

Mainzeal – the lessons for directors

The High Court has now released a much anticipated decision on directors' liability in relation to the collapse of construction firm Mainzeal.

Mainzeal Property and Construction Limited was a significant player in the New Zealand construction industry prior to its collapse in early 2013.

Mainzeal's liquidators, Andrew Bethell and Brian Mayo-Smith of BDO, have now successfully sued the former Mainzeal directors for reckless trading, with the Court requiring former directors to pay \$36M to the liquidators.

Relevant facts

Mainzeal was part of a group of companies and up until 2009 was wholly owned by a company called Richina Pacific, an investment consortium associated with Mainzeal director Richard Yan.

Over a period of time, Richina Pacific and associated group companies, had removed funds from Mainzeal to help fund other business interests, including asset purchases in China. The effect was that there was significant amounts of money owing back to Mainzeal by its other group companies.

This left a balance sheet "hole" in Mainzeal but the directors of Mainzeal had received assurances, primarily from Mr Yan, that support from other group companies would be provided to Mainzeal as required.

Ultimately, such support was not forthcoming when needed. There were a number of reasons for this, but they included the group's inability to remove sufficient cash from China due to Chinese regulatory requirements, and also the fact that Mainzeal's profitability was poor following a period of difficult trading including major contract disputes and leaky building claims.

Following Mainzeal's collapse, unsecured creditors were owed \$110M.

Claim

The liquidators claimed that the Mainzeal directors breached their duties under section 135 of the Companies Act 1993, commonly known as the reckless trading provision.

Section 135 requires that a director of a company must not 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 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.

The liquidators argued that the directors acted improperly by continuing to trade Mainzeal from around 2011, when they considered that Mainzeal was balance sheet insolvent, and that the directors inappropriately relied purely on verbal assurances of support from its parent company. The liquidators claimed \$75M as a result of the claimed breaches.

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In their defence, the directors argued that there was nothing inappropriate in the directors continuing to trade in the circumstances and that it is normal for a company forming part of a wider group to rely on assurances of support from other companies in that group.

Result

The High Court¹ found that the directors breached their duties under section 135 in the circumstances, with key considerations being:

- Mainzeal was trading while balance sheet insolvent because money Mainzeal lent to other group companies was not, in reality, recoverable;
- There was no assurance of broader group support on which the Mainzeal directors could reasonably rely if adverse circumstances arose; and
- 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.

The Court made an order for the directors to pay \$36M to the liquidators in light of the breaches. The Court found that Mr Yan had greater liability as he had an inherent conflict of interest, he induced the directors to breach their duties and he benefited considerably from the funds that were extracted from

Mainzeal causing it to become insolvent. Mr Yan therefore has principal liability for the full amount of the \$36M, with fellow former directors Dame Jenny Shipley, Mr Gomm and Mr. Tilby each being jointly and severally liable with Mr Yan to pay \$6M.

Lessons

The decision is an important reminder of directors' legal duties.

While there remains a high legal hurdle to establish liability for reckless trading, and such a claim is highly fact specific, directors must consider whether the commercial decisions that they are making in the circumstances, and the information that they are relying on in doing so, discharge their legal duties. Such decisions may be judged harshly with hindsight.

Some general lessons for directors:

- Do not rely on non-legally binding assurances of financial support where such support is critical to the company
- Be clear who your legal duties are owed to when you are a director of a company which is a part of a group of companies
- If relying on financial support from other companies in a group, regularly and critically assess whether that support is robust and will be available when needed
- Take independent advice if you are unsure of, or uncomfortable with, the

¹ The High Court judgment is *Mainzeal Property and Construction Limited (In Liquidation) v Yan and Others* [2019] NZHC 255

Mainzeal – the lessons for directors
(Continued)

information that you are receiving -
sooner rather than later

- Directors' and officers' insurance cover should be regularly reviewed for adequacy given the size and value of the company and its trading activities
- Where cash is tight, directors need to constantly review the company's trading position with the benefit of the most up to date information available to make informed decisions
- Keep good written records decisions made, the reasons for those decisions, the information considered and the benefit of any advice received

Want to know more?

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