's serious balance sheet insolvency, and succeeded in obtaining further capital or (at the least) assurances of support on which they could reasonably rely.

[466] The admitted claims by principals in respect of those four contracts, and by bond providers who indemnified those principals and were subrogated to their claims, are as follows:

Contract	Principal claim	Bond claim	Total
Wigram Museum	nil	nil	nil
MIT	$14,831,437.04	$3,250,000	$18,081,437.04
ANZ Tory St	nil	nil	nil
Ministry of Justice Manukau Precinct	$1,700,000	$500,000	$2,200,000
Total			$20,281,437.04

[467] The same reasoning applies to longer term obligations to subcontractors on these projects: in particular, retentions that would only be payable at the conclusion of the subcontract or the project. The following claims were admitted from subcontractors on these four projects:

Contract	Subcontractor claims
Wigram Museum	$1,619,000
MIT	$6,092,000
ANZ Tory St	$3,069,000
Ministry of Justice Manukau Precinct	$442,000
Total	$11,222,000

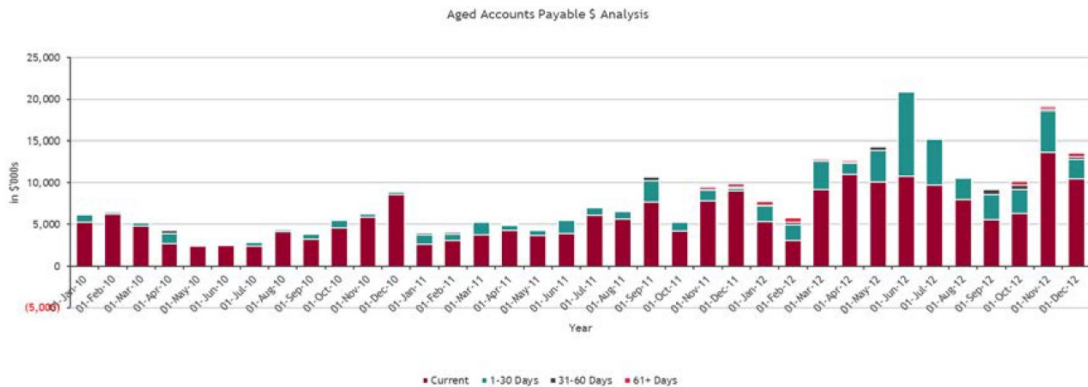
[468] Some of these claims (including all the claims relating to ANZ Tory St and the Manukau precinct) relate to payment obligations incurred from July 2012 onwards: that category of obligation is discussed separately below. But some of these claims may relate to retentions that accrued from February 2011 onwards, and were payable at the conclusion of the relevant subcontract or of the project. The directors agreed to these obligations being incurred: they were incurred in the ordinary course of Mainzeal's construction business. The directors did not have reasonable grounds for believing that deferred obligations of this kind would be able to be paid when due.

[469] We do not consider that it was necessary for a claim in respect of the obligations arising out of these four projects to be specifically pleaded, or put to the directors, in order for the liquidators to succeed in respect of these obligations. Rather, we have found that the global claim that the directors should not have agreed to Mainzeal entering into new obligations from 31 January 2011 onwards succeeds, at least so far as this subset of obligations is concerned, for the (generic) reasons in relation to the company's overall financial position and trading strategy that were pleaded and argued at trial by the liquidators. We now turn to consider whether the claim is made out in respect of entry into other obligations from 31 January 2011 onwards.

[470] The position in relation to short-term obligations incurred after 31 January 2011 is more complex. As a matter of fact, the directors had reasonable grounds for expecting that short-term obligations incurred in February 2011 would be met when they fell due. As against this, the liquidators emphasise that the company's ability to meet these obligations depended on a strategy of incurring new obligations on a rolling basis while failing to address the very serious underlying balance sheet insolvency issue. And it was based on continuing to trade in a manner that breached s 135, as a reasonable director would have appreciated. The liquidators say that the directors' belief that short-term obligations could be met was based on the adoption of a trading strategy that was not itself reasonable.

[471] We accept it is arguable that s 136 is breached where the directors' belief that the company will meet its obligations is predicated on a trading strategy that involves breaching their obligations under the Act and that merely postpones the risk of failing to meet obligations without addressing underlying solvency problems. But we consider that the present case can be resolved on the basis of the narrower approach identified above that focuses on whether, *as a matter of fact*, there were reasonable grounds for believing that obligations would be performed when due. This approach is sufficient for present purposes because it appears from the evidence before us that the short-term obligations that the company undertook in the months immediately following 31 January 2011 were in fact performed by the company. We set out below

(and in larger format in Appendix D) a graph prepared by the liquidators showing aged accounts payable up to December 2012:



[472] It is apparent from this graph that as at 1 December 2011, Mainzeal had minimal aged debts. Through to mid-2012, Mainzeal had an increasing amount of debt overdue by up to 30 days, but minimal debt overdue for more than 30 days. So the question whether s 136 was breached in relation to short-term obligations incurred in 2011 is academic: the relevant creditors were paid, and no compensation would be recoverable by the liquidators on a new debt basis in respect of those obligations in any event.

[473] We consider that in these circumstances, the s 136 analysis should focus on the short-term obligations incurred by the company that remained unpaid at the date of liquidation in February 2018. Those appear to be the only relevant short-term obligations so far as the liquidators' claim for compensation is concerned. And it appears from the evidence before us that all (or virtually all) of those short-term obligations were incurred in the second half of 2012. So the important question for practical purposes is whether, at that time, the directors had reasonable grounds for believing that new short-term obligations would be met when they fell due.

[474] By June 2012 overdue accounts represented almost half of the company's accounts payable. The company was not in fact paying its debts as they fell due. At the board meeting on 27 June 2012 Mr Pearce, the CFO, advised the directors that cashflow remained critical. His report referred to "[e]xtreme cashflow pressures resulting in micro-management on a daily basis which has been covered by temporary banking facilities on a month by month basis." Before the next board meeting on

5 July 2012, Sir Paul sent the email (referred to at [156] above) to Mr Yan which described Mainzeal as in a "precarious position to say the least", and described the unsecured creditors as "seriously exposed". BNZ agreed to provide further short-term funding in the form of a $4 million "excess" facility. But BNZ was no longer satisfied with its security over the company's assets, and sought a personal guarantee from Mr Yan supported by a mortgage over his Remuera home. BNZ also required Mainzeal to provide it with daily cashflow information. The excess facility was provided on the basis that it would be reviewed monthly. On 5 July 2012 the board accepted BNZ's proposal to provide further funding on this basis.

[475] Whatever the position may have been in 2011, we consider that by 5 July 2012 the directors did not have reasonable grounds for believing that the company would be able to meet new short-term (unsecured) obligations when they fell due. It was in fact failing to do so: as the graph at [471] above demonstrates, from March 2012 onwards, and especially in June 2012, the company had significant overdue debt. The company's "precarious position" could result in failure at any time, in particular, if BNZ decided to withdraw the temporary facilities on which the company's continuing trading depended at any of the scheduled monthly reviews. The directors knew all of this: these matters were squarely on the table at the 27 June and 5 July 2012 board meetings. By 5 July 202 at the latest the directors lacked reasonable grounds for believing that Mainzeal would be able to meet any newly incurred obligations when they fell due.

[476] It follows that the directors breached s 136 in relation to all obligations incurred from 5 July 2012 onwards. That appears, on the evidence before us, to include all (or almost all) of the short-term obligations that remained unpaid at the time of liquidation. Those obligations could not properly be incurred in the absence of arrangements with BNZ or Mainzeal's related companies that would ensure payment in the (increasingly likely) event that Mainzeal was unable to continue to trade. No such arrangements were put in place. The creditors who dealt with Mainzeal in this period were exposed to an abnormal level of risk. They suffered precisely the harm that s 136 is designed to prevent. In these circumstances the directors should not have agreed to Mainzeal continuing to trade in a "business as usual" manner, and enter into new obligations, from 5 July 2012 onwards.

[477] We are not in a position to quantify this category of claims. But it will include all the subcontractor claims in respect of ANZ Tory St and the Manukau Precinct. It is also likely to include all or most of the admitted claims of approximately $9.5 million in respect of debts to trade creditors and suppliers who were not subcontractors.

[478] We need not decide the difficult question of whether there were breaches of s 136 in respect of short-term obligations incurred between February 2011 and June 2012, as on the evidence before us this question appears to be of little or no practical significance when it comes to assessing compensation.

[479] We are conscious of the possibility that there may have been breaches of s 136 in respect of longer-term obligations entered into between February 2011 and June 2012 that did not relate to the Wigram Museum and MIT contracts. But on the evidence before us it is not possible to identify those obligations or make any findings in relation to them.

[480] In summary, we have concluded that the directors breached s 136 in respect of:

(a) obligations to principals and bond providers under the four substantial construction contracts entered into after 31 January 2011;

(b) obligations to subcontractors under those contracts in relation to retentions; and

(c) all obligations incurred on or after 5 July 2012.

Relief under s 301 for breach of ss 135 and 136

[481] Where a claim is brought by a liquidator under s 301, the compensation that is recoverable cannot exceed the amount that would be recoverable in an action by the company, for the reasons explained above at [302]. Section 301 does not create new rights of action and does not permit the courts to adopt a different and more onerous approach to quantifying loss than would be available in a claim brought by the company for breach of the relevant duty.

[482] It is therefore necessary to begin by considering what compensation would be recoverable by Mainzeal against the directors in respect of the breaches of ss 135 and 136 identified above. If the company would be able to claim compensation for breach of those duties, it is then necessary to consider what award should be made under s 301.

[483] We will consider each of the three possible approaches to assessment of compensation for breach of ss 135 and 136 that were canvassed before us: the Judge's entire deficiency approach, the net deterioration approach, and the liquidators' new debt approach.

Compensation for s 135 breach based on entire deficiency in liquidation

The issue

[484] The directors submitted that the Judge should not have awarded compensation for breach of s 135 on the basis of the entire deficiency in the liquidation for three overlapping reasons:

(a) An award of compensation on this basis was not open as a matter of law, having regard to the nature of the breaches by the directors.

(b) A claim for compensation on this basis was not pleaded and was not put to the directors. The finding was procedurally unfair.

(c) The argument that the liquidation was caused by the directors' breaches was not supported by the evidence. The Judge's theory that if the directors had pressed for legally binding support commitments those commitments would have been obtained, preventing the liquidation, was speculative and was not supported by such evidence as there was on this issue. There was little evidence squarely directed to this issue, however, precisely because it was not pleaded and was not squarely on the table at trial.

[485] The liquidators supported the Judge's reasoning. They submitted that the Judge did in fact find that it was likely that if the directors had acted in accordance with their duties under s 135, legally binding support commitments would have been obtained, and these commitments would have prevented the liquidation of Mainzeal.

Was an award on this basis available as a response to the relevant breaches?

[486] This is not a case where, prior to the breaches of duty by the directors that were the subject of these proceedings, the company was solvent. Put another way, those breaches of duty did not cause the insolvency of Mainzeal. It was a fundamental plank of the liquidators' case that by January 2011, Mainzeal was hopelessly insolvent. As the Judge found, if Mainzeal had stopped trading in January 2011, the result would have been very substantial losses to creditors that would have been greater than the losses eventually suffered by the creditors in the aggregate in 2013.[221] We return to that issue below at [513]–[518]. For present purposes, however, the critical point is that on the case presented by the liquidators, in early 2011 the directors could have acted in a manner that was entirely consistent with their duties, whether by resigning and triggering a liquidation or by themselves applying to the court for the appointment of a liquidator. The result would have been an insolvent liquidation in which creditors suffered very serious losses. The directors would not have been liable for those losses.

[487] The duty of the directors under s 135 did not extend to curing, or procuring the shareholders to cure, the existing deficit in the capital of the company. Nor did they have a duty to avoid losses that were inherent in the company's (insolvent) position as at the pleaded breach date.

[488] In circumstances where an insolvent liquidation would have been the result of courses of action that were lawfully open to the directors in January 2011, we do not consider that the liquidation of Mainzeal can be attributed to any breach of duty by the directors at that time. Even if their breach of duties had been shown to be a "but for" cause of the liquidation, because there were steps they could have taken which would

221 High Court Judgment No 1, above n 1, at [397] and [538].

have led the shareholders to provide further capital, the deficiency on liquidation was in large measure a pre-existing loss that was not caused by the pleaded breaches, and that fell outside the scope of the pleaded duties. A wrongdoer is not liable for every "but for" consequence of their conduct. The harm that is compensable is the harm that the wrongdoer had an obligation not to bring about. As Lord Hoffmann put it in *South Australia Asset Management Corp v York Montague Ltd*:[222]

> Normally the law limits liability to those consequences which are attributable to that which made the act wrongful.

[489] This approach to director liability in the insolvent trading context was adopted in England and Wales in *Re Continental Assurance Co of London plc (in liq) (No 4)*, where Park J said:[223]

> [378] My general point is that, before a court will be prepared to impose liability on directors in a case where there has been an unjustified decision to carry on trading, it is not enough for a liquidator claimant merely to say that, if the company had not still been trading, a particular loss would not have been suffered by the company. There must, in my view, be more than a mere 'but for' nexus of that type to connect the wrongfulness of the directors' conduct with the company's losses which the liquidator wishes to recover from them. In many cases the connection will be obvious and may not require any discussion. If the company's business was inherently loss-making, and the directors ought to have known that but unjustifiably turned a blind eye to it, it is plainly appropriate to use the section to seek recovery from them of continued trading losses of precisely the kind which they ought to have known would result if the company carried on with its trading operations.
>
> [379] However, not every loss which a company may sustain after the directors have reached a wrongful decision to trade on (or wrongfully failed to consider at all the question of whether to trade on or not) is like that. One of the previous cases under s 214 which was cited to me was *Re Brian D Pierson (Contractors) Ltd* [2001] 1 BCLC 275. The judge (Hazel Williamson QC, sitting as a High Court judge) held that the directors were in principle liable under the section, but, from the amounts which she considered that they ought to be required to pay to the company, she sought to exclude the element of worsening of the company's position which was attributable to particularly bad weather conditions of 1994–95. The company's business was to construct and maintain golf courses, so it was vulnerable to bad weather entirely independently of whether the directors took justifiable or unjustifiable decisions about trading on or closing down instead.

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222 *South Australia Asset Management Corp v York Montague Ltd* [1997] AC 191 (HL) at 213.

223 *Re Continental Assurance Co of London plc (in liq) (No 4)* [2007] 2 BCLC 287. See also [380]–[381] of that case.

[490] In the present case, suppose that in late 2010 or early 2011 the directors had strenuously attempted to obtain further capital and assurances of support from companies with the means to provide that support, but had been unsuccessful. They would then have had little choice but to trigger a receivership or liquidation or resign. They would not be liable for the significant losses that creditors would have suffered in this scenario. It follows that liability for their breaches of s 135 cannot fairly extend to those losses, which are not attributable to any wrongful conduct on their part. So for example their breaches cannot render them liable for losses suffered by pre-breach creditors, such as "legacy" claimants, who would have suffered the same losses in an earlier liquidation. Nor can they be liable for the costs of conducting a liquidation, as the company's insolvency was not attributable to their wrongdoing: if they had acted as the liquidators say they should have acted, liquidation costs would have been incurred in any event and there is no reason to think that those costs would have been materially lower.

[491] It follows that in a claim for breach of s 135 from 31 January 2011 onwards, and in the circumstances of this case, an award of compensation based on the entire deficiency in the liquidation is not available. A more targeted approach is required that links the amount of compensation to the loss on liquidation that is fairly attributable to the directors' breach of s 135.

Entire deficiency approach not open on the pleadings — procedural unfairness

[492] The directors submitted that the Judge's approach to assessing compensation was not pleaded and was not a feature of the liquidators' evidence or opening submissions. It was not adopted by the liquidators following the Judge's Minute (No 5) part way through the trial. Indeed it was expressly disclaimed at that time. The directors prepared for trial on the basis that the complaint was that they should have ceased trading by either 31 January 2011, or alternatively 31 July 2011. That failure was alleged to have caused loss on either the new debt or net deterioration

approach. In those circumstances, and despite the issue of Minutes (No 5) and (No 6), it was unfair for them to be found liable on the basis that:

(a) The relevant breach of duty was a failure to bring pressure to bear on the Chinese entities to provide additional capital and/or formal commitments to support Mainzeal.

(b) If they had done so, the company would have traded on successfully and there would have been no insolvent liquidation.

(c) As a result, the directors were responsible for the entire deficiency in the liquidation of some $110 million.

[493] We agree that the approach adopted in the High Court differed in material respects from the theory of liability and approach to compensation set out in the liquidators' pleading. Pleadings play a fundamental role in defining the parameters of a trial. The parties are entitled to prepare for trial on the basis that the pleadings identify the facts in issue and the nature and scope of the case that the plaintiff will present and the defendant must meet. For good reason, after the close of pleadings any amendment requires the leave of the court. It is not open to a plaintiff to present a case beyond the scope of the pleadings at trial without seeking leave to amend. The process of seeking leave to amend serves two purposes:

(a) It identifies the additional facts and issues raised by the new argument that the plaintiff wishes to present, and that must be established by the plaintiff if they are to succeed. If there is a change of course part way through a trial, the defendant is entitled to have that new course mapped with the same clarity that is required in advance of trial.

(b) The application for leave requires the parties, and the court, to engage squarely with the question whether the new departure can fairly be accommodated. In some cases, where the change in approach is essentially a matter of law that raises no new questions of fact, the trial will be able to continue with little or no interruption. In some cases,

> fairness will require that the defendant have an opportunity to consider the new argument and prepare evidence — fact and/or expert — to respond to the modified case they now need to meet. They may also need to carry out further research and analysis in relation to legal aspects of the modified claim. An adjournment may be needed to give the defendant a fair opportunity to understand, and respond to, the modified claim. In some cases, the only way to provide that fair opportunity will be by re-starting the trial after such an adjournment. And in some cases, especially where a trial is well advanced, the burden on the defendants of having to re-frame their defence and prepare for a resumed trial (or fresh trial) many months down the track will be so great that amendment should not be permitted. It is important that these issues be squarely confronted where a plaintiff wishes to change tack in a material way.

[494] The pleading rules are not arid technicalities. They give effect to fundamental requirements of natural justice protected by s 27 of the New Zealand Bill of Rights Act 1990. The courts rightly emphasise substance over form. But ensuring that a plaintiff has a proper opportunity to present their claim, and have their day in court, cannot take precedence over a defendant's entitlement to procedural fairness including fair notice of the material elements of the claim they are required to meet. The High Court Rules 2016 in relation to pleadings are designed to strike that balance, and are flexible enough to do so in the wide range of circumstances that arise in civil trials.

[495] In this case, following the Judge's Minute (No 5), the liquidators did propose an amendment to the pleadings. However as explained above at [333], that amendment did not depart from the basic thesis that the company should have stopped trading, or stopped incurring new obligations, by no later than either January 2011 or July 2011. Nor did it adopt the entire deficiency approach that follows from the argument that the breaches by the directors led to an insolvent liquidation that could otherwise have been avoided.[224] Even that more modest amendment was abandoned,

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224 See above at [335].

once it became clear that it would be likely to require a substantial adjournment to enable the defendants to respond effectively to it.

[496] We consider that it was not open to the High Court to find for the plaintiffs on the basis of the materially different approach outlined above at [399]–[411], in the absence of an amendment to the pleadings to add that claim. The identification of this possible approach by the Judge in Minutes (No 5) and (No 6) was not sufficient to require the defendants to respond to this claim, and expose them to the risk of adverse findings on this basis, in circumstances where the liquidators elected not to amend their pleadings to adopt this theory of the case.

[497] The Judge considered that it was open to him to adopt this approach because of the references in s 301 of the Act to the court conducting an inquiry and awarding an amount of compensation that the court considers just.[225] However as we have explained above at [302], s 301 does not authorise an open-ended inquiry into the conduct of directors, following which compensation can be assessed without reference to any underlying legal wrong. Rather, the essential starting point before an award can be made under s 301 is that the director has breached a duty. The compensation awarded under s 301 cannot exceed the amount of compensation that would otherwise be recoverable by the company in respect of that breach of duty. It follows that all the facts that are relevant to establishing a breach of duty by the director, and establishing the loss caused by that breach, must be pleaded in a s 301 claim just as they would need to be pleaded in a claim by the company for breach of the relevant duty. The court does not have more flexibility to depart from the pleaded case in a s 301 claim than it would have in any other claim by a company against a director for breach of a duty owed to the company.

[498] The failure by the liquidators to frame their case in this way had significant practical consequences for the way in which the trial was conducted. In particular, there was little or no evidence addressed to the question of whether, if the directors had pressed for adequate capitalisation of the company or formalisation of support,

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[225] The Judge also placed some reliance on the approach to relief adopted in *Re South Pacific Shipping Ltd (in liq)*, above n 50. But in that case relief was awarded under the very different remedial provision in s 320 of the 1955 Act.

that would have been achieved and liquidation would have been avoided. If that theory of the case had been pleaded, this issue would necessarily have been the subject of both fact and expert evidence from the plaintiffs. The directors could have tested that evidence and responded to it. In particular, the directors would have known that they needed to address this issue in the evidence that they gave about events in 2010 and 2011.

[499] The directors sought to adduce further evidence on appeal from Mr Graham, the forensic accounting expert they called at trial, to identify the additional work and additional issues that he would have needed to address had the claim been presented in this way. In this case, we consider that it is self-evident that additional fact and expert evidence would have been needed to respond to this theory of liability, and that substantial time would have been needed to prepare for this. Existing witnesses would have addressed other topics. Additional witnesses might well have been called to give evidence. We therefore do not consider that Mr Graham's affidavit is necessary, and we decline leave to adduce it on appeal. If we had been in any doubt about the need for further expert evidence on these issues, however, we would have been prepared to admit evidence on that point. In those circumstances it would have been cogent. And it would also have been fresh in the only sense that matters: there was no need to adduce such evidence at trial, in circumstances where the liquidators were not seeking to amend their pleading to advance this theory of the case, so there was no reason for this affidavit to be provided at first instance.[226]

[500] The liquidators submitted that the directors could hardly complain that they did not have an opportunity to respond to an argument that additional pressure on the Chinese entities would have produced further support, in circumstances where their argument throughout was that support was always available and likely to be provided, until a "perfect storm" came along and sank the Mainzeal ship. However the case advanced by the directors was based on availability of support on an ad hoc basis. And in Mr Yan's case it was expressly qualified on the basis that support was available while Mainzeal was a going concern. Their evidence did not address the question of

[226] *Paper Reclaim Ltd v Aotearoa International Ltd (Further Evidence) (No 1)* [2006] NZSC 59, [2007] 2 NZLR 1 at [8], confirming *Rae v International Insurance Brokers (Nelson Marlborough) Ltd* [1998] 3 NZLR 190 (CA) at 192: further evidence must be fresh, credible and cogent.

whether formal and binding commitments of support could have been obtained in 2010 or 2011, as that was neither a feature of the liquidators' case nor a feature of the directors' response to that case.

[501] We also accept the directors' submission that if the liquidators had wanted to present the argument outlined above, they needed to put it to the directors (in particular, Mr Yan) and to Mr Walker. Messrs Yan and Walker were the only witnesses at the trial who were in a position to give any evidence in relation to how the Chinese entities would have responded to pressure to provide formal binding commitments of support. But this issue was never put to them.

[502] In summary, we consider that fairness to the directors as defendants required that this theory of the case be properly pleaded and put to relevant witnesses. It was not. In those circumstances, it was not open to the Court to find them liable on that basis.

Entire deficiency approach not supported by the evidence

[503] If we had considered that the entire deficiency approach outlined above at [399]–[411] was open to the liquidators before the High Court, we would have found that the liquidators had not made out that claim on the basis of the evidence at trial. We agree with the observation of the Judge that asking whether the directors would have succeeded in persuading Richina Pacific and the CHC to change tack involves a degree of speculation, or at least considerable uncertainties.[227] There are some indications that formal support might have been forthcoming if sought in late 2010 or early 2011. But there are also strong indications that no formal support would have been provided at that time, that would have made a difference to the ultimate outcome in 2012/2013:

(a) The Judge found that recapitalisation of Mainzeal was unlikely, and this was not challenged by the liquidators on appeal.[228]

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[227] High Court Judgment No 1, above n 1, at [416].
[228] At [421] and [425].

(b) There are many reasons to think that the Chinese entities would have declined to provide any legally and practically enforceable commitment, given the care that they had taken to avoid any such commitment in the previous 10 years or so, and given the regulatory barriers to entry into such a commitment by the Chinese entities.

(c) There is a greater likelihood that informal assurances of support could have been obtained direct from the CHC, given the mixed messages in the 2010 exchanges about which entity would provide letters of support. But it is far from clear that informal assurances of this kind would have made a difference in practice in 2012 and 2013 when Mainzeal was under significant financial pressure.

(d) There is no direct evidence at all about what the CHC would have been willing and able to provide by way of legally and practically enforceable commitments in early 2011, if pressed to do so.

(e) There was no evidence that directly addressed how the provision of such assurances would have affected subsequent events.

[504] The lack of evidence bearing directly on these issues is unsurprising, in circumstances where this theory of the case was not squarely pleaded and was not the focus of argument or evidence at trial.

[505] In these circumstances it would be unsafe to find that on the balance of probabilities, survival of Mainzeal was more likely than not if the directors had applied more pressure at an earlier time.

[506] We would have been prepared to find that the failure by the directors to seek further capital, or further assurances of support from the CHC, meant that Mainzeal lost an opportunity to obtain those benefits, and lost an opportunity to achieve sufficient resilience to weather the events of 2012 and 2013. Because the outcome of the directors taking these steps depended on decisions made by third parties — the Chinese entities — it seems to us that a loss of chance approach would in principle be

available.[229] But the liquidators did not present their claim on a "loss of chance" basis and expressly disclaimed any such argument in the course of the hearing before us.

[507] In circumstances where the claim was not pleaded on a loss of chance basis, and evidence directed to the assessment of that chance was not before the Court, it would in any event have been too late to advance such an argument on appeal.

Summary in relation to entire deficiency approach

[508] For the reasons set out above we have concluded that judgment should not have been entered for the liquidators on the basis of the entire deficiency approach. We consider this approach to assessment of compensation was not available as a response to the breaches established. If we are wrong about this, and the approach was in principle available, it was not pleaded by the liquidators: it would be unfair to the directors to find against them on this basis. And — as a result of the way in which the liquidators' case was run — there was little evidence to support this theory of liability and it was not made out on the balance of probabilities.

[509] The directors' appeal against the finding that they were liable on this basis must therefore be allowed.

Compensation based on the net deterioration approach

The issue

[510] One of the approaches pleaded by the liquidators in relation to both ss 135 and 136 was the net deterioration approach. The liquidators argued at trial that the financial position of the company had deteriorated between January 2011 and early 2013, when liquidation began. They sought to quantify this by comparing the value of the claims made in the actual liquidation with an estimate of the value of the claims that would have been made in a notional liquidation in early 2011.

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[229] James Edelman, Simon Colton and Jason Varuhas (eds) *McGregor on Damages* (20th ed, Sweet & Maxwell, London, 2018) at ch 10, especially [10-057] ff.

[511] As set out above at [398], the High Court rejected the net deterioration approach on the basis that the company's position had in fact improved slightly between early 2011 and early 2013.

Liquidators' submissions

[512] The liquidators' cross-appeal advanced a number of criticisms of the High Court analysis, with a view to establishing that the position of the company had deteriorated over that two-year period. By the time of the hearing before us, their challenge to the High Court's conclusion focussed on one of the issues on which the experts disagreed: quantification of the likely liability to contract principals in a notional liquidation in early 2011. The liquidators argued that the Judge's approach was unduly influenced by one outlier contract in the actual liquidation, which should have been disregarded when assessing the ratio of expected claims by contract principals to the value of construction bonds on issue at the relevant time.

Analysis

[513] We agree that some aspects of the approach that the Judge adopted to quantifying the likely liability to contract principals in a notional liquidation in early 2011 are open to challenge. It was based on a number of significant assumptions and approximations. But precisely the same criticisms can be made of the approach adopted by the liquidators' expert — Mr Apps — at trial, and by the liquidators on appeal before us.

[514] We are sceptical about the appropriateness of assessing liability on a net deterioration approach by reference to the amounts for which creditors would claim in an actual and notional liquidation, rather than on the basis of the change in the company's net financial position. In some cases, proofs by creditors might represent a reasonable proxy for the liabilities of the company. But in the case of a construction company, the complexity of arrangements with principals has a significant impact on the likelihood of proofs by principals. Another significant complication in this case comes from the substantial liabilities of the company in relation to leaky building claims and other legacy claims. In circumstances where other defendants in those proceedings were jointly and severally liable with Mainzeal, many plaintiffs chose not

to pursue a proof against Mainzeal but simply to continue proceedings against other solvent defendants. And the very low dividend that unsecured creditors could expect in Mainzeal's liquidation would have had a significant influence on the likelihood that creditors would invest time and money in proving a claim in the liquidation. So proofs were not a good proxy for liabilities in this case.

[515] We are also sceptical about the attempt to extrapolate from the value of a subset of the construction bonds on issue at a given time to the likely value of claims in a notional liquidation at that time. There was no evidence to suggest that there is an established relationship between these figures in construction company liquidations, and we doubt very much that there is any general relationship of that kind. There is no reason to think that the ratio observed in the actual liquidation of Mainzeal in 2013 would have been replicated in an earlier liquidation. Indeed there is every reason to think that the outcome could have been quite different. It is not possible to extrapolate a linear relationship from a single point observation. Such an extrapolation is even less reliable in circumstances where there is no consistent relationship as a matter of logic between the two variables. It seems to us that the attempt to estimate likely proofs by contract principals in an earlier liquidation was essentially speculative. Put another way, the margin of error was very large, and the approach adopted by the Judge was no less appropriate than a wide range of other approaches.

[516] In those circumstances, the liquidators have failed to establish that there was a net deterioration in Mainzeal's financial position between January 2011 and early 2013.

[517] We agree with the Judge that the conclusion that a net deterioration was not made out is far from surprising.[230] The trading losses over this two-year period were to a significant extent offset by financial support from the Chinese entities. And the contract book was much smaller at the time of liquidation: some 42 per cent of the book as at 31 January 2011. Other things being equal, one would expect both losses and claims to be significantly lower in those circumstances.

230 High Court Judgment No 1, above n 1, at [539].

[518] We therefore uphold the Judge's finding that the liquidators have not established that there was any recoverable loss on a net deterioration approach.

Compensation based on the new debt approach

The issue

[519] The new debt approach was pleaded and argued by the liquidators as their preferred approach to assessment of compensation for breach of ss 135 and 136. Plainly the company did take on significant new debt between January 2011 and liquidation in early 2013: the liquidators say the relevant figure is $75.21 million. They acknowledged that the $11.659 million that related parties are no longer claiming in the liquidation should be deducted from that figure. So the amount claimed on the new debt approach is $63.551 million.

[520] The critical question is whether, as a matter of law, this is an available approach to assessment of compensation for breach of ss 135 or 136. The Judge did not consider that this approach was available under s 135. He emphasised that the duty was owed to the company, not to individual creditors; any proceeds would be distributed pari passu to unsecured creditors and would not flow to the new creditors; and this was not a case in which the cause of the loss was a decision by the directors to continue to trade a company destined to fail, creating further losses to creditors in doing so.[231]

Submissions on appeal

[521] The liquidators submitted that the new debt approach is the approach that best reflects the policy concern in relation to new creditors dealing with a hopelessly insolvent company, in circumstances where the directors knew or ought to have known that there was a substantial risk that those creditors would not be paid. They said that compensation should be assessed on a basis that is consistent with that policy concern, and that maximises recoveries for those new creditors. Their argument focuses on the second limb of the policy concerns noted above at [233]: exposing new creditors to the abnormal and unacceptable risk of dealing with a company that is insolvent or near-insolvent, without the creditors being alerted to that risk.

[231] At [390]–[391].

[522] The directors adopted the Judge's reasoning. They emphasised that the duty is owed to the company, so compensation should reflect the loss to the company. Where some existing creditors have been paid, the amount of new debt taken on bears no relationship at all to losses suffered by the company. They also emphasised the mismatch between an award on this basis and the identity of the creditors who will benefit from the award. Because any award will be distributed pari passu, existing creditors will receive a windfall and new creditors will be under-compensated. That underscores the inappropriateness of assessing compensation in this manner.

[523] The directors also submitted that assessing liability by reference to new debt incurred would discourage directors from attempting to rescue a company facing temporary financial difficulties, as they would become the effective guarantors of all new obligations undertaken by the company.

[524] Both the liquidators and the directors sought to draw support for their arguments from the recent decision of the Supreme Court in *Debut Homes*. The liquidators submitted that the Supreme Court recognised that it is not an answer to a s 135 claim that trading on had the potential to benefit some creditors, or to reduce the overall deficit.[232] The directors emphasised that the Supreme Court confirmed that in most cases the appropriate starting point for relief for breach of s 135 would be the net deterioration approach "because the section looks at the creditors and the business as a whole".[233]

Analysis

[525] We agree with the liquidators that one of the policy concerns at which ss 135 and 136 are aimed is the risk to new creditors of dealing with hopelessly insolvent companies, in circumstances where the directors should have made the decision to stop trading. There are statutory schemes in other countries that enable directors to be held liable to new creditors in those circumstances.[234]

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232 *Debut Homes*, above n 64, at [72].

233 At [164].

234 See for example Van Zwieten, above n 106, at [14–25], [14–52] and [14–54], discussing the United Kingdom's fraudulent trading regime and compensation orders under the Company Directors Disqualification Act 1986 (UK).

[526] But it seems to us that s 135 is not framed in this way. The focus is on the first type of harm to creditors identified above at [233]: directors deciding to trade on using creditors' money as working capital, and depleting the funds available to meet those creditors' claims. The second type of harm — the enhanced risk to new creditors dealing with an insolvent or near-insolvent company — is addressed more directly by s 136.

[527] As the Judge emphasised, the duty in s 135 is owed to the company, not to creditors. Creditors cannot bring a claim individually, or as a group, in respect of new obligations incurred after the company should have stopped trading. Plainly they cannot do so if the company is not in liquidation. Nor, as discussed above at [308], does s 301 enable a liquidator to bring a claim on behalf of a subset of creditors.

[528] It may be possible to read s 135 as extending to cases where there is a substantial risk of serious loss to a subset of creditors — for example where the directors pursue a deliberate policy of trading on at the expense of some creditors while seeking to repay others. As the Supreme Court said, the potential for benefit to some creditors at the expense of others is not an answer to a s 135 claim. That subset could be "new creditors". On this approach, s 135 could be breached by trading on in circumstances where there is a substantial risk of serious loss to new creditors. But that is not how this case was run. And there are some difficulties with reading s 135 in this way: as the Supreme Court said in *Debut Homes*, the provision looks at the creditors and the business as a whole.[235] We see s 136 as a more promising vehicle for claims that focus on harm to new creditors.

[529] We have therefore concluded, for essentially the same reasons as the High Court Judge, that the new debt approach is not available in relation to a claim for breach of s 135.

[530] However as discussed above, we consider that it follows from *Debut Homes* that the new debt approach is available in relation to a claim for breach of s 136. As the Supreme Court explained, in order to make s 136 work in practice, the new debts incurred in breach of that provision must be treated as a form of harm to the company,

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[235] *Debut Homes*, above n 64, at [164]. See also *Löwer v Traveller*, above n 50, at [89].

disregarding offsetting benefits to the company from the relevant transactions. This approach is not without its difficulties, but is preferable to adopting an approach that renders s 136 a dead letter in many of the cases where its policy rationale is squarely engaged.

[531] Thus, in the present case, compensation assessed on a new debt basis is recoverable by the company from the directors in relation to their breaches of s 136. An award of compensation on this basis fairly reflects the harm done to the new creditors, who would not have had an exposure to the company if the directors had not agreed to the company incurring the relevant obligations in breach of s 136. That harm is treated as harm to the company for the purpose of the s 136 duty, and for the purpose of assessing compensation for breach of that duty.

Quantum and apportionment of liability

[532] The directors appealed from the orders made by the Judge setting their overall liability for breach of s 135 at $36 million and apportioning that liability among them. The liquidators cross-appealed on the basis that the discount allowed to the directors was excessive: liability should not have been reduced from the starting point of $110 million to $36 million. In particular, they argued that the liability of Mr Yan, and of Dame Jenny as Chair, should have been greater.

[533] We need not consider the amount of compensation payable for breach of s 135, as we have concluded that the claim for compensation for breach of that provision fails. However we do need to determine the amount of compensation payable by the directors for their breaches of s 136.

[534] The liquidators claimed $75.21 million on a new debt approach, after allowing for certain adjustments made by Mr Apps at trial. As we understand it, that figure reflects all new debt incurred from 31 January 2011 onwards that remained unpaid as at the date of liquidation. As the liquidators acknowledged before us, that figure needs to be reduced by the $11.659 million not now claimed in the liquidation by related parties. So the amount of new debt claimed by the liquidators is approximately $63.551 million.

[535] It seems likely that a substantial proportion of this figure is represented by obligations in respect of which we have found the directors liable under s 136: claims by principals (or bond providers who have indemnified those principals) in respect of the four significant construction contracts entered into after 31 January 2011, subcontractor retention claims in respect of those contracts, and claims in respect of obligations incurred from 5 July 2012 onwards. But we do not have sufficient information to determine that issue.

[536] The liquidators' figures also do not appear not to include any allowance for dividends paid or payable to the relevant creditors from other recoveries in the liquidation. We consider that only the net deficit to relevant creditors after 31 January 2011, after making an allowance for all payments received by them before liquidation or during the liquidation (other than, of course, as a result of these proceedings), can be recovered for breach of s 136.

[537] The liquidators' figures also do not, as we understand the position, make any allowance for interest since the date of liquidation, and may not make any allowance for interest at all.

[538] We are not in a position to determine the figure that is potentially recoverable for breach of s 136, in light of the outstanding issues identified above at [534]–[537]. The determination of that figure will need to be referred back to the High Court.

[539] The High Court will also need to consider whether the amount that is prima facie recoverable for breach of s 136 should be reduced in the exercise of the s 301 discretion, in light of the issues identified at [303]–[307] above. The Judge previously drew a distinction between Mr Yan and the other directors, but will need to consider whether that remains appropriate in light of our conclusions about their breaches of duty under s 136.

[540] We therefore refer the proceeding back to the High Court to quantify the compensation payable under ss 136 and 301, on the basis of the findings set out in this judgment.

Conclusion

[541] The directors of Mainzeal breached s 135 of the Act by no later than 31 January 2011. They exposed the company's creditors to a substantial risk of serious loss.

[542] But that risk did not materialise, if one looks at the creditors and the business as a whole. There was no net deterioration in the company's position. That is the relevant approach to assessment of compensation for breach of s 135 in this case. The entire deficiency approach is not relevant on the facts of this case, as the breaches for which the directors are liable did not cause the company to become insolvent. The liquidators did not establish on the balance of probabilities that liquidation would have been avoided if the directors had not breached their s 135 duties. Nor was this an approach pursued by the liquidators in the High Court: we consider it would not be fair to impose liability on the basis of an entire deficiency approach in circumstances where that approach to quantifying the claim was not pleaded, and was not the subject of relevant fact and expert evidence. Nor is the new debt approach available in s 135 claims, as the law currently stands.

[543] It follows that no compensation is recoverable in respect of the breach of s 135 under s 301 of the Act.

[544] The directors also breached s 136 of the Act by entering into certain new obligations after 31 January 2011: four significant long-term obligations to contract principals entered into after 31 January 2011, associated obligations to subcontractors, and all obligations entered into from 5 July 2012 onwards. The directors believed the company would be able to meet those obligations when they fell due, but they did not have reasonable grounds for that belief. They are liable to pay compensation to the company in respect of those breaches, assessed on a new debt approach.

[545] The result is thus that the directors' appeals in relation to the High Court compensation award succeed. The liquidators' cross-appeals also succeed. The liquidators are entitled to orders for payment of compensation on the basis outlined above, to be quantified by the High Court.

Costs

[546] The conclusion we have reached in relation to liability to pay compensation also means that the arguments advanced before us about the costs consequences of the outcome in the High Court are no longer relevant. The High Court will need to determine costs in light of our findings.

[547] In this Court, the directors failed to overturn the finding that they breached s 135, and were found to have breached s 136. The directors were successful in relation to compensation for their breaches of s 135, but were found liable to pay compensation for their breach of s 136 on a new debt approach, to be quantified by the High Court. The liquidators were the successful party in relation to liability, and have established that they are entitled to an award of compensation in respect of the directors' breaches. In these circumstances, we consider that the liquidators were substantially successful in this Court. There should be no award of costs in respect of the appeal, but the liquidators should receive costs in respect of the cross-appeal, assessed on the basis that the cross-appeal occupied three days of hearing time. We therefore award costs to the liquidators for a three-day complex appeal on a band B basis, with usual disbursements. We certify for second counsel.

Result

[548] The appellants' application in CA113/2019 and CA119/2019 for leave to adduce further evidence is declined.

[549] The appeals are allowed.

[550] The cross-appeals are allowed.

[551] The orders made in the High Court are set aside.

[552] The appellants must pay compensation to the first respondent under s 301 of the Act on the basis set out above at [534]–[539] . The proceedings are referred back to the High Court to determine the amount of compensation payable on that basis.

[553] Costs in the High Court are to be determined in that Court.

[554] The appellants must pay one set of costs for a three-day complex appeal on a band B basis to the liquidators, with usual disbursements. We certify for second counsel.

Solicitors:
LeeSalmonLong, Auckland for Appellant in CA113/2019 and CA373/2019, and Third Respondent in CA119/2019
MinterEllisonRuddWatts, Auckland for First to Fourth Respondents in CA113/2019 and CA373/2019, and First and Second Respondents in CA119/2019
Chapman Tripp, Auckland for Fifth to Tenth Respondents in CA113/2019 and CA373/2019, and First to Third Appellants in CA119/2019

Glossary of Defined Terms

1933 Act	Companies Act 1933
1955 Act	Companies Act 1955
Act	Companies Act 1993
BNZ	Bank of New Zealand
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CHC	"Chinese Holding Company" / Richina Pacific (China) Investment Ltd
Dame Jenny	Dame Jennifer Shipley
EBIT	Earnings Before Interest and Taxes
Isola	Isola Vineyards Ltd
King Façade	King Façade Ltd
Mainzeal	Mainzeal Property and Construction Ltd
Mainzeal Group	Mainzeal Group Ltd (incorporated in 1987)
MGL	Mainzeal Group Ltd (established as immediate holding company for Mainzeal in 2012)
MIT	Manukau Institute of Technology
MLG	MLG Ltd
PwC	PriceWaterhouseCoopers
REH Capital	REH Capital Ltd
RGREL	Richina Global Real Estate Ltd (previously named Richina Land (NZ) Ltd)
Richina Holdings (BVI)	Richina Holdings (BVI) Ltd
Richina Pacific	Richina Pacific Ltd (incorporated in Bermuda)
SAFE	State Administration of Foreign Exchange
SBLC	Standby Letters of Credit
Siemens	Siemens (N.Z.) Ltd
Sir Paul	Sir Paul Collins
SLC	Shanghai Leather Co Ltd
Third ASC	Third amended statement of claim filed in July 2018
Vero	Vero Insurance

APPENDIX A

Register of Cash Flows between Richina Companies and Mainzeal from 1 January 2010

Date of transfer	Amount of transfer cash in/(cash out)	Approx Balance c/f	Reason for transfer	Approval request to Board
		(1,325,628)	C/F ex 2009	14/12/2009
11/02/2010	(357,143)	(1,682,771)	Tsfr USD250k to RPL	11/02/2010
5/03/2010	1,100,000	(582,771)	Advance ex Richina Ltd facility	Part of facilities
8/03/2010	(100,000)	(682,771)	Funding of expenses	8/03/2010
10/03/2010	550,000	(132,771)	Advance ex Richina Ltd facility	Part of facilities
26/03/2010	(141,844)	(274,615)	Advance to Richina Land	
26/03/2010	(1,655,089)	(1,929,704)	Repayment of Richina Ltd facility	Part of facilities
29/03/2010	1,418,037	(511,667)	Short term advance from Richina Ltd	
30/03/2010	(100,000)	(611,667)	Funding Richina Ltd expenses	30/03/2010
14/04/2010	(100,000)	(711,667)	Funding Richina Ltd expenses	14/04/2010
19/05/2010	(31,429)	(743,095)	Funding US$22k to RPL	
14/06/2010	(1,276,415)	(2,019,510)	Part and total repayment of advance made on 29 March	
14/06/2010	(1,449,275)	(3,468,785)	Advance to Richina Land to be repaid on 18 June	
18/06/2010	1,449,275	(2,019,510)	Repayment of advance made on 14 June	
13/07/2010	(1,200,000)	(3,219,510)	Request for advance for 1 month	13/07/2010
16/08/2010	(1,200,000)	(4,419,510)	Request for further advance	12/08/2010
7/09/2010	677,000	(3,742,510)	Repay US500k (which was sold)	
14/09/2010	(2,000,000)	(5,742,510)	Temporary Advance with US$1.4m rec'd back	11/09/2010
16/09/2010	1,000,000	(4,742,510)	Repayment	
17/09/2010	816,419	(3,926,091)	Repayment	
20/09/2010	179,184	(3,746,907)	Repaymnt- Deposit for Crane paid on behalf	
19/10/2010	(200,000)	(3,946,907)	Advance for Richina	
22/11/2010	456,742	(3,490,165)	Repaymnt- 65% for Crane paid on behalf	
30/11/2010	326,087	(3,164,078)	GST Refund on Waikehe	
17/12/2010	64,474	(3,099,605)	Profitool License fees - paid on behalf	
31/12/2010	(288,100)	(3,387,705)	Richina Salaries paid on behalf for 2010	
31/12/2010	(47,000)	(3,434,705)	Misc expenses to date for Waikehe Developmnts	
31/12/2010	5,300,000	1,865,295	Repaymnt ex MLG/Richina	
5/01/2011	(2,000,000)	(134,705)	Tsfr to MLG	
7/01/2010	*(208,333)*	(343,038)	*Tsfr US150k to Richina (backed by LC)*	
18/01/2011	*(1,369,863)*	(1,712,901)	*Tsfr US1m to SRL (backed by LC)*	
10/01/2011	(500,000)	(2,212,901)	Tsfr to Richina	
27/01/2011	(500,000)	(2,712,901)	Tsfr to Richina	
11/02/2011	*(277,778)*	(2,990,679)	*Tsfr US200k to Richina (backed by LC)*	
10/03/2011	*(810,811)*	(3,801,489)	*Tsfr US$600k to Richina (backed by LC)*	
25/03/2011	(2,300,000)	(6,101,489)	Tsfr to Richina	
20/04/2011	(856,368)	(6,957,857)	Tsfr to Richina	
2/05/2011	(100,000)	(7,057,857)	Tsfr to Richina	
31/05/2011	(49,162)	(7,107,019)	Waikehe costs since 31 Dec	
7/06/2011	(100,000)	(7,207,019)	Tsfr to Richina	
30/06/2011	(57,124)	(7,264,143)	Waikehe costs June	
4/07/2011	(100,000)	(7,364,143)	Tsfr to Richina	
31/07/2011	(56,047)	(7,420,190)	Waikehe costs July	
4/08/2011	(100,000)	(7,520,190)	Tsfr to Richina	
31/08/2011	(158,676)	(7,678,866)	Waiheke costs July	
30/09/2011	(124,235)	(7,803,101)	Waiheke/Richina costs Sept	
31/10/2011	(87,233)	(7,890,334)	Waiheke/Richina costs Oct	
30/11/2011	(140,844)	(8,031,178)	Waiheke/Richina costs Nov	
31/12/2011	(261,145)	(8,292,323)	Waiheke/Richina costs Nov	
31/12/2011	259,200	(8,033,123)	Richina Ltd repayment	
31/12/2011	3,164,556	(4,868,567)	MLG repayment	
31/12/2011	2,944,563	(1,924,005)	MLG repays US facility	
29/02/2012	(257,812)	(2,181,817)	Waiheke Vineyards funding	
2/01/2012	74,898	(2,106,919)	Richina advances	
27/03/2012	(500,000)	(2,606,919)	MLG Advance	
30/04/2012	(256,740)	(2,863,659)	Waiheke Vineyards funding	
30/04/2012	(255,502)	(3,119,161)	Richina expense paid (4 mths)	

Date	Goods paid for in China on account	Accumulated Balance	Remarks
1/07/2010	123,400	123,400	Baradene
1/10/2010	260,000	383,400	Car Stacker
1/12/2010	870,000	1,253,400	Car Stacker
1/12/2010	282,200	1,535,600	Rotorua Hospital
21/05/2010	897,000	2,432,600	Car Stacker
21/05/2010	447,200	2,879,800	Geyser
30/09/2011	690,000	3,569,800	Geyser
31/10/2011	600,000	4,169,800	Geyser
30/11/2011	1,200,000	5,369,800	Geyser
24/02/2012	1,200,000	6,569,800	Geyser
29/02/2012	600,000	7,169,800	Geyser/Otahuhu
20/03/2012	800,000	7,969,800	Geyser/Otahuhu/Mainzeal House

Approx Net cash balance since Jan 2009		
ex Intcoy	(3,119,161)	
ex China Materials	7,969,800	Note this is still incomplete at time of print
	4,850,639	

APPENDIX B

Table 22

Adjusted net asset position

As at 31 December	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Current assets	84,196	72,669	74,381	74,781	84,315	107,734	87,926	97,370
Current liabilities	(86,686)	(67,182)	(63,130)	(59,397)	(66,452)	(84,578)	(98,091)	(123,712)
Net working capital	(2,490)	5,487	11,251	15,384	17,863	23,156	(10,165)	(26,342)
Non-current assets	44,053	12,289	17,826	13,584	13,347	8,758	37,977	38,235
Non-current liabilities	(41,011)	(2,429)	(2,621)	(7,740)	(6,699)	(5,644)	(8,704)	(5,655)
Reported net assets (parent)	**552**	**15,347**	**26,456**	**21,228**	**24,511**	**26,270**	**19,108**	**6,238**
Less: RGRE (RLL)	(12,683)	(14,604)	(14,719)	(11,169)	(11,787)	(11,964)	(14,504)	(131)
Less: MLG	(20,260)	(22,173)	(24,679)	(27,936)	(30,321)	(30,030)	-	-
Less: Prepaid Building Materials	-	-	-	-	-	-	(33,346)	(27,037)
Less: KF(NZ)L	-	-	-	(300)	(689)	(954)	(1,719)	(15,018)
Less: KFL	-	-	-	-	-	(1,106)	(5,617)	(6,548)
Less: MLL	-	-	-	-	-	-	(537)	(1,716)
Less: MGL	-	-	-	-	-	-	-	(17,109)
Plus: Midland Tower payable forgiven	37,301	-	-	-	-	-	-	-
Less: shares in subsidiary written off	(30,000)	-	-	-	-	-	-	-
less: related party and intercompany accounts	**(25,642)**	**(36,778)**	**(39,398)**	**(39,405)**	**(42,797)**	**(44,054)**	**(55,723)**	**(67,559)**
Adjusted net assets	**(25,090)**	**(21,431)**	**(12,942)**	**(18,177)**	**(18,286)**	**(17,784)**	**(36,615)**	**(61,321)**

APPENDIX C

Table 3 – Financial performance Year ended 31 December	2005	2006	2007	2008	2009	2010	2011	2012
	Stats[36]	**Stats**[37]	**Stats**[38]	**Stats**[39]	**Stats**[40]	**Stats**[41]	**Stats**[42]	**Mgmt Accs**[43]
All $ amounts in $'000's								
Revenue from Construction Contracts	**432,244**	**451,928**	**288,656**	**269,993**	**378,823**	**340,742**	**382,080**	**333,292**
Cost of Sales	(428,485)	(431,142)	(269,284)	(256,428)	(363,055)	(321,200)	(364,605)	(321,654)
Gross Profit	**3,760**	**20,786**	**19,372**	**13,564**	**15,768**	**19,542**	**17,475**	**8,639**
Gross margin	*0.9%*	*4.6%*	*6.7%*	*5.0%*	*4.2%*	*5.7%*	*4.6%*	*3.5%*
Other Income	212	-	-	3,652	220	-	1,257	-
Forgiveness of debt	-	37,290	-	-	-	-	-	-
Investment write-off	-	(30,000)	-	-	-	-	-	-
PPP Bid Costs	-	-	-	-	-	-	(4,440)	-
Legal expenses	-	-	-	-	-	(3,717)	(5,063)	-
Undisclosed expenses [note 1]	(799)	-	-	-	-	-	-	-
General and administrative expenses	(16,115)	(15,912)	(16,847)	(19,622)	(15,135)	(16,846)	(19,356)	(21,841)
Operating Profit (at the level of EBIT)	**(12,143)**	**12,164**	**2,525**	**(2,406)**	**854**	**(1,021)**	**(10,126)**	**(13,202)**
Finance income	5,411	2,688	3,026	3,498	3,406	2,799	3,077	375
Finance costs	(1)	(56)	(488)	(276)	(976)	(20)	(111)	(349)
Finance income – net	**5,411**	**2,632**	**2,539**	**3,222**	**2,431**	**2,779**	**2,966**	**26**
Profit before income tax	**(7,533)**	**14,795**	**5,063**	**816**	**3,284**	**1,758**	**(7,161)**	**(13,176)**
Income tax (expense)/credit	-	-	6,045	(6,045)	-	-	-	-
(Loss)/Profit for the year	**(7,533)**	**14,795**	**11,108**	**(5,229)**	**3,284**	**1,758**	**(7,161)**	**(13,176)**

Note 1: The 2005 comparative figures in the 2006 financial statements do not appear to add correctly. I have assumed that this is because of undisclosed expenses of $799,000

APPENDIX D