'I DIDN'T KNOW, I DIDN'T KNOW, I DIDN'T KNOW': RELIANCE ON INFORMATION AND ADVICE AS A DEFENCE TO BREACHES OF DIRECTORS' DUTIES IN NEW ZEALAND

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I. Introduction

Section 138 of the *Companies Act 1993* (NZ) provides a defence to an accusation that a company director has breached one or more directors' duties[1] if certain conditions are met. This provision is set to take on greater significance[2] with the New Zealand government announcing its intention to introduce public enforcement of directors' duties and to criminalise 'intentional egregious' breaches of these duties in line with the approach taken in Australia.[3]

It has recently been held[4] that s 138 may also provide a defence (or at least 'afford protection') in both civil cases and criminal proceedings under such legislation as s 36A of the *Financial Reporting Act 1993* (NZ) and s 58 of the *Securities Act 1978* (NZ). In the wake of the global financial crisis ('GFC'), and the resulting spate of corporate collapses since about 2007, this application of s 138 – and indeed the very existence of the provision – have been criticised as allowing directors to avoid thinking for themselves or having to critically analyse advice obtained from outside sources.

This paper examines the defence provided to company directors by s 138 and considers whether it strikes the right balance, places too onerous a burden on directors, or allows the 'empty-headed' to inappropriately rely on their 'pure hearts'.[5]

II. Section 138 of the *Companies Act 1993* (NZ) – 'Use of Information and Advice'

Section 138[6] allows a company director, in certain circumstances, to rely on others who have skills or knowledge that the director does not have. The section reads as follows:

> (1) Subject to subsection (2) of this section, 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:

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1 See ss 131-137 of the *Companies Act 1993* (NZ).

2 See 'III Greater Significance?' below.

3 See *Securities Law Reform*, Cabinet Paper from the Office of the Minister of Commerce, 21 February 2011, [210], available at <http://www.med.govt.nz/upload/76654/Cabinet%20paper-securities%20law%20reform.pdf>.

4 See *Ministry of Economic Development v Feeney* (2010) 10 NZCLC 264,715; and *Davidson v Registrar of Companies* [2011] 1 NZLR 542.

5 See Ashley Burrowes and John Karayan, 'Feltex and Enron Bankruptcies' [2010] *New Zealand Law Journal* 406, 406.

6 The equivalent Australian provision is s 189 of the *Corporations Act 2001* (Cth). Detailed consideration of the Australian law is beyond the scope of this article. The issue of directors' reliance on information and advice provided by others has recently been prominent in Australia, following the 'Centro' decision, *Australian Securities and Investments Commission v Healey* (2011) 196 FCR 291. See Philip Crutchfield and Catherine Button, 'Men Over Board: The Burden of Directors' Duties in the Wake of the Centro Case' (2012) 30 *Company and Securities Law Journal* 83; and Tim Leung and Jon Webster, 'Directors' Duties, Financial Literacy and Financial Reporting After Centro' (2012) 30 *Company and Securities Law Journal* 100.

(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) of this section 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

(c) Has no knowledge that such reliance is unwarranted.

A. *A Defence, Not A Core Duty*

Though it appears under the heading 'Directors' Duties', it is clear that s 138 does not constitute one of the core duties of a director. Rather, reliance on information and advice under s 138 may provide a defence to a breach of such duties:

> There is no provision in the Act for the consequences of relying on information or advice provided by others. Therefore, rather than constituting one of the core duties of a director, reliance in terms of s 138 might instead be seen as a defence to a breach of a core duty. Prudent directors who are aware that they lack expertise in a particular area may avoid potential liability (for example under s 137) by obtaining the advice of an expert.[7]

This reflects the way the section has been treated by the New Zealand courts: see *Mason v Lewis*[8] *and FXHT Fund Managers Ltd v Oberholster*,[9] noted below, for example.

B. *To Whom Does It Apply?*

The duties of directors apply to all those who fit the very broad statutory definition of 'director' in s 126 of the *Companies Act 1993* (NZ). Section 138, which is stated to be available to 'a director of a company' is therefore of interest beyond those persons who are validly appointed to the office of director by a majority vote of shareholders.[10]

The definition includes any person 'occupying the position of director … by whatever name called'.[11] This has been held to include both a 'de jure' director – a person validly appointed; and a 'de facto' director – someone who, although not validly appointed, 'assumes to act as a director. He is held out as a director by the company and claims and purports to be a director'.[12]

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7 *Brookers Company Law*, Thomson Reuters, <http://www.brookersonline.co.nz>, CA138.02(1). The Australian Corporations and Markets Advisory Committee, Parliament of Australia, *Corporate Duties Below Board Level* (2006) 35, notes the equivalent Australian provision in its discussion of 'the range of defences available to directors in complying with their statutory duties'; Ashley Black, Tom Bostock, Greg Golding and David Healey, *CLERP and the New Corporations Law* (1998) [4.9] describe that provision as 'a "safe harbour" for reliance by a director on information or professional or expert advice'.

8 [2006] 3 NZLR 225, 237.

9 (2009) 10 NZCLC 264,562, [111].

10 See Susan Watson and Chris Noonan, 'Defining Directorship' (2010) 25 *Australian Journal of Corporate Law* 5, 6, where it is noted that 'appointment with consent to the position of director is not in fact the defining characteristic of directorship'.

11 *Companies Act 1993* (NZ) s 126(1)(a).

12 *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180, 183.

The New Zealand Court of Appeal in *Clark v Libra Developments Ltd*[13] considered the case of the sole director of a company who had become bankrupt (and thus disqualified from validly acting as a director),[14] yet continued to do so in every respect. The court held that, '[d]espite his disqualification and the prohibitions statutorily imposed on him, he was still "occupying" the position'.[15]

In *HLH Equity Trading Ltd v White*,[16] the court held that the former wife of the sole appointed director of the company in question was not herself a de facto director. Although she played a part in promoting the offer of securities that was the subject of the action, she did not take part in the 'corporate governance' of the company, which the court interpreted to mean the undertaking of 'functions in relation to the company which could properly be discharged only by a director'. She did not make decisions on the company's behalf, but rather acted 'as a conduit to pass messages on to' the appointed director.[17]

As well as those 'occupying the position', the definition of 'director' also includes those known as 'shadow directors' and those delegated directors' powers by the board.[18] 'Shadow directors' are persons in accordance with whose directions or instructions a person occupying the position of director, or the board of a company as a whole, may be required, or is accustomed, to act. According to Watson and Noonan:

> A shadow director is not like a de facto or de jure director who acts on an equal footing with the directors on the board. Instead, a shadow director is like a superior who instructs or directs the directors. Liability as shadow directors is imposed on persons who will usually not be identified by the company to outsiders as directors and who will usually not assent to the company holding them out as directors.[19]

An example of a person being deemed a director by delegation is *Fatupaito v Bates*,[20] where a director purportedly appointed the defendant as a receiver but, due to a misunderstanding of the law, no legal appointment occurred. The appointment had the effect of handing over the powers that had previously resided in the board to the purported receiver, which was enough to make him a deemed director and liable as such.

III. Greater Significance?

Reliance on information and advice as a defence available to directors has not been utilised often in the New Zealand courts to date and, perhaps as a reflection of that lack of use, is not generally discussed in much detail in leading New Zealand company law texts.[21]

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13 [2007] 2 NZLR 709.

14 *Companies Act 1993* (NZ) s 151(2)(b).

15 *Clark v Libra Developments Ltd* [2007] 2 NZLR 709, [179].

16 (Unreported, High Court Tauranga, Lang J, 24 May 2010). The case considered the definition of 'director' in s 2(1) of the *Securities Act 1978* (NZ), paragraph (a) of which is identical to s 126(1)(a) of the *Companies Act 1993* (NZ). The plaintiff sought to hold the directors personally liable for breaches of the securities legislation.

17 *HLH Equity Trading Ltd v White* (Unreported, High Court Tauranga, Lang J, 24 May 2010), [62], [80], citing *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180, 183.

18 *Companies Act 1993* (NZ) s 126(1)(b)–(c).

19 Watson and Noonan, above n 10, 22.

20 [2001] 3 NZLR 386.

21 See, for example, Susan Watson (Ed.), *The Law of Business Organisations* (5th ed., 2009) ¶10.02.3, 12.04, where s 138 is briefly noted in the context of the delegation of board powers to others and the directors' duty of care, diligence and skill respectively. John Farrar (Ed.), *Company and Securities Law in New Zealand* (2008) is equally brief in its treatment: see ¶13.1, 14.22, 16.4, 16.9, 33.5.1(1)(c), 36.2.1(2). Andrew Beck, *Guidebook to New Zealand Companies and Securities Law* (8th ed., 2010) ¶318 is unusual in including a reasonably detailed discussion of s 138.

This could, however, be set to change. The defence is potentially of much more interest to directors following the GFC and resulting recession. In New Zealand, the finance sector has been particularly hard-hit, with an 'almost complete demise of property finance companies' in the last three years.[22] As well as more insolvencies almost certainly leading to more directors being held to account, directors also face the prospect of reforms to New Zealand's securities laws that may increase their exposure to liability.

In February 2011 the Minister of Commerce released a Cabinet Paper recommending reforms to a number of aspects of securities law.[23] Tucked into this set of proposals was a plan to introduce for the first time in New Zealand, public enforcement of company directors' duties and to criminalise certain breaches of the duties. The paper notes that there are disincentives for companies and shareholders to bring private actions against directors. Companies must balance the expected returns of a successful action against its likely costs; individual shareholders may be dissuaded from bringing a derivative action by the fact that any remedies awarded will go to the company unless the court orders otherwise, and coordination of a group of shareholders to take legal action is difficult.[24]

The paper concludes that the answer is public enforcement and acknowledges that this may discourage some people from becoming directors or, once appointed as directors, discourage them from taking legitimate business risks. It also concludes, however, that:

> [T]here is the potential for substantial harm to individual and public interests from directors breaching their duties, in particular where they are directors of companies that hold substantial assets in a fiduciary capacity for broad groups of outsiders, as in finance companies. Many investors lost much or all of their savings and endured a significant fall in their standard of living as a result of finance company failures.[25]

The Cabinet Paper further opines that criminal liability is appropriate where conduct causes substantial harm to individual or public interests.[26] At present, breaches of directors' duties in New Zealand may result in civil proceedings only,[27] a situation that has (according to the paper) led to concern about the lack of power available to any regulator to take action against directors for intentional or reckless breaches of their duties.[28] In order to 'provide a comprehensive range of offences to punish serious offending by directors',[29] the paper proposes that intentional contraventions of the following duties be criminalised:

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22 '63 companies failing, taking with them a potential $8.59 billion of investors' money, held in more than 205,000 deposits': Peter Fitzsimons, 'The New Securities Regime: Capital-raising NZ Style in the 21st Century' [2011] *Company and Securities Law Bulletin* 61, 61.

23 See *Securities Law Reform*, above n 3. The content of the paper is summarised by Peter Fitzsimons above n 22.

24 *Securities Law Reform*, above n 3, [202]–[203].

25 Ibid, [205].

26 Ibid, [206].

27 There is an offence of being 'knowingly a party to a company carrying on business with intent to defraud creditors of the company or any other person or for a fraudulent purpose' in s 380 of the *Companies Act 1993* (NZ). This appears to be seldom enforced, perhaps because of the high standard set by the courts for the requisite 'intent to defraud': 'Mere bad faith or immorality or dubious business practices are not sufficient in themselves to sustain the element of criminality required for a conviction', according to *R v Holland-Kearins* [1999] DCR 535, 539. See also *Re Nimbus Trawling Co. Ltd* [1986] 2 NZLR 308, 320, where the equivalent provision in the *Companies Act 1955* (NZ) was stated to be 'not aimed at persons who are blameworthy, irresponsible or even hopelessly optimistic. It is directed against persons who deliberately and knowingly set out to cheat or defraud creditors'.

28 *Securities Law Reform*, above n 3, [209].

29 Ibid, [210].

- The duty to act in good faith and in what a director believes to be the best interests of the company;[30]
- The duty to avoid carrying on a company's business in a manner likely to create a substantial risk of serious loss to the company's creditors;[31] and
- The duty to not incur obligation unless the director believes, on reasonable grounds, that the company will be able to perform them when required to do so.[32]

Intentional breaches of these duties, which are most commonly enforced after a company collapses, amount to 'intentional egregious behaviour' in the Minister's view. He considers that imposing criminal liability in such cases will ensure 'an appropriate balance between not deterring competent people from becoming directors, but providing a deterrent to dishonest conduct'.[33]

These proposals bring New Zealand's corporate enforcement regime closer to that of Australia, where public enforcement is already widely undertaken by the Australian Securities and Investments Commission ('ASIC')[34] and criminal sanctions[35] apply to reckless or intentionally dishonest breaches of the directors' duties to exercise powers and discharge duties in good faith in the best interests of the corporation and for a proper purpose,[36] to not improperly use their position to gain an advantage for themselves or someone else or to cause detriment to the corporation[37] and to not improperly use corporate information to gain such an advantage or cause such detriment.[38] The Australian director's duty to prevent insolvent trading – broadly similar to ss 135 and 136 of the New Zealand Act – also attracts criminal liability if dishonestly breached.[39] Surprisingly perhaps, the Australian provision allowing directors to rely on information and advice (s 189 of the *Corporations Act 2001* (Cth)) appears to have been seldom used.[40] This may be because of the overly rigorous wording of s 189 which requires (in contrast to New Zealand's 'proper inquiry where the need for inquiry is indicated by the circumstances'),[41] the arguably more stringent test of 'independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of the structure and operations of the corporation'.[42] In the view of one commentator, this: 'actually requires directors in every instance to make an independent assessment of the information or advice on which they want to rely'.[43] It is, he continues, more in keeping with the 'practicalities of corporate governance'[44] if:

30 *Companies Act 1993* (NZ) s 131.
31 Ibid s 135, entitled 'Reckless Trading'.
32 Ibid s 136.
33 *Securities Law Reform*, above n 3, [210].
34 See Matthew Berkahn, *Regulatory and Enabling Approaches to Corporate Law Enforcement* (2006) 79-84.
35 The criminal sanctions are imposed by s 184 of the *Corporations Act 2001* (Cth).
36 *Corporations Act 2001* (Cth) s 181.
37 Ibid s 182.
38 Ibid s 183.
39 Ibid s 588G(3). A defence similar to the general defence in s 189 applies to proceedings brought for a contravention of s 588G: see s 588H(3).
40 The 'Tables of Statutes Judicially Considered' in the *Australian Corporations and Securities Reports* volumes since s 189 was enacted in 1999 (volumes 30 to 81, covering the years 1999 to 2011) show only two cases that refer to the provision – *MacDonald v ASIC* (2007) 65 ACSR 299 and *Re AWB Ltd* (2008) 68 ACSR 374. Both cases were procedural in nature and refer to s 189 in passing only. The 'Section Finding Lists' for volumes 17 to 29 of the *Australian Company Law Cases* (1999 to 2011) show no cases at all referring to s 189.
41 *Companies Act 1993* (NZ) s 138(2)(b).
42 *Corporations Act 2001* (Cth) s 189(b)(ii).
43 Mark Byrne, 'Do Directors Need Better Statutory Protection When Acting on the Advice of Others?' (2008) 21 *Australian Journal of Corporate Law* 238, 252-253.
44 Ibid, 253.

> [p]rovided one meets the minimum expectations in terms of keeping oneself informed there is scope for appropriate delegation and reliance on that delegation without the constant need for the independent assessment of the received information or advice unless of course matters arose which put you on enquiry.[45]

IV. Section 138 in the New Zealand Courts

A. *Nippon Express*

One of the first cases to apply s 138 was *Nippon Express (New Zealand) Ltd v Woodward*.[46] In the course of a company's liquidation, a creditor sought a contribution towards payment of the company's debts by its directors on the grounds of a beach of the 'reckless trading' duty in s 135 of the *Companies Act 1993* (NZ). The defendants played little part in the company's day-to-day operations, and no part in satisfying the business's accounting requirements as they had only rudimentary accounting knowledge. Those roles were satisfied by another director, a Mr Harrington.

Mr Harrington falsely represented to the defendants that the company was making a profit and concealed significant company debts from them. Upon becoming aware of these deceptions, the defendants considered shutting down the business but, fearing the loss of funds they had advanced to the company, elected to continue trading. Mr Harrington assured them that there were no other outstanding liabilities when, in fact, the company owed around $170,000 to the plaintiff and over $1 million in total. It appeared that large sums of money were embezzled by Mr Harrington (who, 'when the game was up … took off for a Caribbean cruise on a luxury liner').[47]

The defendants did not actually invoke s 138, but the court noted that it was relevant to the assessment of their conduct for the purposes of s 135.[48] It held that they were not derelict until such time as they had 'manifest indications of Mr Harrington's dishonesty'. From that point, 'the most ingenuous of directors must have realised that Mr Harrington simply could not be trusted':

> There is no suggestion that they ever acted otherwise than in good faith. Plainly, however, … the defendants failed to make proper inquiry where the need for it was indicated by the circumstances and they did in fact have knowledge that reliance on Mr Harrington was unwarranted. They may not have wished to recognise that they had been deceived but they must have known that they had been.[49]

This suggests that directors are entitled to rely upon advice from advisors or fellow-directors until they have reason not to.

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45 Ibid. See also Crutchfield and Button, above n 6, 93. Crutchfield and Button note that s 189 did not assist the defendant directors in the recent 'Centro' case, *Australian Securities and Investments Commission v Healey* (2011) 196 FCR 291, both because they did not meet the 'independent assessment' standard, and because the case involved breaches of the duties imposed by Part 5C.1 of the *Corporations Act 2001* (Cth). Part 5C.1 deals with the registration of managed investment schemes and imposes duties upon directors of entities that operate such schemes. Section 189 applies only to the general directors' duties imposed by Part 2D.1 of the Act and by the general law.

46 (1998) 8 NZCLC 261,765.

47 Ibid, 262,774.

48 Ibid, 261,768.

49 Ibid, 261,773-261,774

B. *Mason v Lewis*

Mason v Lewis[50] involved a similar set of facts to the *Nippon* case. It was again claimed (this time by the company's liquidators) that the defendant directors had breached s 135. The company was formed in 1999 and the defendants (amongst others) were appointed directors. A Mr Grant was appointed 'manager', but not director of the company. Early in 2000 a major contract was terminated, thus removing 'the economic heart of the new venture'.[51] The company was in serious financial trouble from this point.

Mr Grant told the Lewises of the loss of the contract around six weeks later, assuring them that things were 'under control' and showed them documents suggesting an 'upward trend' in income. However, an accountant (Mrs Rowe), employed to keep the company's books, prepared a draft set of accounts that indicated a state of trading insolvency.

In late 2000, Mr Grant suggested factoring[52] at last some of debts owing to the company. Mr Lewis, on his personal accountant's advice, refused to agree. The factoring agreement went ahead however, with Mrs Grant (Mr Grant's wife) signing as director. The business then 'simply drifted on until January 2002 … The Lewises simply allowed the affairs of the company to repose in the hands of Mr Grant'.[53] It later became apparent that Mr Grant was dishonest; he had been providing false invoices under the factoring agreement and was convicted of around $1 million worth of fraud.

As in the *Nippon* case, the defendants did not specifically plead s 138 as a defence, but they did claim that their reliance on Mr Grant and Mrs Rowe should excuse them from liability. Salomon J in the High Court agreed,[54] but the Court of Appeal did not. It held that, 'as directors the Lewises paid no or no proper attention to the financial affairs of the company'. The fact that they were not made aware of the loss of the company's biggest client for at least six weeks after the event 'should have caused the Lewises to be on guard with respect to Mr Grant and his assurances'.[55] However, while that fact – and the entering of the factoring agreement without their agreement – concerned them, they continued to accept Mr Grant's assertions. The alleged reliance on Mrs Rowe was, according to the court, too limited to provide a defence:

> The discussions between Mrs Rowe and Mr Lewis were limited, and there appears to be no conflict that … the company was insolvent – but whether it could trade through that or not was a different issue. Nothing in that evidence precluded the necessity for the Lewises to reach their own informed view on precisely that issue.[56]

The court thus emphasised again that it is not enough for directors to honestly rely on information and advice from others – the reliance must also be reasonable. When there is cause to be 'on guard' with respect to the credibility of the advice given, that credibility must be verified by the director. The *Mason* case also gives some insight into the type of information that may be relied upon under s 138. Bare factual information or opinions, such as that supplied by the accountant Mrs Rowe, cannot be relied upon to defend a decision that requires analysis of such information to 'reach [the director's] own informed view'.

C. *Goatlands Ltd v Borrell*

The latter point was also made in *Goatlands Ltd v Borrell*.[57] The defendants made an unconditional agreement for the company to purchase a new property. To fund the purchase they needed to sell some of the business's existing landholdings. They received advice from a real estate agent

50 [2006] 3 NZLR 225.
51 Ibid, 228.
52 That is, selling, at a discount, the right to collect the invoices.
53 *Mason v Lewis* [2006] 3 NZLR 225, 237 and 235.
54 *Re Global Print Strategies Ltd* (2004) 2 NZCCLR 236.
55 *Mason v Lewis* [2006] 3 NZLR 225, 235.
56 Ibid, 237.
57 (2006) 3 NZCCLR 726.

that the rural property market was 'reasonably buoyant', and from a solicitor that the risk of the proposed transactions was 'manageable'.[58] Ultimately, sufficient property was not sold to complete the purchase and the agreement had to be cancelled. The company was later placed into liquidation and the liquidator brought proceedings against the directors alleging breaches of ss 135 and 136 of the *Companies Act 1993* (NZ).

The directors claimed that the advice they had received from the real estate agent and the solicitor was sufficient to give them a complete defence to the liquidator's claim. The court, however, held that the advice obtained from both was not 'within the category of advice that might provide a defence' under s 138. With respect to the real estate agent, the court said:

> In the end … he could only say that the market at that time was 'reasonably buoyant' and that, in his opinion, it should be possible to sell the subdivided blocks within three or four months … I do not consider that any reasonable person in the position of Mr and Mrs Borrell would have relied upon [that] opinion as providing any guarantee or assurance that the blocks would sell within three or four months or, for that matter, that they would sell within any given period … [T]he ability to find a buyer for the blocks was subject to many variables, virtually all of which were beyond the control of [the agent] and Mr and Mrs Borrell.[59]

The same conclusion was reached in relation to the solicitor. He was not the defendants' regular solicitor and knew very little about their overall financial position. It appears he was not aware that they were committing themselves to a purchase in circumstances where they did not have the present ability to complete it, and therefore did not address alternative strategies.[60]

D. *FXHT Fund Managers*

The case of *FXHT Fund Managers Ltd v Oberholster*[61] confirms that reliance on general, informal and unsubstantiated advice will not satisfy s 138. Directors cannot simply believe without question what they are told by their advisors or fellow-directors. The defendant was a medical practitioner who became a director of a funds management company, although this was outside his area of expertise. He left the company's management to another director, Mr Hitchinson, who allegedly defrauded the company of several hundred thousand dollars and was being prosecuted for fraud when this case was heard. The company became insolvent and investors lost large amounts of money. The Court of Appeal held that Dr Oberholster had breached both the reckless trading duty in s 135 and the duty of care, diligence and skill in s 137. He claimed that he was entitled to rely on s 138, as he had relied on Mr Hitchinson who appeared to him to be trustworthy.

The court held, however, that Mr Hitchinson's 'very informal oral advice' could not be relied on in Dr Oberholster's defence:

> [F]or the protection of s 138 to attach, the information the director relies on must be prepared and provided more formally than the very informal oral advice Dr Oberholster was prepared to accept in this case. The section speaks of reliance on reports, statements, financial data and other information. That contemplates proper written documentation … The information passed on to Dr Oberholster by Mr Hitchinson was no more than general and unsubstantiated advice that the investors' funds were secure, and that the company was operating okay.[62]

58 Ibid, [56], [58].
59 Ibid, [92]–[93].
60 Ibid, [102].
61 (2009) 10 NZCLC 264,562.
62 Ibid, [104].

E. MED v Feeney

It is probably fair to say that, until recently, it was assumed that s 138 could only be invoked in relation to the directors' duties under the *Companies Act 1993* (NZ) and not as a defence to breaches of other legislation such as the *Financial Reporting Act 1993* (NZ). The District Court, however, rejected this argument, as well as the assumption that s 138 is available as a defence only to civil claims and not to criminal prosecutions, in *Ministry of Economic Development v Feeney*.[63]

The defendants were the directors of Feltex Carpets Ltd, a listed company that had recently adopted the New Zealand equivalent to the International Financial Reporting Standards ('NZIFRS'). In recognition of the complexity of the new standards, the board set up comprehensive processes and procedures to ensure that they were applied correctly. This included the engagement of a financial management team that was, in the words of the company's principal external accounts advisor:

> both competent and sufficiently well-resourced to generate the sort of management financial information required for a company the size of Feltex … [T]he directors … had every reason to consider that the financial management team that were reporting to them were a competent operation.[64]

The board also engaged a highly respected accounting firm, Ernst and Young, to provide ongoing advice and assistance with the transition to the new standards. This included a review of the first set of financial statements prepared under those standards to ensure compliance with them.[65]

Despite these attempts to ensure compliance, those statements – approved by the board in February 2006 – did not comply with the applicable standards. The directors were charged with breaching s 36A of the *Financial Reporting Act 1993* (NZ), which states that every director of a reporting entity under that Act commits an offence if any financial statement prepared by, or on behalf of, that entity does not comply with any applicable financial reporting standard. The directors did not dispute that the statement in question was faulty, but they claimed that they had, under s 40 of the Act, taken 'all reasonable and proper steps to ensure that the applicable requirements … would be complied with', which provides a defence to a charge under s 36A.

The directors submitted that, in assessing whether they had met s 40, they were entitled to rely on s 138 of the *Companies Act*. The court agreed, holding that the two Acts are 'tied together':

> There is no suggestion in CA 93 [that is, the *Companies Act 1993* (NZ)] or the FRA [*Financial Reporting Act 1993* (NZ)] that the powers and duties specified in Part 8 are inapplicable to the exercise of powers and the performance of duties under the FRA. On the contrary, as vital requirements concerning corporate financial reporting had been moved from the companies legislation to the FRA, CA 93 and the FRA must be read together to achieve seamless integration of the requirements in CA 93 relating to the management of companies with the specific requirements in the FRA in relation to financial reporting and accounting standards … Section 138 applies 'when [a director] is exercising powers or performing duties as a director'. Undoubtedly when dealing

63 (2010) 10 NZCLC 264,715.
64 Ibid, [80].
65 Ibid, [85], [101].

> with a statement as referred to in FRA s 36A, the director is exercising powers or performing duties as a director.[66]

The court's response to the proposition that the directors 'should have done it themselves'[67] was that it was 'utterly unrealistic'.[68] The directors were not personally required to each have:

> [T]he requisite qualifications, expertise and experience to analyse the financial statement from the perspective of the accounting standards and to have reached a conclusion about compliance based on their own judgment … When the proposition … is tested by analysing the way in which the directors would need to have equipped themselves and what they would need to have done it can be seen why the common law developed the principle codified by s 138, that directors are entitled to rely on advice where appropriate conditions are satisfied.[69]

Thus, the court held that, though Ernst and Young's IFRS assessment report was 'completely wrong',[70] the board was entitled to rely upon it under s 138 because their reliance was reasonable in the circumstances.

F. *The Finance Company Cases*

Davidson v Registrar of Companies[71] did not deal with a breach of directors' duties as such, but an order from the Registrar of Companies to ban a director from being involved in the management of companies under s 385 of the *Companies Act 1993* (NZ).[72] Mr Davidson, the director in question, appealed against the order on the grounds that it would not be just nor equitable for him to be banned.

The case concerned the Bridgecorp group of finance companies that collapsed in mid-2007. Mr Davidson was chairman of the group's parent company. The group's directors were charged under the *Securities Act 1978* (NZ) for approving two prospectuses that included untrue statements[73] (including failing to disclose that the company had already missed several interest and principal payments that were due to investors and failing to properly account for several related-party transactions, which obscured the fact that the group was 'in survival mode').[74]

Mr Davidson did not raise s 138 in his defence but both the Registrar and the court considered it. He claimed that he relied on the other directors and lower level managers when it came to accounting and financial issues. As a commercial lawyer rather than an accountant, he thought

66 Ibid, [37]–[38]. Support for this interpretation appears in the report of the New Zealand Law Commission that preceded the enactment of the 1993 company law reform package, including both the *Companies Act 1993* (NZ) and the *Financial Reporting Act 1993* (NZ). That report recommended that '[t]he new *Companies Act* should be concerned with the formation, operation and termination of all companies. It should contain the basic law applicable by reason of shared principle to all companies. Legal requirements not derived from those shared principles or applicable only to some companies (for example to listed companies) should be imposed through specific legislation and rules superimposed upon the general company law base': The Law Commission (NZ), Report No. 9: *Company Law Reform and Restatement*, NZLC R9 (1989), [67].

67 *Ministry of Economic Development v Feeney* (2010) 10 NZCLC 264,715, [143].

68 Ibid.

69 Ibid, [142]–[143].

70 Ibid, [180].

71 [2011] 1 NZLR 542.

72 That section applies when a company has (inter alia) been put into liquidation because of inability to pay its debts, and the Registrar is satisfied that the manner in which the company's affairs were managed was wholly or partly responsible for the company being in that state of insolvency. In such a case, the Registrar may, by notice in writing to a person who was, within the preceding five years, a director or manager of the company, prohibit that person from taking part in the management of a company for a period not exceeding five years.

73 *Securities Act 1978* (NZ) s 58. See *R v Petricevic* [2012] NZCCLR 7.

74 *Davidson v Registrar of Companies* [2011] 1 NZLR 542, 551.

it best to rely on others 'who were better qualified'.[75] He stated that, as the group's financial position worsened, the board relied on assurances 'that performance was in line with budgets, suggesting either that the board did not receive orthodox monthly management accounts or that he did not read them'.[76]

Counsel for the Registrar summarised Mr Davidson's case as follows: he said, 'I didn't know, I didn't know, I didn't know' … Mr Davidson did not say this company was not mismanaged. He said that it was mismanaged 'but I am not personally responsible for the mismanagement'.[77]

The court's rather damning conclusion was that:

> Mr Davidson was not fully qualified for the office that he held … A director must understand the fundamentals of the business, monitor performance and review financial statements regularly.[78] It follows that a degree of financial literacy is required of any director of a finance company. Without it, Mr Davidson could scarcely understand the business, let alone contribute to policy decisions affecting risk management and monitor the company's performance, yet his presence and reputation might encourage investors to believe that the group was well managed.[79]

The approach taken in the *Davidson* case has been upheld in other cases dealing with breaches of securities law by finance company directors. In *R v Moses*,[80] the court held that:

> [I]t is axiomatic that a director of a finance company will be assumed to have the ability to read and understand financial statements and the way in which assets and liabilities are classified … That approach is consistent with the terms of … s 138 of the *Companies Act 1993*. [Section 138] envisage[s] the possibility of the need for further inquiry by a director on the basis of information already held or incomplete information on which further explanation is required. The protection afforded by … s 138 will be forfeited if appropriate inquiry is not made.[81]

It was later argued in *R v Graham*[82] – a case widely discussed in the media due to the fact that two of the defendant directors were former New Zealand Ministers of Justice[83] – that the standard applied in the earlier cases was too restrictive, in that it required directors to carry out detailed analyses that was more appropriately left to lower-level managers. The court rejected that argument:

> Whilst each situation is fact-specific, any circumstances that would lead a reasonable finance company director to question the reliability of what he or she is told triggers an obligation to make further inquiry and therefore brings to an end the entitlement of a director to rely on the information provided to him or her on a particular topic. [Section 138 cannot] be read in a way that would relieve a director of the obligation to check on the competence of a delegate, in any circumstances where a signal occurs that would put a reasonable director on notice of the need to do so.[84]

75 Ibid, 569.
76 Ibid, 569–570.
77 Quoted in 'Davidson: I am Not to Blame', *Manawatu Standard* (Palmerston North), 13 July 2010, 11.
78 *Australian Securities and Investments Commission v Adler* (2002) 41 ACSR 72, [372].
79 *Davidson v Registrar of Companies* [2011] 1 NZLR 542, 570.
80 (Unreported, High Court Auckland CRI-2009-004-1388, Heath J, 8 July 2011); affirmed *Doolan v R* [2011] NZCA 542.
81 Ibid, [83], [86].
82 [2012] NZCCLR 6.
83 The Rt Hon Sir Douglas Graham, Minister of Justice 1990 to 1999, Attorney General 1997 to 1999; and the Hon William Jeffries, Minister of Justice 1989 to 1990. Sir Douglas was the minister responsible for the major company law and financial reporting reforms of 1993.
84 *R v Graham* [2012] NZCCLR 6, [33]–[35].

G. *Reaction To The Cases*

As noted above, until recently the defence provided by s 138 has provoked little comment from academics and other commentators. However, recent corporate collapses have provoked some criticism of the provision, particularly in the aftermath of cases like the 'Feltex decision', *Ministry of Economic Development v Feeney*.[85]

Burrowes and Karayan,[86] accounting professors at Woodbury University, California, compare the decision to the infamous *Enron* case in the United States.[87] They claim that the application of s 138 in *MED v Feeney* allows directors to avoid thinking for themselves or having to critically analyse advice obtained from outside experts. They characterise s 138 as representing an 'empty head, pure heart' doctrine:

> This rule excused both boards [Enron and Feltex] for their putative failures to fulfill their corporate governance responsibilities relating to the sufficiency of the firms' financial statements … As in *Enron*, the Feltex board was shielded from liability for failing critically to examine Feltex's inconsistent and imprecise financial reports by virtue of having relied on a large international firm of accountants to do the thinking for them.[88]

In a similar vein are comments of New Zealand Shareholders' Association Chairman John Hawkins:

> If directors can rely entirely on outside advisors then that begs the question of why directors have to be paid so well for exercising their judgment.[89]

Though not referring to the *Feeney* case or s 138 in particular, Mark Thomas of Chartered Secretaries New Zealand Inc. notes that the boards of large companies such as Feltex 'often tend to be large and unwieldy'[90] which can lead to:

> [S]ocial loafing and a sense of 'Oh well, It's not my responsibility' … to the point that you wonder how and why directors are appointed ... It is a given that board members need to be able to ask the hard questions and rigorously examine and interpret the information on hand [and] pose the questions around vital information that is not being presented – either by omission or commission.[91]

On the other hand, there are those who fear that the wording of s 138 and its treatment by the courts are likely to unfairly punish directors. In the period immediately following the enactment of the 1993 reform package, Shirtcliffe was troubled by s 138(2):

> [W]hich says that I can only rely on these persons [listed in s 138(1)] if I have no knowledge that such reliance is unwarranted. What does this mean? … Does it mean I have to be completely certain that the person is up to the job? Or will courts sensibly qualify this obligation so that my duty is just that the outcome of my inquiries, if put on notice, must, after having balanced up the risks, reassure me?

85 (2010) 10 NZCLC 264,715.
86 Burrowes and Karayan, above n 5.
87 *Skilling v United States*, 561 US, No. 08-1394 (2010).
88 Burrowes and Karayan, above n 5, 406.
89 Noted by Michael Dobson, *The Feltex Decision – and its Import for Other Directors* (2010) Chapman Tripp, <http://www.chapmantripp.com/publications/Pages/The-Feltex-decision-and-its-import-for-other-directors-.aspx>.
90 Mark Thomas, 'The Need for Better Governance Practices, Not Better (and More) Legislation' *NZLawyer*, Issue 155, 11 March 2011, 20.
91 Ibid.

> Here we come to the crux of the issue: I do not know what these positive obligations mean – or what a court will later interpret them to mean. The only prudent response is to oversee and second-guess management.[92]

Most scathing was the comment on the *Feeney* case by commercial lawyer and former member of the Securities Commission and ACT[93] Member of Parliament, Stephen Franks. Franks condemns the court's decision that the s 138 defence only applies as long as trust in the advisor is warranted and there are no reasons to suspect that the reliance may be misplaced:

> [The court's words] no doubt seem reasonable to lawyers, sitting in comfortable hindsight. But most business decisions are made under uncertainty … [They] are necessarily judgments which balance the cost and practicality of getting better information against the costs and losses from delay, including loss of opportunity.
>
> In practice there are also frequently 'reasons to suspect that [the trust] may be misplaced'. A director works with the material given. One often has 'reason to suspect' that the people on whom one is relying are less than optimum. Some will be learning on the job, and making the mistakes that we all must make. Others will be known to be out of their depth, but retained because they are the devil we know, and in a tight labour market they are better than no one. Some may even be being 'managed out' because labour law says they cannot be dismissed. So the 'no reason to suspect' qualification … is weasel words … drawn from the sanctimonious phrasing of section 138 of the *Companies Act*.[94]

These sharply different interpretations of the section and its application lead one to question – does s 138 allow the 'empty-headed' to avoid their rightful responsibilities on the grounds of a 'pure heart'?[95] Does it not allow for the inherent uncertainties of real-life business by requiring of directors an unrealistic level of confidence in their advisors before they make use of the provision? Or does it strike the right balance somewhere in between?

V. Conclusion

A useful starting point in assessing whether s 138 of the *Companies Act 1993* (NZ) sets an appropriate standard is to summarise the principles arising from the New Zealand cases that consider the section. These principles should provide comfort for those on both sides of the debate noted above. 'Empty-headedness' is precluded by the requirements that directors may rely upon advice from advisors or fellow-directors only until (or unless) they have reason not to,[96] that further analysis of advice is required when such analysis is necessary for a director to reach an informed decision,[97] and that only substantiated documentation may be relied on, rather than just vague verbal assurances that things are operating acceptably.[98]

But neither are the requirements of the defence too onerous on directors. The cases confirm that directors are not necessarily expected to personally have all of the knowledge and expertise

92 Peter Shirtcliffe, 'Good Governance: A Case for Paternalism or Personal Responsibility?' [1998] *Company and Securities Law Bulletin* 66, 70.

93 A small New Zealand political party that, according to its website, 'stands … for individual freedom and personal responsibility. For smaller and limited government … for private property rights, free markets, choice and competition, low and flat tax': <http://www.act.org.nz/news/statement-from-hon-rodney-hide>.

94 Stephen Franks, *Pricing the Risks of Public Company Directorship – The Feltex Decision* (2010) Stephen Franks Blog Archive, <http://www.stephenfranks.co.nz/?p=2899>.

95 Burrowes and Karayan above n 5.

96 *Nippon Express (New Zealand) Ltd v Woodward* (1998) 8 NZCLC 261,765; *Mason v Lewis* [2006] 3 NZLR 225; *R v Moses* (Unreported, High Court Auckland CRI-2009-004-1388, Heath J, 8 July 2011); *R v Graham* [2012] NZCCLR 6.

97 *Mason v Lewis* [2006] 3 NZLR 225; *Goatlands Ltd v Borrell* (2006) 3 NZCCLR 726.

98 *FXHT Fund Managers Ltd v Oberholster* (2009) 10 NZCLC 264,562; *Davidson v Registrar of Companies* [2011] 1 NZLR 542.

required to govern the company without recourse to outside advise (unless, of course, a particular area of knowledge is vital to their role as director of the company in question).[99] In the new era of publically enforced directors' duties and potential criminal liability in New Zealand, the availability of s 138 to protect against both civil claims and criminal prosecutions, whether brought pursuant to companies' legislation or other provisions dealing with directors' duties and responsibilities,[100] will also reassure directors.

99 *Ministry of Economic Development v Feeney* (2010) 10 NZCLC 264,715; *Davidson v Registrar of Companies* [2011] 1 NZLR 542; *R v Moses* (Unreported, High Court Auckland CRI-2009-004-1388, Heath J, 8 July 2011).

100 *Ministry of Economic Development v Feeney* (2010) 10 NZCLC 264,715.