IN THE COURT OF APPEAL OF NEW ZEALAND

CA229/2015
[2016] NZCA 157

BETWEEN	DAMIEN GRANT AND STEVEN KHOV AS LIQUIDATORS OF NZNET INTERNET SERVICES LIMITED (IN LIQUIDATION) Appellant
AND	ROWAN KENLEY JOHNSTON Respondent

Hearing:	16 February 2016
Court:	Harrison, Fogarty and Toogood JJ
Counsel:	B J Norling and A Cherkashina for Appellant S J Ropati for Respondent
Judgment:	29 April 2016 at 2.15 pm

JUDGMENT OF THE COURT

A The appeal is dismissed.

B The appellants are ordered to pay the respondent costs for a standard appeal on a band A basis together with usual disbursements.

REASONS OF THE COURT

(Given by Harrison J)

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Introduction

[1] The liquidators of NZNet Internet Services Ltd (NZNet), Damien Grant and Steven Khov, have sought orders that three former directors pay compensation to satisfy debts due to the company's creditors. The liquidators claim that the directors breached various statutory duties when performing their offices.

[2] Following trial in the High Court at Auckland, Brown J found that all three directors had breached their duties but at different times and in different ways,[1] with the consequences as follows:

(1) Stephen Andrews, NZNet's managing director and majority shareholder, was found to have acted recklessly and in breach of his duty of care from an unspecified date but for a period covering some years.[2] He was ordered to contribute $1,089,591 towards NZNet's assets by way of compensation and declared to be personally responsible for outstanding debts of the same amount due at the date

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1 *Grant & Khov v Johnston* [2015] NZHC 611 [HC decision].

2 At [175]; Companies Act 1993, ss 136 and 137.

of liquidation.[3] Mr Andrews took no steps to defend the proceeding and does not appeal.

(2) A second director, George Thomas, was found to have acted in breach of his duty of care for a three-month period. He was ordered to contribute $83,812 towards the company's debts by way of compensation.[4] Mr Thomas defended the proceeding but does not appeal.

(3) A third director, Rowan Johnston, was found to have acted recklessly for two months within a five-month period when he was also in breach of his duty of care. However, he was not ordered to contribute towards NZNet's debts because the company's liability to him — totalling $460,000 — exceeded any loss attributable to his breaches.[5]

[3] The liquidators appeal only against the judgment in Mr Johnston's favour. Their wide-ranging grounds are based on the premise that Brown J erred in finding Mr Johnston was not liable in breach of his duties owed to the company, either during the entire term of his directorship of about 20 months or for some shorter period but longer than five months. Alternatively, they say that even if Brown J was correct that Mr Johnston's breaches of duty were limited to that five-month period, he should nevertheless be ordered to pay compensation of $76,456.

Background

(1) NZNet's relevant history

[4] The facts are recited at considerable length in Brown J's judgment. However, there is no contest about those which are central to the issues, and we can narrate them in relatively short order.

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3 At [175]; Companies Act, ss 300 and 301.
4 At [175]; Companies Act, s 301.
5 At [145].

[5] Mr Andrews incorporated NZNet on 12 July 1995. He was the sole shareholder and director. The company carried on business in Albany as an internet service provider.

[6] Brown J found that NZNet began to experience financial difficulties in July 2007 when it fell into arrears of payments due to the Inland Revenue Department (IRD). In November 2008 NZNet agreed with the IRD to settle the outstanding payments in instalments of $2,000 per month.[6] However, the company defaulted in making its January 2009 payment.

[7] Brown J found also that from July 2008 Mr Andrews entered into a series of agreements which caused NZNet to incur significant losses.[7] One was a complex agreement with Horizon Pacific Group (HPG), an internet service provider to business customers, to supply wholesale services including wireless internet, telehousing, dial-up internet and technical services. A dispute arose shortly after the agreement was entered into, culminating in HPG's application to the High Court for an injunction and other remedies.

[8] In a judgment delivered on 11 December 2009, declining HPG's application for an order for an equitable lien, Courtney J referred to NZNet's financial difficulties as follows:[8]

> [42] Relevant to consideration of this aspect is the fact that NZNet appears to be in difficult financial circumstances. In his second affidavit Mr Andrews annexed a copy of NZNet's financial statements to 31 March 2009 which he claimed showed current assets exceeding current liabilities by almost $140,000. However, the larger picture is not quite as good. Total liabilities exceeded total assets by $325,161. The company's largest asset, (accounting for a little over 60% of the asset base) is a debt of $256,735 owed on the shareholders' overdrawn current account.

(2) Mr Johnston's shareholding

[9] In November 2009 Mr Andrews contacted Mr Johnston. They had known each other for over 30 years through church activities, scouts and indoor cricket.

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6 At [11].
7 At [12].
8 *Horizon Pacific Group Ltd v NZNet Internet Services Ltd* HC Auckland CIV-2009-404-7597, 11 December 2009.

Mr Johnston had also been a subscriber to the company's services for a substantial period. Mr Andrews enquired whether Mr Johnston would be interested in investing in NZNet. Mr Andrews proposed that Mr Johnston become a "keystone" shareholder with an investment of $260,000 — $220,000 for a 20 per cent shareholding and a $40,000 loan for working capital.[9]

[10] Brown J described Mr Johnston's financial pedigree and the steps he took in response to Mr Andrews' proposal as follows:

> [21] Mr Johnston is financially literate and has a Bachelor of Commerce degree (Economics and Finance). He worked as a personal banker with BNZ from 1997 to 1999 and was employed as an investment analyst and subsequently a stock broker with Forsyth Barr from 1999 to 2013. However, because of his long association with Mr Andrews, whose honesty and credibility he unreservedly accepted, he obtained some objective advice from his lawyers, Brookfields.
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> [22] As part of the due diligence process a significant volume of information was obtained including:
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> (a) A copy of the budget for the year ending March 2010;
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> (b) Copies of bank statements for the months up to the purchase date;
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> (c) Copies of sales data for the months October and November 2009;
>
> (d) Copy of the Xero P & L for the months of September–November 2009 showing a profit in September, a loss in October and a profit in November.
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> He also requested, but did not receive, copies of the loan agreement with Mr Andrews' mother and the premises rental agreement relating to the building owned by Mr Andrews' family trust.
>
> [23] In an email to Mr Andrews of 8 December 2009 seeking information on various matters, including the outcome of penalties due to IRD in 2008 and the then current position on bad debts and late payments, he explained his investment philosophy in this way:
>
> > When I value a business, I look at Enterprise value, which is the key metric used these days. This values NZNet at

Equity	$1.1m (using the proposed 20% stake you are selling to me @ $220k)
plus SA FT loan	$0.175m
plus R Andrews loan	$0.335m
TOTAL	$1.610m

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9 HC decision, above n 1, at [20].

> To justify me to pay the price offered, I need to be able to see EBITDA [earnings before interest, tax, depreciation and amortization] of $200K+ within 12 months, and also satisfy myself to the risks associated with the loans (totalling $0.5m) as I have a number of other opportunities where I can generate very high return on investment in the next 1–3 years.

[11] In conducting his due diligence inquiry into NZNet's financial circumstances, Mr Johnston, with assistance from his solicitors, Brookfields, asked Mr Andrews a number of questions.[10] In particular he enquired about the company's overdrawn shareholders' account of $256,000, its liability on penalties to the IRD, and the current position of bad and late debts, with emphasis on those outstanding for more than 90 days. Mr Johnston was satisfied by Mr Andrews' comprehensive answers, in particular, by his explanation that IRD penalties on Goods and Services Tax (GST) liabilities were caused by accounting errors; and that he was expecting a GST refund of $100,000.

[12] Because it assumed some significance in Mr Norling's argument for the liquidators, we interpolate to note that NZNet's profit and loss accounts as supplied to Mr Johnston for the period ending 31 October 2009 incorrectly recorded a liability to the IRD of $4,000. The liquidators' evidence is that the correct figure was by then $173,303.

[13] After considering Mr Andrews' answers and completing his due diligence inquiry, Mr Johnston decided to invest. He expected that his investment would be for a relatively short term of one to two years. On 23 December 2009 Mr Johnston agreed to purchase from Mr Andrews 20 per cent of NZNet's shares for $220,000. As the Judge noted, the agreement contained an extensive schedule of warranties and undertakings about the accounts, taxation liabilities, loans and accounting records.[11] On 30 December 2009 Mr Johnston was appointed a director.

(3) Mr Johnston's directorship: 2010

[14] Brown J described the nature of Mr Johnston's role in NZNet as follows:

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10 At [24].
11 At [26].

> [28] Mr Johnston continued to hold his full time job at Forsyth Barr and initially he had no involvement in the day-to-day decisions and management of NZNet. He had no company credit card, no access to bank accounts and no access to the office. Although a director, his role appeared to be as an investor/shareholder and the business continued to be run by Mr Andrews. Mr Johnston saw his role as being to provide funding for NZNet initially to tidy up sundry creditors and to fund growth through the purchase of wireless equipment, new modems and payment of additional staff wages when there was a shortfall in working capital.

[15] On 28 February 2010 Mr Johnston loaned NZNet $50,000 for a term of 24 months at an interest rate of 14 per cent. Mr Andrews guaranteed the company's liability to repay. However, in March 2010 Mr Johnston became aware that Mr Andrews had not fully disclosed NZNet's financial position to him and that his budget forecasting had been inaccurate. Mr Johnston learned that the company had applied his loan of $50,000 to pay debts, instead of expanding the business as he anticipated when making the advance.

[16] During April and May 2010 Mr Johnston learned of NZNet's defaults in meeting monthly instalments to two contracting parties. He received from Mr Andrews comforting reports about actual and potential new sales, and steps taken to meet what Mr Andrews assured him were short-term financial problems. Nevertheless, in early June Mr Johnston proposed that he should have greater day-to-day involvement with the company's financial management. Mr Andrews welcomed the prospect of Mr Johnston's participation "to oversee the financial side of the business", freeing him to "grow the business". In Mr Andrews' view the company would also be strongly placed for future growth if it was relieved from its obligations under financing agreements.

[17] Among other things, Mr Johnston considered Mr Andrews' provision of a spreadsheet of outstanding creditors as at June 2010. Mr Norling placed particular emphasis on Mr Johnston's email to Mr Andrews on 12 June 2010 as follows:

> At my first glance of the accounts with Xero today, nznet is even in more worse shape than I thought.
>
> Can you also explain the status of the credit cards, is there seriously over $40k outstanding on those?? Why has this not been added to any amounts outstanding in spreadsheets?

> I can't help you and the business if you are not giving me all the information.
>
> I think I will work every Sat from now on to get this mess sorted out. We will never know where we are until we even get XERO fully up to date… The business is bleeding money left right and centre and I now understand why Dwayne took the position he did. He is right, NZNET is in terrible shape.

[18] Despite this adverse discovery, Mr Johnston was satisfied that NZNet's cash flow problems would be answered by another injection of his capital. He proposed to advance a further $80,000, taking his total financial commitment including his shareholding to $350,000.

[19] Further correspondence followed between Messrs Johnston and Andrews about the state of NZNet's accounts. Having conducted his own assessment, and offering to work in the company during weekends, Mr Johnston was satisfied that NZNet was making positive steps towards improving its systems.

[20] An immediate problem arose in June 2010 when a finance company served a statutory demand for $48,391 and threatened to appoint receivers. Mr Johnston resolved this crisis by negotiating a settlement with the creditor, which he was required to fund. On 1 July 2010 Mr Johnston agreed to lend NZNet $100,000 at an interest rate of 12 per cent and a default rate of 22 per cent for the purpose of refinancing the company's liabilities. Again Mr Andrews guaranteed the loan.

[21] Mr Johnston was overseas for most of the third quarter of 2010. However, Brown J found that he maintained email contact with Mr Andrews during this period.[12] He requested Mr Andrews to update the company's accounting systems so that an accurate budget could be prepared for August 2010. Based on his own revision of Mr Andrews' budget forecast, Mr Johnston worked out that NZNet's monthly expenses were likely to exceed expected sales by $15,000.[13] In Mr Johnston's opinion the company needed a rapid increase in sales "very soon".

[22] On enquiry Mr Johnston learned from Mr Andrews of a projected shortfall for September 2010. That problem would be alleviated if Mr Johnston advanced a

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12 At [45].
13 At [46].

further $12,000 to meet one particular financial obligation, which he agreed to do.[14] In late October 2010 Mr Johnston advised Mr Andrews that after checking the accounts that morning he was satisfied NZNet would still be in overdraft but only by a small amount. He also formulated an eight-part financial plan to be implemented from November including paying all liabilities and operating in credit for the future.[15]

[23] In November 2010 Mr Johnston advanced $5,000 to the company to ensure that wages were paid in full. Despite some frustration with Mr Andrews, Mr Johnston had made further cash advances to the company totalling $35,000 over the preceding month.

[24] In December 2010 Mr Johnston requested an update from Mr Andrews on a number of issues including NZNet's payment of pay-as-you-earn withholding tax on employees' income (PAYE). His inquiry had been generated by a recently published article about the IRD "cracking down" on companies in arrears of PAYE payments. Mr Andrews assured Mr Johnston that payments had been made. Mr Johnston's evidence was that he had no reason to disbelieve him.[16] In fact, by 22 December 2010 the company owed the IRD about $82,000 for overdue PAYE.

[25] At about this time, Mr Thomas became involved in NZNet. His role was to be marketing manager for the company's sales initiatives. Mr Johnston then knew that without significant sales improvements NZNet would not sustain its business model. Mr Thomas aggressively spearheaded a plan to boost revenue through sales from around January 2011.

(4) Mr Johnston's directorship: 2011

[26] Contrary to Mr Johnston's expectations, NZNet's financial position did not improve in 2011. As the Judge noted:

> [66] Mr Johnston and Mr Andrews also had interests in Caprica Ltd, an internet gaming business which had a business connection with NZNet.

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14 At [47].
15 At [48].
16 At [51].

> Significant funding for Caprica was also being provided by Mr Johnston. Jocelyn Crosby who was experienced in company administration was employed by Caprica in December 2010 to attend to the accounts. As foreshadowed in the 24 January 2011 email, Mr Johnston arranged for Ms Crosby to also work at NZNet to assist with accounts, administration and payroll with the job title of Administrator.
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> [67] Although Mr Andrews and Mr Thomas were initially reluctant to provide Ms Crosby with any access to the NZNet accounts, through Mr Johnston's intervention she obtained access to the payroll and the accounting system (including Xero) by early April 2011. Ms Crosby reported directly to Mr Johnston. As she explained in her interview with Mr Norling and Ms Boparoy on 28 August 2013, she saw herself as "very much [Mr Johnston's] eyes and ears".

[27] Nevertheless, Mr Johnston continued to transfer funds to the company to cover its liabilities — $12,000 on 14 February 2011 and another $9,000 on 17 February to cover wages.[17] Mr Johnston called an urgent board meeting at the company's solicitors' office on 16 February 2011 in which Mr Andrews agreed to finalise the company's accounts promptly and introduce Mr Johnston to the company's accountant.

[28] NZNet's problems continued through March and April. On 5 March 2011 Mr Johnston agreed to transfer $22,000 to the company to fund debt, making a total of $70,000 extra advances in two months. As he said in an email on 7 March 2011, he had agreed to provide "lifeline" funding for NZNet. On 15 April 2011 Mr Johnston transferred a further $25,000 to the company. By then, however, his funding sources were nearly exhausted.[18]

[29] Mr Andrews had not told Mr Johnston that on 1 February 2011 he had signed a contract for NZNet with a company called Superdockets, which provided printing and advertising on the rear of supermarket dockets.[19] That agreement bound the company to pay a total of $89,835 by twelve monthly instalments of $7,448.

[30] It is unnecessary for us to examine subsequent evidence. Brown J found that from 1 April 2011 until his resignation as a director on 15 September 2011 Mr Johnston contravened his obligations under s 137 of the Companies Act 1993 —

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[17] At [60].
[18] At [72].
[19] At [72].

that is to perform his duties as a director with "the care, diligence and skill that a reasonable director would exercise in the same circumstances".[20] Brown J was satisfied that by then Mr Johnston should have "realised that all was not well despite his commitment to provide 'lifeline' funding".[21] Mr Johnston has not cross-appealed against this finding.

[31] The evidence which most graphically supports this finding is found in these passages from Brown J's judgment:

> [73] On 20 April 2011 Mr Johnston became aware not only of the Superdockets commitment but also the fact that NZNet's situation was worse than he had understood. His lengthy email of 20 April 2011 was notable for its reference to GST and PAYE. Among other things it stated:
>
> > It has today come to my attention that the NZNET situation is a lot worse than you have outlined to me at anytime previously. You have effectively lied to me from day 1 of my investment into NZNET. Your original accounts and forecasts were complete lies and have only got worse over time. It has now become clear why you have not allowed Jocelyn access to the NZNET accounts up to this time – they are in a shocking state.
> >
> > …
> >
> > Also you have not paid GST or PAYE or many other payments for nznet and now I'm aware of massive bills outstanding in other areas which nznet has no funds to pay. You have proven time and time again you are not fit to run this company. Your technical ability is excellent but you have proven that you cannot run a company.

[32] Brown J found that Mr Johnston was separately in breach of his duty under s 135 of the Companies Act — that is, not to 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 — from 26 July 2011 until his resignation.[22] Mr Johnston has not cross-appealed against this finding.

[33] By special resolution dated 17 November 2011 Messrs Grant and Khov were appointed as liquidators pursuant to s 241(2)(a) of the Companies Act.

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20 At [118].
21 At [118].
22 At [119]–[121].

Liquidators' case

[34] In the High Court the liquidators advanced their claims against all three directors on separate statutory grounds but ultimately relying on the same core facts and allegations of breach.

(1) Reckless trading

[35] First, the liquidators claimed that the directors had engaged in reckless trading, defined by s 135 of the Companies Act as:

> **135 Reckless trading**
>
> A director of a company must not—
>
> (a) 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
>
> (b) 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.

[36] It was common ground at trial and on appeal that the test for determining whether a director is in breach is objective in nature, focussing on the manner in which the company's business was carried on and whether that created a substantial risk of serious loss; a director's beliefs are not directly relevant in this context.[23]

[37] What must be emphasised is that s 135 is not concerned with ordinary business risks but with allowing the business to be carried on in a manner which is likely to create "a substantial risk of serious loss". The section is prospective in its effect, requiring the directors in a given situation to consider with care whether continuing to trade has realistic prospects of generating sufficient revenue to meet current and future liabilities.[24]

[38] Significantly, as the purpose of the s 135 is to avoid an inappropriate loss to a company's creditors through reckless trading, the company's financial position at all

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23 *Mason v Lewis* [2006] 3 NZLR 225 (CA) at [51].
24 At [50]–[51].

relevant times is critical.[25] It follows that a director cannot be in breach where he or she does not know a company's true financial position, *despite making reasonable enquiries for that purpose*, because of its concealment by another director or senior manager. It is important to note that Mr Johnston's position is distinct from that of a sleeping director who fails to conduct a proper inquiry and then claims immunity for loss caused by the fraud of a co-director.[26] Here, as always, the question is what the reasonably prudent director in Mr Johnston's shoes would have done to control the business of the company.[27]

[39] The factual basis for the liquidators' allegation of the directors' breach of s 135 was that from 1 February 2008 NZNet was unable to pay its due debts because it traded throughout at a loss. In the year ended 31 March 2009 its loss was $8,169, in the 2010 financial year it was $95,747 and in the 2011 financial year it was $247,971. Also the accounts showed that liabilities consistently exceeded assets.

[40] The liquidators alleged that the directors had agreed, caused or allowed the business to trade in a reckless manner by: (1) leaving Mr Andrews to run the business without sufficient control; (2) failing to ensure proper reporting systems were in place; (3) taking a gamble with creditors' funds; (4) each failing to properly appreciate the nature of the business for himself; and (5) poorly managing the company's affairs.

[41] The liquidators further alleged that there was a substantial risk of serious loss to creditors arising from the company entering into transactions without the requisite finance, allowing the company to trade without realistic prospects of generating cash to allow for servicing of pre-existing debt while its overall position deteriorated, and taking illegitimate business risks.

(2) Incurring obligations

[42] The liquidators' second claim, in the alternative, was that the directors breached s 136, which materially provides as follows:

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25 At [57].
26 At [81]–[83].
27 *FXHT Fund Managers Ltd (in liq) v Oberholster* (2009) 10 NZCLC 264,562 (HC) at [59]–[61].

136 Duty in relation to obligations

> A director of a company must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.

[43] Brown J dismissed this cause of action against Mr Johnston. He was satisfied that s 136 is directed towards incurring an obligation on a particular transaction rather than on the general conduct of the company's business. By contrast, s 135 appropriately governs debts incurred on revenue account.[28] Mr Norling accepted that the Judge's construction of s 136 was correct and that, in any event, the liquidators' allegations of breach of it did not add materially to their case. Accordingly we do not intend to consider this ground further.

[44] We do note, however, the Judge's finding that:

> [137] In those circumstances I find that there was a breach of s 136 by Mr Andrews in contracting to assume the Superdockets liability in the sum of $89,385.92. The liquidators' submissions recognised that Mr Johnston was not a party to and did not agree to NZNet assuming the Superdockets liability. Consequently the finding in respect of s 136 is confined to Mr Andrews alone.

(3) Negligence

[45] The liquidators' third claim, in the alternative, was that the directors breached their duties of care under s 137 as follows:

137 Director's duty of care

> A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation,—
>
> (a) the nature of the company; and
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> (b) the nature of the decision; and
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> (c) the position of the director and the nature of the responsibilities undertaken by him or her.

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[28] HC decision, above n 1, at [134].

[46] Again, there is no dispute about the approach required by s 137. The standard to be applied is objective, and performance is to be measured by reference to the reasonably competent director. However, we must emphasise the statutory identification of the circumstances material to an inquiry into breach. The nature of the company, of the relevant decision or decisions and of the director's position and responsibilities are particularly important.

[47] In support of this claim the liquidators repeated the same underlying factual allegations advanced in support of the reckless trading claim. In addition they said that, having regard to NZNet's financial position and its creditors, the directors could have had no reasonable grounds for believing at the time debts were incurred that the company would be in position to settle with creditors, that they failed to have regard to the creditors' legitimate interests, and that they failed to take reasonable steps to "place themselves in a position to guide and monitor the management of NZNet".

(4) Keeping proper accounting records

[48] The liquidators' fourth claim was that the directors failed to comply with s 194, which materially provides:

> **194 Accounting records must be kept**
>
> (1) The board of a company must ensure that there are kept at all times accounting records that—
>
> (a) correctly record the transactions of the company; and
>
> (b) will enable the company to ensure that the financial statements or group financial statements of the company comply with generally accepted accounting practice (if the company is required to prepare such statements under this Act or any other enactment); and
>
> (c) will enable the financial statements or group financial statements of the company to be readily and properly audited (if those statements are required to be audited).
>
> (2) The board of a company must establish and maintain a satisfactory system of control of its accounting records.
>
> …

[49] As NZNet was an exempt company in terms of s 6A(1) of the Financial Reporting Act 1993 with a balance date of 31 March in each year, its directors were obliged to ensure that within five months of balance date the company completed financial statements complying with s 12 of that Act.[29] Brown J summarised the liquidators' complaints as follows:

> [166] With reference to NZNet's financial statements the liquidators noted:
>
> (a) the financial statements as at 31 March 2008 did not record "Tax Payable" under current liabilities despite the fact that known PAYE as at 31 March 2008 totalled $7,370.37;
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> (b) the financial statements as at 31 March 2009 did not record "Tax Payable" under current liabilities. Those financial statements only recorded GST due for payment in the sum of $21,606 whereas it was said that at 31 March 2009 NZNet had at least $11,370.18 outstanding for unpaid PAYE;
>
> (c) the financial statements as at 31 March 2010 did not record "Tax Payable" under current liabilities. Rather it appeared to be partially accounted for under a separate heading labelled "Trade and Other Payables". As it seemed that the IRD liability was lumped in with "Accrued Expenses", it was submitted that it was not possible to identify the true quantum owed;
>
> (d) the financial statements as at 31 March 2010 were not prepared and signed until much later than the required date and they were not co-signed by Mr Johnston.

[50] Brown J was not satisfied that Mr Johnston breached s 194 of the Companies Act. He was satisfied that Mr Johnston sought and obtained financial information at the outset, that he was plainly misled by Mr Andrews despite undertaking due diligence inquiries, and that when he became concerned about the company's situation he engaged Ms Crosby.[30] However, by the time Mr Johnston understood the true position, the die was effectively cast. In any event, the Judge would have declined to make a declaration under s 300 that Mr Johnston is personally liable on this ground.[31]

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29 At [165].
30 At [173].
31 At [174].

[51] We record also that this claim added nothing to the liquidators' primary claims under ss 135 and 137 of reckless trading and negligence respectively and we do not intend to address it further.

Appeal

[52] As foreshadowed by the statement of claim, the factual bases for the liquidators' claims of reckless trading and breach of duty of care overlapped. The liquidators support Brown J's findings of Mr Johnston's breaches both of ss 135 and 137. They appeal on the ground that the Judge erred, however, in failing to find that Mr Johnston's breaches ran from dates earlier than 1 April 2011 and 26 July 2011 respectively. In argument Mr Norling postulated various alternatives as the appropriate starting date for finding a breach, the first being the date of Mr Johnston's appointment as a director of NZNet.

[53] Mr Norling submitted that Brown J erred in applying a subjective test to both the ss 135 and 137 inquiries; and that if the Judge had applied an objective criterion he would have found Mr Johnston was in breach of both duties from 30 December 2009 or sometime during the following year. In particular, Mr Norling submitted:

(1) Mr Johnston allowed NZNet to trade while insolvent given that during the due diligence process he obtained information from Mr Andrews which placed him or ought to have placed him on notice as to the company's true financial position. Following his appointment Mr Johnston learned that NZNet was in a worse position than originally thought. Notwithstanding significant warning signs, he continued to allow the company to trade by paying creditors, which were essential for keeping the business going, and allowed other debts to increase. Mr Johnston continued to advance funds to the company, allowing it to pay urgent creditors while enabling it to trade on and incur large debts to others — his advances served to compound the company's indebtedness.

(2) Mr Johnston allowed Mr Andrews, who had proved to be neither competent nor honest, to remain in control of NZNet with little or no controls or oversight in place.

(3) Mr Johnston entrusted Mr Thomas with all the powers necessary to improve NZNet's profitability, despite the latter's obvious incompetence, and had knowledge that the sales forecasting and budgeting was overly optimistic.

[54] In summary, Mr Norling said, Mr Johnston failed to undertake a sober assessment of NZNet's likely future income revenues or prospects, thereby failing to exercise reasonable skill, care and diligence, or placing its creditors at substantial risk of serious loss.

Decision

[55] We accept that Brown J did not address the liquidators' staged claims within the framework provided by ss 135 and 137 and the leading authorities. However, it appears to us that the Judge may not have had the benefit of careful analytical argument from either side.

[56] While Brown J's reasons might be described as economical, he relied on two notable features of Mr Johnston's office as a director of NZNet in dismissing the liquidators' claims of breach during 2010 and early 2011. One was that Mr Johnston was not, at least originally, involved in the operation of the business.[32] The other was Mr Johnston's willingness to inject substantial personal funds into the company.[33] In addition to his original advance of $50,000 in February 2010, Mr Johnston made advances during that year of $120,315 and during 2011 of $238,340. He advanced the company a total of $460,000,[34] which the Judge was satisfied kept NZNet afloat.[35]

32 At [114].
33 At [115].
34 We infer that the amount of $460,000 includes accrued interest.
35 HC decision, above n 1, at [116].

[57] We shall address the liquidators' appeal by reference to their staged allegations of Mr Johnston's breach, starting with his appointment as a director on 30 December 2009.

(1) 30 December 2009

[58] The liquidators' argument for findings of breach from 30 December 2009 was based on the premise that while conducting his due diligence inquiry Mr Johnston obtained information from Mr Andrews that did, or should have, placed him on notice of NZNet's financial difficulties. Mr Norling referred in particular to:

> (1) Mr Johnston's receipt of financial statements showing NZNet had a net deficit of assets for $325,161 while its largest asset (over 60 per cent of its asset base) was a debt of $256,735 owed on Mr Andrews' overdrawn shareholders' current account;
>
> (2) what was said to be Mr Andrews' highly optimistic budget forecast in terms of sales and NZNet's growth which, it was said, completely ignored the company's outstanding debts and identified penalties incurred for non-payment of GST;
>
> (3) Mr Andrews' vague and misleading answers to Mr Johnston's enquiries; and
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> (4) NZNet's indebtedness to the IRD of $173,303 at the date of Mr Johnston's appointment.

[59] We open by observing what may seem trite. While the statutory tests are objective, performance of the requisite standard is to be measured by reference to the responsibilities of the particular director within the particular company structure. A director is not absolutely liable for all losses suffered while he or she holds office as a director. This observation does not conflate the issue of breach with determination

of appropriate relief under s 301.[36] Instead it reinforces that liability is only imposed to the extent that the director acts or fails to act in a proscribed way.

[60] A director, when exercising his or her powers or in performing his or her functions, must act in good faith and in what he or she believes to be the company's best interests.[37] In this context it is important not to confuse the role of a non-executive director like Mr Johnston with that of a company's management. A non-executive director is responsible for exercising a reasonable degree of skill and care in overseeing the company's management and control and when participating in any significant decisions to which the company is a party.[38] He or she is not responsible for managing the company's business on a daily basis.

[61] Having reviewed the evidence afresh, we are satisfied that Mr Johnston undertook a thorough assessment of NZNet's business before acquiring a 20 per cent shareholding on 23 December 2009 and accepting appointment as a director. His enquiries were careful and comprehensive. He was satisfied of NZNet's financial potential based on his knowledge of the business, both as a subscriber and a business analyst. And, on an objective assessment, there was nothing to place him on alert about the answers given to his questions by a man who had with apparent success operated NZNet's business for over 20 years, and in whom he had developed trust through a lengthy personal relationship.

[62] With the benefit of hindsight, Mr Norling criticises Mr Johnston's reliance on Mr Andrews' optimistic budget forecasts. But we are not satisfied that in December 2009 Mr Johnston had any reason to doubt Mr Andrews' forecasts. Mr Andrews was fully familiar with his business and the market in which it operated. A net deficit of assets of $325,000 in the company's 2009 accounts is not decisive. Mr Johnston was entitled to assume that his purchase price of $220,000 for a 20 per cent shareholding would be used to retire debt and that his loan of $50,000 would be applied in funding future business growth. Finally, Mr Johnston had no independent way of knowing that the company was then indebted to the IRD for

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36 *Mason v Lewis*, above n 23, at [52].
37 Companies Act, s 131.
38 See *R v Moses* HC Auckland CRI-2009-004-1388, 8 July 2011 at [401].

$173,303. He had Mr Andrews' assurance that a GST refund of $100,000 was due, more than offsetting any current liability for that tax.

[63] The liquidators' focus on Mr Johnston's due diligence inquiry is misplaced as the foundation for claiming that he agreed or allowed NZNet to trade in a reckless manner from office from the moment of assuming office. He did not then owe NZNet or its creditors any duties. His inquiry was directed to deciding whether to commit his capital to the company. By doing so he was not agreeing to a course of action which was likely to create a substantial risk of serious loss to the company's creditors.

[64] Mr Norling submitted that if Mr Johnston had not agreed to make a financial commitment in December 2009 the company would have likely then gone into liquidation and that his financial lifeline only served to compound NZNet's indebtedness.[39] However, a strict "but for" approach has no place in this analysis. The fact that his private financing facility allowed the company to continue trading is not evidence that Mr Johnston agreed to allow the company to trade recklessly or acted negligently.

[65] Mr Norling's submission ignores the rationale for Mr Johnston's involvement. He was ready, willing and able to provide a substantial capital injection to enable NZNet to expand its income sources. In our judgement he had a reasonable foundation on the material available to him for deciding that NZNet had a realistic prospect of generating sufficient revenue to meet current and future liabilities.

[66] The liquidators' claim that Mr Johnston acted negligently in this period fails for largely the same reasons. They have ignored the nature of NZNet's business and Mr Johnston's position and the responsibilities undertaken by him. NZNet was Mr Andrews's creation. As we have noted, he knew the business and its market. He ran the company in every respect.

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39 See also HC decision, above n 1, at [98].

[67] Mr Johnston was a non-executive director. He required time to familiarise himself with NZNet and its operations. He cannot be held responsible for failing to act from the day he assumed office as a director. On the information then available to him, Mr Johnston had reasonable grounds for believing that with his financial support NZNet would be able to meet its debts as they fell due.

[68] The liquidators' allegation that Mr Johnston was in breach of his statutory duties from the date of his appointment as director, and before he had an opportunity to fully familiarise himself with NZNet's business, is unrealistic and must fail.

(2) 30 June 2010

[69] There is more substance to Mr Norling's submission that Mr Johnston was in breach by about 30 June 2010. By then he had six months' familiarity with NZNet's operations. Mr Johnston was aware that Mr Andrews had not fully and accurately disclosed NZNet's financial position and that his budget forecasting was inaccurate. Mr Johnston was also aware that the company had applied his loan of $50,000 to pay debts rather than in developing its sales activities, had defaulted in meeting monthly instalments under two separate contractual arrangements, "was in even more worse shape than [he] first thought", and a creditor had issued a statutory demand for $48,391 with a threat to appoint receivers.

[70] We accept that by 30 June 2010 Mr Johnston was on notice of Mr Andrews' managerial weaknesses, overly optimistic sales forecasting and inaccurate financial reporting. However, in our judgment he is absolved of any breach of duty by virtue of the affirmative steps he took to impose financial disciplines and controls on Mr Andrews. He used his own resources to settle with the creditor which had served a statutory demand. He also agreed to lend NZNet a further $100,000 to refinance its short-term liabilities, supplemented by additional advances of $52,000 later in the year.[40] In terms of his obligations as a director of NZNet, it was not unreasonable to commit the company to additional debt when he knew he would himself have to bear the losses associated with a failure. He also confirmed his agreement to provide

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[40] See [20]–[23] of this judgment.

funds to pay the company's debts as they fell due wherever NZNet was not itself in a position to meet them from its own cash flow.[41]

[71] In return, Mr Andrews agreed to Mr Johnston's requirement for a closer involvement with NZNet's financial management. That was his area of expertise, and he was prepared to and did assist in improving the company's poor financial systems. With the benefit of time and a greater familiarity with its activities, he formulated a detailed financial plan for recovery. We reject Mr Norling's criticism of Mr Johnston's plan as being insufficiently detailed.

[72] Mr Johnston took these active steps in the expectation, which on the available information he was still objectively entitled to maintain, that Mr Andrews would continue to grow the company's revenue base, which was his area of expertise. Indeed, NZNet's financial statements show an increase in revenue from sales from $124,903 for the 2009 financial year to $329,163 for the 2010 financial year. Mr Norling accepted that throughout 2010 Mr Johnston continued to pursue his aim of getting the company with his assistance to a financially neutral base from which it could launch its expansion plans.

[73] In our judgment Mr Johnston had a reasonable basis for pursuing this strategy in his capacity as a director and for concluding that NZNet's financial problems were not terminal but could be rectified with his continued funding support and greater participation in its management. By this means the company would be well placed to fulfil its future potential.

[74] It must be emphasised that Mr Johnston did not simply invest his capital and then sit on his hands. To the contrary, he acted affirmatively and responsibly in the first 12 months of his appointment by familiarising himself with NZNet's affairs and by employing his own expertise to its benefit. He was confronted with the immediate challenges of Mr Andrews' pre-existing method of financial operation for which he bore no responsibility. He used his best endeavours to improve its

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41 *Yan v Mainzeal Property and Construction Limited (in receivership and in liquidation)* [2014] NZCA 190 at [86].

deficiencies to propose and implement financial systems designed to improve NZNet's position.

[75] Mr Johnston's performance is not to be judged by the failure of his efforts but by the reasonableness of his actions given the limitations imposed by Mr Andrews' direct control of the company's activities. To borrow William Young J's phraseology in *Re South Pacific Shipping Ltd (in liq)*, Mr Johnston's behaviour did not depart so markedly from orthodox business practice or involve such extensive and unusual risks to NZNet's creditors that it can fairly be stigmatised as negligent or reckless.[42]

(3) 31 December 2010

[76] However, we agree with Mr Norling that from 31 December 2010 Mr Johnston failed to exercise reasonable skill and care in discharging his duties. By then Mr Johnston had a year's familiarity with NZNet's business and, significantly, with Mr Andrews' failed promises and of his misleading advice to his fellow directors. While sales continued to grow, so too did the mounting evidence of Mr Andrews' ill-disciplined and incompetent management and its adverse effect on the company's financial position.

[77] In particular, by 31 December 2010 Mr Johnston knew or ought to have known enough not to accept at face value Mr Andrews' answer to his request for an update on the company's liabilities for PAYE. If he had made a proper enquiry Mr Johnston would have learned that NZNet owed $82,000 for overdue PAYE. Mr Norling is correct that Mr Johnston should have been on notice from the accounts submitted by Mr Andrews that the company as an actively trading entity was not paying its multiple tax liabilities. Mr Johnston accepted at trial that he would not have agreed to lend the company further funds had he known that it was not meeting its taxation liabilities.

[78] We accept that all communications from the IRD to the company were sent to a post office box controlled by Mr Andrews. However, Mr Johnston should have

42 *Re South Pacific Shipping Ltd (in liq)* (2004) 9 NZCLC 263,570 (HC) at [151]. See also *Jordan v O'Sullivan* HC Wellington CIV-2004-485-2611, 13 May 2008 at [254].

insisted upon Mr Andrews' provision of proof that NZNet was paying its regular tax commitments.

[79] Mr Johnston is not saved from a finding of negligence as at 30 December 2010 by the fact that he continued to keep NZNet financially afloat during 2011. By then he had sufficient knowledge of Mr Andrews' method of operation and the company's continued deterioration under his mismanagement — he ought to have known that the company should not continue to assume additional debt, even from a friendly source. In this respect we note that Mr Johnston would not be the first director whose judgment was compromised by his financial involvement with a company, leading to the pursuit of good money after bad. An objective evaluation would have shown Mr Johnston that by early 2011 NZNet had passed the point of no return, despite its engagement of Mr Thomas and later Ms Crosby, and that Mr Andrews' pattern of managerial deception was beyond redemption. He should have dismissed Mr Andrews or, more realistically, resigned.

[80] In view of this finding it is unnecessary for us to consider the liquidators' alternative claim of allowing the company to trade in a reckless manner.

[81] It follows that we disagree with Brown J, who did not make findings on the issue of breach as at 31 December 2010, that Mr Johnston was not in breach of his s 137 duty until 1 April 2011. We must now consider the consequential question of Mr Johnston's liability for compensation for his negligence from 1 January 2011.

Compensation

[82] A negligent director's liability is governed by s 301, which materially provides:

> **301 Power of court to require persons to repay money or return property**
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> (1) If, in the course of the liquidation of a company, it appears to the court that a person who has taken part in the formation or promotion of the company, or a past or present director, manager, administrator, liquidator, or receiver of the company, has misapplied, or retained, or become liable or accountable for, money or property of the company, or been guilty of negligence, default, or

breach of duty or trust in relation to the company, the court may, on the application of the liquidator or a creditor or shareholder,—

(a) inquire into the conduct of the promoter, director, manager, administrator, liquidator, or receiver; and

(b) order that person—

(i) to repay or restore the money or property or any part of it with interest at a rate the court thinks just; or

(ii) to contribute such sum to the assets of the company by way of compensation as the court thinks just; or

(c) where the application is made by a creditor, order that person to pay or transfer the money or property or any part of it with interest at a rate the court thinks just to the creditor.

…

[83] The liquidators received these proofs of debt totalling $1,098,591 as tabulated in their statement of claim:

Creditor	Amount owed	Date range of debt
Aherne Electrical	$370.30	31/10/11
Amit Kumar	$5,347.10	
Anupama Chhabra	$5,415.18	
Brookfields Lawyers	$25,330.31	31/05/11 – 30/09/11
Clearvision Communications	$655.50	26/10/11 – 17/01/12
Data Insurance International (APAC) Limited	$245.81	30/06/11 – 04/10/11
Debtworks NZ Limited	$308.25	02/09/11 – 01/01/12
DNG Data Insurance Limited	$4,272.12[43]	11/09/09 – 21/10/11
Fervor Limited	$12,650.00	30/09/11 – 29/10/11
George Thomas	$15,901.00	01/02/11 – 01/04/11
Geraint David Hedley Bycroft	$12,322.70	

43 This claim was accepted in error and is not included in the total. See HC decision, above n 1, at [6].

IFM Limited	$1,293.75	27/10/11
IMS Security Limited	$598.00	01/08/11 – 01/11/11
Inland Revenue	$386,322.39	29/02/08 – 30/09/11
JJ Richards and Sons NZ Limited	$467.72	02/09/11 – 25/11/11
Konica Minolta Business Solutions	$312.37	29/09/11 – 31/10/11
MH Publications	$2,439.15	12/04/11
North Shore Canvas	$384.70	30/11/11 – 08/12/11
Rowan Kenley Johnston	$460,000.00	19/02/10 – 04/08/11
Sunaina Bharti	$7,002.08	
Superdockets Advertising Limited	$94,971.05	31/12/10 – 02/05/11
Vector Communications Limited	$44,323.36	10/11/11 – 08/12/11
Vibe Communications Limited	$14,870.04	31/08/11 – 15/11/11
Wairau 100 Limited	$914.40	31/12/11
Ye Tran	$6,146.13	

[84] As noted, the Judge found Mr Andrews liable to pay compensation equal to the full amount of $1,098,591 outstanding to creditors as at the date of liquidation. However, he absolved Mr Johnston from any liability on the basis that from 1 April 2011 to 15 September 2011, the date of his resignation as a director, NZNet's financial position deteriorated by $243,490 (Mr Johnston's advances of $165,340 were the largest component).[44] Against this, NZNet was indebted to Mr Johnston for $460,000.[45] Thus the Judge found that Mr Johnston was not liable to pay any compensation to the liquidators.

[85] Mr Norling submitted that, even if the Judge's breach findings were correct, he erred in failing to order Mr Johnston to contribute $76,456 to the company's

[44] At [143]–[144].
[45] At [145].

assets. However, the liquidators' approach to assessing damages has not been of assistance, either in the High Court or on appeal. Their case in the High Court was confusing and its ground appeared to change during the trial. Their quantification of loss based solely on a 30 December 2009 breach date, spanning the entire period of Mr Johnston's directorship without a realistic allowance for any intermediate breach dates, was unsatisfactory. Brown J's decision dismissing the liquidators' application to recall details the problems he encountered in fixing quantum.[46]

[86] As we have found that Mr Johnston's liability arose from 30 December 2010, rather than from 1 April 2011, we must approach the issue of compensation afresh. It is common ground that the measure of Mr Johnston's liability for damages is the extent of the deterioration in NZNet's financial position between the dates of his breach and of resignation. That period is between 1 January 2011 and 15 September 2011. After that figure has been settled, we must take into discretionary account the factors of causation, culpability and the duration of trading.[47]

[87] The liquidators have failed to discharge their evidential onus of proving the measure of NZNet's financial deterioration between 1 January 2011 and 15 September 2011. Mr Norling advised from the bar that the amount was $210,625, excluding any allowance for Mr Johnston's advances in that period. But we cannot rely on this advice in the absence of an evidential foundation accompanied by an informed analysis. In this respect we record our reservations about the liquidators' disclosure of the extent of their recoveries, actual or potential, from Mr Andrews, which is important because liability between directors is not joint and several but separate.[48]

[88] In any event Mr Johnston would be entitled to a significant pro rata allowance against the total amount of NZNet's quantified deterioration to reflect his substantial advances over the relevant period. On the way the liquidators' case was presented it is not possible for us to attempt to quantify that figure. But on a rough assessment, it would account for most, at least, of any deterioration.

46 *Grant and Khov v Johnston* HC Auckland CIV-2013-404-1302, 24 April 2015.
47 *Mason v Lewis*, above n 23, at [109]–[110].
48 At [116].

[89] However, even if we had found that NZNet's financial position had deteriorated in the relevant period, we would not have exercised our discretion by ordering Mr Johnston to pay compensation. The factors of causation, culpability and ultimately fairness combine decisively in his favour for a number of reasons.

[90] First, on causation we agree with the Judge that Mr Andrews was primarily responsible for the company's losses. Mr Andrews was NZNet's driving force and its controlling hand. His sustained mismanagement of its business was the operative cause of the losses suffered by the company's creditors. Mr Johnston did not contribute to that mismanagement in any material way. To the contrary, he attempted unsuccessfully to rectify it. His omission to resign was of no causative effect; his ongoing agreement as director for some six months to continue borrowing funds from himself simply caused the company to prolong its demise and compounded his losses. Mr Andrews should be adjudged solely liable for all losses including those suffered during Mr Johnston's breaches of duty from early 2011.

[91] Second, in terms of culpability Brown J found that Mr Andrews actively misled Mr Johnston over a sustained period of time.[49] Mr Norling subjected this finding to detailed challenge. But on analysis his argument reduced to the proposition that, by exercising greater scrutiny, Mr Johnston should have discovered from the day he accepted appointment as a director that Mr Andrews was misleading him.

[92] We reject Mr Norling's proposition. The Judge had a proper evidential foundation for his finding. Mr Johnston's culpable fault was in continuing in the face of mounting evidence of deceit to trust a man whom he had known and trusted for 30 years instead of resigning his office. That step would not have deterred Mr Andrews, as subsequent events showed. Mr Johnston paid the price for his trust by suffering easily the largest loss of any of NZNet's creditors. It is not just that he should be visited with further liability.

[93] Third, within the causation inquiry, we record that the IRD would be the largest beneficiary of a compensation order. It was NZNet's second largest creditor

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49 HC decision, above n 1, at [107].

after Mr Johnston. The liquidators' undisputed evidence was that the company owed $173,303 to the IRD when Mr Johnston assumed office as a director. The IRD had taken no steps to recover this growing debt for over a year. Instead it was apparently content to continue sitting on its rights, allowing NZNet's indebtedness to escalate with accrued penalties to $386,322 over the next two years without enforcing the company's compliance with its statutory requirements to pay PAYE and GST.

[94] 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.

[95] We add that Superdockets is the other significant creditor. The parties accepted that Mr Johnston had no liability for its debt which was incurred by Mr Andrews without his knowledge. A number of the other significant creditors have lodged claims for debts incurred by NZNet after Mr Johnston's resignation as a director. He cannot be held liable to contribute to these losses.

[96] Fourth, the duration of Mr Johnston's breach of duty was relatively short in NZNet's lifespan — a matter of nine months.

[97] Finally, although it is not directly relevant to compensation, we note that the trial lasted for at least a week. The evidence was discursive, a large volume of documents was produced and cross-examination ranged far and wide. The economic benefits of pursuing such claims are questionable — it must have been apparent to the liquidators, on a sober assessment of the case (to adopt their characterisation of Mr Johnston's alleged failures), that the maximum amount of Mr Johnston's potential liability was very modest indeed. As a result, both parties have incurred costs which must exceed any potential benefits from this litigation.

Result

[98] The appeal is dismissed.

[99] Costs must follow the event. The liquidators are ordered to pay Mr Johnston costs for a standard appeal on a band A basis together with usual disbursements. However, we did not receive any assistance from Mr Ropati for Mr Johnston. He would not engage in argument except to rely on the findings in the High Court judgment. But for the fact that Mr Johnston is entitled to recover his legal costs, we would have reduced our reward by 50 per cent to take into account Mr Ropati's unsatisfactory participation.

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