

## Liability of directors for company debts: Supreme Court in *Mainzeal* orders directors pay \$39.8 million plus interest.

**The Supreme Court's recent decision in *Yan v Mainzeal Property and Construction Limited*<sup>1</sup> is, as the Court describes, of fundamental importance to the business community, as it sets the bar for director liability.**

**The guidance offered by the Supreme Court is, however, unlikely to provide the certainty hoped for by directors and their insurers.**

### ***Mainzeal***

Mainzeal was one of New Zealand's largest construction companies. It was placed in liquidation February 2013 owing \$110 million to unsecured creditors. Prior to its liquidation, Mainzeal's balance sheet inaccurately indicated a positive net asset position by including as assets advances to related companies that it would not be able to recover. Mainzeal required shareholder support to continue trading solvently but, while it sought out assurances from shareholders, these commitments were not legally enforceable.

Consequently, in 2015, the liquidators of Mainzeal brought proceedings against the former directors of the company. The liquidators claim was that the directors had traded recklessly (s135 of the Companies Act) and incurred obligations that the company could not have reasonably believed it could perform when required to do so (s136).

### ***Background to Supreme Court decision***

In 2019 the High Court<sup>2</sup> concluded the directors of Mainzeal had breached section 135 of the Companies Act. However, it did not consider that they had breached section 136 because it considered that the obligations owed must arise out of specific contracts and should not be a general incurring of obligations as the liquidators had claimed at the time.

The High Court ordered the directors to pay \$36 million as a fair contribution to the losses incurred, under its discretion contained in section 301 of the Companies Act. Both parties appealed the decision.

The Court of Appeal, in 2021,<sup>3</sup> found the directors in breach of both sections 135 and 136 (contrary to the High Court decision). In particular, it held that liability for section 136 should not be specific but applied to all new obligations undertaken in the ordinary course of business. The directors were given leave to appeal to the Supreme Court and the liquidators cross appealed.

### ***The Supreme Court's decision***

On 25 August 2023, the Supreme Court addressed whether the directors were liable under sections 135 and 136 and clarified implications for the future of its approach to this liability, upholding the decision of the Court of Appeal.

It also decided how loss in relation to section 135 and 136 should be quantified and, in this case, what order for compensation should be made.

### ***Liability under section 135***

The Supreme Court held that from 31 January 2011, the directors adopted a trading policy that was "likely to

<sup>1</sup> *Yan v Mainzeal Property and Construction Ltd (in liq)* [2023] NZSC 113.

<sup>2</sup> *Mainzeal Property and Construction Ltd (in liq) v Yan* [2019] NZHC 1637.

<sup>3</sup> *Yan v Mainzeal Property and Construction Ltd (in liq)* [2021] NZA 99.

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create substantial risk of serious loss to the company's creditors".

The decision specifically notes the Court of Appeal's suggestion that the other directors could have pressured Mr Yan to provide his best offer for resolution of the issues affecting Mainzeal (potentially reinforced by threats of resignation or winding down the company). It considered the directors were, at least, in a position to make an informed decision about whether to continue to let the company trade on. They instead allowed the company to continue trading without achieving a resolution.<sup>4</sup>

*Liability under section 136*

The Supreme Court found the directors in breach of their duty in relation to obligations arising out of Mainzeal's four major contracts from 31 January 2011, and for all obligations incurred in the ordinary course of business from 5 July 2012. The reason for the distinction between dates being that the directors would have known Mainzeal could not meet its medium to long term obligations from 11 January 2011 but it was not until 5 July 2012 that the directors knew Mainzeal could not meet any of its obligations.

The Supreme Court's decision confirms that directors can be in breach of all their obligations that arise in the ordinary course of business and this is not limited to specified obligations arising from contracts.

*Implications for the future*

The Court has given the following practical guidance to directors:<sup>5</sup>

- directors have a continuing obligation to monitor performance and prospects of their company;
- if monitoring reveals potential for a substantive loss to creditors or, doubt as to whether there

is a reasonable basis the obligations incurred will be able to be honored, the directors are to squarely address the future of the company;

- directors may need to take professional or expert advice from external sources to adequately assess the situation; and
- if the company determines the risks can be adequately mitigated, it should create and adhere to a plan for continued trading that offers a reasonable basis for why there will be no substantial loss to creditors and that obligations incurred will be honoured.

*How should loss be quantified*

Loss for a breach of section 135 or 136 was calculated by way of net deterioration. This means that the loss incurred as a result of the directors' breaches (since the date of this breach), when compared with loss resulting from liquidation at the date of the breach, will amount to the total award for compensation. The Court noted that this is not the only method of quantification and in some circumstances net deterioration will not be an appropriate standard.<sup>6</sup>

*The award of compensation.*

No net deterioration was found to have occurred in respect of section 135 and, consequently, no award was made for compensation under this section.

Under section 136 however, the Court calculated that the directors were responsible for \$39.8 million of the loss caused by their breach.

Treating culpability as the critical factor, the Court ordered that compensation to be paid, together with interest and, on the basis that Mr Yan was responsible for the entire amount, apportioned liability such that the

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<sup>4</sup> Above n1 at [235].

<sup>5</sup> At [269-273].

<sup>6</sup> At [282].

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other directors' liability was each limited to \$6.6 million plus interest.

***Implications for directors.***

Protection for creditors was central to the Supreme Court's decision. Directors of companies in financial distress should take exceptional care in their management of a business in financial difficulty, both to minimise loss to creditors, but also to ensure that they do not become personally liable for additional company loss.

The Court acknowledged that decisions of directors that were reasonable when made, can appear unreasonable in hindsight and, often times, there is scope for more than one reasonable course of action. Also, the Court acknowledged that directors are often required to make complex decisions under pressure, at times, without complete knowledge of the circumstances (despite efforts to acquire this knowledge).

Directors managing a company in financial distress should ensure that careful monitoring of the company's performance is undertaken and, when necessary, external professional advice should be sought about what options the company can take.

Plainly, directors must not continue to trade if the company is insolvent and cannot be resurrected. Notably, the Court also highlighted the need for a review of the legislation to ensure it provides a coherent and practically workable scheme for protection of creditors in these circumstances.

**Want to know more?**

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