

Directors in breach not always liable

A director is not absolutely liable for all losses suffered by a company on his or her watch.

So the Court of Appeal has ruled in a recent liquidation dispute.

The context

Rowan Johnston, a former investor and director in NZNet, pumped funds into the company when it ran into difficulties, but found that NZNet's managing director Stephen Andrews had misled him about the company's financial position.

On 15 September 2011, he resigned his directorship and a couple of months later, NZNet went into liquidation.

The liquidators sued the former directors for breach of duty in the High Court, which found Mr Johnston had acted recklessly, but did not order him to contribute to NZNet's assets.¹ The liquidators appealed.

The Court of Appeal

As with the High Court, the Court of Appeal accepted² that Mr Johnston had failed to exercise reasonable skill and care as a director, but declined to order that he pay compensation because:

- the liquidators had failed to establish the extent of the deterioration of NZNet's finances between January and September 2011. In any event, Mr Johnston would have been entitled to an allowance for the substantial advances he made to the company over 2011

- Mr Andrews as managing director was primarily liable for NZNet's losses. Mr Johnston was not an executive director. He did not run the company
- Mr Andrews actively misled Mr Johnston over a sustained period of time, and
- the duration of Mr Johnston's breach was relatively short – a matter of nine months.

Interestingly, one of the factors that influenced the Court's decision was the position of the IRD, which stood to gain the most from any compensation order. However, as the Court pointed out, it allowed NZNet's tax debt to escalate without taking any recovery steps. This led the Court to observe that:³

There is an irony in the liquidators' complaint that Mr Johnston should have moved earlier when the company's second largest creditor was guilty of the same inaction. The IRD's failure to act is unexplained and inexplicable; if it had acted much earlier its claimed loss would have been reduced accordingly. The IRD contributed significantly to its own losses.

The Court of Appeal also questioned the economic benefits of the liquidators bringing the claim when Mr Johnston's potential liability was "very modest indeed."⁴

Take-outs

The performance of a director will be measured by reference to the particular responsibilities of that person within the particular company structure.⁴ Even if a director is found to have breached his or her duties, the Courts will still address factors of causation, culpability and fairness when deciding whether to order compensation.

For liquidators, the case highlights what most practitioners know already: that claims against directors must be realistic, well-prepared and supported by an adequate evidential foundation. Not all claims against directors will be worth pursuing and not all breaches cause loss resulting in damages.

Footnotes

- 1 *Grant & Khov v Johnston* [2015] NZHC 611
- 2 <http://www.chapmantripp.com/publications/Documents/Court%20of%20Appeal%20judgment.pdf>
- 2 *Grant & Khov v Johnston* [2016] NZCA 157 at [94]
- 3 *Grant & Khov v Johnston* [2016] NZCA 157 at [97]
- 4 *Grant & Khov v Johnston* [2016] NZCA 157 at [59]

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