

**IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY**

**CIV-2013-404-1302
[2015] NZHC 611**

UNDER Part 18 of the High Court Rules and the
Companies Act 1993

IN THE MATTER of the liquidation of NZNet Internet
Services Limited (in liquidation)

BETWEEN DAMIEN GRANT AND STEVEN
KHOV
Plaintiffs

AND ROWAN KENLEY JOHNSTON
First Defendant

STEPHEN ANDREWS
Second Defendant

GEORGE POYKAIL THOMAS
Third Defendant

Hearing: 9-13 June, 14-15 August 2014

Appearances: B J Norling and J Boparoy for plaintiffs
S J Ropati for first defendant
S H Barter for second defendant (leave to withdraw granted)
Third defendant in person

Judgment: 30 March 2015

JUDGMENT OF BROWN J

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Introduction

[1] NZNet Internet Services Ltd (in liquidation) (NZNet) was incorporated on 12 July 1995. The second defendant (Mr Andrews) was the sole shareholder and a director from that date. At all material times NZNet carried on business in Albany as an internet service provider specialising in providing niche business services including wireless, fibre, voice, backup and server hosting.

[2] By special resolution of the shareholders of NZNet on 17 November 2011 the plaintiffs were appointed liquidators at 3 pm pursuant to s 241(2)(a) of the Companies Act 1993 (the Act).

[3] In this proceeding the plaintiffs seek orders under ss 300 and 301 of the Act against the defendants who were directors of NZNet during the following periods:

- (a) First defendant (Mr Johnston) from 30 December 2009 to 15 September 2011.
- (b) Mr Andrews at all material times;
- (c) Third defendant (Mr Thomas) from 5 May 2011 to 10 August 2011.

[4] At the commencement of the hearing Mr Barter advised that Mr Andrews would not be appearing to defend the claim and that it was open to the plaintiffs to proceed by way of formal proof against him. Mr Barter then sought leave to withdraw as counsel for Mr Andrews, which I granted.

Formulation of claim

[5] The plaintiffs received 25 proofs of debt in the liquidation amounting to \$1,102,863.41 with a date range shown in the table below:

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	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	
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	

[6] The total comprised 19 unsecured creditor claims (\$333,370.39), one secured creditor claim, namely Mr Johnston, (\$460,000.00) and seven preferential creditor claims (\$309,493.02). Of those, the claim for \$4,272.12 by DNG Data Insurance was accepted in error. Consequently the base amount for the calculations of the claims against the defendants was reduced by that amount to \$1,098,591.29. One of the unsecured creditors, Superdockets Advertising Ltd (Superdockets) was a funding creditor for the litigation.¹

[7] The amounts sought to be recovered from the defendants vary according to the duration of their tenure as directors and any amount owed by NZNet to them:

(a) Mr Johnston:

Debts incurred 30/12/09-15/9/11	794,675.11
Less amount owed	<u>460,000.00</u>
	334,675.11 ²

(b) Mr Andrews:

Total debt incurred	<u>1,098,591.29</u>
	1,098,591.29

(c) Mr Thomas:

Debts incurred 5/5/11-10/8/11	142,589.32
Less amount owed	<u>15,901.00</u>
	126,688.32

[8] The statement of claim pleads four causes of action against all three defendants in respect of the Superdockets debt of \$85,385.92 which reduced the claim to \$249,289.19:

(a) Reckless trading in contravention of s 135;

(b) Breach of duty in relation to obligations in contravention of s 136;

¹ Companies Act 1993, sch 7 cl (1)(e).

² In the context of the s 136 cause of action the plaintiffs recognised a further deduction for Mr Johnston.

- (c) Failure to exercise the director's duty of care in contravention of s 137;
- (d) Failure to keep accounting records in contravention of s 194.

[9] The issues arising were identified by the plaintiffs and recorded in the Minute of Associate Judge Bell of 4 September 2013 as follows:

- (a) Whether the ... Defendants have traded recklessly pursuant to section 135 of the Act by agreeing, causing or allowing the business of NZNet Internet Services Limited ("NZNet") to be carried on in a manner likely to create a substantial risk of serious loss to NZNet's creditors?
- (b) Whether the ... Defendants have breached directors' obligations pursuant to section 136 of the Act by incurring or agreeing to incur obligations to NZNet without believing on reasonable grounds that NZNet will be able to fulfil those obligations when it was required to do so?
- (c) Whether the ... Defendants have breached their directors' duties of care pursuant to section 137 of the Act by failing to exercise the care, diligence and skill that a reasonable director would have exercised in the same circumstances?
- (d) Whether the ... Defendants failed to keep proper accounting records pursuant to section 194 of the Act?
- (e) If the court finds the ... Defendants in breach of section 194 of the Act, whether the Court would direct, if it thinks it proper to do so, that the ... Defendants are personally responsible, without limitation of liability, for all or any part of the debts and other liabilities of NZNet pursuant to section 300(1) of the Act?
- (f) Whether the Court should direct that the ... Defendants are under an obligation or ought to contribute such sum to the assets of NZNet by way of compensation as the Court thinks just pursuant to section 301(1)(b)(ii) of the Act?
- (g) Whether the ... Defendants should pay the Plaintiffs the costs of and incidental to this application?

Relevant history of events

[10] Absent Mr Andrews' participation in the hearing the liquidators were the source of the evidence relating to the early years of NZNet. It appears that from the outset Mr Andrews ran the affairs of NZNet in an ad hoc manner. Based on the records available to liquidators it seems that NZNet began to have financial difficulties in July 2007 when it fell into arrears with payments to the IRD.

[11] Between August to September 2008 Mr Andrews met with the IRD in order to discuss overdue returns and debts. On 13 November 2008 NZNet entered into a payment arrangement with the IRD to pay the outstanding tax by instalments of \$2,000 per month. The arrangement was short-lived with NZNet defaulting on the January 2009 payment.

[12] From July 2008 Mr Andrews entered into a series of agreements which caused NZNet to incur significant losses. One such agreement was the joint venture with Horizon Pacific Group Ltd (HPG).

Agreement with Horizon Pacific Group

[13] HPG was an internet service provider to business customers. In 2008 NZNet entered into a complex arrangement with HPG for NZNet to supply wholesale services including wireless internet, tele-housing, dial up internet and technical services. As Mr Grant understood the position,³ the agreement was that NZNet would provide those wholesale services directly to HPG on an ongoing monthly basis. Initially NZNet issued monthly invoices to HPG but in December 2008 it was agreed that, rather than invoicing HPG directly, NZNet would provide its billing data to HPG and HPG would generate the invoices through its accounting software.

[14] During 2009 a dispute occurred between the parties which involved NZNet contending that some invoices to HPG were not based on the billing data provided by NZNet and were underpaid or, in some cases, unpaid.

[15] As part of the joint venture agreement NZNet agreed to provide wholesale services directly to HPG. HPG agreed to move equipment to NZNet's data centre in Albany where internet and tele-housing services by NZNet would be provided.

[16] As the dispute escalated, HPG made an application in the High Court at Auckland seeking the return of its equipment. HPG also sought an injunction restraining NZNet from disconnecting the data centre hosting facilities until the equipment had been removed. NZNet opposed HPG's applications and asserted that it had a common law lien over the equipment.

³ Mr Andrews sought Mr Grant's assistance concerning HPG in mid-2009: See [94] below.

[17] On 11 December 2009 in the Auckland High Court Courtney J declined to grant the order for an equitable lien. The judgment commented on the difficult financial circumstances that NZNet faced:⁴

[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.

...

[47] I have concluded that NZNet has no lien over the equipment currently held at its premises. The balance of convenience easily favours HPG on the question of whether it should be permitted to remove the equipment. There is undeniable risk to HPG and its customers in being forced to leave the equipment under NZNet's control. Such a risk could eventuate through no fault of NZNet. However, NZNet's conduct over the last several months does not provide a high level of comfort. If the equipment is damaged or power to it disconnected there is a serious risk of substantial loss to both HPG and its customers. On the information before me it is unlikely that NZNet would be in a position to compensate for such loss.

[18] However it is clear that Mr Andrews remained of the view that HPG was a substantial debtor of NZNet. Mr Grant stated that Mr Andrews placed considerable weight on that alleged debt as a cause of the failure of the NZNet business. However on the basis of his investigation Mr Grant was unconvinced that there were any merits to NZNet's claim against HPG.

[19] In or around November 2009, NZNet anticipated increasing its service offerings to the SME market within large business areas. In order to do this, the focus was on increasing sales through recruiting sales staff and looking for savvy investors who were willing to fund NZNet and to settle the outstanding debt.

Mr Johnston becomes a director and shareholder

[20] Mr Andrews had been known to Mr Johnston for over 30 years through church activities, Scouts and indoor cricket. Mr Andrews contacted Mr Johnston out of the blue in November 2009 and asked whether he would be interested in investing in NZNet with which

⁴ *Horizon Pacific Group Ltd v NZNet Internet Services Ltd* HC Auckland CIV-2009-404-7597, 11 December 2009.

Mr Johnston had been a subscriber for a substantial period. In a letter dated 21 November 2009 Mr Andrews proposed that Mr Johnston become a “keystone shareholder” in NZNet and suggesting an investment of \$260,000 comprising \$220,000 for a 20 per cent shareholding and a \$40,000 loan for working capital.

[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.

[22] As part of the due diligence process a significant volume of information was obtained including:

- (a) A copy of the budget for the year ending March 2010;
- (b) Copies of bank statements for the months up to the purchase date;
- (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.

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
	\$1.610m

TOTAL

To justify me to pay the price offered, I need to be able to see EBITDA 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.

[24] Mr Andrews provided seemingly comprehensive responses to the questions which Mr Johnston, assisted by his lawyer, asked. Some such questions and responses particularly pertinent to NZNet's financial situation were:

- **What is the shareholders overdrawn amount (\$256k) in relation to on the asset side of the balance sheet (end Mar 09)?**

This relates to me taking drawings out of NZNET the last few years. I don't take a wage from the business. This is to be offset and removed from the business as and when I sell the additional shareholding and eject (sic) the money back in the business. This money will then be used to repay my mother. The NZNET accountant and lawyer thought this was the simplest and most effective way to remove the loan and overdrawn shareholders account.

- **What happened in relation to penalties to IRD in 2008? Why?**

There are IRD penalties as some GST payments had not been paid. The reason for this is that Horizon Pacific had included sales for direct debits which NZNET collected the funds (Horizon Pacific was not to include any direct debit sales as they did not have any facility to process till March/April 2009). What had happened is that both Horizon Pacific Albany and NZNET had processed GST returns... Horizon Pacific Albany's sales being too high in 2008. This was adjusted by the accountant in producing the March 2009 accounts so that there was not a duplicate of sales. I am waiting on up-to-date account information from Horizon Pacific Group to the end of August so that the accountant and I can make adjustments to the GST returns and re-file. This should be offset.

- **What is the current position of bad debts/late payments? We noted a number of payments by clients had been reversed, ie they had no funds. How much is more than 90 days owing? Any other comments would be helpful?**

The reversed payments you are referring to are as a result of the direct debit processing we do at the end of each month. We do a batch upload to the bank of all bank account information of clients and their monthly fee. The money is automatically deposited into our account. If a client does not have sufficient funds in their account, you might get up to 5 a month, then the amount is reversed. We capture that and follow up the client immediately to seek payment.

I have attached a spreadsheet of the Aged Accounts receivable as at today's date. I have removed the abnormal ones such as Horizon Pacific for which we are going at them for about \$230K. Also Engini prior to April 2009. The Engini one is that NZNET financially supported Engini prior to April 2009. This is seen as a loan in the NZNET accounts. I have removed these as it blows the debtors ledger way out and does not show a true picture of the month to month trading with the large number of good paying customers we have.

[25] Mr Johnston said that he took comfort from Mr Andrews' advice that he was negotiating significant contracts for NZNet which would result in a large increase in sales, that NZNet was due a significant GST refund of approximately \$100,000 and that he was in talks with larger companies with a view to selling NZNet as the industry was consolidating. It was on the basis of that third item that Mr Johnston had an expectation that his investment would be for a relatively short term of one to two years.

[26] An agreement for sale and purchase of shares between Mr Andrews and Mr Johnston was signed dated 23 December 2009. It contained an extensive schedule of warranties and undertakings including in relation to accounts and taxation, loans and the completion of records and returns. On 30 December 2009 Mr Johnston was appointed a director of NZNet after having completed his due diligence.

[27] The first loan by Mr Johnston to NZNet was for \$50,000 for a period of 24 months at an interest rate of 14 per cent. The loan agreement which was executed on 28 February 2010 incorporated a guarantee by Mr Andrews.

The operation of NZNet during 2010

[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.

[29] Shortly after Mr Johnston's appointment as director the office administrator who had attended to the NZNet accounts resigned and it was decided that Mr Andrews would attend to the accounts until the cashflow and sales of the business improved. Mr Johnston was aware that Mr Andrews had an accountant, Mr James Kelso, who prepared accounts for NZNet based on information provided to him by Mr Andrews. However, Mr Johnston had no contact with Mr Kelso until after Mr Johnston's resignation in September 2011.

[30] It soon became apparent to Mr Johnston that he had not been provided with full disclosure by Mr Andrews as to the financial position of NZNet and that the budget forecastings were not as Mr Andrews had represented them to be. In an email of 22 March 2010 to Mr Andrews, Mr Johnston commented that he did not realise things were quite as bad as they were. He noted that the \$50,000 which he had advanced had been expended in paying debts and not in actually growing the business. However, describing himself as an eternal optimist and reflecting the philosophy that he displayed for a considerable period, Mr Johnston observed that "that is in the past and we need to move on". He requested a list of all outstanding payments and emphasised that there was a need to have accurate forecasting and budgeting in the future.

[31] Mr Andrews and Mr Johnston met on Easter Sunday, 4 April 2010, and worked through a spreadsheet of expenses and sales targets which Mr Andrews had provided. Having obtained directly from the finance company Equico details of three lease agreements in respect of which NZNet was paying approximately \$1,785 per month Mr Johnston sent an email to Mr Andrews enquiring about payments in default. He said:

Are there any other payments we are behind, we need to itemise all payments we are behind, incl your rent, my interest, Equico etc and anything else and work on a plan to get back to fully up to date.

[32] On 3 May 2010 Mr Andrews advised Mr Johnston that application had been made for a bank overdraft of \$10,000:

Just to get us through the small short fall and trying to keep all payments up to date.

[33] Although he considered that the overdraft represented expensive financing, Mr Johnston did not have a problem with an overdraft but requested from Mr Andrews a list of the payments which NZNet was behind in making. He signed the guarantee which the BNZ required in the sum of \$13,500.

[34] On 13 May Mr Andrews contacted Mr Johnston about a payment due to ICONZ who was threatening to turn off services to NZNet customers Mr Johnston agreed to deposit \$10,500 to NZNet's bank account, apparently with the intention that the amount would be refunded later that month.

[35] In a series of emails in late May 2010:

- (a) Mr Johnston suggested that he should have access to the Xero accounts for NZNet from his personal computer and Mr Andrews agreed to arrange for a login setup;
- (b) Mr Andrews provided encouraging reports about actual and potential new sales contracts;
- (c) with reference to a proposal from the factoring company Working Capital Solutions (WCS), Mr Johnston suggested that it might be better for him to provide more funding at a cheaper rate than WCS charged. As he considered that the NZNet should have reached a profit position he stated that he was more than happy to put more funds in to grow the business. He suggested leaving his \$10,000 temporary loan in NZNet until after the cash position was reviewed at a meeting on Saturday, 29 May 2010.

[36] At that meeting there was discussion about Mr Johnston acquiring a larger shareholder in NZNet. In an email on Monday, 31 May (which was acknowledged by Mr Johnston) Mr Andrews described the proposal as follows:

I have discussed your suggestions with Elena and we really appreciate your involvement in NZNET and are more than happy for you to take a higher shareholding to release more funds to the business. Your option to allow us to buy back shareholding at a future date when we sell the shares in our other company is very much appreciated. If you can work that into the agreement it would be appreciated... our goal however is to build a very strong company that will generate

high returns for us as shareholders. Having you on board to oversee the financial side of the business is a great help and will free my time to grow the business without the worry and stress which eventuated the tight funds with HPG, Sam and Farhan. Without having to pay finance agreements and needing the WCS facility and bank overdraft NZNET will be on a very strong footing going forward.

[37] Having taken legal advice Mr Johnston considered that a better course was to lend money to NZNet rather than take an increased shareholding. In those circumstances Mr Andrews suggested keeping the finance agreements in place and simply paying off other outstanding accounts and WCS in order to avoid “stretching [Mr Johnston] too much”. He expressed the optimistic view that with new May sales and expected June sales the NZNet cashflow position “should start to look really good”.

[38] Mr Andrews provided a spreadsheet of outstanding creditors as at June 2010 which he and Mr Johnston reviewed. The spreadsheet made reference to a payment to the IRD for PAYE in the sum of \$9,200.00. As it was Mr Johnston’s understanding that PAYE was paid every two months, that figure did not appear to him to be out of the ordinary.

[39] Mr Johnston proposed that he become involved in the financial side of the business. In an email of 4 June 2010 he said:

I know you are working extremely hard, but I think I should take a more active role in the finance side of things to make sure we are going monthly budgets, and making sure we have funding before payments are required, not trying to find money to pay them after we receive invoices. I’m happy to work on a weekend on a regular basis on the finance side of things for no cost until we get to a point where we are cashflow positive.

Mr Andrews’ response was that he would really appreciate Mr Johnston’s help on the financial side.

[40] On 8 June 2010 Mr Johnston advised that he did not feel comfortable advancing more than a further \$80,000 as that would take his total financial commitment to \$350,000. He noted that the accounts were in dire shape and that NZNet came nowhere near the target (\$200K + EBITDA 2010) on which the 20 per cent shareholding was sold to him.

[41] At about this time Mr Johnston obtained access to the Xero data. In his email to Mr Andrews of Saturday, 12 June 2010 he said:

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.

[42] Mr Andrews endeavoured to reassure Mr Johnston. His email of 15 June 2010 stated:

Once we get all the accounts correct with Xero we can look at finishing them with James [the company's accountant]. This should be a straight-forward task with everything is correct in Xero. Then you and I can decide with James how we want to treat HPG in the accounts. For the funds we have not received from HPG if we exclude those (we need to have direction from Gaze Burt as well) then this may show the accounts in a loss situation. Those losses can be offset by you in your current tax paid and offset with me in the future. Depending on how much this is it could provide quite a large quick net gain or benefit to you.

[43] Mr Johnston's response suggested that he was reassured:

I put another \$2k into the account last night. That makes \$20k I've put in since the \$50k loan (so total now \$70k).

Having a look at XERO this morning, I see what James has done – I agree that some things were in the wrong place. It's probably still not quite right, but we are getting there. Yes, you are right re the HP payments as only the interest component is an expense, the rest is repayment of principal. However it's still a cashflow item, so we still need cash to fund the payment.

[44] However it was during June 2010 that WCS served a statutory demand for \$48,391 and threatened to appoint a receiver to NZNet. That crisis was averted when Mr Johnston negotiated a final settlement with WCS which involved his making a payment of \$31,000 on behalf of NZNet. On 1 July NZNet executed a second loan agreement with Mr Johnston for the sum of \$100,000 at an interest rate of 12 per cent with a default rate of 22 per cent. This loan was guaranteed by Mr Anderson and his wife as trustees of the Stephen Andrews Family Trust.

[45] Mr Johnston was overseas for much of the third quarter of 2010 but he maintained email contact with Mr Andrews during that period. It was while Mr Johnston was away that Mr Andrews signed the three year contract with Vibe Communications Ltd which involved a monthly commitment of \$3,375.

[46] Mr Johnston asked Mr Andrews to have Xero up to date in order that an accurate budget could be prepared for August 2010. By 1 August 2010 Mr Johnston had “redone the budget” which disclosed monthly cash expenses in excess of \$49,000, monthly income of \$34,000 using July sales, with a resultant monthly shortfall of \$15,000. Mr Johnston concluded that NZNet needed a rapid increase in sales “very soon”.

[47] Mr Johnston’s inquiry on 3 September whether there was adequate funding for NZNet that month prompted a response from Mr Andrews that there was a shortfall. He advised that if Mr Johnston could assist with the ICONZ bill for \$11,870 that would assist. In an email of 8 October 2010 Mr Johnston made the point that he had paid the ICONZ bill in the expectation that NZNet was finally to the point of cashflow positive. Mr Johnston deposited funds into the NZNet account of \$12,000. On 2 October 2010 Mr Johnston attempted to access Xero for NZNet to discover that access had been suspended due to non-payment of the Xero subscription. He made the point that he could not keep an eye on things if he did not have access to the Xero data.

[48] In an email of 21 October 2010 Mr Johnston advised Mr Andrews that having checked the Xero accounts that morning NZNet would still be in overdraft but not by much. He asked Mr Andrews to inform the bank manager that it was anticipated that the company would remain under the \$10,000 overdraft limit going forward due to new sales and lower costs. He proposed the following plan:

The plan for November onwards as I see it for NZNET financially

- 1) pay off final amount owing IFM in one payment
- 2) start paying regular salary to you – we will sit down and discuss amount
- 3) pay off OD completely and remain in credit going forward
- 4) start paying interest on my loan
- 5) start making principal repayments on my loan
- 6) make payments for any other overdue payments (i.e get Equico up to date)
- 7) pay off the car loan asap.
- 8) Start making rent payments as per new lease.

[49] However by mid November 2010 Mr Johnston felt it necessary to put \$5,000 into NZNet's account in order to ensure that wages would be paid in full on 16 November 2010. During this time Mr Andrews had been negotiating an arrangement with Mr George Thomas of Secure Sources Ltd. Mr Thomas had inquired of Mr Andrews whether NZNet could assist by providing him \$2,500 per month for three months in his start-up phase. When Mr Andrews floated the proposal with Mr Johnston, Mr Johnston's reply of 18 November 2010 signalled his frustration with the state of the NZNet business:

A good concept, but where is the money going to come from?

We already owe \$6k Power and \$12k ICONZ due by this Friday plus we are going to have to fund the new accounts person so we need to find another xx \$k per month for that person also. I need an updated budget from nznet before agreeing to this..

...

If you want to fund it out of your funds that's fine, but I'm sick of sticking money into nznet and getting nothing back for it.

[50] However within a week Mr Johnston had again transferred funds into NZNet. His email to Mr Andrews dated 24 November 2010 stated:

Stephen,

I have transferred enough this morning to NZNET to allow the following (it will show as clear funds in nznet's account as we speak)

- 1) payment of all wages to staff as per schedule
- 2) please make remaining payment owing to ICONZ for \$3-4k (whatever is outstanding)
- 3) please give Centurion a bank cheque for \$6k
- 4) please make payment of \$2k to George as you suggest.

Note, no payment (sic) are to be made to you yet until I approve it. We will sort out a regular wage for you from 1st week of December onwards

A further email the following day recorded that Mr Johnston had injected \$35,000 into NZNet in the previous month. He proposed a meeting the following weekend.

[51] In an email to Mr Andrews of 13 December 2010 Mr Johnston sought an update on several matters including the issue of PAYE. On that matter he said:

Update on PAYE owing. IRD are cracking down on payments owing, see article last week where they put a company into receivership for a small amount of tax owing.

It was Mr Johnston's evidence that Mr Andrews assured him that the payments had been made and that the company was up to date and that Mr Johnston had no reason to disbelieve him. In fact as at 22 December 2010 NZNet owed the IRD approximately \$82,000 for overdue PAYE.

Mr Thomas becomes involved

[52] Mr Thomas' company, Secure Sources Ltd executed a memorandum of understanding with NZNet (signed by Mr Andrews) dated 15 October 2010 whereby Secure Sources was to be the marketing partner for NZNet's sales initiatives.

[53] Although as noted above Mr Johnston's initial reaction to the proposal concerning Mr Thomas was somewhat negative, in an email of 22 November 2010 to Mr Andrews he said:

You have offered George a contract and you need to follow through with it, and deliver on it – NO EXCUSES.

Make no mistake, the only way NZNET will survive is to grow your sales! If you don't, I don't want to consider the likely outcome.

I suggest you go back to him, apologise profusely and offer him the \$3500 per month he asked for to try and rectify this situation. If he is as great as you keep telling me, \$3.5k a month is nothing.

Get this fixed sorted asap PLEASE

[54] Consequently that same day Mr Andrews offered Mr Thomas a position with NZNet as follows:

In addition to your commitment from Secure Sources to NZNET we would like you to be responsible for our sales and marketing at NZNET till further notice. We will be paying you a token fee of \$3500 per month which may be renegotiated based on your performance.

[55] It appears that there was some initial friction between Mr Thomas and another employee. That culminated in Mr Johnston sending an email dated 18 December 2010 to Mr Thomas, the other employee and Mr Andrews which said:

The Board, namely Stephen and I have given full support to George to make whatever changes are needed to move NZNET from its current unsustainable business model to a position where the business can thrive going forward.

Mr Thomas acknowledged that email and stated that he would “do his best to turn this around for you both”.

[56] The plan to boost revenue through sales was aggressively driven by Mr Thomas from around January 2011. Part of this role required Mr Thomas to take charge of recruiting sales representatives and forecasting future sales.

The first quarter of 2011

[57] 2011 commenced with a suggestion that Mr Johnston might inject still further funds into NZNet. An email from Mr Thomas to Mr Andrews dated 8 January 2011 attached a sales and expenses analysis. It stated:

I wrote to [Mr Johnston] this morning and instead of mentioning it vigorously, I mentioned it suggestively. Trying to make him think, so that when we meet him I could then raise it directly with him. I hope it is okay with you.

[58] The communication to Mr Johnston was not in evidence but it was apparent from Mr Johnston’s email of 10 January referring to the spreadsheet that what was in contemplation was an injection of \$40,000 to fund proposed sales initiatives. On the same day Mr Johnston sent a “discrete reply” to Mr Thomas spelling out clearly the assistance which he had provided to Mr Andrews on several occasions in the previous year. Yet in the face of it Mr Johnston continued to be optimistic as demonstrated by an email to Mr Andrews (copied to Mr Thomas) of 24 January 2011 in which among other things he stated that he would still like to obtain the **NZNET 1** licence plate for Mr Andrews’ car and perhaps NZNET2 or 3 for other company cars.

[59] The proposed direction for NZNet in 2011 was set out in an email from Mr Johnston addressed to the staff dated 24 January 2011:

Dear staff,

Stephen and I had a Board meeting on Saturday whereby we confirmed the direction that NZNET is to take going forward. Some of the key points worth highlighting are as follows:-

- We have previously appointed George Thomas through Secure Sources to take over the **sales and operations** management of NZNET. He has the **full backing of the Board** to undertake whatever measures are required to achieve the results we are forecasting going forward and we expect your co-operation with George to achieve this.

- As a result, we are forecasting a big lift in sales as George will be employing additional sales people through Secure Sources to achieve the targets we expect.
- This by necessity means we need to lift our game in the technical area and NZNET will be making additional appointments in this area to give the support that our current and new customers will expect. This may mean a change of layout in the office to support these additional technical people so please be tolerant of any changes we must make.
- Jocelyn Crosby will also begin to work on the NZNET accounts in the next few weeks or so and will be taking over the payroll and accounts functions from Stephen and Geraint.
- These are exciting times for NZNET as we have major opportunities ahead of us but we need to move quickly to take advantage of these. We had a difficult year in 2010 with many challenges, but the Board is looking forward to a much brighter 2011 and beyond. It is only by working together we will achieve our goal to grow NZNET.

[60] Mr Johnston continued to transfer funds to NZNet's account to cover its liabilities. \$12,000 was transferred on 14 February 2011, apparently to cover a payment due to ICONZ and that Mr Thomas' request a further \$9,000 was transferred on 17 February to cover the wages of NZNet staff.

[61] An urgent Board meeting was convened at Mr Johnston's behest at the offices of Brookfields Lawyers on 16 February 2011. Mr Andrews agreed to finalise the company accounts as soon as possible and to introduce Mr Johnston to the company's accountant. A new mail system was introduced whereby all mail for NZNet was to be delivered unopened to Mr Andrews each day for his review and Mr Andrews agreed to show Mr Johnston any correspondence that was not ordinary day-to-day business correspondence as soon as practicable.

[62] During February 2011 there was some friction among staff at the NZNet office which caused Mr Thomas to send some reasonably lengthy emails. One such email provided the following insight into the state of the NZNet accounting records:

NZNET account is not in a mess. From pure book keeping it should have been brought up to date it has been brought up to date. (the transactions should have been entered into ZERO and Platapos). The fact is that we do not have a debt collector and there is such a huge back log on customers with regard to payment because everybody who owes us money is talking only about a dispute and hence settlement not taking place. Customers have rung back and spoken to me of the shabby way that they have

been treated and hence part of the reason for not paying is shabby treatment and shabby accounting in the past and slack follow up.

NZNET needed an accountant two years ago. Another month and we should be fine. James Kelso has completed the accounts. He should possibly deliver a draft of the accounts by Tuesday. He seems to have also completed the management accounts till the end of January, and I have been after both Stephen and James on this.

[63] By the beginning of March Mr Johnston again was concerned about the cashflow position as reflected in his email to Mr Andrews of 4 March 2011:

As MD, I need to know why sales received in February were <\$15k what you have told me they are on a monthly basis, ie \$40k v \$55k (why have \$15k not paid). I provided funding in Feb above the amount I committed to pay ICONZ, 2 lots of wages and other bills and yet still there is no money for wages. Engini is \$3k, where is the remaining? WHERE IS ALL THE MONEY GOING?

[64] However at a Board meeting on Saturday, 5 March 2011 he agreed to transfer \$22,000 into NZNet for the purpose of funding certain debt specified in an email dated 6 May 2011 to Mr Andrews and Mr Thomas. In that email he referred to another potential cost for the purchase of 500 telephones, commenting:

This will bring the total transferred up to \$70k in 2 months, with the expectation the total amount will not exceed \$100k in 3 months as per the original budget.

[65] The record does not disclose when Mr Johnston agreed to provide additional funding of that level. However in an email of 7 March 2011 he made reference to his having agreed:

To provide "lifeline" funding for NZNet.

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

[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”.

The revelations in April 2011

[68] An email from Mr Johnston to Mr Thomas and Mr Andrews of 31 March 2011 seeking an update on NZNet and noting that he was still waiting for the accounts from James Kelso recorded that he had put \$73,000 into NZNet in the prior six weeks. His email the following day to Mr Thomas noted the fact that a further transfer of \$10,000 that morning to cover specified outgoings. It appears that on that Friday evening Mr Thomas provided an update on the company’s position which indicated a need for still further funding. Mr Johnston’s position was reflected in an email of 4 April 2011 to Mr Thomas which stated:

Thanks for the update on Friday night. It will take at least a week to provide some or all of the funding required as per your spreadsheet.

...

I will work on sourcing funding and let you know asap. Can you keep me updated on the status of the above. Feel free to go ahead and hire the extra staff as mentioned but bear in mind this will be the last round of funding I can put into nznet. All future costs must be funded by cashflow from operations.

Keep up the great work. I will make sure you are compensated adequately if you can turn nznet around and will reward your efforts when cashflow allows us to do so.

[69] An email of the same date to Mr Andrews, Mr Thomas and to senior staff members included the following:

...

We have not paid any PAYE or GST for sometime, so this will start from April onwards with first PAYE payments to be made in May (for April salaries).

Thanks for George’s sales initiatives and efforts, we anticipate NZNET will be in a much better position from May onwards. Since I’s (sic) the primary funder of NZNET, Jocelyn will report directly to me on the NZNET accounts.

...

As is currently in place, Stephen and I as Directors have authorised George full authority on sales and operations issues, incl hiring/firing of staff, etc. Any staff queries over salaries, commissions, hours, fuel bills, etc will be dealt with by George only. Staff cannot go to Stephen or Jocelyn to try and circumnavigate the process so please refer any staff queries on such issues to George.

Let's all work together to make NZNET the successful business it has promised for so long.

[70] One week later in an email acknowledging an update received from Mr Thomas, Mr Johnston itemised payments totalling \$40,000 which needed to be made that day. He advised that he had transferred \$40,000 to NZNet so that those payments could be made. He noted that that loan was to be on the same terms as his existing loans. His email the following day indicated that he would put more funds into NZNet to cover the imminent rent payment if the overdraft facility with the BNZ had not been renewed by that time.

[71] As was generally recorded when he made further advances to NZNet, Mr Johnston viewed the advances as covered by a second loan agreement distinct from his initial loan of \$50,000.⁵ An email to Ms Crosby of 13 April 2011 recorded Mr Johnston's expectations concerning interest payments to him:

Re my loans to nznet – my original loan is \$50 @ 14% pa.
Subsequent loans are all at 12% pa (incl settlement of Working Capital solutions)
*** Perhaps you could put together a spreadsheet (it will take a while) with all my loan payments, and interest owing each month.***

I have attached copies of the two loan agreements – **note penalty interest is interest rate plus 10%**.

So we will need to calculate the first \$50k @ 24% and the second (~\$200k+) is 22%.

Yes, very high, but that's the penalty for not making interest payments (let alone principal payments)

The only interest payments that have been made are the ones in the past 3-4 months, nothing prior. Once nznet is in positive cashflow from June onwards, we will start making full interest payments.

[72] On 15 April 2011 Mr Johnston transferred a further \$25,000 to NZNet (on the usual basis). However he stated that his funding sources were nearly completely exhausted and foreshadowed the need for NZNet to provide the bulk of the funds necessary to meet a final settlement of the dispute with Hosting Direct Ltd. Unbeknown to Mr Johnston, on 1 February 2011 Mr Andrews had signed a contract on behalf of NZNet with Superdockets, a company which provided a service of printing advertising on the rear of supermarket docketts. NZNet's contractual commitment was \$89,385.92 to be paid by 12 monthly instalments of \$7,448.83 commencing on 29 February 2011.

⁵ At [27] above.

[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.

[74] In an email on the following Monday, 25 April, Mr Johnston advised that he had discussed with his lawyers placing NZNet into receivership if positive cashflow was not achieved by the end of May 2011. That email addressed not only the Superdockets issue but also the funding arrangement which had been agreed with Mr Thomas:

Stephen, I have put \$75,000 into NZNET into your business in April 2011 and it still can't pay its wages. Where on earth is all the money going? I paid the VIBE bill, Hosting bill, wages bill, credit card bill, John Holmes bill. I'm also livid you signed a contract for \$7k+ per month for superdockets without my authority. How on earth do you expect to pay this? My patience has now run its course and I have completed my obligation to George which was to put \$100k+ into the business (in reality, its been over \$130k+) in the past 3 months. For me, this is just throwing money down the tube as my expectation of getting any money back is now almost zero. I have received virtually no interest payments and according to Jocelyn's calculations, you now owe me \$285k in principal and interest. If nznet can't even pay its bills, how can I possibly expect to get any interest or principal payments.

I will be putting NO further funds into nznet from this date forward. If payments to suppliers can't be made, wage payments to you Stephen will be ceased. Why should you get paid when I don't get my interest and suppliers don't get paid!?

Mr Thomas becomes a director

[75] In early May 2011 Mr Johnston took steps in relation to Mr Andrews drawing wages from NZNet. The email is significant in its recognition of the obligations of a company director:

Effectively immediately, I am moving your wages payment back into the same wages schedule as all other employees (\$800 AP has been cancelled). As the major shareholder and MD, you need to understand you cannot pay yourself while there are thousands in outstanding bills – this is effectively fraud. Wage payments to you are suspended this week, and will be reviewed each fortnight depending on bills owing. As a Director of NZNET, I am in breach of my obligations as a Director if I authorise wage payments to you when I know of other payments not being made or ignored.

In particular I will note I'm making payments from my own money to pay your legal bills from the past to your lawyer to avoid him liquidating NZNET, I'm working unpaid for Caprica and NZNET, and I receive a fraction of my interest owed, meanwhile you continue to be paid a salary.

In addition, you signed a contract for \$7k+ per month for superdockets without my authority.

There is no money in the kitty – the vault is empty and Bank of Rowan is not going to continue paying your wages. You need to understand the repercussions of your prior actions – until payments are up to date and all arrears cleared, you cannot be paid wages. Do not blame anyone but yourself for this.

[76] A Board meeting was held the following day when Mr Johnston and Mr Andrews agreed to appoint Mr Thomas as managing director until at least the end of 2011. Mr Andrews' role was to be confined to that of Technical Director. The NZNet staff were advised of this development in an email from Mr Andrews dated 5 May 2011:

Attention NZNET Staff:

As of Thursday the 5th of May 2011 George Thomas will be taking over as Managing Director of NZNET Internet Services Ltd.

The day-to-day running of NZNET will be overseen by George. If you have any company related problems or client problems where they wish to speak to the Manager then please refer them to George.

The board has taken this approach as we are trying to address issues with supplier relationships where they circumvent George as operations manager. Hopefully this will better streamline the business going forward.

I will still be involved in NZNET but in the capacity as Technical Director. I am doing this to free up my time to focus my attention on the technical requirements and direction of the company.

[77] In his own email to the staff dated 6 May 2011 Mr Thomas shared his dream for NZNet with the staff, noting that the company was in a bad situation financially, pledging to get out of that mess and seeking their help and co-operation.

[78] Later that same morning Mr Thomas received from Hosting Direct a copy of a statutory demand on NZNet demanding payment of the sum of \$28,340.60 which it was stated was “acknowledged by you as properly due by way of an agreement dated 15 April 2011”. Unbeknown to Mr Johnston, Mr Andrews had signed an agreement with Hosting Direct on 15 April 2011 acknowledging a debt owed to that company and agreeing to pay it by 20 April 2011. Mr Johnston’s reaction was spelt out in his email of 8 May 2011 to Mr Andrews:

Well I’m extremely disappointed you have signed this without consulting me as the funder of your business. Please explain how you expected to pay the bill? You know there is no money to pay this bill, yet you sign an agreement acknowledging the debt, and agreed to pay it by the 20th. You didn’t think to run this by me first as I’ve put over \$130k into your business in the past 3 months????

How long did you have to look at this document and did you get legal advice? If he made you sign this guarantee under duress and time pressure, we may be able to invalidate this

....

Stephen, I am so close to shutting NZNET down because of your terrible business decisions. I hope you understand that you can be paid no wages until all bill (sic) are up to date. This month is the most critical month in the history of your company and probably your life. NZNET hangs by a thread, and rest assured, I will chase you for every dollar you owe me if I put it into receivership for default of my loan payments which may mean bankrupting you.

[79] In spite of the distinct lack of funds available in NZNet to pay the existing debt, in an email dated Sunday, 8 May 2011 Mr Thomas advised Mr Johnston “quite affirmatively” that he could turn the company around by June 2011. He asked Mr Johnston to refrain from taking any hasty action.

[80] Remarkably Mr Johnston contemplated injecting still further funds provided Mr Thomas was given a free 20 per cent shareholding and Mr Johnston was given a free 11 per cent shareholding in lieu of the unpaid time that he had put into NZNet. His email of 11 May to Mr Andrews commenced as follows:

I have just received the list of payments that need to be made today, \$30k, plus a further in the next week, plus superdockets.

I'm on the verge of putting nznet into receivership but George seems to think he can make work if I put funds in. I personally don't think we can make it work but since George thinks he can, and he is being paid next to nothing, I want to follow through with the shareholding you promised him initially.

[81] However Mr Johnston had further cause for concern when Ms Crosby advised him that she had opened a letter from the IRD containing an overdue statement of account in the sum of \$18,980. Ms Crosby was able to provide a copy to Mr Johnston a few days later. Mr Johnston claimed that until that point he was unaware that monies were owed to the IRD. On receiving that letter from Ms Crosby he said that he confronted Mr Andrews and received an assurance that Mr Andrews had been in contact with the IRD and that everything had been resolved.

[82] Still Mr Johnston continued to inject funds into NZNet. In his email of 7 June 2011 to Mr Thomas which suggested delaying the wages payment by a day and providing the staff with the false explanation that the delay was due to the public holiday, he recorded that he had put \$58,000 into NZNet in the previous 30 days together with an expected \$20,000 that same day with the consequence that, having also settled the Hosting Direct issue, he had made a contribution of approximately \$100,000 into NZNet in the previous month.

[83] During June 2011 Mr Thomas was concerned to obtain the transfer of his shareholding, Superdockets had served a statutory demand for \$25,795.32 on NZNet and Mr Johnston was pressing Mr Andrews for execution of further loan documents for his advances to NZNet. BNZ was considering the provision of a permanent overdraft facility provided Mr Johnston signed a guarantee. However he indicated to Mr Andrews that he would not do so until the loan documents were signed, the Superdockets issue was resolved and NZNet had returned funds which Mr Johnston's father had made available a short time previously.

[84] On 23 June Mr Thomas informed Mr Johnston that approval had been given for an overdraft to \$25,000. Mr Thomas proposed that the documentation be signed the following morning so as to gain access to the funds. However Mr Johnston advised that he would not sign the guarantee or the overdraft agreement until his loan agreement and security had been signed by Mr Andrews and his wife.

Mr Thomas resigns

[85] On 13 July 2011 power to the data centre was cut off. It transpired that there was an unpaid bill of approximately \$37,000. Mr Thomas sought unsuccessfully to persuade Centurion Power that the debt was not the responsibility of NZNet.

[86] Mr Thomas requested a Board meeting for 22 July for the purpose of resolving the completion of his employment conditions and share transfer and the resolution of the issue concerning power supply to the data centre. Ms Crosby's employment with NZNet terminated on that day.

[87] Following the Board meeting Mr Thomas sent a letter dated 26 July 2011 advising of his resignation from NZNet with immediate effect and giving one months notice in terms of his employment obligations. On 26 July 2011 Mr Andrews notified him that his resignation had been accepted and informed him that he was to have no further contact with clients or suppliers.

[88] With the departure of Mr Thomas, Mr Andrews assumed again the role of managing director. Mr Johnston sent an email to Mr Andrews on 29 July 2011 advising that he had been through Mr Thomas' incomplete budget, detailed the outgoings which were due for payment and proposed the following cause of action:

Lets go through the whole budget on the weekend, we will probably need to reduce staff further. Even if we breakeven, that leaves no money to pay you wages, and doesn't leave us anything for super dockets, increase in rent to come next month, centurion, brookfields, MHP print, PAYE, etc. We need to get this business making \$10k+ per month as soon as possible to clear all the arrears.

Any suggestions or recommendations? It just seems to me with a turnover of \$82k per month and staff of 8, we have too many people. Yes, Vibe bill will go down, but Maxnet will go up – net savings are minimal. There is little else we can do, except, increase prices, increase sales, or lay off people.

[89] However Mr Johnston was agitated that Mr Andrews had still not arranged for execution of the further loan documents which Mr Johnston had submitted. In an email of 2 August 2011 he said:

More concerning is the fact the NZNET bank a/c is \$30k in OD, (\$5k over the limit due to all the DD's dishonoured), Maxnet bill of \$34k due this week, wages due this week I think you better tell the staff we can't pay anyone till the end of the week at the earliest.

You have continually refused to sign my loan documents and security, so therefore we have no option but to enter liquidation. Your promises for funds continue to be empty promises. I'm already in the gun for the \$25k BNZ OD which I signed a guarantee on – The situation is getting out of control. We must arrest this today. I'm talking to Bruce about receivership options as he agreed with me that I should provide no further funds.

A further loan agreement was then executed on 2 August 2011 for the amount of \$250,000 with guarantees from Mr and Mrs Andrews as trustees of the Stephen Andrews Family Trust and from Mr Andrews personally.

Mr Johnston resigns

[90] Because the further loan documents had been signed Mr Johnston decided to advance funds for the payment of the Maxnet bill, albeit the funds had been sourced from his father. He noted that neither he nor his father had any further funds left and that it would be necessary for NZNet to survive on its own two feet in the future. He also advised that he would be away from New Zealand from the end of August until the second week of September.

[91] On 29 August 2011 NZNet's application to set aside the statutory demand served by Superdockets on 30 May 2011 was heard in the High Court at Auckland. In a judgment dated 31 August 2011 Associate Judge Bell concluded that there was no substantial dispute as to the liability of NZNet to pay Superdockets the sum of \$25,795.32 and he ordered NZNet to make that payment by 21 September 2011.

[92] When he returned to New Zealand Mr Johnston received a letter from IRD dated 12 September 2011. That letter advised that IRD records showed that NZNet had either not paid or had short-paid employer deductions to the IRD for 31 months and that the total amount of employer deductions outstanding (including penalties and interest) was \$252,489.01.

[93] Mr Johnston resigned as a director of NZNet on 15 September 2011.

The liquidation of NZNet

[94] Mr Andrews had first met Mr Grant of Waterstone Recovery Ltd in mid-2009 when he sought assistance with respect to the debt allegedly owed by HPG to NZNet. After

Mr Johnston's departure Mr Andrews had a number of discussions with Mr Grant concerning the state of the NZNet business. Mr Grant was of the view that NZNet was insolvent and he advised Mr Andrews that the business should be placed into liquidation. Mr Andrews placed NZNet into voluntary liquidation on 17 November 2011.

[95] After their appointment the liquidators ran the NZNet business as a going concern for a short time with the intention of selling the business. However both the ISP business and the Telco business had been badly degraded in the month leading up to the liquidation due to the disconnection of wholesale services and there was a high level of dissatisfaction among the internet customers.

[96] Although an offer to purchase the business was received, the offer was subject to the approval of the GSA holder, a trust associated with Mr Andrews' mother. Mr Grant explained that because the liquidators were unable to obtain that consent and given the hostile approach of the GSA holder they were forced to make the decision to disclaim the contracts to supply both internet and voice-over services through Telco.

Overview of liquidators' case

[97] The liquidators submit that viewed objectively, NZNet failed the solvency test from March 2008 when its liabilities exceeded its assets and it remained unable to pay the IRD. Mr Andrews failed to undertake a sober assessment as to NZNet's future income or prospects and sought to hide the true financial position from the other directors of NZNet which created a substantial risk of serious loss to the company's creditors.

[98] So far as Mr Johnston is concerned, it is said that he failed to implement any processes to control the business of NZNet and in effect "authored the situation" whereby Mr Andrews had free reign to open and conceal mail at his sole discretion. The liquidators submitted that NZNet would likely have gone into liquidation soon after December 2009 if Mr Johnston had not provided the financial lifeline which he did and they argued that Mr Johnston's advances served to exacerbate the indebtedness of NZNet. As Mr Grant stated in evidence:

Unfortunately his [Mr Johnston's] money was used to allow the business to become much bigger, and so the failure was ... larger than what it otherwise would have been. So in some ways this ship was always going to sink. The only question was how far

out from shore it was when it sunk. And it was a long way out when it finally did go down.

[99] In relation to Mr Thomas, it is contended that he understood that NZNet had an unsustainable business model and that he was authorised to make whatever changes were necessary to change that. The liquidators maintain that in the period prior to his appointment as managing director Mr Thomas was effectively a de facto director, the significance of the point being that Mr Thomas had significant time in which to take stock of the company's financial situation before he assumed the role of director. Yet despite the grim circumstances, Mr Thomas prepared forecasts which were unrealistic and overly optimistic. Such optimism was a factor in enticing Mr Johnston to inject still further funds into NZNet.

Mr Johnston's affirmative defence

[100] Because the evidence in this proceeding occupied the entire week which was allocated for the case, a timetable for written submissions was agreed and those submissions were presented at a further hearing on 14-15 August 2014. The timetable provided for the plaintiffs' closing submissions to be filed first followed by the defendants' submissions.

[101] In the first defendant's closing submissions dated 28 July 2014 Mr Johnston purported to raise for the first time an affirmative defence under s 138 of the Act which relevantly provides:

138 Use of information and advice

- (1) Subject to subsection (2), a director of a company, when exercising powers or performing duties as a director, may rely on reports, statements, and financial data and other information prepared or supplied, and on professional or expert advice given, by any of the following persons:
 - (a) an employee of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned:
 - (b) a professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional or expert competence:
 - (c) any other director or committee of directors upon which the director did not serve in relation to matters within the director's or committee's designated authority.

- (2) Subsection (1) applies to a director only if the director–
 - (a) acts in good faith; and
 - (b) makes proper inquiry where the need for inquiry is indicated by the circumstances; and

...

[102] It appeared from the written submissions that Mr Johnston was seeking to rely on information and advice not only from Mr Andrews and Mr Thomas but also from his lawyer (Mr Costain), Ms Crosby and the company accountant, Mr Kelso.

[103] Unsurprisingly the liquidators took the point that r 5.48(4) of the High Court Rules requires an affirmative defence to be pleaded. They relied upon the decision of the Court of Appeal in *Manukau Golf Club Inc v Shoye Venture Ltd* where the Court observed that only if such affirmative defences are pleaded can they be defined, answered and properly analysed.⁶ The liquidators argued that if an application had been made for leave to advance this defence the liquidators would have opposed leave on the basis that:

- (a) discovery was not given by any parties based on this defence;
- (b) the liquidators did not seek to adduce any evidence relevant to this defence including calling any relevant witnesses to rebut the defence;
- (c) the liquidators did not cross-examine the witnesses on the basis of this defence.

[104] Having regard to those valid concerns raised by the liquidators I consider that it is too late for a defence of the affirmative nature of that in s 138 to be raised for the first time in closing submissions. Hence this defence is not available to Mr Johnston in this case.

⁶ *Manukau Golf Club Inc v Shoye Venture Ltd* [2012] NZCA 154, (2012) 21 PRNZ 235 at [22].

The s 135 claim

[105] Section 135 of the Act states:

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.

[106] In *Mason v Lewis* the Court of Appeal identified the essential pillars of s 135 as follows:⁷

The essential pillars of the present section are as follows:

- the duty which is imposed by s 135 is one owed by directors to the company (rather than to any particular creditors);
- the test is an objective one;
- it focuses not on a director's belief but rather on the manner in which a company's business is carried on, and whether that modus operandi creates a substantial risk of serious loss;
- what is required when the company enters troubled financial waters is what Ross ... accurately described as a "sober assessment" by the directors, we would add of an ongoing character, as to the company's likely future income and prospects.

Mr Andrews

[107] As sole director from 1995 to 2009 Mr Andrews had a comprehensive knowledge of the trading history of NZNet and its financial position. He was privy to the full circumstances of the HPG arrangement and he was at all times aware of the outstanding liabilities to the IRD. He did not provide his fellow directors with accurate information which was available to him. Indeed he actively misled Mr Johnston over a substantial period of time.

⁷ *Mason v Lewis* [2006] 3 NZLR 225 (CA) at [51].

[108] As Ms Crosby deposed:

Stephen was reactive. He used to keep the overdue accounts on his desk in a pile, and only dealt with them if the supplier was chasing payment. A number of overdue accounts were held back from me and the others. For example, the Body Corporate charges for 5 Douglas Alexander being around \$44,500. This only came to light in my last couple of weeks of employment.

[109] Furthermore, without consultation with Mr Johnston, Mr Andrews rashly committed the company to obligations which it was not able to discharge, in particular the arrangement with Hosting Direct and the contract with Superdockets.

[110] I have no hesitation in finding that at all material times Mr Andrews caused and allowed the business of NZNet to be carried on in a manner likely to cause a substantial risk of serious loss to the company's creditors.

Mr Johnston

[111] The budget which Mr Andrews provided to Mr Johnston on 21 November 2009 was highly optimistic in terms of both sales and growth. The net profit for 2008 was stated to be \$13,059 with forecasts for the following four years as follows:

Year	\$
2009	128,127
2010	152,470
2011	838,320
2012	3,665,880

[112] Furthermore, misleading responses were provided to the questions which Mr Johnston had asked with the guidance of his lawyers. Noteworthy in that regard are the answers to the questions at [] above. I accept that at the outset Mr Johnston did not have reason to question the veracity of Mr Andrews. Rather he was impressed by the fact that NZNet was known as the first ISP in New Zealand, a fact which, to Mr Johnston's knowledge, Mr Andrews was very proud of.

[113] I do not accept the liquidators' submission that "from day one" Mr Johnston was put on notice about serious issues which NZNet was facing including the IRD debt. Indeed, as Ms Crosby explained, Mr Andrews received the steady stream of IRD correspondence but did not disclose it.

[114] There are two notable features to Mr Johnston's tenure as a director of NZNet. The first is that he was not, at least originally, involved in the operation of the business. As he explained in his evidence, he was initially viewed only as an investor/shareholder in a business which would continue to be run in the fashion that Mr Andrews had always run the business, namely "his way". Such an approach is not a basis for avoiding the responsibilities of directorship. As Hammond J said *Mason v Lewis*:⁸

Directors must take reasonable steps to put themselves in a position not only to guide but to monitor the management of a company. The days of sleeping directors with merely an investment interest are long gone: the limitation of liability given by incorporation is conditional on proper compliance with the statute.

[115] A second notable feature of Mr Johnston's participation in NZNet was his willingness to inject substantial amounts of his personal funds into the company. The proof of debt which he filed revealed, in addition to his initial advance of \$50,000 in February 2010, advances to or on behalf of NZNet during 2010 of \$120,315 and during 2011 of \$238,340.

[116] There is no doubt that Mr Johnston's advances kept NZNet afloat. That was the reason why he advanced the funds. As the Court of Appeal observed in *Yan v Mainzeal Property and Construction Ltd (in receivership and in liquidation)*:⁹

Finally, we do not share the Judge's view that the fact that RGREL had to rely on Isola and the Richina parent companies for support tends to suggest it cannot pay its debts. It is common for companies to require funding support from related companies in a group or from shareholders. ...

[117] Counsel for the liquidators sought to distinguish that case from the present on the grounds that NZNet's position was a lot more volatile in that no funds were secured by Mr Johnston in a trust account for the purposes of paying off creditor debts. While I recognise that the factual scenarios are different and that Mr Johnston's advances were made

⁸ *Mason v Lewis* above n 7, at [83].

⁹ *Yan v Mainzeal Property and Construction Ltd (in receivership and in liquidation)* [2014] NZCA 190 at [86].

on an ad hoc basis, the reality is that for a substantial period of time NZNet was able to trade with the assistance of Mr Johnston's substantial financial injections.

[118] Nevertheless I consider that by April 2011 he should have realised that all was not well despite his commitment to provide "lifeline" funding.¹⁰ It was during April 2011 that he learned not only of the Superdockets liability¹¹ but also about the general financial position including the fact of liabilities for GST and PAYE.¹² From that point in time in my view he failed to exercise the care, skill and diligence of a reasonable director.

[119] However even at that point I do not consider that Mr Johnston acted in contravention of s 135. He had confidence in Ms Crosby and Mr Thomas and he continued to inject funds into the company – in April 2011 alone he advanced \$75,000. But the point of no return, in my assessment, was when Mr Thomas resigned on 26 July 2011, making it plain that he considered that NZNet was insolvent. Certainly at that point Mr Johnston should have taken steps to stop the company trading.

[120] Instead he conferred with Mr Andrews about a strategy for continuing to run the business,¹³ he ensured that his further loan documentation was executed¹⁴ and he then went overseas for a fortnight. It was not until he personally received a letter from the IRD that he resigned his directorship.

[121] I find that in the period from 26 July 2011 to 15 September 2011 Mr Johnston acted recklessly in contravention of s 135.

Mr Thomas

[122] Mr Thomas' sudden promotion to managing director came as something of a bolt from the blue. He was no doubt somewhat flattered but also recognised the opportunity to consolidate his position in the company.

¹⁰ At [65] above.

¹¹ At [72] above.

¹² At [73] above.

¹³ At [88] above.

¹⁴ At [89] above.

[123] Mr Thomas makes the point that the case is unusual in that he was appointed a director very late in the life of the company and that he was a director for only a short period of time, an issue which I discuss further below. He claimed that he was not aware that the company was insolvent at the time of his appointment. Rather he genuinely believed that, while experiencing financial problems, the company was solvent and capable of being turned around financially. When he discovered the true situation he called for a meeting of directors and, when satisfactory explanations were not provided, he resigned. He claimed that he would never have become a director had he known of the true situation.

[124] The difficulty for Mr Thomas is that in the months prior to his becoming a director he gradually became aware of the company's difficulties and of the friction between Mr Johnston and Mr Andrews. He was the recipient of Mr Johnston's email of 4 April 2011 advising that Mr Johnston intended his proposed payment to be his last round of funding of NZNet.¹⁵ He also received the email of 4 April which recorded that the company had not paid any PAYE or GST for some time.¹⁶ He was copied into the email in which Mr Johnston advised Mr Andrews that the NZNet situation was a lot worse than Mr Andrews had previously outlined¹⁷ and he was soon aware of Mr Johnston's reaction to the Superdockets liability.¹⁸ In addition, shortly before his appointment as managing director, he was copied into Mr Johnston's email of 3 May 2011 recording that "the vault is empty".¹⁹

[125] Consequently at the time when he agreed to assume the role of managing director Mr Thomas was well aware of both Mr Johnston's concerns and his unwillingness to sink still further funds into NZNet. Furthermore as the liquidators point out, Mr Thomas' email to the NZNet staff immediately following his appointment stated that the company was in a bad situation financially.²⁰ Two days later he received a copy of Mr Johnston's email to Mr Andrews concerning Hosting Direct in which Mr Johnston stated that "NZNet hangs by a thread".²¹

¹⁵ At [68] above.

¹⁶ At [69] above.

¹⁷ At [73] above.

¹⁸ At [74] above.

¹⁹ At [75] above.

²⁰ At [76] above.

²¹ At [77] above.

[126] While I do not consider that in his short duration as managing director Mr Thomas acted in a manner which would constitute contravention of s 135, it is my view that, given his experience with NZNet in the prior six months and the state of his knowledge as at May 2011, which was roughly comparable to that of Mr Johnston, Mr Thomas failed to exercise the care, skill and diligence of a reasonable director as required by s 137.

The s 137 claim

[127] Section 137 states:

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
- (b) The nature of the decision; and
- (c) The position of the director and the nature of the responsibilities undertaken by him or her.

[128] Section 137 is the statutory expression of the director's duty of care and skill. The standard to be applied is that of the reasonably competent director. Although a director's personal knowledge and experience is no longer relevant, the reference in para (c) to the position of the director and the nature of the responsibilities undertaken by him or her introduces an element of subjectivity.²²

[129] The degree of overlap between ss 137 and 135 is accentuated in a case such as the present where essentially the same allegations are made in support of both claims.²³

[130] Having regard to Mr Andrews' conduct of the affairs of the company which led me to the conclusion that he had acted in contravention of s 135, I similarly form the view that from a date well before December 2009 Mr Andrews failed to exercise the care, diligence and skill of a reasonable director. Accordingly I find that he was in contravention of s 137 at all material times.

²² *Vercauteren v B-Guided Media Ltd* [2011] NZCCLR 9 (HC) at [57].

²³ Compare *FXHT Fund Managers Ltd (in liq) v Oberholster* (2009) 10 NZCLC 264,562 (HC) at [95].

[131] For the reasons explained in my analysis of their conduct in the context of s 135, I have also concluded that both Mr Johnston and Mr Thomas failed to exercise the care, diligence and skill of a reasonable director. In the case of Mr Johnston such failure commenced early in April 2011. In the case of Mr Thomas the failure occurred throughout the comparatively brief period of his directorship.

The s 136 claim

[132] Section 136 states:

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.

[133] On this issue, in addition to repeating the allegations made in relation to the s 135 cause of action, the statement of claim asserts:

The first to third defendants knew, or ought to have known, of the debts of NZNet and its financial position. At the time that the debts were incurred from creditors of NZNet, there was no possibility that NZNet could perform the obligations unless sales increased. The first to third defendants were not reasonable to rely on sales increasing in order to meet obligations that they caused NZNet to incur.

There was significant pre-existing debt that NZNet could not pay. Yet the first to third defendants continued to allow NZNet to incur further indebtedness. The first to third defendants have failed to apply their minds to the information which was available. Further, the first to third defendants have failed to understand that information.

[134] In *Peace and Glory Society Ltd (in liq) v Samsa* the Court of Appeal noted Professor Farrar's description of the purpose of s 136 as being to deal with obligations on capital account such as major investments.²⁴ It focuses on a particular transaction rather than on the general conduct of the company's business whereas s 135, by contrast, deals with debts on revenue account.

²⁴ *Peace and Glory Society Ltd (in liq) v Samsa* [2009] NZCA 396, [2010] 2 NZLR 57 at [44].

[135] Applying that approach in *Richard Geewiz Gee Consultants Ltd (in liq) v Gee*,²⁵ I considered that s 136 did not appropriately apply when the primary liability was a steadily mounting tax debt which was effectively being used as the company's bank. I considered that such a scenario was more appropriately the subject of s 135 and s 137.

[136] With the exception of the Superdockets transaction, I adopt the same approach in the present case. Although the Superdockets liability is in consideration for the provision of services, I consider that it is closer to an obligation on capital account than any of the other liabilities which NZNet incurred.

[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.

The second stage

[138] Section 301 provides in material part:

301 Power of court to require persons to repay money or return property

- (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

²⁵ *Richard Geewiz Gee Consultants Ltd (in liq) v Gee* [2014] NZHC 1483.

- (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.

[139] The Court of Appeal in *Mason v Lewis* described the approach to be followed:²⁶

[109] The standard approach has been to begin by looking to the deterioration in the company's financial position between the date inadequate corporate governance became evident (really the "breach" date), and the date of liquidation.

[110] Once that figure has been ascertained, New Zealand courts have seen three factors - causation, culpability, and the duration of the trading - as being distinctly relevant to the exercise of the Court's discretion (citations omitted).

Mr Andrews

[140] In the case of Mr Andrews, I consider that the "breach date" occurred well prior to December 2009. Consequently I accept the liquidators' submission that Mr Andrews ought to contribute to the full extent of the outstanding creditor debt as at the date of liquidation, namely \$1,098,591.29.

Mr Johnston

[141] My findings in respect of Mr Johnston are that he was in contravention of s 137 from the beginning of April 2011 and in contravention of s 135 from 26 July 2011, in both cases until the date of his resignation as a director on 15 September 2011.

[142] The schedule which the liquidators produced entitled "Rowan Johnston Liability Analysis" calculated Mr Johnston's liability on the basis of the entire duration of his directorship. In endeavouring to calculate the deterioration in NZNet's financial position in the period 1 April 2011 to 15 September 2011 I have analysed the IRD Statement of Account for the company to 2 February 2012 which was annexed to IRD's proof of debt. I have also utilised the equivalent liability analysis schedule for Mr Thomas which conveniently focuses on the periods 5-31 May 2011, June, July and 1-10 August 2011.

²⁶ *Mason v Lewis*, above n 7.

[143] From the IRD Statement of Account I calculate that various taxation liabilities in the total sum of \$36,976.82 accrued in the period 1 April 2011 to 15 September 2011 as follows:

GST	30/9/2011 (half)	125.00	
	31/7/2011	1,043.41	
	31/5/2011	250.00	<u> </u>
			1,418.41
KSE	30/9/2011 (half)	141.97	
	31/8/2011	403.66	
	31/7/2011	791.27	
	30/6/2011	405.11	
	31/5/2011	554.27	
	30/4/2011	594.57	<u> </u>
			2,890.85
KSR	30/9/2011 (half)	69.26	
	31/8/2011	195.56	
	31/7/2011	380.70	
	30/6/2011	226.31	
	31/5/2011	352.61	
	30/4/2011	384.72	<u> </u>
			1,609.16
PAYE	30/9/2011 (half)	1,615.34	
	31/8/2011	3,779.97	
	31/7/2011	7,421.57	
	30/6/2011	4,300.83	
	31/5/2011	7,603.80	
	30/4/2011	6,336.89	<u> </u>
			<u>31,058.40</u>
	Total		36,976.82

[144] To that sum, the following amounts should be added to determine the debts incurred in the period I have found to be relevant:

Brookfields Lawyers	24,620.85
Data Insurance	245.81
Debtworks	21.03
George Thomas	15,901.00
IMS Security	299.00
J J Richards	85.04
R K Johnston	<u>165,340.60</u>
	206,513.33

This produces a total debt figure of \$243,490.15.

[145] In accordance with the liquidators' calculation at [7] above, the amount of the debt owed by NZNet to Mr Johnston of \$460,000 is then to be deducted. The result is a negative figure. Hence Mr Johnston's liability is nil. I simply note in passing that by my rudimentary calculation the point at which the company's debts (working backwards from 15 September 2011) would exceed the debt owed to Mr Johnston would be at about 31 November 2010.

Mr Thomas

[146] Mr Thomas raises a preliminary issue with reference to his potential liability by reference to the duration of his directorship.

[147] He first contends that he did not consent to being appointed a director until the terms and conditions of his engagement were agreed and that that did not occur until his signed consent was sent to the Registrar of Companies on 15 June 2011.

[148] I accept the liquidators' submission that the term of his directorship commenced on 5 May 2011 even though the registration did not occur until at least a month later. It was on 5 May 2011 that he assumed the role and his email to the staff was sent on the following day.²⁷ I also note that the consent and certificate under s 152 of the Act which Mr Thomas signed specifies 5 May 2011 as the date of his appointment.

²⁷ At [77] above.

[149] However the liquidators contend that, although Mr Thomas gave notice of his resignation by a letter dated 26 July 2011, in fact his resignation did not become effective until 10 August 2011, that being the date recorded on the Companies Register. The liquidators refer to s 157(2) of the Act which states:

- (2) A director of a company may resign office by signing a written notice of resignation and delivering it to the address for service of the company. The notice is effective when it is received at that address or at a later time specified in the notice.

[150] They also place reliance on the fact that Mr Thomas' email of 23 July 2011 stated that his last day at NZNet would be 25 August 2011 and that his letter of 26 July 2011 said that he would be relieved of his responsibility on 25 August 2011.

[151] In my view Mr Thomas' references to 25 August 2011 simply reflect the fact that he was not only resigning as a director but he was also giving one month's notice of the termination of his employment by NZNet. The letter was explicit that Mr Thomas intended his resignation as a director to be "with immediate effect".

[152] In those circumstances I consider that the date on which his responsibilities as a director ended was 26 July 2011. Hence the relevant period for a s 301 analysis in respect of Mr Thomas is from 5 May 2011 to 26 July 2011.

[153] In fixing that period I have considered Mr Thomas' submission that, as in some other cases, he should be allowed a reasonable time within which to make an assessment of the company's position before any liability should be imposed. However for the reasons explained at [124]–[125] I consider that Mr Thomas ought to have been and was in fact aware of the troubled financial situation in NZNet by the point in time that he took up his directorship. His state of knowledge is reflected in the contents of the June 2011 budget which he sent to Mr Johnston under cover of his email of 8 May 2011 in which he stated that until that time he "was not knowing anything about the financials".²⁸

²⁸ At [79] above.

[154] As noted above, the liquidators' schedule entitled "George Thomas Liability Analysis" covers the entire period from 5 May to 10 August 2011. As a consequence of my holding above it is necessary for me to endeavour to calculate the deterioration in NZNet's financial position for the lesser period of 5 May to 26 July 2011.

[155] Working from the schedule, but adopting instead the information relating to Mr Johnston's advances in the calculation annexed to his proof of debt (but without any interest component), I calculate the debts incurred in the relevant period to be:

Brookfields Lawyers	12,954.78
Data Insurance	90.56
Inland Revenue	23,329.88
R K Johnston	<u>63,340.60</u>
	99,715.82

After deducting the amount of \$15,901.00 owed to him in accordance with the liquidators' calculation at [7] above, Mr Thomas' liability is \$83,814.82.

[156] This result may appear somewhat harsh for Mr Thomas, particularly when compared with the outcome for Mr Johnston. It is a consequence of the fact that the bulk of the deterioration in the NZNet financial position in the period of Mr Thomas' directorship represented advances by his co-director, Mr Johnston. However, as in January 2011,²⁹ so too when he became a director it was Mr Thomas' wish that Mr Johnston should continue to fund the company.³⁰

[157] Indeed as soon as 13 May 2011 Mr Thomas found it necessary to ask Mr Johnston to "redeem the situation immediately" when the bank unexpectedly reversed the scheduled staff salary payments. Similarly in an email to Mr Thomas dated 2 June 2011 Mr Johnston advised that he had been to BNZ to make a payment to NZNet and he authorised the full payment then outstanding to VIBE of \$11,000. The fact is that Mr Thomas was aware of the significant sums which Mr Johnston transferred into NZNet during the relevant period.³¹

²⁹ At [57] above.

³⁰ At [80] above.

³¹ At [82] above.

The s 194 claim

[158] Section 194 relevantly 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.

[159] The consequences of a failure to comply with s 194 are spelled out in s 300 which relevantly provides:

300 Liability if proper accounting records not kept

- (1) Subject to subsection (2) of this section, if—
 - (a) a company that is in liquidation and is unable to pay all its debts has failed to comply with—
 - (i) section 194 (which relates to the keeping of accounting records); or
 - (ii) ...
 - (b) The court considers that—
 - (i) The failure to comply has contributed to the company's inability to pay all its debts, or has resulted in substantial uncertainty as to the assets and liabilities of the company, or has substantially impeded the orderly liquidation; or
 - (ii) For any other reason it is proper to make a declaration under this section,—

the court, on the application of the liquidator, may, if it thinks it proper to do so, declare that any one or more of the directors and former directors of the company is, or are, personally responsible, without limitation of liability, for all or any part of the debts and other liabilities of the company as the court may direct.

- (2) The court must not make a declaration under subsection (1) of this section in relation to a person if the court considers that the person—
- (a) Took all reasonable steps to secure compliance by the company with the applicable provision referred to in paragraph (a) of that subsection; or
 - (b) Had reasonable grounds to believe and did believe that a competent and reliable person was charged with the duty of seeing that that provision was complied with and was in a position to discharge that duty.

[160] With reference to s 300, the Court of Appeal in *Mason v Lewis* commented:³²

[85] Section 300 is important in its own right. It works in tandem with s 135: a director cannot be heard to say “I did not realise we were in such a pickle, because we did not have any, or adequate, books of account”. It is fundamental that such books must be kept, and directors must see to it that they are kept.

[161] The pleading of this head of claim was as follows:

There is a significant debt owed to the Inland Revenue Department (“the IRD”). This debt has not been included on any accounting record.

The debt to the IRD is a liability of NZNet and ought to be recorded on the accounting records.

The second defendant signed the financial statements.

The omission of this debt does not allow the financial position of NZNet to be determined with reasonable accuracy.

The failure to comply with the obligation to keep proper accounting records has contributed to NZNet’s inability to pay its due debts as the true financial position could be determined by the first and third defendants.

Had proper accounting records been kept, the first and third defendants may have caused the affairs of NZNet to be operated differently and an aggressive expansion of NZNet may not have occurred.

Maintenance of accounting records of NZNet

[162] The evidence revealed that primary control of the maintenance of the financial accounts was vested in Mr Andrews. Mr Johnston explained that at the time of his appointment as a director the accounts were prepared by an office administrator called Hannah and an outside contractor employed by Mr Andrews. When Hannah resigned from her position in early 2010 discussions were held about employing a new administrator but it

³² *Mason v Lewis*, above n 7.

was decided that Mr Andrews could maintain the accounts until the cashflow and sales of the business improved which would result in a saving of \$3,000 per month.

[163] That appears to have remained the position until Mr Johnston introduced Ms Crosby into NZNet. She explained:

16. Xero Accounting Software was used by NZNet, but only as a Cashbook system. What I mean is that items would pull through from the bank account overnight and be posted from there. When I became involved in the NZNet accounts there were many weeks of transactions not yet posted. Also, at that point, there was no creditor's ledger or debtor's ledger.
17. PAYE returns were not being completed, and it was my understanding that they had not been done for several years. I believe James Kelso, NZNet's accountant had made provision in the accounts for PAYE, but it was never paid.
18. Up until late March/early April 2011 there was no creditors ledger maintained. As I considered this to be very important, I created one in Xero based on invoices/statements taken from Stephen's desk, but even then I still wasn't sure it was complete.
19. In order to set up the creditor's ledger, I asked Stephen for every invoice and statement that he had. It took some time to get this information from him. I was not ever convinced that he had given me everything, but by mid-May we had a Creditors ledger of around \$60,000. This did not include the large monthly invoices from our major internet suppliers; those were on a regular payment basis. It also didn't include any payments due to the IRD.

[164] In addition to observing that Mr Andrews was reactive³³ and that invoices and other correspondence related to the accounts were scattered across his desk in complete disarray, Ms Crosby deposed that Mr Andrews was aware of the IRD debt because he had received all the IRD correspondence but held it back. She stated that prior to her creation of the creditor's ledger Mr Johnston would likely have had limited knowledge of the extent of the debt due by NZNet. However with the benefit of the ledger he had a better idea and attempted to manage cashflow and payment to creditors. She made the point that while the directors all had access to Xero, Xero was only as good as the data inserted and that it was not kept properly up to date by Mr Andrews with reference to overdue accounts.

³³ At [108] above.

The liquidators' submissions

[165] The liquidators' closing submissions noted the guidance on the types of records that must be kept to be found in decisions in the context of s 151 of the Companies Act 1955 (the predecessor to s 194), in particular *Maloc Construction Ltd (in liq) v Chadwick*.³⁴ They pointed out that 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. It was mandatory that the directors of NZNet ensured that within five months after 31 March of each year the company completed financial statements that complied with s 12 of that Act.

[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;
- (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.

³⁴ *Maloc Construction Ltd (in liq) v Chadwick* (1986) 3 NZCLC 99,794, (1986) 2 BCR 217 (HC); see also *Walker v Ariyathas* [2012] NZHC 1648.

[167] The liquidators placed some emphasis on the fact that Mr Johnston acknowledged in cross-examination that it was difficult to determine the true financial position of NZNet from the accounts:

- Q. So would you say that these accounts are reliable?
- A. I'd say they'd be finalised. Either by the accountant or Stephen, or a combination.
- Q. And the true financial position of NZNet is hard to determine from these accounts, isn't it?
- A. That's correct ...

Mr Johnston went on in his answer to note that the statements for 31 March 2010 were not signed off by Mr Andrews until a year later and that Mr Johnston did not recall receiving them until September 2011.

[168] The liquidators submitted that the Xero accounting records were never properly kept up to date and that there was no accounting on Xero for aged payables or receivables until after April 2011. PAYE returns had not been completed for several years and as a consequence there were insufficient source records to enable accurate financial statements to be completed. On the basis of the various identified deficiencies it was said to be clear that NZNet's accounting records did not speak for themselves, nor did they allow the true financial position to be determined with reasonable accuracy at any time. The substantial uncertainty as to NZNet's true asset and liability position was said to have likely contributed to what the liquidators' described as "Mr Johnston's continuation of reckless investment which resulted in a deeper indebtedness of NZNet".

Analysis

[169] I accept the liquidators' submission that the omission of the significant IRD debt from the accounting records did not allow the directors to properly determine the financial position with reasonable accuracy. Their further submissions are likely also correct, namely that had proper accounting records been kept the directors may have caused the affairs of NZNet to be operated differently and that the aggressive move towards sale and expansion may not have occurred.

[170] Consistently with their pleaded case, the liquidators placed primary responsibility at the door of Mr Andrews stating that he would have known the true position despite it not being recorded. However the closing submissions placed greater focus than did the pleadings on Mr Johnston and Mr Thomas.

[171] Echoing the observation in *Mason v Lewis*³⁵ it was submitted that while they may not have “fully” appreciated the pickle NZNet was in, they ought to have ensured proper records were being kept so that they could take stock of the situation. The liquidators said:

All three directors contributed to the failures to comply with the financial requirements. Mr Andrews is the most culpable. However, Messrs Johnston and Thomas allowed NZNet to be operated in such a way whereby Mr Andrews was given leave to do as he pleased with no controls in place.

[172] I accept that Mr Andrews is culpable. He was at all material times aware of the true state of indebtedness of the company and he took steps, successfully, to conceal that level of indebtedness from Mr Johnston. I declare in terms of s 300 that he is to be personally liable for the amount of the company’s indebtedness, namely \$1,098,591.29.

[173] However I am not satisfied that either Mr Johnston or Mr Thomas should properly be viewed as culpable. This is not a case where there was an absence of an accounting system. Mr Johnston sought and obtained appropriate financial information at the outset. However the sad reality is that he was plainly misled by Mr Andrews despite the due diligence which he undertook. When in due course he became concerned about the company’s situation, he took steps to address the situation by introducing Ms Crosby to the company and ensuring that she had access to and maintained the company’s financial records.

[174] When reality finally dawned on Mr Johnston, the die was effectively cast. Having reviewed the passage of events during Mr Johnston’s directorship, I do not consider that a declaration under s 300 is appropriate. Likewise in respect of Mr Thomas, the duration of his directorship was so short and so late in the piece that a declaration under s 300 is not justified. Had I taken a different view of the matter, I would not have considered making a declaration for a sum that exceeded the compensation order made in respect of Mr Thomas under s 301.

³⁵ At [160] above.

Disposition

[175] In summary my findings are:

Mr Andrews

- Mr Andrews was in contravention of s 135 at all material times.
- Mr Andrews was in contravention of s 137 at all material times.
- Mr Andrews was in contravention of s 136 by contracting on behalf of NZNet to assume the Superdockets liability in the sum of \$89,385.92.
- Under s 301 Mr Andrews is ordered to contribute to the assets of NZNet by way of compensation to the full extent of the outstanding creditor debt as at the date of liquidation, namely \$1,098,591.29.
- Mr Andrews was in contravention of s 194 at all material times.
- Under s 300 Mr Andrews is declared to be personally responsible for the outstanding creditor debt as at the date of liquidation, namely \$1,098,591.29.

Mr Johnston

- Mr Johnston was in contravention of s 137 from 1 April 2011 to 15 September 2011.
- Mr Johnston was in contravention of s 135 from 26 July 2011 to 15 September 2011.

Mr Thomas

- Mr Thomas was in contravention of s 137 from 5 May 2011 to 26 July 2011.
- Under s 301 Mr Thomas is ordered to contribute \$83,814.82 to the assets of NZNet by way of compensation.

Costs

[176] Having regard to the orders made, I direct that costs memoranda be filed in the following sequence:

- (a) Mr Johnston within 15 working days of this judgment;
- (b) the liquidators within 15 working days of receipt of Mr Johnston's memorandum;
- (c) Mr Thomas within 15 working days of the liquidators' memorandum.

Solicitors:
Waterstone Insolvency, Albany, Auckland

Brown J