SPEAKMAN LAW

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Mainzeal...

Last week's $36m damages award against the directors of failed Mainzeal Construction, including Dame Jenny Shipley, offers many lessons.

The judgment is pivotally important for all directors, as it is for those advising on governance matters. Given its significance I will discuss and analyse it at my forthcoming corporate seminar (at 8.00am on Wednesday 3 April; if you have not attended one of these and wish to, let me know and I will send you details).

The key findings were:

a. Dame Jenny Shipley, Peter Gomm and Clive Tilby each suffered a damages award against them of $6m;

b. Richard Yan, the representative director for the parent company, Richina Pacific, and a sizeable shareholder himself, suffered an award against him of $18m;

c. Liability of Dame Shipley, and Messrs Gomm and Tilby was established to be several, ie they are each liable for no more than the $6m award against them;

d. Liability of Mr Yan is on a joint and several basis, ie he is liable for the full $36m.

The judgment records that the directors have $20m of liability cover. I do not have details but media coverage suggests that Dame Shipley is fully covered by insurance. It is foreseeable that there may be complications in collecting under the insurance policy. The timing of notices to the insurer and any right of contribution that Mr Yan may seek from his fellow directors will be relevant but those issues are a sideshow to the essential points in this newsletter, so I say no more about them.

Questions you may ask are how was the $36m award arrived at and how does it relate to the total losses suffered by Mainzeal?

The total losses are reported as $110m. Included in this sum is losses suffered by Mainzeal on account of failing to complete its projects. Had it been able to complete them, the company could have expected those projects to generate profits; failure to complete them transformed profitable contracts into large loss makers – a bit like being on the point of scoring a try at one end of the field only to suffer an intercepted pass and conceding a try at the other end of the field, often referred to as a 14 point try. The award of $36m is one third of the total loss, which represents the High Court's assessment of the directors' culpability. I say more about this below.

Why were the directors not liable for the full $110m? Primarily the answer to that question is because directors are not expected to guarantee a company's solvency; a finding that they were liable for the full $110m would be tantamount to that.

Instead, directors are liable only for losses that spring from a breach of their directors duties, in this case what is colloquially referred to as reckless trading. That term encompasses the practice by directors of allowing a company to continue to trade whilst insolvent, at substantial risk to creditors.

The first pre-requisite to be met before liability will befall upon directors for reckless trading is that the company is insolvent. It might be thought trite that Mainzeal's losses of $110m are evidence enough that it must have been insolvent. Whilst insolvency was found, it wasn't quite as obvious as the quantum of that loss suggests. That outcome was in good part a result of what ought to have been profitable contracts metamorphosing into large loss makers and sizeable (approximately $40m) intercompany related loans ultimately being dishonoured, against the directors expectations. Dame Shipley, Peter Gomm and Clive Tilby also plainly had a genuine belief that the parent company would provide financial support.

It might also be a cause for wonder how Mainzeal, with such large losses, was able to continue to meet its bills enabling it to trade. It is the fact that Mainzeal was able to meet its bills as they fell due that appears to have obscured the directors thereby clouding their appreciation of the severity of Mainzeal's problems. Mainzeal was only able to carry on trading despite its sizable losses courtesy of the cash flow feature of the construction industry entailing a lag between progress payments to principal contractors and payment by them to subcontractors.

That lag in timing establishes a cashflow advantage for the principal contractor and allows it to trade with the subcontractors' money, thereby relieving the principal contractor of the need for its own working capital.

For a sufficiently capitalised company this would not matter one iota as its capital base would allow it to weather claims against it regardless of its own committed working capital.

In this case, the cashflow advantage inherent in the construction industry evidently caused Mainzeal's directors to downplay the urgent need to secure from the parent company legally enforceable financial support of some sort. That is not to say the directors did not recognise the need for this. They most certainly did and in part the ability for Richina Pacific to provide support was hamstrung by Chinese law foreign exchange restrictions. But warning signs that Richina Pacific also wanted to manage its NZ exposure were, with the benefit of hindsight, aplenty. All that really needs to be said is the directors adopted a policy of trading in a state of balance sheet insolvency.

The directors allowed Mainzeal to trade in that way for a period of years, not months or days. It was that practice for which the directors were ultimately held accountable.

What should the directors have done? Should they have resigned immediately upon learning of Mainzeal's insolvency (notwithstanding that it was able to meet its debts as they fell due)? Does it mean that a director of a company automatically becomes personally liable upon the company, of which he or she is director, enters financial backwaters? How did someone as experienced as Dame Shipley allow all this to occur and how did the parent company, Richina Pacific, so persistently and effectively repel her repeated demands for reliable parent company support?

I will deal with each of these questions in turn.

While hindsight is in many cases palpably unfair (what appears obvious afterwards is so often unearthed only by accident and until then is obscured), it is plain

in my view that there came a point that the directors should have resigned.

Undoubtedly the directors were appalled at the prospect of potentially propelling the company towards catastrophe that foreseeably may have accompanied their resignations.

Concomitant with that appal was the directors preference to embark on a course of seeking to steer Mainzeal through crocodilian waters. That the directors had this preference is understandable, but only for a period. For what period? Months. Not days and not years. That is what previous cases before the courts have established. Here, the directors maintained this preference for a matter of years. In the Judge's view (and mine also) they were wrong to have allowed Mainzeal's vulnerable state to have prevailed for as long as they did.

Returning to the question I pose above, no the directors ought not to have resigned immediately upon Mainzeal's insolvency being established.

They ought to have done so, however, after some months had elapsed without either a material improvement in Mainzeal's trading results or securing decisive and legally enforceable support from Richina Pacific.

I also pose the question about whether directors should, as a rule, immediately get out once the company of which they are director is in financial trouble. No, they should not. Directors do not become personally liable simply because they trade a company while it is in an insolvent position. Directors must however act cautiously from that time because they are no longer trading with the shareholders money and instead are trading with creditors money. The cases demonstrate that there are clear limits to the extent to which directors can trade companies with creditors' money in the hope that things will improve. In most cases, the time allowance has been limited to a matter of months. At some point the decision to trade on will be regarded as illegitimate risk taking.

Is it a safeguard in these respects that the company is able to meet its debts as they fall due? No, as the Mainzeal case illustrated, balance sheet insolvency is a key aspect of the test of solvency precisely because it affects creditors in a highly relevant though not immediate way. Liability will follow where the risk to creditors is substantial.

All this begs the question how someone as experienced as Dame Shipley managed to err so badly that the Court assessed damages against her to the tune of $6m. I can't help thinking there is an institutional element to this. Plainly she was persuaded by Richina Pacific that it would come to the party at the end of the day. Plainly also she came to her directorship with the experience of the Crown, as ultimate shareholder for publicly funded operations, always being there to bail out the company. One suspects that may have been a factor in her reliance on what she was, or wasn’t, being told by Richina Pacific. Perhaps she also believed that she would have been able to bring her political skills to bear on Richina Pacific, downplaying Richina Pacific's commercial constraints and agendas.

All that having been said, regardless of how one looks at it the Mainzeal case it is a clear case of the directors getting it wrong. In my view the biggest thing they got wrong and the key learning from the case is the need to recognise and react to balance sheet insolvency. Directors ignore it at their peril.

A second lesson from the Mainzeal case is the need to obtain legal advice early on. The Mainzeal directors sought and obtained legal advice far too late in the piece, such advice evidently stressing the points I make here that it is not appropriate to downplay balance sheet insolvency and that securing legally enforceable parent company support was essential. One wonders whether the result both for Mainzeal and the directors may have been wildly different had the directors obtained legal advice early on.

An intriguing aspect of the case is the quantum, ie how the $36m damages award was arrived at. It is intriguing because the Judge did not follow contemporary judicial precedence in this respect, namely that damages are calculated on a "what if" basis, ie what would the loss have been had the directors desisted (or resigned) from trading Mainzeal earlier once the insolvency issues had taken hold.

I have spoken to a couple of senior barristers who are both critical of the judgment on this score. Far be it for me to suggest they are wrong, but nevertheless for what it is worth, I see great attraction in how the Judge arrived at his conclusion on the quantum of liability ($36m). This was not a case where a particular event could be pointed to that sparked the company's collapse or even a particular point of time that with

hindsight it was clear that any recovery for Mainzeal would only be possible with the help of Peter Pan.

Rather this was a case where the directors simply did not, for a period of years, pay sufficient regard to Mainzeal's balance sheet solvency. They allowed Mainzeal to trade on for years precariously. Whose money was at risk while they did so? That of the creditors and most unfairly, in particular, that of the subcontractors. All the while the creditors will have been relying on the directors good name, good character and wisdom in making their own decisions to support the company by continuing to provide services and supply goods to it. While there is a balance here, one does not balance this over a period of years.

The Judge has therefore determined that the directors' actions have been tantamount to guaranteeing solvency. Thus their share of loss is the entire loss, as a starting point, adjusted for events that were outside their control for which they have no culpability. The Judge determined this to be one third of the total loss. On this basis it can be seen why the Judge did not follow the "what if" (counterfactual) assessment of damages adopted in other cases.

Given the amount of money involved an appeal is expected. This measure of damages will then be scrutinised by the Court of Appeal – unless the decision is overturned. But do not expect that to happen.

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