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Mainzeal. Nectar for lawyers.

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Building new case law: Mainzeal and Directors' duties

In the Court of Appeal, the judges declared that the *"...legislation governing insolvent trading in New Zealand is unsatisfactory."* They then went on to pen a 554-paragraph judgement outlying why our insolvency laws are broken.

Let's take a quick re-cap.

Mainzeal

Mainzeal was a behemoth on the domestic construction scene. It was involved in 7.5 billion worth of projects during its lifetime and employed over four hundred people. At the time of its failure it had two knights of the realm on its board, including a former Prime Minister.

Its key figure was Richard Yan, a prominent Chinese and New Zealand citizen with deep commercial connections both here and in his homeland, where he now apparently resides.

According to evidence presented to the High Court, by early 2011 Mainzeal was in trouble, but its balance sheet was bolstered by forty-four million dollars in loans from a related entity. However, this entity, MLG Limited, had no ability to repay this loan and when Mainzeal fell into receivership and then liquidation, these loans were not recovered.

Mainzeal, it seems, was harvested for cash in order to fund the purchase of a massive land holding in Shanghai, that eventually netted as much as half a billion dollars for Mr Yan and his other associates.

According to the High Court judgement, the accounts looked like this;

	000s	Related party	Adjusted
Current Assets	**97,370**	**(67,559)**	**29,811**
Non Current Assets	**38,235**		**38,235**
Current Liabilities	**(123,712)**		**(123,712)**
Non Current Liabilities	**(5,655)**		**(5,655)**
Net Position	**6,238**		**(61,321)**

Much of the litigation centered around this issue. The board relied on undertakings from the parent company and parties connected with it, including Mr Yan, on the financial support from the shareholder of Mainzeal. However, this support was never legally binding nor realistic, as it was hindered by the fact that most of the parent's capital was in China and subject to Chinese financial controls.

There was also the problem that the inter-company debt, much of it to New Zealand resident firms, were companies with no assets.

The liquidators, BDO, with funding from the LPF, New Zealand's largest and most active litigation funder, took the directors to court for breaches of their duties as directors.

The High Court Case; Section 136

Section 136 stipulates that directors should not incur an obligation without a reasonable belief that the company can meet the obligation. This is not about trading recklessly in general, but about specific debts being incurred.

The liquidators alleged that there were seventy million dollars of specific debts that Mainzeal incurred beyond the point where a responsible director should have known that these debts could not be paid. They identified four specific contracts where most of these costs occurred.

There were some technical legal problems with the claim, but the judge made his position clear; based on the evidence before him:

> *"…there is no reason to conclude that the directors either did not believe that these obligations would be fulfilled, or to conclude that the reasons for believing they would be fulfilled were unreasonable."*

The High Court judge took the view that there was no reason for the board to believe that failure was imminent, and that it was therefore not unreasonable to enter into new construction contracts.

The Court of Appeal Case; Section 136

The Court of Appeal went in a different direction. In order to meet the ongoing obligations of the four construction contracts, the board should have put in place measures, specifically shareholder support, to ensure that the costs to be incurred on these projects could be met.

The higher court concluded;

> *"In these circumstances, we consider that significant obligations with a longer time horizon were undertaken…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…"*

This is a significant conclusion, especially for those in the construction sector but also in any firm where long-term projects are being committed to where the future path of the company may involve uncertainty and therefore require shareholder support.

The directors were found to have breached Section 136 for the four large projects began after the point at which the Court of Appeal considered that the directors' belief of ongoing shareholder support was not reasonable.

The High Court found on Section 135; Reckless Trading

Drawing on past authorities, the High Court held that once a company passes from a solvent to an insolvent state, the directors are trading with the creditors, and not the shareholders' money. This does not mean that they company must cease trading, but that if the board is gambling with the shareholder's cash and their support, that is their choice. However, gambling with creditors' money, who do not stand to share in the profit but must pay the price for failure, exposes the directors to liability.

Looking at the specifics of this case, the High Court made three findings:

a) Mainzeal was balance sheet insolvent

b) There was no assurance of shareholder or group support if required

c) Mainzeal's trading was patchy which meant it required a strong capital base.

Each one of these had to be the case for a breach of Section 135 to be upheld, and in this case, it was:

> *"…the directors allowed Mainzeal to continue to trade in highly unorthodox circumstances, which involved a very significant risk to the creditors."*

The court then went on to ascribe liability to the directors for this failure.

The Court of Appeal; Section 135

The Court of Appeal confirmed that the directors had breached Section 135. The judges wrote that:

> *The approach taken by the directors involved a large measure of wishful thinking…* when it came to the collectability of the related party loans of the financial support from the parent company.

However, they differed from the High Court when it came to ascribing liability. They found that, from the time that the breach of Section 135 occurred, and through to the date of liquidation, there had been no deterioration in the net position of the company.

The court found that:

> *"…those breaches of duty did not cause the insolvency of Mainzeal."*

Further, there had been no deterioration in the financial position from when the breaches of 135 began and the eventual failure of the business.

As a consequence, there was no compensation awarded to the liquidators.

This may seem counter-intuitive, but it appears to have been a consequence of the way the case was pleaded. The liquidators did not contend that the decisions leading up to the point of insolvency, early 2011, were reckless, only that trading beyond that point was reckless. It is possible that if the case had been argued differently, then the directors could have been held liable on the reckless trading claim.

Hindsight is a powerful tool in litigation.

Liability; High Court

The first thing to appreciate about liability is that it is a two step process. First; did the director breach their duties? If yes, then the court moves onto Section 301, where judicial discretion is applied. The courts look at three factors; the duration of the breach, the culpability of the individual directors, and any losses caused by the breach.

The High Court set liability at $36 million for the main director, Mr Yan, and $6 million for the others. This was about one third of the total losses. The High Court rejected a claim by the liquidators that the directors be liable for $75 million, being the total value of all those creditors whose liabilities resulted from the decision to continue to trade on from the point that the court found the directors were breaching their duties.

This was because the duty was owed to the company, Mainzeal, and not to the individual creditors.

Liability; The Court of Appeal

The higher court agreed with the High Court, that the new debt approach was not appropriate for reckless trading breaches. However, the appeal judges found that the new debt approach could be applied to breaches of Section 136, and sent the matter back to the High Court to work out how much this should be.

There were some caveats, but it appears likely that the High Court will substantially increase the total amount that the directors will need to pay to the liquidation. However, the High Court does have wide discretion, and it is near certain that this will be used to reduce the total liability down from the high-water-mark claim of $75m claimed by the liquidators.

Cost overruns on the Vector Arena contributed to Mainzeal's failure.

Debt Collection in an age of inflation

Inflation was once a feature of commercial life. Wages and prices were expected to rise by five to ten percent each and every year. When such uncertainty in the value of the dollar was pervasive, firms would build into their contracts provisions for inflation.

Many commercial arrangements allow for payments to be made in the future. However, when prices were moving quickly, parties needed some way to fix the future value to something that would make sense. Most businesses are not into currency trading and wanted some certainty.

Two approaches were used. The first was a price, with adjustments linked to the inflation index, usually but not always the CPI, or Consumer Price Index. Many larger organisations liked to use the Producer Price Index. The other was to build into the contract an interest rate that incorporated not only the time-value-of-money but also the expectation of inflation.

If you assumed that prices would rise by five percent, and you wanted a two percent return on any outstanding capital, an interest rate of seven percent was what you would go for.

However, inflation was tamed nearly three decades ago under the formidable Reserve Bank governor Dr Don Brash. Now prices rise by a steady and predictable one to two per cent annually. Firms have fallen out of the habit of building into their agreements any reference to the CPI or other indexes.

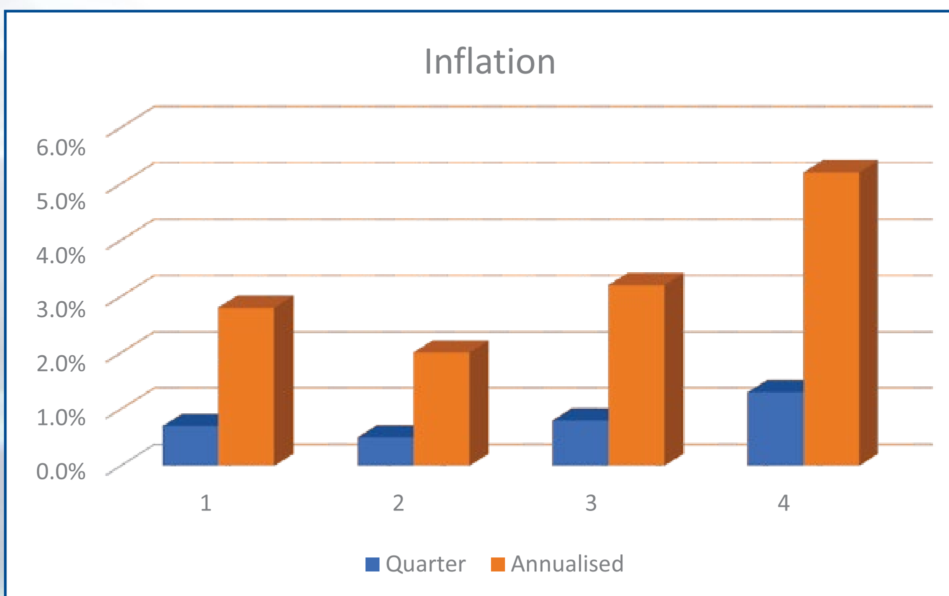
Now, however, the rules of the game might be about to change. There was much media excitement last month when Statistics New Zealand announced that annual inflation was now 3.2 percent. However, what most media missed was that the changes in quarterly inflation looked like this;

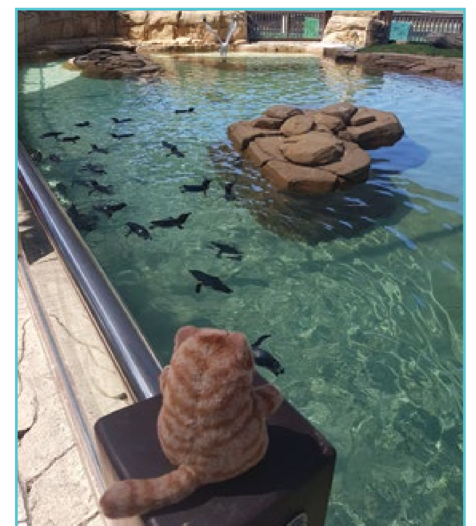
Failing to index contracts to inflation could see firms losing out

Prices in the last quarter rose by 1.3 percent, which equates to an annual rate of inflation of over five percent. By quoting the figure of 3.3 percent, the media were only telling us how far we have come, not how fast we are going.

This is like measuring the average speed of a race car from the moment the starters light turns green and the first ten seconds, without mentioning how fast the car is speeding at the ten second mark. Well, at the moment we are at the ten second mark and the speed is 5.2 percent.

With luck, the Reserve Bank can wrestle this genie back into its bottle, but if it cannot, those of us in the business of managing receivables ledgers and setting future contract prices, will need to brush off long-lost skills.





Our mascot, Prudence, watching stingrays at Seaworld, Brisbane.

The overlooked virtue of the Disputes Tribunal

Debt collection can be a frustrating task and one of the most effective tricks deployed by persistent debtors is to raise a meritless dispute.

For a debt collector or an accounts receivables manager, this can be tricky. Sometimes, the debtor has a real grievance. However, those responsible for delivering the product or service can be less than forthcoming with the credit manager. Being seen to side with the disgruntled customer can create internal tensions.

However, sometimes, just sometimes, customers lie.

Regardless of which situation the credit manager finds themselves, the Disputes Tribunal is a powerful tool. There is a limit of thirty thousand and any debts referred to the Tribunal must actually be disputed. You cannot use this as a means of getting an enforceable judgement.

However, within these two constraints, the Disputes Tribunal is without question the most effective and efficient of part of our judicial system.

It is true that sometimes the arbitrators are not well clued up in the law, but over recent years the quality of arbitrators has been increasing. It is also true that the judgements are not as 'safe' as those from the District Court, in terms of getting the decision right, but the difference is marginal.

These two issues are trivial, however, compared to the advantages of referring disputed debts to the Tribunal. Decisions are fast. They are cheap. No lawyers are allowed. Even if you lose, you lose quickly and at minimal cost. This is a far superior outcome than losing after a long and bitter process sometimes lasting years.

If the disputed debt is over thirty thousand, it can make sense to refer it. You cannot get a judgement for more than thirty thousand, but when you factor in the cost of lawyers, it is better to get a thirty thousand decision from the Tribunal than a fifty thousand one from the District Court that cost forty thousand in legal fees.

Disputes Tribunal decisions carry the weight of a District Court judgement. They cannot usually be appealed. The only ground is that the referee ran the hearing in an unfair way that had an impact on the result. If the decision was wrong on the law, or was just wrong on the facts of the case, well, that is that.

This makes some creditors nervous. It shouldn't. In a small minority of cases you will lose cases you should win, but equally you will sometimes win when you should not. The value in this process is the speed and efficiency.

Sometimes, disputes are best resolved quickly and cheaply,

The long-arm of the liquidator just got longer

The power of a liquidator to interview a director, shareholder, lawyer or even a creditor of a company in liquidation is a remarkable one. Governed by Section 261 of the Companies Act, the liquidator has the right to interview anyone who has 'knowledge of the affairs of the company'.

There is a belief, not really backed up by much in the way of case law, that a liquidator cannot use the process of what is commonly called a '261 interview' to obtain a collateral advantage in litigation by getting information through that process rather than via discovery.

This issue was tested directly in a recent case involving a company called Eversons International Limited. Eversons got into trouble with the Commissioner of Inland Revenue through the time-honored path of not paying taxes. The company found itself in liquidation with Vivian Fatupaito and Elizabeth Keene of KPMG.

Eversons was in the business of making legal highs. Synthetic cannabis. Sadly, due to the moral cowardice of Peter Dunne, this product went from being legal highs, to illegal highs. Eversons ceased making the product and the manufacture and distribution of synthetic cannabis was left to the criminal underworld with the resulting grim harvest of around eighty deaths at the latest coroner's report.

But this isn't a morality tale about the failings of prohibition. Alert readers will be able to discover this author's views on that matter in back issues of the Sunday Star Times.

Eversons initially went into liquidation with Andrew Oorschot, a liquidator in Christchurch. Mr Oorschot concluded that the failed firm's biggest asset was some six and a half million listed in the accounts simply as "Overseas Investments".

Oorschot attempted to obtain details of this asset from the director, Evan Stewart. Mr Stewart wrote a letter which wasn't especially helpful. Oorschot resigned in favour of Mesdames Keene and Fatupaito, who hit the same obstructive wall when it came to getting any details from the director.

The new liquidators then took legal action against the director, suing for three million dollars, pertaining to payments to a related entity. They also took action for a two million dollar overdrawn current account.

These court cases were on foot when Stewart attended a 261 interview with the new liquidators. Stewart, claimed the liquidators, was not that forthcoming.

Here is where things become interesting. The Companies Act, under Section 266, has a provision for an interview to be conducted in front of a judge, rather than just the liquidator. This is what the liquidators Keene and Fatupaito proceeded to do.

The director responded that doing so would give the liquidators a collateral advantage in their litigation against him, and they should not be allowed to do this. Any information the liquidator wants should have to be obtained via discovery. There was also an argument that Stewart would be required to say something under the 266 interview that may undermine one of his defences to the ongoing litigation and that this is oppressive.

Stewart also made the excellent argument that the reason his business failed was the result of the Crown changing the law regarding legal highs, and now the Crown, via the IRD, was the only creditor. It wasn't clear what Stewart's lawyer wanted the court to do with this argument, but it was so creative it seems worth mentioning.

Drawing on past New Zealand case law, the court found that the following matters were ones that the court should consider before exercising its discretion;

- If the request is necessary for the liquidator to perform their duties
- If the request imposed an unreasonable burden on the subject
- Alternative legal proceedings available to the liquidator
- If the subject would be more vulnerable to future claims by complying
- If the subject was a central or peripheral figure in the failed company
- The nature of the information sought

In this case, the court considered that Stewart had been uncooperative, was the only person with access to the information, and that the risk of compromising his legal position was remote.

Perhaps the key sentence from the judgment was this;

> *I am satisfied that, in fact, the liquidators' primate purpose is to identify, locate and recover the company's assets.*

The court seemed to be saying that because the liquidators were trying to recover assets, and not seek information to assist in their legal claims against the director, that the judge was minded to find in favour of granting the order for Mr Stewart to be interviewed in front of a High Court judge, Which is what the judge did.

Eversons International Limited (in liq); Fatupaito and Keene v Evan Stewart. CIV-2021-409-000131

From Russia. With Interest.

Russia. A enigma wrapped in a riddle and where the answers to many problems can be found in the bottom a vodka bottle. In February 2020 the City Court at Krasnogorsk, a suburb of Moscow, gave judgement against Igor Stepanov and in favour of Andrei Spiridonov in the sum of just over four million rubles.

This works out to be about eighty thousand in our money. Not a Czar's ransom, but enough to get worked up over.

Both men are Russian citizens, but the defendant, Stepanov, is periodically resident in New Zealand. The plaintiff wanted to enforce the judgment in this country. He went to the High Court.

A number of issues were in play. The first is that the judgement was in Russia, and Russia is, well Russia. There is a Court of Appeal case on point, that recognised that our High Court can accept judgements in foreign jurisdictions. The decision must be for a definitive sum, the foreign court must have jurisdiction to give the decision and the decision must be final and conclusive.

There are exceptions, such as the judgment was not obtained by fraud, enforcing the judgement not against public policy and that the foreign judgement was not obtained via some breach of natural justice.

Our high Court looked at the features of the case run by the Krasnogorsk court and decided that, although it was given by default, the defendant knew it was occurring, and elected not to participate.

The defendant claimed that there were breaches of natural justice in the way the case was handled, but the New Zealand judge, after examining the documents and evidence, concluded it was not. The details don't matter so much as the wider principle; that our courts will look objectively at an overseas judgement and, if they are satisfied that the judgements are safe, will admit them in New Zealand.

Arkhangelskoye Palace, Krasnogorsky, Russia. Some distance from the City Court.

What will be the new normal in the Post-Covid World?

As part of our regular Breakfast Series, we invited Dr Oliver Hartwich, Chief Executive of the NZ Initiative, to speak to our clients and guests in June. Dr Hartwich outlined that the post-war period had been exceptionally stable, but that *"...history restarted in the Fukuyama sense after 9-11... and again after the GFC."*

Looking for the mega trend since these events, he believes it is the growth of government, a referenced and excellent book by Robert Higgs; Crisis and Leviathan, which maintains that government expands in a time of crisis and does not fully retreat after the crisis.

Assisting the trend has been the abandonment of the gold standard by Nixon, after the fiscal pressure from the Vietnam War. Now, instead of having to tax or borrow to pay for the expansion of the state, governments now have no financial limits to their spending. This is a development that had escaped New Zealand until we embraced Quantitative Easing in March last year.

Hartwich predicts that the effects of central banks being untethered means that we are seeing more business cycle volatility with each new crisis being bigger than the last.

He ended his speech with the optimistic statement;

"If we institute the basic principles of a market economy we've got a chance to create our own future, it will be a better one, a better normal.. if we don't; unfortunately, the next crisis is already programmed in."

Dr Hartwich presents his speech

Standing room only!

Damien Grant desperately seeks validation by proximity to Dr Hartwich

One of the strengths of Waterstone is the number of former staff who have gone on to successful insolvency careers, as lawyers and insolvency practitioners and who we maintain close connections.

The venue is the rooftop garden at QT in Auckland's viaduct district.

Andrew Kingstone, the director of Gravity, before opening the event.

New Zealand based experts with many decades of experience managing Bad Debt and Receivables.

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