IN THE COURT OF APPEAL OF NEW ZEALAND

I TE KŌTI PĪRA O AOTEAROA

CA427/2022
[2023] NZCA 410

BETWEEN	MANAS DHARMENDRA KUMAR Appellant
AND	SMARTPAY LIMITED Respondent

Hearing: 25 July 2023

Court: Collins, Lang and Woolford JJ

Counsel: Appellant in person
D J Chisholm KC and J D Ryan for Respondent

Judgment: 31 August 2023 at 9.30 am

JUDGMENT OF THE COURT

A The appeal is dismissed.

B The appellant is to pay the respondent costs for a standard appeal on a band A basis together with usual disbursements. We certify for two counsel.

REASONS OF THE COURT

(Given by Collins J)

Introduction

[1] Mr Kumar's appeal challenges two judgments of the High Court in which Downs J concluded Mr Kumar is liable to pay $850,427 to the liquidators of

Optimizer Corporation Ltd (OCL).[1] This was the loss claimed by Smartpay Ltd (Smartpay), a creditor of OCL, arising from what the High Court found were Mr Kumar's breaches of three sections of the Companies Act 1993 (the Act) when he was a director of OCL.[2]

[2] The three sections of the Act that Mr Kumar was found to have breached, are:

(a) Section 131, which concerns the duty of a director to act in good faith and in what the director believes to be the best interests of the company.

(b) Section 135, which prohibits a director from allowing a company to carry on business in a manner likely to create a substantial risk of serious loss to the company's creditors.

(c) Section 136, which provides a director must not agree to the company incurring obligations unless he or she reasonably believes at the time that the company will be able to perform its obligations when required to do so.

We will explain these and other provisions of the Act in further detail at [35] to [66].

[3] In addition to disputing that he breached the Act, Mr Kumar maintains the High Court miscalculated the amount of Smartpay's losses.

Background

[4] The litigation focuses upon three companies:

(a) OCL, which was incorporated on 5 June 2013 and placed into liquidation on 10 December 2015.

(b) Odev Ltd (Odev), which was incorporated on 21 January 2005 and also placed into liquidation on 10 December 2015.

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1 *Smartpay Ltd v Kumar* [2022] NZHC 997 [Interim judgment]; and *Smartpay Ltd v Kumar* [2022] NZHC 2685 [Quantum judgment].

2 Interim judgment, above n 1, at [42].

(c) Optimizer HQ Ltd (HQ), which was incorporated on 11 April 2013 and placed into liquidation on 27 November 2020.

Together, these three companies shall be referred to as the group of companies.

[5] At all relevant times Mr Kumar was the managing shareholder of HQ, the sole director of Odev, and a director of OCL. When OCL was incorporated it issued 1,000 shares at $1 per share. All of OCL's shares were owned by HQ.

[6] Odev developed a product called Swipe HQ, which was a debit and credit card system that enabled merchants to process Eftpos transactions through a mobile Eftpos terminal.

[7] Two agreements are central to the dispute.

Spark agreement

[8] Pursuant to the first agreement, dated 28 May 2014, OCL provided Spark NZ Ltd with the right to market and sell Swipe HQ and supplied Spark with mobile Eftpos terminals. This agreement was for one year. No fee was payable by Spark to OCL. It appears to have been assumed that OCL would gain revenue from Spark's clients who used the Swipe HQ system.

Smartpay agreement

[9] Under the second agreement, dated 18 September 2014, Smartpay, which makes and supplies Eftpos terminals, agreed to supply OCL with Eftpos terminals. Specifically:

(a) Under cl 6.1 and schedule 1 of the agreement, OCL was to rent Eftpos terminals from Smartpay and pay Smartpay $48 per terminal, a fee of $18 per month for each terminal and 0.35 per cent (plus GST) of the "Gross Transaction Value from credit cards processed through the [Eftpos] Terminals per month".

(b) Under cl 3, the agreement between OCL and Smartpay was for two years.

Both agreements were signed by Mr Kumar on behalf of OCL.

[10] In addition to the Spark and Smartpay agreements, OCL entered into other significant financial commitments, including the lease of commercial premises for a five-year period commencing 1 March 2015 at an annual rent of $103,327 plus GST. This lease followed an earlier lease that OCL had executed for the same premises on 30 September 2014.

[11] Contrary to the assumption that underpinned the Smartpay agreement, OCL received no revenue from Spark's clients. Rather, revenue generated from the Spark agreement went to HQ. In reality, OCL had no revenue and was dependent on HQ or Odev to meet its obligations to its creditors, including Smartpay.

[12] The gravamen of Smartpay's claim against Mr Kumar is that he allowed OCL to incur significant liabilities knowing that it had no revenue or meaningful assets and was therefore not in a position to meet its liabilities and obligations to Smartpay.

[13] In 2014, OCL began to default on its obligations to provide Spark with Swipe HQ and mobile Eftpos terminals. OCL also began to default in its obligation to pay Smartpay the debts it owed Smartpay under the Smartpay agreement. As a consequence:

(a) Spark terminated the Spark agreement on 22 May 2015.

(b) Smartpay began to issue OCL with statutory demands, some of which were paid by Odev and a shareholder of Odev. Ultimately, however, HQ placed OCL and Odev into liquidation on 10 December 2015.

High Court judgment

[14] Following a four-day hearing during which Mr Kumar was represented by senior counsel, Downs J issued an interim judgment in which he made the following key factual findings:[3]

> [41] First, OCL had no assets beyond the $1,000 it presumably received for its shares. So, as soon as OCL incurred liabilities of more than $1,000, it became balance sheet insolvent. Second, OCL had no revenue. So, as soon as OCL incurred liabilities, it became cashflow insolvent. Third, OCL was, therefore, balance sheet and cashflow insolvent from near inception. OCL cannot have been other than insolvent in both respects when it entered the Spark agreement [on] 28 May 2014. Fourth, the revenue anticipated to OCL by the Spark agreement went not to OCL, but HQ. Fifth, OCL was therefore reliant on others—HQ, Odev or both—to meet its obligations under the Spark agreement. Indeed, OCL was reliant on others to meet every obligation it had, including those to Smartpay under the Smartpay agreement. Sixth, OCL had no legally enforceable means of securing financial help from HQ or Odev. So, at all material times, OCL was (a) insolvent; and (b) absent legally enforceable aid. Seventh, in testimony, Mr Kumar acknowledged he did not consider OCL's interests, only the interests of the group. Mr Kumar also acknowledged, again in testimony, OCL gained *nothing* by entering the Spark agreement. Eighth, Mr Kumar's interests conflicted in these circumstances: he was a director of every company in the group; the majority shareholder of HQ; and HQ wholly owned OCL.

[15] The Judge was satisfied Mr Kumar "unquestionably breached" ss 131, 135 and 136 of the Act and that he failed to understand his duties as a director of OCL. Instead of focusing on his responsibilities to OCL Mr Kumar believed it sufficient to consider the interests of the group of companies as a whole.[4]

[16] Downs J conducted a second hearing in relation to quantum. By that stage Mr Kumar was no longer represented by counsel and he did not appear at the second hearing.[5] In assessing liability under s 301(1)(b)(ii) of the Act, Downs J relied on the evidence of Smartpay's Chief Business Officer, and Mr Van Delden, the liquidator of OCL. In his quantum judgment, Downs J summarised the evidence in relation to quantum in the following way:

> [3] … Smartpay supplied OCL 2161 terminals, of which 1002 were recovered or returned to Smartpay. So, 1159 terminals remain outstanding at a cost of $345 per terminal—a total of $399,855. To this must be added two

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3 Interim judgment, above n 1 (footnotes omitted).
4 At [42].
5 Quantum judgment, above n 1, at [4] and [7]–[8].

> amounts. First, what Smartpay was owed by OCL at the date of its liquidation: $120,407.43. Second, post-termination fees payable by OCL to Smartpay under the distribution agreement. These come to $330,165. The three sums total $850,427.43, a figure the liquidators have accepted.

Accordingly, Downs J ordered Mr Kumar to pay $850,427.43 (plus interest) to the liquidators by way of compensation.[6]

Grounds of appeal

[17] Mr Kumar appeared for himself in this Court. He did so by way of AVL from India. Mr Kumar filed very comprehensive written submissions and argued his appeal with considerable diligence.

[18] Mr Kumar appeared to accept that OCL by itself had no assets or income. He submitted, however, that when the assets of HQ and Odev were factored into the equation, the financial position of the group of companies as a whole was very secure.

[19] Mr Kumar said, by way of example, that between 2013 and 2015 HQ raised a total of $9.912 million in fresh capital from local and offshore investors. He contended that while there was no documentary evidence of the financial interdependency of the three companies, the following three factors, at least implicitly, provided him with a "Tripod of Confidence" in OCL's abilities to meet its debts and obligations:

(a) the overall financial strength of the company;

(b) the business partnerships that were in place; and

(c) the potential for business growth.

[20] When inviting us to consider the substance of the financial viability of the overall group of companies Mr Kumar drew attention to the judgment of Lord Reed P in *BTI 2014 LLC v Sequana SA* [*Sequana*].[7] We shall explain that judgment when discussing the relevant legal principles.

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[6] At [12(a)].

[7] *BTI 2014 LLC v Sequana SA* [2022] UKSC 25, [2023] 2 All ER 303 [*Sequana*].

Section 131 Companies Act

[21] In relation to the claim under s 131 of the Act, Mr Kumar argued:

(a) The High Court failed to properly consider s 131(2) of the Act, which provides that where a company is a wholly owned subsidiary, the director of the subsidiary can consider the best interests of the holding company when the constitution of the subsidiary company permits that course of action, even though such an approach may not be in the best interests of the subsidiary company.

(b) A subsidiary company cannot be considered insolvent when its circumstances equate to those in *Sequana*.

(c) The High Court erred when it rejected Mr Kumar's testimony that he acted in good faith.

(d) OCL did generate revenue, although it was not recorded as such in its accounts.

Section 135 Companies Act

[22] In addition to repeating many of the points raised in relation to s 131 of the Act, Mr Kumar submitted:

(a) He had no reason to think that OCL was unable to meet its obligations, particularly in light of the ability of HQ to raise capital and the "Tripod of Confidence" concerning the viability of the overall group of companies.

(b) The argument that OCL had no way of compelling HQ and or Odev to lend assistance to OCL was a "narrow technical view" because HQ and Odev often met OCL's obligations.

Section 136 Companies Act

[23] In addition to the submissions raised in relation to the claims under ss 131 and 135 of the Act, Mr Kumar said that the distribution agreement involved Spark clients being billed in advance, $399 for each device. Hence, Mr Kumar submitted, he did not breach s 136 of the Act because he had every reason to believe OCL could meet its obligations when required to do so.

Causation

[24] In a separate argument that applied to all three claims, Mr Kumar said that there was a high failure rate among the devices supplied by Smartpay and that as a consequence, the actions of OCL did not cause the losses alleged by Smartpay.

Miscellaneous matters

[25] At the commencement of the trial, Downs J declined to receive evidence from Mr Damien Grant, an insolvency practitioner, whom Mr Kumar wished to rely upon. The Judge was not satisfied Mr Grant had the requisite experience to be an expert in this case and, in any event, parts of Mr Grant's evidence were problematic because of its partisan nature and therefore not substantially helpful.[8] Mr Kumar submits that the evidence of Mr Graham, Smartpay's expert witness at trial, should have also been excluded.

Quantum

[26] Mr Kumar submitted that a separate hearing on quantum was only required because significant discrepancies emerged at trial concerning Smartpay's alleged losses. Mr Kumar contended that the way the High Court Judge went about considering quantum constituted a breach of due process and that the Judge over-assessed Smartpay's losses.

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[8] Interim judgment, above n 1, at [52]–[65].

Summary of respondent's case

[27] It is not necessary for us to explain in any depth the comprehensive submissions made on behalf of Smartpay by Mr Chisholm KC.

[28] Mr Chisholm submitted that Mr Kumar had misstated important parts of the evidence and that there was no doubt OCL had no income and did not itself benefit from the way the group's businesses were structured.

Section 131 Companies Act

[29] In relation to the claim under s 131 of the Act, Mr Chisholm contended Mr Kumar's obligation was to OCL and that he could not simply rely on unenforceable possibilities of support from HQ and Odev to excuse his failure to discharge his obligations as a director of OCL.

Section 135 Companies Act

[30] Mr Chisholm's primary point in relation to s 135 of the Act was that it was not reasonable for Mr Kumar to rely on voluntary support from HQ and Odev.

Section 136 Companies Act

[31] The arguments in relation to s 136 of the Act substantially overlapped with those in relation to ss 131 and 135 of the Act.

Miscellaneous matters

[32] Smartpay argued that Mr Grant did not meet the qualifications for being an expert witness in this case.

Quantum

[33] Similarly, it was submitted on behalf of Smartpay that the process followed to determine quantum and the calculation of quantum was unimpeachable.

Relevant legal principles

[34] We shall now explain further the three key provisions of the Act that we have summarised at [2] as well as other parts of the Act that are relevant to the claim.

Section 131 Companies Act

[35] Sections 131(1) and (2) state:

> **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.
>
> …

[36] In *Madsen-Ries v Cooper* [*Debut Homes*],[9] the Supreme Court analysed the duties of directors under ss 131, 135 and 136 of the Act. The Court observed that "the interests of creditors have to be considered where the company is insolvent or nearly insolvent."[10]

[37] When explaining the application of s 131 of the Act, the Supreme Court took advantage of the opportunity to dispel early suggestions that s 131 involved an amalgam of objective standards and subjective criteria.[11] The Court said:[12]

> [112] … The test [under s 131] is subjective. This follows from the wording of s 131 (expressed subjectively) and the legislative history … This aligns with the common law test and policy considerations. Courts are not well equipped, even with the benefit of expert evidence, to second-guess the business decisions made by directors in what they honestly believed to be in

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9 *Madsen-Ries (as liquidators of Debut Homes Ltd (in liq)) v Cooper* [2020] NZSC 100, [2021] 1 NZLR 43 [*Debut Homes*].

10 At [31], citing *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 (CA) at 250 and 255; *Sojourner v Robb* [2006] 3 NZLR 808 (HC) at [102]. .

11 See for example, *Sojourner v Robb*, above n 10, at [102].

12 *Debut Homes*, above n 9 (footnote omitted).

> the best interests of the company. The courts would also be judging directors' decisions with all the dangers of judging with the benefit of hindsight. …

[38] The Supreme Court also explained however, that although the test under s 131 of the Act is subjective, the section may be breached, for example:[13]

> (a) where there is no evidence of actual consideration of the best interests of the company;
>
> (b) where, in an insolvency or near-insolvency situation, there is a failure to consider the interests of creditors;
>
> (c) where there is a conflict of interest or where the action was one no director with any understanding of fiduciary duties could have taken …

Sequana

[39] As we have noted at [20], Mr Kumar placed weight on the judgment of the United Kingdom Supreme Court in *Sequana*. In particular, Mr Kumar drew comfort from the following passage from Lord Reed P:[14]

> [46] … The interests of a company, an artificial person, cannot be distinguished from the interests of the persons who are interested in it. Who are those persons? Where a company is both going and solvent, first and foremost come the shareholders, present and no doubt future as well. How material are the interest of creditors in such a case? Admittedly existing creditors are interested in the assets of the company as the only source for the satisfaction of their debts. But in a case where the assets are enormous and the debts minimal it is reasonable to suppose that the interests of the creditors ought not to count for very much.
>
> [47] … So long as a company is financially stable, and is therefore able to pay its creditors in a timely manner, the interests of its shareholders as a whole, understood as a continuing body, can be treated as the company's interests for the purposes of the directors' duty to act in its interests. It is the shareholders whose interests are affected by fluctuations in its profits and reserves, as they are the persons entitled to share in its distributions and its surplus assets. … [S]o long as the company is financially stable, the creditors' interests do not require to be considered as a discrete aspect of the company's interests for the purposes of the directors' fiduciary duty to the company. It is sufficient for the directors to promote the interests of the shareholders in order for the company's business to be carried on over the long term and for the company's debts to be paid as part of the conduct of its business.
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> [48] That situation alters if the company is insolvent or bordering on insolvency. As losses are incurred, and the company's surplus of assets over liabilities disappears, the company's creditors as a whole become persons with

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13 At [113].

14 *Sequana,* above n 7, citing *Brady v Brady* [1988] BCLC 20 at 40 per Nourse LJ.

> a distinct interest (possibly, depending on the gravity of the company's financial difficulties, the predominant interest) in its affairs, as they are dependent on its residual assets, or on the possibility of a turnaround in its fortunes, for repayment. I refer to the creditors 'as a whole' for two reasons. First, individual creditors may be in different positions, and may even have conflicting interests: that may be the position, for example, of secured creditors as compared with unsecured creditors. Secondly, the interests of the company cannot be confined to the interests of current creditors as at the time of a given decision by the directors, any more than they can be confined to the interests of current shareholders. Since the identities of the company's creditors constantly change so long as debts continue to be incurred and discharged, any consideration of the company's long term interests … must include consideration of the interests of its creditors as a class rather than as a fixed group of individuals.

[40] Properly understood however, that judgment does not provide the panacea that Mr Kumar suggested. In *Sequana*, the Court considered the scope of s 214 Insolvency Act 1986 (UK) which has some similarities to ss 135 and 136 of the Act.

[41] Section 214 of the Insolvency Act (UK) states:

> **214 Wrongful trading**.
>
> (1) Subject to subsection (3) below, if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.
>
> (2) This subsection applies in relation to a person if—
>
> (a) the company has gone into insolvent liquidation,
>
> (b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation or entering insolvent administration, and
>
> (c) that person was a director of the company at that time;
>
> but the court shall not make a declaration under this section in any case where the time mentioned in paragraph (b) above was before 28th April 1986.
>
> (3) The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him that person took every step with a view to minimising the potential loss to the company's creditors as (on the assumption that he had knowledge of the matter mentioned in subsection (2)(b)) he ought to have taken.

…

[42] As we shall explain when discussing ss 135 and 136 of the Act, the United Kingdom Supreme Court recognised in *Sequana* that directors have a common law duty to the company that includes considering the interests of the company's creditors where the company faces imminent insolvency or insolvent liquidation is probable.[15] It is only when insolvent liquidation becomes inevitable that the interests of creditors become paramount.[16] It will be noted that s 214 is engaged only if a director knew, or ought to have known there was no reasonable prospects of avoiding insolvent liquidation.

[43] Last week, the Supreme Court in *Yan v Mainzeal Property and Construction Ltd (in liq)* [*Mainzeal*] affirmed that:[17]

> [142] … the courts have also recognised that in circumstances of doubtful solvency, actual insolvency or inevitable insolvent liquidation, directors may be required to have regard to the interests of creditors … [although] any requirement to have regard to the interests of creditors was a subset of the duties owed by directors to the company.

[44] *Mainzeal* had some similarities to the case before us. Mainzeal became insolvent when, contrary to the expectations of its directors, a related overseas company did not provide financial support for Mainzeal.

[45] The Supreme Court also discussed in some detail the reasoning in *Sequana* in relation to consideration of the interests of creditors, highlighting the key policy considerations as follows:[18]

> [180] … A policy consideration that underlies the *Sequana* reasoning is that as the financial affairs of a company deteriorate the economic stake (which is not a proprietary interest) that the creditors have in the company's residual asset increases. As will become apparent, we see this policy consideration as underpinning ss 135 and 136 and 301. …

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15 *Sequana,* above n 7, at [48]–[51].

16 At [50] per Lord Reed P; [171]–[176] per Lord Briggs and Lord Kitchin; and [222]–[227] per Lord Hodge DP.

17 *Yan v Mainzeal Property and Construction Ltd (in liq)* [2023] NZSC 113 [*Mainzeal* (SC)]. See also [143] where the Supreme Court discusses *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 (CA); *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 (NSWCA); and *West Mercia Safetywear Ltd (in liq) v Dodd* [1988] BCLC 250 (CA).

18 Footnote omitted.

[46] In relation to the finding in *Sequana* that the interests of creditors become *paramount* when insolvent liquidation is inevitable, the Supreme Court in *Mainzeal* stated that:[19]

> We are not called upon in this case to decide whether, and at what point, the interests of creditors become paramount. Rather we are required to interpret and apply ss 135 and 136. We propose to do this on the basis that, **in the circumstances in which those sections are likely to be engaged, directors are required to have at least substantial regard for the interests of creditors,** a policy consideration that is plainly material to the way those sections should be applied.

[47] The Supreme Court's conclusion is that a lower level of consideration applies for creditors once ss 135 and 136 are engaged – being "substantial regard" rather than their interests becoming "paramount" as in *Sequana*. However, this must be read in context. The Supreme Court stated that the relevant liability threshold in the UK is "distinctly higher than that implied by… s 135", which is "likely to occur **before** liquidation becomes practically inevitable".[20]

[48] Therefore, *Sequana* is not as helpful to him as Mr Kumar submitted. Section 135 will generally be triggered earlier than the UK provision. Once s 135 is triggered, "significant regard" must be given to the interests of creditors. However, this does not preclude the application of the finding in *Sequana* that once insolvent liquidation is practically inevitable – which may occur *after* the s 135 threshold is passed – the interests of creditors become paramount.

[49] The conclusions in *Mainzeal* and *Sequana* coexist, to create a sliding scale of consideration that must be given to the interests of creditors starting with "significant regard" once s 135 is triggered, and moving towards paramountcy as the company gets closer to insolvent liquidation. This is entirely consistent with the policy rationale described by the Supreme Court at [45], that "as the financial affairs of a company deteriorate the economic stake … that the creditors have in the company's residual asset increases."[21]

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[19] At [184(a)] (emphasis added).
[20] At [182] and [182(a)] (emphasis added).
[21] At [180].

Section 135 Companies Act

[50] Section 135 of the Act provides:

> **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.

[51] The scope of s 135 of the Act was also discussed by the Supreme Court in *Mainzeal*. The Supreme Court came to the following conclusions in relation to s 135:[22]

> (a) An objective approach is to be taken in determining whether the business of the company was carried on in the prohibited manner (so that subjective awareness of the likelihood of substantial risk or serious loss is not necessary).
>
> (b) However, when assessing whether the actions of the directors in agreeing to, or causing or allowing that trading were in breach of s 135, the courts will proceed on the basis of those facts and circumstances of which the directors were aware, or should have been aware, if exercising appropriate care, skill and diligence.

[52] The Court made the following observations in relation to the wording of s 135; "likely to create a substantial risk of serious loss to the company's creditors":

> [198] "Risk" generally is a product of the probability of an adverse contingency occurring and the severity of the consequences of that contingency should it occur. In this context, "substantial" refers to probability of loss to creditors and "serious" to the extent of that loss. For this reason, "likely" might be thought to introduce an element of tautology. However, in company with Cooke J and the Court of Appeal, we see it as adding emphasis to the probability of substantial risk of serious loss.
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> [199] In most circumstances, a risk of the magnitude just described will engage s 135. This is appropriate as those who extend credit to a company will generally not anticipate exposure to risk that goes beyond the usual vagaries of commercial life. That said, the business of a company may carry a recognised heightened risk of loss — in respect of which potential creditors (or some of them) may be able to protect themselves (for instance by not extending credit or doing so only on terms that reflect the risk). In such a case, the recognised heightened risk of loss may provide a baseline against which the language of s 135 should be applied. This, however, is not an issue in this

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22 At [211].

> case. How s 135 will work in such a situation is better determined against the facts of a case in which the issue actually arises.

[53] The Court also commented on the relevance of assurances of support, saying that:

> [216] Assurances of support on which the directors can reasonably rely may be material to whether they can be appropriately satisfied that continued trading will not breach s 135. If assurances were not legally binding or practically enforceable and were not honoured (as in this case), there are likely to be questions as to the reasonableness of reliance on them.

Section 136 Companies Act

[54] Section 136 of the Act states:

> **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.

[55] In *Debut Homes*, the Supreme Court explained that s 136 of the Act is not limited to situations when directors cause a company to incur direct contractual obligations in circumstances where the director does not reasonably believe the company will be able to perform its obligations under the contract.[23] The respondent in that case was held to have breached s 136 of the Act when he authorised Debut Homes to enter into sale and purchase agreements knowing the company would incur GST obligations that it would not be able to fulfil.

[56] Section 136 was also considered by the Supreme Court in *Mainzeal*, where it concluded that that "s 136 … is not confined to obligations of a particular kind, and may be invoked in relation to a course of trading to which the director has agreed."[24]

[57] The Court also said:

> [272] Directors should also recognise that a long-term strategy of trading while balance sheet insolvent is generally not acceptable. As will be noted, we have used the word "generally" as we accept that there may be circumstances in which it will be legitimate for such a long-term policy to be followed, most

23 *Debut Homes,* above n 9, at [91].

24 *Mainzeal*, above n 17, at [249], affirming *Yan v Mainzeal Property and Construction Ltd (in liq)* [2021] NZCA 99, [2021] 3 NZLR 598 [*Mainzeal* (CA)] at [280].

> particularly where there are assurances of support from a parent or sister company or third parties that can reasonably be relied on.

Section 301 Companies Act

[58] The relevant portion of s 301(1) of the Act states:

> **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, … has … 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 … director …; and
>
> (b) order that person—
>
> …
>
> (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.
>
> …

[59] As we have noted at [16], in this case, the orders made by Downs J were pursuant to s 301(1)(b)(ii) of the Act.

[60] Claims for breach of the fiduciary obligations set out in s 131 of the Act are assessed in accordance with the principles governing claims for breach of fiduciary duty.[25]

[61] Claims under s 135 will normally, but not invariably, be assessed by examining the net deterioration in the company's financial position between the date trading should have ceased and the date of actual liquidation. As the Court explained in *Debut*

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[25] *Mainzeal* (CA), above n 24, at [255(f)] and [288].

Homes, the usual starting point in s 135 cases is net deterioration "because the section looks at the creditors and the business as a whole."[26]

[62] The Supreme Court in *Mainzeal* discussed some situations where the net deterioration approach would not be appropriate:

> [282] Assessment of loss based on net deterioration is necessarily premised on a counterfactual that assumes cessation of trading, and in practical terms liquidation, at breach date. Where that is not the appropriate counterfactual, there is no occasion for a net deterioration calculation. As well, there may be other situations in which other measures of loss will be appropriate. Measures of loss other than net deterioration may be necessary, or appropriate, where:
>
> > (a) the breach of s 135 is itself the cause of the company's failure, in which case the entire deficiency may be the basis of the award;

[63] In particular, the Court noted that in the example under (a), "liquidation at breach date would not be the relevant counterfactual. Rather, the counterfactual would simply be not trading in breach of s 135."[27]

[64] Breaches of s 136 of the Act, however, are not necessarily amenable to the net deterioration approach to assessing compensation:[28]

> [165] We do not, however, consider that the same 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 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.

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26 *Debut Homes*, above n 9, at [164].
27 *Mainzeal* (SC), above n 17, at [282(a)], n 185.
28 *Debut Homes,* above n 9 (footnotes omitted).

[65] The Supreme Court in *Mainzeal* summarised that:

> [117] … *Debut Homes* stands as authority for the propositions that:
>
> (a) for the purposes of s 136, the harm to the company is the incurring of debts in breach of that section and all that flows from that;
>
> (b) it is therefore appropriate that relief ordered should operate to reverse that harm; …
>
> …
>
> [291] Dealing first with the logic of s 136, there is an apparent difference in focus between ss 135 and 136. Whereas s 135 is concerned with the general conduct of the business of the company and the risk that such conduct poses to creditors, s 136 addresses the incurring of obligations to creditors. Section 135 is expressed in terms that are consistent with treating creditors as a class in relation to compensation. In contrast, s 136, as we construe it, does not treat all creditors as a class but rather contemplates both (a) an obligation-by-obligation, and thus a creditor-by-creditor, approach and (b) as we have found, an approach based on categories of obligations and therefore creditors. So, the wording is consistent with the view that the damage for which compensation should be available under s 136 is the incurring of obligations that were not met and that such damage is most logically measured by the deficiency in respect of those obligations. …

[66] Importantly, the Court concluded that the court has flexibility in assessing compensation under s 301:

> [351] For the reasons just outlined, we consider that flexibility in remedial response for breach of ss 135 and 136 is appropriate to respond to facts of particular cases, making it appropriate for the courts to be free to tailor relief in ways that respond to the particular breach or wrong, to the harm that flows from that and, at least to some extent, the culpability (particularly amongst themselves) of the directors.

Analysis

Causation

[67] It is convenient to deal first with the question of causation which underpinned Mr Kumar's defence to all three claims.

[68] Mr Kumar described causation as being the "Cancerous Leg" of the "Tripod of Confidence" we have referred to at [19].

[69] Mr Kumar pointed to a number of factors that undermined the viability of the group's business venture, but his principal concern related to what he described as being a high failure rate of Smartpay's devices. Mr Kumar said the issue went from "bad to worse" and that no resolution was forthcoming from Smartpay.

[70] From this, Mr Kumar submitted that it was not the fact OCL was the contracting party with Smartpay that caused Smartpay's losses. Rather, "it was the fact that HQ and [Odev] could no longer fund OCL's payment obligations" that caused Smartpay's loss, and that those losses would have arisen, in any event, if the Smartpay agreement was with HQ.

[71] In the High Court, Downs J declined to engage with this argument because Smartpay's claim under s 301 of the Act was concerned with OCL's losses caused by Mr Kumar's breaches of ss 131, 135 and 136 of the Act.

[72] We agree with the High Court and Mr Chisholm that Mr Kumar has misunderstood the issue of causation.

[73] The claim against Mr Kumar is because of the way he failed to discharge his responsibilities as a director of OCL and in particular, how he allowed OCL to incur significant debts without having its own income or meaningful assets.

[74] In any event, we cannot on the evidence before us conclude that Smartpay would have incurred the same or similar losses if its contract had been with HQ. What we can say is that although Odev was placed into liquidation at the same time as OCL, it appears HQ had income and assets and was able to stave off liquidation until five years after OCL and Odev were placed into liquidation. Thus, it is conceivable, that in 2015 Smartpay may not have suffered as much loss as it did if its contract had been with HQ.

Section 131 Companies Act

[75] As we have noted at [21(a)], Mr Kumar relied on s 131(2) of the Act. We can quickly dispose of Mr Kumar's submissions based on s 131(2) because there was no evidence that OCL's constitutional documents permitted its directors to act in the best

interests of HQ and contrary to the best interests of OCL, as is expressly required under s 131(2).

[76] The issue raised by the appeal in relation to s 131 of the Act is whether Downs J erred when he found that Mr Kumar did not act in good faith and in what he believed were the best interests of OCL when he authorised OCL to enter into the Smartpay agreement.

[77] Mr Kumar is correct when he argues s 131, in general, entails a subjective analysis of a director's intentions and understanding. There are, however, as we have set out at [38], circumstances in which s 131 will clearly be breached including: where a director fails to consider the best interests of the company; where there was a failure to consider the interests of creditors in an insolvency or near insolvency situation; and where a director breaches their fiduciary duty by failing to properly manage conflicts of interest.[29] All three of these circumstances were engaged in this case.

(i) Mr Kumar's failure to consider the interests of OCL

[78] The focus of Mr Kumar's attention was always on the overall best interests of the group of companies. In particular, Mr Kumar did not specifically consider the best interests of OCL to the exclusion of the other companies in the group. The evidence that supports this conclusion came from Mr Kumar. For example, Mr Kumar told the High Court:

> (a) That the "group structure" was designed to be "seen as a single unified body operating as one [entity]".
>
> (b) That he agreed that OCL did "not [have] any revenue of its own" and had "no assets with the exception of [its] $1,000 share capital".
>
> (c) That OCL had obligations to Spark and Smartpay under the respective agreements with those companies.

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29 *Debut Homes*, above n 9, at [113].

(d) That the revenue from the Spark and Smartpay agreements was received by HQ and not OCL.

(e) That OCL did not benefit from the liabilities it incurred as a result of entering into the Spark and Smartpay agreements.

(f) That there was no "legally enforceable obligation" to compel HQ, Odev or any other entity to meet OCL's liabilities.

[79] Mr Kumar's overall approach to OCL was encapsulated in his acknowledgement that OCL was merely a "shell company" in the sense that it had no "revenue stream" or meaningful assets. Mr Kumar's approach meant that he did not consider OCL's best interests independently from the group.

(ii) OCL was insolvent, or near insolvent from the time it commenced trading

[80] Without income or meaningful assets OCL was always in a precarious financial position from the time it incurred liabilities to Spark and other creditors (such as its landlord). By the time OCL entered into the Smartpay agreement, the only way it could meet its liabilities was through voluntary contributions from HQ, Odev or other entities willing to prop up OCL. In reality, however, OCL was incurring liabilities without any revenue or enforceable means of securing funding.

[81] As the High Court found, OCL was insolvent, or close to insolvent from the time it started trading. This was therefore a paradigm example of a company trading in circumstances in which the director needed to consider the position of the company's creditors.

[82] Contrary to Mr Kumar's submissions, the judgment of Lord Reed in *Sequana* is of no assistance to Mr Kumar. The United Kingdom Supreme Court recognised that directors are required to consider the interests of a company's creditors where insolvency is imminent and that the interests of creditors become paramount when it

is inevitable the debtor company will face liquidation.[30] The position articulated in *Sequana* is very similar to that articulated by the Supreme Court in *Debut Homes*, which we have set out at [38]. The Supreme Court in *Mainzeal* also confirmed that directors are required to consider the interests of the company's creditors as insolvency becomes imminent.

[83] We understand Mr Kumar's submission that he believed the financial strength of the overall group of companies was solid. Mr Chisholm disputed this saying that as at 31 September 2015 the group had a cash trading deficit of $804,388.

[84] Even if Mr Kumar genuinely believed that the overall financial position of the group of companies was sound, the reality is that OCL was never solvent from the time it commenced trading and it never had any ability to require HQ or Odev to meet its liabilities.

[85] We do not accept Mr Kumar's submission that he should avoid liability under s 131 of the Act because, according to him, OCL generated revenue. What actually happened was that any revenue generated by OCL was paid to HQ, not OCL.

(iii) Breaches of fiduciary duty

[86] When structuring the business affairs of the group of companies, and in particular the way OCL incurred liabilities without having any revenue or meaningful assets, Mr Kumar placed himself in an impossible conflict of interest. That conflict arose through his failure to consider his responsibilities as a director of OCL and his conflicting position as a director and shareholder of HQ and Odev. This conflict of interest also establishes a breach of s 131.

[87] We are therefore satisfied that the High Court was correct in finding that Mr Kumar breached s 131 of the Act and was liable to pay compensation to the liquidator. We shall address the use of quantum separately.

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30 *Sequana,* above n 7, at [50] per Lord Reed P; [171]–[176] per Lord Briggs and Lord Kitchin; and [222]–[227] per Lord Hodge DP.

Section 135 Companies Act

[88] Mr Kumar maintained that he did not breach s 135 of the Act because of his belief in:

(a) the overall financial viability of the group of companies; and

(b) the "Tripod of Confidence" he had in the business model.

[89] We need not repeat the evidence concerning Mr Kumar's acknowledgements that OCL did not itself have income or significant assets but at the same time it incurred significant debts without having in place any enforceable way to meet its obligations.

[90] When we apply the criteria concerning breaches of s 135 set out in *Mainzeal*, we reach the following two key conclusions:[31]

(a) On an objective assessment OCL's business was carried on in a manner likely to create a substantial risk of serious losses to OCL's creditors.

(b) A director exercising an appropriate level of care, skill and diligence would have been aware that OCL was in "troubled financial waters" and would have undertaken a "sober assessment" of OCL's likely future income and prospects, including obtaining professional advice.[32] Mr Kumar failed to do so.

[91] We find that the High Court was correct to find that Mr Kumar breached s 135 of the Act.

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31 *Mainzeal* (SC), above n 17 at [211].

32 *Mainzeal* (CA), above n 24, at [263] and [269]; and *Mainzeal* (SC), above n 17, at [211(b)], [215], and [271].

Section 136 Companies Act

[92] The evidence from Mr Kumar, which we have summarised at [78] demonstrates that he arranged for OCL to incur obligations when he did not reasonably believe OCL would be able to fulfil its obligations to entities such as Smartpay.

[93] The liability which Smartpay incurred as a result of its contract with OCL was outside the normal and acceptable range of business risks that a creditor could expect to face when dealing with a company.

[94] The High Court therefore correctly held Mr Kumar breached s 136 of the Act.

Miscellaneous matters

[95] Mr Kumar challenges the decision of Downs J to exclude proposed evidence from Mr Grant, an insolvency practitioner.[33]

[96] Mr Grant's evidence was excluded because:

(a) Although Mr Grant had experience in managing or liquidating insolvent companies his qualifications did not extend to determining whether a company is solvent. That type of expertise is usually the preserve of chartered accountants.[34]

(b) Significant parts of Mr Grant's evidence were unhelpful as he engaged in partisan commentary, such as describing Mr Kumar as "an impressive individual" whose business achievements were remarkable. Mr Grant made assumptions about causation and concluded Mr Kumar did not act with intention to defeat creditors.[35]

[97] We have reviewed Mr Grant's evidence and for the reasons we have summarised at [96], we agree with Downs J that Mr Grant lacked the requisite

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33 Interim judgment, above n 1, at [52]–[65].
34 At [56]–[57].
35 At [58]–[63].

qualifications to give evidence about OCL's lack of solvency and therefore his proposed evidence was not substantially helpful.

[98] Mr Grant's proposed evidence contrasted markedly from that of Mr Graham, who qualified as an expert witness and whose evidence was substantially helpful.

Quantum

[99] Downs J was entitled to conduct a separate hearing on quantum when questions arose during the trial about how many Eftpos devices were recovered by Smartpay from OCL. That evidence, which was accepted by the liquidator and not challenged at the quantum hearing demonstrated:

(a) The value of the unpaid fees and invoices at the time OCL was placed into liquidation was $120,407.43.

(b) 1,159 terminals were not recovered. These were worth $399,855.

(c) The post-termination fees payable under cl 13.4 of the Smartpay agreement totalled $330,165.

(d) This produced a total sum of $850,427.43.

[100] Ordinarily, the net deterioration approach would be used under s 135. However, we consider that this situation exemplifies that contemplated by the Supreme Court in *Mainzeal*, where "the breach of s 135 is itself the cause of the company's failure".[36] Thus, the "entire deterioration" is appropriate as the basis of the award. In this case, the entire deterioration is the same as adopting the new debt approach under s 136 with effect from the Smartpay agreement, namely 18 September 2014.

[36] *Mainzeal* (SC), above n 17, at [282(a)].

[101] Therefore, in assessing quantum, we consider the best approach is to follow the course taken in *Mainzeal*,[37] namely to focus upon the measure of damages that adequately responds to Mr Kumar's breach of s 136 of the Act.

[102] We follow this course because the claim before us is from one creditor that arose through OCL's breaches of its obligations under the Smartpay agreement. Mr Kumar should not have allowed OCL to enter into the Smartpay agreement because, as we have explained, he could not possibly have believed on reasonable grounds that OCL would be able to fulfil its obligations to Smartpay under the Smartpay agreement.

[103] The evidence demonstrates that the actual loss suffered by Smartpay is $850,427.43. That loss arises specifically from OCL's breach of its obligations under the Smartpay agreement. OCL's breaches occurred solely because Mr Kumar plainly failed to discharge his responsibilities as a director of OCL. It is therefore the appropriate measure of compensation under s 301(1)(b)(ii) of the Act.[38]

Result

[104] The appeal is dismissed.

[105] The appellant is to pay the respondent costs for a standard appeal on a band A basis together with usual disbursements. We certify for two counsel.

Solicitors:
Claymore Partners Ltd, Auckland for Respondent

[37] *Mainzeal* (CA), above n 24, at [542], affirmed in *Mainzeal* (SC), above n 17, at [289].
[38] *Mainzeal* (SC), above n 17, at [351].