

Wake up New Zealand: Directors' Duties Reform Responses to the GFC*

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I Introduction

Major corporate collapses in recent decades¹ caused by, *inter alia*, board mismanagement, have spurred many countries to consider whether the directors of corporations meet the standard of care and conduct that investors legitimately expect in the modern commercial world. Nations such as Australia responded by undertaking relevant law reform reviews in the late 1980's and early 1990's.² The recommendations contained in these reports led to significant legislative amendments to Australian directors' duties in 1992,³ 1999⁴ and 2001⁵ and judicial reform,⁶ particularly in the early and mid-1990's.⁷ As discussed below, New Zealand has not taken similar steps to strengthen its directors' duties. This is not because New Zealand was immune from the GFC. There have been a number of spectacular corporate collapses that have seen many investors losing much or all of their savings.⁸

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¹ Globally, the fate of the Enron group of companies provides an example of a notable corporate collapse. Australia experienced major corporate collapses through mismanagement in the 1980s (notably the Bond Corporation group of companies) and in the early 2000s (notably the HIH group of companies). As detailed below, New Zealand was not immune to the GFC.

² Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties, Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989) ('Cooney Report'); House of Representatives Standing Committee on Legal and Constitutional Affairs, *Report on Corporate Practices and the Rights of Shareholders* (1991) ('Lavarch Report').

³ *Corporate Law Reform Act 1992* (Cth).

⁴ *Corporate Law Economic Reform Program Act 1999* (Cth).

⁵ *Corporations Act 2001* (Cth).

⁶ The judicial reform began with a series of insolvent trading cases (*Commonwealth Bank of Australia v Friedrich* (1991) 9 ACLC 946; *Group Four Industries Pty Ltd v Brosnan* (1991) 9 ACLC 1181; (1992) 10 ACLC 1437; *Statewide Tobacco Services Ltd v Morley* (1990) 8 ACLC 827; (1992) 10 ACLC 1233) which in turn spurred judicial reform of the duty of care: *AWA Ltd v Daniels (Trading as Deloitte Haskins & Sells)* (1992) 10 ACLC 933; *Daniels v Anderson* (1995) 13 ACLC 614.

⁷ Note, the ASX also responded by introducing the ASX Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations* (March 2003), the second edition being published relatively recently, *Corporate Governance Principles and Recommendations with 2010 Amendments*.

⁸ See Ministry of Economic Development (MED), *Review of Securities Law Discussion paper* (June 2010) at [134]; Office of the Minister of Commerce Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee, *Securities Law Reform* (February 2011) at [205]; Report of the Commerce Committee, *Inquiry into finance company failures* (October 2011) at 7. See also Noel Yahanpath and John

The immediate impact of such collapses on investors, shareholders, creditors and employees will be obvious and apparent. However, in New Zealand there is also a consequent broader public mistrust and lack of confidence in capital markets and the finance sector generally.⁹ This distrust is very apparent in every day conversations. There is reference to “greedy directors” and a clear mistrust in investing in public corporate vehicles.

The 2011 Commerce Committee’s Inquiry into the New Zealand corporate failures states that since May 2006 45 finance companies have collapsed with losses estimated at over \$3 billion and affecting between 150,000 and 200,000 investors.¹⁰ While there are a number of possible causes of these corporate collapses,¹¹ it is clear that the negligence and misconduct of company directors led to the collapse of significant finance companies.¹² Some of the most significant New Zealand corporate collapses include Hanover Finance¹³, Five Star Consumer Finance¹⁴, Capital + Merchant Finance Ltd¹⁵, Bridgecorp Ltd¹⁶, Nathans Finance Ltd¹⁷, Lombard Finance & Investments Ltd¹⁸, OPI Pacific Finance¹⁹, Strategic Finance Ltd²⁰ and South Canterbury Finance.²¹ Despite this reality, the response to the GFC in New Zealand has been confined to reform of the banking sector and more recently securities laws. To this end post the GFC a number of significant pieces of legislation have been enacted impacting on the area of financial

Cavanagh, “Causes of New Zealand Finance Company Collapses: A Brief Review” (<http://ssrn.com/abstract=1906923>) at 2.

⁹ MED at [134]; Commerce Committee, above n 8, at 16. See also Susan Watson and Rebecca Hirsch “Empty Heads, Pure Hearts: The Unintended Consequences of the Criminalisation of Directors’ Duties” (2011) 17 NZBLQ 97 at 101.

¹⁰ Commerce Committee at 7.

¹¹ See the discussion in Commerce Committee, above n 8. See also Stace Hammond, *Inquiry into Finance Company Failures*. (2009) (49SCCO_EVI_00DBSCH_INQ_9325_1_A20276_StaceHammond.pdf); Noel Yahanpath and John Cavanagh, “Causes of New Zealand Finance Company Collapses: A Brief Review” (<http://ssrn.com/abstract=1906923>).

¹² Commerce Committee, above n 8, at 7; M Peart, “Finance company collapses – a sign of poor governance” (www.archivesearch.co.nz/?webid=mgt&articleid=29810) at 7, 11 and 26; Yahanpath and Cavanagh, above n 8 at 16.

¹³ Hanover Finance collapsed and went into receivership in December 2008 owing \$464 million to approximately 13,000 investors: Commerce Committee at Appendix D.

¹⁴ Five Star Consumer Finance collapsed and went into receivership in August 2007 owing \$55 million to approximately 2,100 investors: at Appendix D.

¹⁵ Capital + Merchant collapsed and went into receivership in November 2007 owing \$167 million to approximately 7,500 investors: at Appendix D.

¹⁶ Bridgecorp collapsed and went into receivership in July 2007 owing \$459 million to approximately 14,367 investors: at Appendix D.

¹⁷ Nathans Finance collapsed in August 2007 owing \$174 million to approximately 7,082 investors: at Appendix D.

¹⁸ Lombard Finance & Investments collapsed and went into receivership in April 2008 owing \$111 million to approximately 3,900 investors: at Appendix D.

¹⁹ OPI Pacific Finance & Investments collapsed and went into receivership in April 2008 owing \$450 million to approximately 1,200 investors: at Appendix D.

²⁰ Strategic Finance collapsed and went into receivership in December 2008 owing \$350 million to approximately 15,000 investors: at Appendix D.

²¹ South Canterbury Finance collapsed and went into receivership in August 2010 owing \$1, million to approximately 1,200 investors: at Appendix D.

securities.²² However, to date company directors' conduct under the *Companies Act 1993* continues to be governed by a regime that is weak in terms of both standards of conduct²³ and review²⁴ and penalties. Coupled with the lack of power in the regulatory body, now the Financial Markets Authority ('FMA')²⁵ (formerly Securities Commission), to pursue directors for even egregious breaches, the reality is that the New Zealand regime has failed to punish, much less prevent, serious breaches of directors' duties. As a consequence of these weaknesses, if the FMA wish to pursue directors for criminal offences they have had to resort to alternative sources of punishment, in particular offences relating to misstatements in financial products.²⁶ While the FMA has had some success in this regard, directors of companies such as Capital + Merchant Finance Ltd,²⁷ Nathans Finance²⁸ and Bridgecorp²⁹ being jailed for significant periods of time,

²² For example, *Financial Advisers Act 2008*, *Financial Advisers Amendment Act 2010*, *Financial Advisers Amendment Act 2011*, *Financial Services Providers (Registration and Dispute Resolution) Act 2008*, *Financial Services Providers (Registration and Dispute Resolution) Amendment Act 2010*, *Reserve Bank of New Zealand Amendment Act 2008*, *Insurance (Prudential Supervision) Act 2010* and *Securities Trustees and Statutory Supervisors Act 2011*. Most recently the *Financial Markets Conduct Act 2013* replaced, *inter alia*, the *Securities Act 1978* and *Securities Markets Act 1988*.

²³ Eisenberg asserts that this “states how an actor should conduct a given activity or play a given role”: “The Divergence of Standards of Conduct and Standards of Review in Corporate Law” 1993 (63) *Fordham L Rev* 437 at 437. He traces the distinction between standards of conduct and standards of review to Bentham, *A Fragment on Government and an Introduction to the Principles of Morals and Legislation* (1948) 430.

²⁴ According to Eisenberg this “states the test a court should apply when it reviews an actor’s conduct”: at 437.

²⁵ Pursuant to the *Financial Markets Authority Act 2011*.

²⁶ Note, however, the Serious Fraud Office has also successfully brought charges under the s 220 *Crimes Act 1961*, theft by a person in a special relationship, against directors of failed companies. For example, former directors of Five Star Consumer Finance Ltd pleaded guilty to charges under the Crimes Act and were convicted and imprisoned for two years and eight months in the case of Nicholas Kirk, two years and three months in the case of Marcus MacDonald and nine months home detention and 100 hours of community work for Anthony Bowden (<http://www.sfo.govt.nz/n273,22.html>). Paul Cropp, former chief executive officer of Dominion Finance was found guilty of four charges of theft by a person in a special relationship (<http://www.sfo.govt.nz/n348.html>). He was sentenced to two years and seven months imprisonment (<http://www.sfo.govt.nz/n359.html>). Former directors of Capital + Merchant Finance Ltd were also convicted and imprisoned for five years for breaches of s 220 *Crimes Act 1961*, theft by a person in a special relationship: *Tallentire v R* [2012] NZCA 610. Again, however, not all breaches of directors' duties entails the extreme conduct of theft.

²⁷ Former Capital + Merchant Finance Ltd director Owen Tallentire pleaded guilty to three charges of making false statements in the company's registered prospectus and advertisements and was sentenced to 12 months imprisonment: *R v Ryan, Sutherland and Tallentire* [2013] NZHC 501. His co-directors were sentenced to seven months home detention and 300 hours community work (Ryan) and six months home detention and 300 hours community work: *R v Ryan, Sutherland and Tallentire* [2013] NZHC 501

²⁸ Three former Nathans Finance directors were found guilty of making untrue statements in the company's registered prospectus and investments statement. Kenneth Moses was sentenced to two years and two months jail and ordered to pay \$425,00 in reparations: *R v Moses, Doolan and Young* HC Auckland CRI-2009-004-1388, 8 July 2011. Moses had previously been involved in a failed mortgage broking firm: : Report of the Commerce Committee, *2007/2008 Financial Review of the Ministry of Economic Development* (2008) at 8. Mervyn Doolan was sentenced to two years and four months jail and ordered to pay \$150,000 in reparations: *R v Moses, Doolan and Young* HC Auckland CRI-2009-004-1388, 8 July 2011; *Doolan v R* [2011] NZCA 542. Donald Young was sentenced to nine months home detention, ordered to complete 200 hours of community work and pay \$310,000 in reparation: : *R v Moses, Doolan and Young* HC Auckland CRI-2009-004-1388, 8 July 2011. A fourth director, John Hotchin, had already pleaded guilty to the Securities Act charges and was sentenced to 11 months home detention, 200 hours community work and to pay \$200,000 in reparations: [R v Hotchin](http://www.sfo.govt.nz/n359.html) HC Auckland CRI-2009-092-20927 [2011] NZHC 49 (4 March 2011).

not all breaches by directors can be tied to false statements in offer documents. As discussed in more detail below, outside the realm of such breaches the FMA is powerless to take action against directors. As noted in the 2011 Cabinet Paper, there are no offences that apply to the core directors' duties post the allotment of securities.³⁰ It is contended that the regulatory regime in New Zealand is inadequate³¹ and an overhaul of directors' duties, the consequences of those breaches and who may enforce same is long overdue in New Zealand.

This article considers a current proposal in New Zealand to criminalise serious breaches of two directors' duties, namely s 131 (the duty of act in good faith and in the best interests of the company) and s 135 (reckless trading). Pursuant to the *Companies and Limited Partnership Amendment Bill*, the *Companies Act 1993* will be amended to introduce two new offences contained in ss 138A and 380. Criminal liability will follow for a breach of the duty of act in good faith when the director acts in "bad faith", "believing the conduct is not in the best interests of the company" and "knowing, or being reckless" as to whether the conduct will cause a "serious loss to the company" or "benefit or advantage" a person: s 138A(1).³² Criminal liability for reckless trading will arise when the director "knows" that as a consequence of the conduct "a serious loss will be suffered by 1 or more of the company' creditors": s 380(4).³³ The director will in turn face the penalties set out in s 373(4) *Companies Act 1993*, namely five years imprisonment or a fine of up to \$200,000. In addition, as a breach of these duties will now

²⁹ More recently, the founder of Bridgecorp Rod Petricevic was convicted of offences under s 242 *Crimes Act 1961*, s 377(2) *Companies Act 1993* and s 58 *Securities Act 1978* and imprisoned for six years and six months: *R v Petricevic* [2012] NZHC 665. It is notable that Petricevic had previously been involved in the \$250m failure of Euro National: Report of the Commerce Committee, *2007/2008 Financial Review of the Ministry of Economic Development* (2008) at 8. Former Bridgecorp director Gary Urwin, who pleaded guilty to ten charges of misleading investors, was sentenced to two years imprisonment: *R v Urwin* [2012] NZHC 715. Bruce Davidson also pleaded guilty to the charges and was sentenced to nine months home detention, plus 200 hours of community work and pay \$500,000 in reparations: *R v Davidson* HC Auckland CRI-2008-004-29179, 7 October 2011. Another Bridgecorp director, Rob Roest, was subsequently convicted and sentenced to nine months home detention, plus 200 hours of community work and pay \$350,000 in reparations: *R v Roest* [2012] NZHC 1086; [2013] NZCA 547.

³⁰ Cabinet Paper, above n 8 at [209].

³¹ See also John Farrar, "Enforcement: A Trans-Tasman Comparison" (2005) NZLR 383 at 384 and 386.

³² Note, under the original version of the Bill the wording was different. It provided that criminal liability will follow for a breach of s 131(1) when the director "knows that the act or omission is seriously detrimental to the interests of the company": s 138A(1). The House of Representatives Supplementary Orders Papers of 5 June 2013 and 19 November 2013 introduced, inter alia, the requirement of "bad faith". Note, the Supplementary Orders Papers also introduced defences largely echoing s 131(2)-(4): s 138A(2)-(4).

³³ Note, under the original version of the Bill the wording was not only different, but was contained in s 138A(2). It provided that criminal liability will follow for a breach of s 135 when the director "knows that the act or omission will result in a serious loss to the company's creditors": s 138A(2). The House of Representatives Supplementary Orders Papers of 5 June 2013 and 19 November 2013 moved this provision to s 380(4) and introduced the additional specific requirements detailed above. Note, the Supplementary Orders Papers also introduced a defence when essentially, the director reasonably believes all the creditors have consented to continue trading: s 380(5)-(8).

constitute an offence, the automatic ban from management for five years under s 382 *Companies Act 1993* will apply.

The article begins by setting out the current directors' duties regime in New Zealand. It then considers the rather elongated process that has led to these proposals. Most importantly the article evaluates the criminalisation of these provisions and the rejection of a civil penalty regime in light of the arguments commonly proffered for/against strengthening directors' duties. Ultimately it is submitted that while the changes are to be applauded, they do not go far enough. In particular it is suggested that criminal breaches should not be confined to these two directors' duties. In Australia, in addition to possible criminal breaches of the duty to act in good faith in the company's interests (s 184(1)(c)) and the insolvent trading provisions (s 588G(3)), under s 184(1)(d), (2) and (3) *Corporations Act 2001* (Cth) criminal liability also extends to the duty to exercise powers for their proper purpose and the duties not to improperly use the directors' position and corporate information.³⁴ The article also suggests these changes would be complemented by the introduction of a civil penalty regime as in Australia. To date this has been rejected by the New Zealand reform bodies.³⁵ However, the author suggests reconsideration is warranted as this would provide the FMA with another useful weapon in its armory, particularly when breaches are not serious enough to not attract criminal liability.

II Current Directors' Duties Regime in New Zealand

In New Zealand the core directors' duties are found in ss 131-138 and 145 *Companies Act 1993*. Briefly, these duties are as follows:

- * duty to act in good faith and in the best interests of the company: s 131;
- * duty to exercise powers for a proper purpose: s 133;
- * duty to comply with the Act and the constitution: s 134;
- * duty to avoid reckless trading: s 135;

³⁴ Note, a dishonest breach of s 208, which in essence prohibits, *inter alia*, a public company giving a related party, such as a director, a financial benefit is an offence under s 209. These provisions are contained in a specific regulatory regime in Chap 2E *Corporations Act 2001* (Cth) and are not considered in this paper.

³⁵ MED, above n 8, at [136] and [138]; Cabinet Paper, above n 8 at [206].

* duty not to agree to the company incurring an obligation that it will be unable to perform: s 136;

* duty to exercise care, diligence and skill: s 137; and

* duty not to disclose, make use of or act on company information: s 145.

The interrelationship between these statutory duties and the equitable fiduciary duties and the common law duty of care remain unclear. Unlike the Australian legislation (ss 185 and 193 *Corporations Act 2001* (Cth)) there is nothing in the *Companies Act 1993* that indicates whether the statutory duties are intended to replace the equitable/common law duties. The assumption can perhaps be made that they continue, as in Australia, to stand side by side with the statutory obligations. The view is supported by the fact the New Zealand judiciary has historically interpreted the statutory duties in light of their equitable/common law equivalents.³⁶ Moreover, as there are no statutory remedies set out in the Act, relief must be sought through the enforcement of the equitable/common law duties. It should be noted, however, that not all of the statutory duties have an equitable/common law equivalent. In particular, s 135, the reckless trading provision, has no equitable/common law equivalent, though conduct breaching this duty may also breach another statutory duty, such as s 131 and its equitable equivalent, the duty to act bona fide in the best interests of the company.

Crucial to an understanding of the impact of the current proposals is the fact that, unlike Australia, New Zealand's directors' duties are based on a private enforcement regime. Echoing the position under equity/common law,³⁷ these core directors' duties are owed to the company: s 169(3)(d)-(i) *Companies Act 1993*.³⁸ Thus the starting point under both equity/common law and the New Zealand statutory duties is that the company is the proper plaintiff where there is a breach of directors' duties. This has obvious limitations in terms of effective enforcement as the

³⁶ For the strongest statement of this approach see *Benton v Priore* [2003] 1 NZLR 564 at 573. See also *Sojourner v Robb* [2006] 3 NZLR 808 at 829. However, in *Manukau City Council v Lawson* (HC Auckland CP210/SW99, 21 May 1999) it was suggested that the statutory directors' duties constitute a code. Note also the comment in the February 2011 Cabinet paper that post the reform proposals the "new legislation will be a 'code', ie a complete regime that sets out all instances when liability will occur": Cabinet Paper, above n 8 at [191].

³⁷ *Percival v Wright* [1902] 2 Ch 421 at 426. See also *Esplanade Developments Ltd v Dinive Holdings Pty Ltd* [1980] ACLC 34,232; *Cope v Butcher* (1996) 20 ACSR 37; *Australian Innovation Ltd v Petrovsky* (1996) 21 ACSR 218 at 222; *Stein v Blake* [1998] 1 All ER 724; *Brunninghausen v Glavanics* (1999) 17 ACLC 1247 at 1254; *Peskin v Anderson* (2001) 19 ACLC 3001; *Johnson v Gore Wood* [2001] 2 WLR 72; *Nestegg Holdings Pty Ltd v Smith* [2001] WASC 227; *Southern Cross Mine Management Pty Ltd v Ensham Resources Pty Ltd* (2003) 21 ACLC 1,665.

³⁸ See MED, above n 8, at [110].

company itself is a legal fiction. It must act through the directors upon whom management powers are conferred under s 128(1) and (2) *Companies Act 1993*.³⁹ The decision to litigate is a management decision⁴⁰ and thus rests in the hands of the directors who will include the offending director and persons possibly closely affiliated to that director.⁴¹ As a consequence, litigation against directors often only occurs once the company is insolvent and management powers have shifted to a liquidator.⁴²

While under s 169(1) and (3)(a)-(c) shareholders can bring actions against directors for duties owed to them personally, these duties are limited. The primary duties owed to shareholders are as the duty to supervise the share register (s 90), the duty to disclose interests (s 140) and the duty to disclose share dealings (s 148). Personal litigation cannot be brought for breaches of the above core directors' duties owed to the company.

In light of the difficulties flowing from such self-regulation amongst boards of directors, the possibility of shareholders bringing a derivative action for a breach of directors' duties was developed in regard to both the equitable/common law duties⁴³ and statutory duties under s 165 *Companies Act 1993*. Similarly in regard to breaches of the reckless trading provision, s 135, and the duty not to incur obligations as specified in s 136, in certain cases shareholders and creditors may initiate proceedings under s 301 *Companies Act 1993*. However, the derivative action regime does not provide for the effective enforcement of breaches of directors' duties. Shareholders face many hurdles that will in most cases prevent any action being taken against a delict director. First, there is no automatic right of a shareholder to bring a derivative action. Leave of the court is required. In turn the statutory derivative action provision contains a number of prerequisites. For example, in addition to the discretionary factors stated in s 165(2), s 165(3)

³⁹ While it is possible under s 128(3) *Companies Act 1993* to modify the normal allocation of such powers pursuant to the company's constitution and place them with the shareholders, it is unclear if s 128(3) could authorise a total transfer of management powers to the shareholders. See further Farrar (ed), *Company and Securities Law in New Zealand* (2008) at 11.2.2. Further, if the management of the company was so allocated to the shareholders they would be deemed directors under s 126(2) and possibly under s 126(1)(b)(iii). See further Farrar (ed), *Company and Securities Law in New Zealand* (2008) at 11.2.2 and 13.5.5.

⁴⁰ *Kraus v JG Lloyd Pty Ltd* [1965] VR 232 at 236-237; *Massey v Wales* (2003) 21 ACLC 1978.

⁴¹ See MED, above n 8, at [122].

⁴² MED at [110]; Cabinet Paper, above n 8 at [202].

⁴³ The exceptions to the 'proper plaintiff rule' as stated in *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189 included fraud on the minority (*Daniels v Daniels* [1978] Ch 406), breaches of members' personal rights (*Residues Treatment and Trading Company Ltd v Southern Resources Ltd* (1988) 6 ACLC 1160) and in later times the controversial 'where justice so requires' exception (*Joinery Products Pty Ltd v Imlach* [2008] TASSC 40). See the discussion of the exceptions to *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189 in Cassidy, *Corporations Law: Text and Essential Cases* (3rd ed, 2010) at [12.40]; Watson and Morgon, "A matter of balance: the statutory derivative action in New Zealand" (1998) 19 *The Company Lawyer* 236.

requires the shareholder to show that the company does not intended to bring, and diligently continue, the proceedings and that it is in the interests of the company that the conduct of the proceedings should not be left to the directors. Second, litigation is costly⁴⁴ and most shareholders will not be able to fund a personal action against a director. Third, and interrelated, as it is a derivative action, any compensation that might be ordered consequent to successful litigation undertaken by a shareholder is paid to the company, not the shareholder.⁴⁵ The rationale for such is again the principle that the duty is owed to the company, not the shareholder. Fourth, shareholders will have limited access to company documentation that would in most cases be crucial to properly preparing a case. Finally, and interrelated with the last proposition, the lack of awareness of the conduct of company management means that shareholders will probably only learn of breaches post the event and after the damage has been done. Thus the potential for a derivative action can only have a limited impact on preventing breaches of directors' duties.

It is against this background that the ineffectiveness of the regulatory body, the FMA, to act against offending directors is accentuated. As may be obvious from the above, the FMA cannot enforce even the statutory embodiment of these core directors' duties. It has no power to litigate seeking compensation for the company, the imposition of a civil penalty for the breach or commence criminal proceedings even for the most serious breaches. This stands in stark contrast to the Australian regulatory body, the Australian Securities and Investments Commission's ('ASIC'), powers to act against offending directors. The FMA's powers to initiate civil actions are limited to contraventions of the Securities legislation.⁴⁶ It has no ability to bring a civil action on behalf of the company or shareholders for breaches of the *Companies Act 1993*, nor the equivalent equitable/common law directors' duties. Moreover, while in addition to the criminal offences under the *Securities Act 1978* noted above, there are some criminal offences stated in s 373 of the *Companies Act 1993*, to date these do not include any of these core directors' duties. To reiterate, the New Zealand directors' duty regime is a private enforcement regime.

⁴⁴ The February 2011 Cabinet Report notes that cost is also an issue for a company considering taking an action against a delinquent director: Cabinet Paper, above n 8 at [203].

⁴⁵ MED, above n 8, at [111] and [122]; Cabinet Paper, at [203]. See also Farrar, above n 31 at 386.

⁴⁶ See MED at [89].

As the Ministry of Economic Development (MED) noted in its 2010 Discussion paper, the combination of the above features of the New Zealand regime has meant that directors' duties are under-enforced.⁴⁷

III Reform proposals

The (possible) implementation of the subject reforms has been comparatively elongated. It began with a Review of Securities Law Discussion paper in June 2010, published by the MED.⁴⁸ The near 200 page document has as its primary focus the reform of New Zealand securities law, including the replacement of, *inter alia*, the *Securities Act 1978* and *Securities Markets Act 1988* and the consolidation of market conduct regulators into the new FMA.⁴⁹

However, in chapter 5 'Other Matters' one of the issues raised is the public enforcement of directors' duties.⁵⁰ The Discussion paper notes that one objective of the directors' duties regulatory regime is to encourage directors "to act in socially appropriate ways" and ensure there are remedies for those "who are adversely affected by contraventions of the duties."⁵¹ In turn it highlighted concerns in New Zealand regarding the under-enforcement of directors' duties under the current regime.⁵² It specifically raised the issue whether the New Zealand regulatory body should have powers akin to the ASIC to bring civil proceedings against directors on behalf of third parties such as corporations.⁵³ Similarly, it raised the issue whether the dishonest and/or reckless conduct of directors that has led to corporate crashes of the magnitude of the GFC, as detailed above, are "sufficiently immoral to justify creating a new offence"⁵⁴ enforceable by the FMA.

⁴⁷ At [122].

⁴⁸ MED, above n 8.

⁴⁹ At 6.

⁵⁰ At 9 and 177.

⁵¹ At 181, [107].

⁵² At 181, [106].

⁵³ At 177, [90]-[91].

⁵⁴ At 186, [135].

Ultimately the Ministry did not make any firm conclusions as to whether there should be a public regime for the enforcement of directors' duties.⁵⁵ However, it stated that there was a case for creating criminal offences for serious breaches of directors' duties, noting its preference for such over introducing a civil penalty regime into directors' duties.⁵⁶ It feared that the latter would deter people from taking on directorships, make boards risk-averse and entail the regulatory body second-guessing what were otherwise viewed as sound business decisions.⁵⁷ These points are addressed below. By contrast it stated that criminal offence provisions aimed at "egregious conduct" that included a "guilty mind" element and were tested against the criminal standard of proof were less likely to have these effects.⁵⁸ It also added that while the introduction of a civil penalty regime should be rejected, there might nevertheless be a case for the regulatory body being able to bring civil proceedings against a director seeking compensation for investors.⁵⁹

A subsequent Cabinet Paper in February 2011 took the opportunity of reviewing New Zealand's securities laws in light of the 2010 Discussion paper, the GFC and the above discussed failure of many New Zealand finance companies.⁶⁰ The major focus of the review was to "address most of the remaining gaps in the financial sector reform agenda ...".⁶¹ However, again, it also noted that "other matters" addressed in the 2010 Discussion paper included the public enforcement of directors' duties.⁶² In turn, the Cabinet Paper recognised the "potential for substantial harm to individual and public interests from directors breaching their duties ...".⁶³ It stated that the best way of tackling this potential for harm was to introduce an "escalating hierarchy of liability".⁶⁴ In particular, it recommended that the FMA and Registrar of Companies have the ability to enforce egregious breaches of these specified directors duties.⁶⁵ Egregious breaches were said to be those where the breach was "deliberate or reckless."⁶⁶ Criminal offences attracting substantial fines or considerable terms of imprisonment were considered appropriate to both punish and

⁵⁵ At 186, [136].

⁵⁶ At 186, [136] and [138].

⁵⁷ At 186, [137] and [138].

⁵⁸ At 186, [136] and [138].

⁵⁹ At 186, [139].

⁶⁰ Cabinet Paper, above n 8 at [23].

⁶¹ At [22].

⁶² At [22].

⁶³ At [206].

⁶⁴ At [191].

⁶⁵ At [13], [26], [192], [211] and [214].

⁶⁶ At [192].

deter such conduct.⁶⁷ Criminal consequences were, however, to be confined to breaches of the duty to act in good faith and in the best interests of the company (s 131), reckless trading (s 135) and the duty not to agree to the company incurring an obligation it cannot perform (s 136).⁶⁸ The narrow range of conduct that would attract criminal consequences is addressed further below. The February 2011 Cabinet Paper again expressed concerns about introducing civil penalty provisions into the New Zealand directors' duties regime.⁶⁹ Echoing the 2010 Discussion Paper, it suggested that civil penalty provisions, with a lower standard of proof than criminal offences, would deter people taking on directorships.⁷⁰ It again stated that it would involve the regulator "second-guessing the soundness of directors' business decisions."⁷¹

This Cabinet document and its recommendations in turn provided the spring board for the Commerce Minister's announcement on 17 March 2011 of Cabinet's decisions on a comprehensive review of securities laws.⁷² The Commerce Minister's announcement reiterated that this included "[m]aking the most serious breaches of directors' duties result in criminal liability."⁷³

The major focus of the subsequent October 2011 Commerce Committee's *Inquiry into finance company failures*⁷⁴ was again the proposed considerable changes to the securities law regime. However, there is a brief endorsement of the Cabinet Paper's recommendation to make certain breaches of the duty to act in good faith and in the best interests of the company (s 131), reckless trading (s 135) and duty not to agree to the company incurring an obligation it cannot perform (s 136) criminal offences.⁷⁵

The consequent *Companies and Limited Partnership Amendment Bill* was referred to the Commerce Committee. The Committee recommended that the Bill be passed with the amendments detailed in its Report.⁷⁶ In regard to the criminalisation of directors' duties, the

⁶⁷ At [192], [130] and [131].

⁶⁸ At [210] and recommendation 140.

⁶⁹ At [206].

⁷⁰ At [206].

⁷¹ At [206].

⁷² Commerce Minister Simon Power, "Government moves to modernise securities law" (Press Release, 17 March 2011) <http://www.beehive.govt.nz/release/government-moves-modernise-securities-law>.

⁷³ Commerce Minister Simon Power, "Government moves to modernise securities law" (Press Release, 17 March 2011) <http://www.beehive.govt.nz/release/government-moves-modernise-securities-law>.

⁷⁴ Commerce Committee, above n 8, at 7.

⁷⁵ At 26.

⁷⁶ Commerce Committee Report, *Companies and Limited Partnership Amendment Bill* (11 December 2012), at 1.

Report again warned that the measures not discourage “positive entrepreneurial behaviour”.⁷⁷ While it recommended further consideration of the wording of the proposed s 1318A to ensure it gives “clear guidance to directors and does not have a chilling effect on legitimate risk-taking”,⁷⁸ the Report made no specific recommendation in this regard apart from minor semantic changes.⁷⁹

The Bill has been the subject of two Supplementary Order Papers.⁸⁰ These separated the proposed s 138A(1) and (2) into two provisions, s 138A(1) and 380(4), modified the wording and, as detailed above, introduced certain defences. As noted above, Criminal liability will follow for a breach of the duty of act in good faith when the director acts in “bad faith”, “believing the conduct is not in the best interests of the company” and “knowing, or being reckless” as to whether the conduct will cause a “serious loss to the company” or “benefit or advantage” a person: s 138A(1). Criminal liability for reckless trading will arise when the director “knows” that as a consequence of the conduct “a serious loss will be suffered by 1 or more of the company’ creditors”: s 380(4). Thus ultimately the criminalisation of breaches of directors’ duties has been confined to just two duties, namely the duty to act in good faith and in the best interests of the company (ss 131 and 138A(1)) and reckless trading (ss 145 and 380(4)). There is no explanation as to why the Bill is confined to just these two duties. The conduct that the 2010 Discussion paper identified as “undesirable conduct by directors”⁸¹ included conduct that would breach a variety of directors’ duties, not just the duty to act in good faith and reckless trading. As noted above, the February 2011 Cabinet Paper had also recommended making the duty not to agree to the company incurring an obligation it cannot perform (s 136)⁸² a criminal offence, but it is no longer included in the reform measures. Equally the subsequent Report of the Commerce Committee detailed that the three duties identified in the 2011 Cabinet Paper were to be criminal offences.⁸³

⁷⁷ At 2.

⁷⁸ At 2.

⁷⁹ For example, the report recommends a slight change in wording, replacing the words “the act or omission” with “that conduct”: at 6.

⁸⁰ House of Representatives, Supplementary Order Paper, 5 June 2013 and House of Representatives, Supplementary Order Paper, 19 November.

⁸¹ MED, above n 8, at [108].

⁸² Cabinet Paper, above n 8 at [210] and recommendation 140.

⁸³ Commerce Committee, above n 8, at 26.

It is unclear why proposed measures would not have the same reach as the Australian provisions, particularly given they were clearly the model on which the New Zealand reform measures are based. As noted above, under the Australian regime a criminal breach can also occur in relation to the proper purposes doctrine (s 181(1)(b) and 184(1)(d)) and an improper use of position or corporate information (ss 182, 183 and 184(2) and (3)). As to s 133 *Companies Act 1993*, the New Zealand proper purposes doctrine, Watson suggests that its exclusion from the reform measures is because the duty is “misunderstood and rarely enforced.”⁸⁴ While there is a wealth of English and Australian case law on the equitable equivalent to this duty, notably there does not appear to have been a criminal prosecution under the Australian statutory provisions, s 184(1)(d) *Corporations Act 2001* (Cth). Thus there may be a logical basis for excluding this duty from the reform measures. The exclusion of an improper use of position from the reforms undoubtedly stems from the absence of a New Zealand statutory equivalent to the Australian prohibition (s 182 and 184(2)). However, there is a New Zealand equivalent to the Australian prohibition of an improper use of corporate information (s 183 and 184(3)), namely s 145 *Companies Act 1993*. The exclusion of this duty from the reform proposals has not been addressed. To this end it is relevant that the leading Australian case on the application of s 184 *Corporations Act 2001* (Cth), *ASIC v Adler*⁸⁵ included criminal breaches of both ss 182 and 183 (s 184(2) and (3)).

Somewhat controversial in Australia is the failure to extend s 184 *Corporations Act 2001* (Cth) to a breach the duty of care and diligence, s 180(1), no matter how serious that breach. The New Zealand reform measures make no reference the statutory equivalent, s 137 *Companies Act 1993*. While perhaps reflecting the position in Australia, to some extent this is surprising given one of the highlighted examples of undesirable conduct detailed in the 2010 Discussion paper is “[n]ot putting sufficient effort, or applying sufficient skill, when making decisions on behalf of the company ...”⁸⁶

As discussed below, s 1317E specifies that, *inter alia*, ss 180 – 183 are civil penalty provisions, a breach of which can attract a penalty of up to \$200,000 under s 1317G *Corporations Act 2001* (Cth). Proposed s 138A has not been coupled with a civil penalty regime. As noted above, the

⁸⁴ Watson and Hirsch above n 9 at fn [50].

⁸⁵ (2002) 20 ACLC 576.

⁸⁶ MED, above n 8, at [108].

suggestion was rejected in the key reports.⁸⁷ The arguments proffered against the introduction of a civil penalty regime are also addressed in the discussion that follows.

IV Arguments for/against reform

Proposals for strengthening directors' duties are typically met with a standard set of arguments purportedly justifying why directors should not be held to a greater degree of accountability. These arguments have been made in a number of contexts including proposals to increase the standard of conduct⁸⁸ and/or review⁸⁹ and proposals to increase the severity of the consequences of a breach. While the arguments proffered against making breaches of directors' duties an offence and the rejection⁹⁰ of a civil penalty regime are specifically addressed, this Part takes each of the points made in these slightly varying contexts and examines them generically to adjudge whether they justify directors being less accountable than other professionals.

A Decisions that turn out badly

First, it has been suggested that is often difficult to distinguish “decisions that turn out badly from bad decisions.”⁹¹ As noted above, both the 2010 Discussion paper and the 2011 Cabinet Report suggested that it would be inappropriate to adopt a civil penalty regime as it would involve the regulator second-guessing whether directors' have made sound business decisions.⁹² The notion is that directors might be unfairly held liable when things go wrong.⁹³

⁸⁷ MED, at [136] and [138]; Cabinet Paper, above n 8 at [206].

⁸⁸ As noted above, this “states how an actor should conduct a given activity or play a given role”: Eisenberg, above n 23 at 437. In this context these are the rules that direct how a director should act. The arguments addressed below have often been made in the context of introducing an objective standard of care for directors.

⁸⁹ As noted above, this “states the test a court should apply when it reviews an actor’s conduct ...”: at 437. In this context these rules are addressed to the courts reviewing a director’s conduct. The arguments addressed below have often been made in both the context of introducing an objective standard of review and the need for a business judgment rule defence.

⁹⁰ Cabinet Paper, above n 8 at [206].

⁹¹ Eisenberg “The Duty of Care of Corporate Directors and Officers” (1990) 51 *Uni Pitt L Rev* 945 at 963. Note, Eisenberg’s comment was made in the context of the arguments for a business judgement rule, but is equally relevant to the public enforcement of directors’ duties.

⁹² MED, above n 8, at [137]; Cabinet Paper, above n 8 at [206].

⁹³ “A securities law expert wants changes to controversial new rules which could criminalise directors’ action, saying it could be detrimental to the economy and deter capable people from standing for boards” (www.radionz.co.nz/news/business/130134.)

The threat of litigation underlying this argument is equally applicable to cases involving ‘non-director’ decision makers. Commentators⁹⁴ acknowledge that other professional groups face the same risk of litigation. As Eisenberg notes, “[i]t is true that the law of medical malpractice accepts this risk ...”.⁹⁵ In turn the argument is only valid if it is justifiable to treat directors differently from other professionals, such as doctors. To this end Eisenberg suggests that physicians can more readily defend themselves by “pointing to established protocols or accepted medical practice” while directors’ decisions are unique and will “seldom shield the quality of their decisions by pointing to protocols or accepted practices.”⁹⁶ It is submitted that the latter point is not entirely true. In recent years standards for the proper conduct of board room affairs have been developed. Thus in the New Zealand context the *Principles of Corporate Governance and Guidelines* provide a principle-based approach to corporate governance with accompanying guidelines.⁹⁷ Moreover, director’s decisions will also be guided by protocols and accepted practices for the particular industry in which the company is conducting its business.

In the specific context of the public enforcement of directors’ duties in New Zealand, this concern is met to some degree by two interrelated facts. First, whether the proceedings were for civil penalties or criminal liability, the onus of proof would lie with the FMA. In the case of civil proceedings for, for example, a breach of s 131(1) of the *Companies Act 1993*, the FMA would have to prove the directors did not “act in good faith and in what the director believes to be in the best interests of the company”. In the case of a criminal breach of s 138A(1), the FMA will have to prove the director acted in “bad faith”, “believing” the conduct is not in the company’s best interests and “knowing, or being reckless” as to whether the conduct will cause, inter alia, serious loss to the company. Thus it is the FMA that must prove that the director has breached his / her duty with the requisite dishonest intent. If the fact finder has any doubts, that uncertainty will lead to an acquittal. While this applies to both civil and criminal public enforcement of directors’ duties, in the context of a criminal offence the standard of proof will be beyond reasonable doubt. Thus the corporate regulator will face a high threshold when seeking to impose criminal liability.

Second, specifically in regard to the current New Zealand proposals, as the June 2010 Discussion Paper and February 2011 Cabinet Report stressed, a high threshold has to be met before criminal

⁹⁴ Eisenberg, above n 92 at 963; Eisenberg, above n 23 at 444; Steinberg, “The Corporate Law Reform Act 1992: A View from Abroad” (1993) A J Corp Law 154 at 164; Arkes and Schipani, “Medical Malpractice v the Business Judgement Rule: Differences in Hindsight Bias” (1994) 73 Oregon LR 587 at 610.

⁹⁵ Namely, the risk that juries / courts will find it difficult to distinguish “decisions that turn out badly from bad decisions: Eisenberg, above n 92 at 963. See also Eisenberg, above n 23 at 444.

⁹⁶ Eisenberg, above n 92 at 964. See also Eisenberg, above n 23 at 444.

⁹⁷ In the Australian context see Australian Securities Exchange Corporate Governance Council’s *Corporate Governance Principles and Recommendations with 2010 Amendments* (2010). See also OECD, *OECD Principles of Corporate Governance* (2004) (www.oecd.org).

prosecution is even a possibility.⁹⁸ It must be recalled that only egregious breaches are intended to be caught.⁹⁹ Sections 138A(1) and 380(4) require knowledge of the serious consequences of the breach. Criminal liability is confined to intentional dishonest breaches. As Watson and Hirsch note, it is “hard to justify not imposing [criminal consequences] on wrongdoing directors” when the equivalent level of serious misconduct attracts criminal consequences under the *Crimes Act 1961*.¹⁰⁰ Their comment is equally pertinent to criminal misconduct under the *Securities Act 1978*. As stated in the June 2010 Discussion paper, if FMA's true concern is prosecuting an egregious breach of directors' duties, it should not have to seek indirect enforcement of such through such securities provisions.¹⁰¹

To some extent this point is equally pertinent under a civil penalty regime. As noted above, the core Australian directors' duties specified in, *inter alia*, ss 180 – 183 are civil penalty provisions: s 1317E. These provisions are also corporations/scheme civil penalty provisions: s 1317DA. The latter effectively allows civil penalties to be ordered against corporate directors.¹⁰² Under the Australian civil penalty regime the ASIC¹⁰³ may seek a declaration under s 1317E(1) that a civil penalty provision has been contravened. If a court is satisfied a person has breached the section, it must make a declaration of contravention under s 1317E(1). A breach of a civil penalty provisions can attract a penalty of up to \$200,000 under s 1317G *Corporations Act 2001* (Cth). A civil penalty allows the court effectively to fine a director for his or her breach of a statutory duty.¹⁰⁴ However, the Australian civil penalty regime includes a higher threshold that a ‘mere’ breach of directors' duties. A civil penalty will only be ordered where the breach materially prejudices the interests of the corporation or its members or the corporation's ability to pay its creditors or constitutes a serious breach of the civil penalty provision. Thus a civil penalty will only be imposed in serious cases, albeit such conduct not necessarily constituting the extremes of a criminal offence.¹⁰⁵

Further, if the above concerns in relation to a civil penalty regime were considered to have merit, the inclusion of a provisions similar to the Australian s 1317S *Corporations Act 2001* should

⁹⁸ MED, above n 8, at [138]; Cabinet Paper, above n 8 at [26].

⁹⁹ MED at [138]; Cabinet Paper at [13] and [26].

¹⁰⁰ Watson and Hirsch, above n 9, at 103-104.

¹⁰¹ See MED, above n 8, at [123]; Commerce Committee Report, above n 32.

¹⁰² For example, a corporation that is a shadow director under s 9(b)(ii): *Standard Chartered Bank of Australia Ltd v Antico* (1995) 13 ACLC 1381.

¹⁰³ Note, only ASIC has standing to seek such a declaration: s 1317J(1).

¹⁰⁴ Note, a civil penalty is intended to impose a personal punishment on the director, while also providing a general deterrent: *ASIC v Adler* (2002) 20 ACLC 1146 at 1172.

¹⁰⁵ Note, while s 1317M states that a pecuniary penalty should not be ordered for breach of a civil penalty provision if the person had already been convicted of an offence for essentially the same conduct, s 1317P states that criminal proceedings may be instigated in regard to essentially the same conduct with respect to which a pecuniary penalty ordered had already been made. See further *R v Adler* (2004) 22 ACLC 784; (2004) 22 ACLC 1460.

alleviate those concerns. Under the *Corporations Act 2001* the ability to order a civil penalty is qualified by s 1317S. This allows a court to excuse a director partially or wholly from liability for a breach of a statutory duty. Subsection 1317S(3) specifies that relief may be provided where the director has acted honestly and, having regard to all the circumstances, ought fairly to be excused.¹⁰⁶ Thus the section revolves around the notions of “honesty” and “fairness” and would ensure that directors are not unfairly subject to a civil penalty.

However, s 1317S can be criticized as affecting an unnecessary divergence in the standard of conduct and the standard of review. Thus the standard of conduct under, for example, s 180(1), the duty of care, is “reasonableness”, the standard of review under s 1317S is merely “honesty” and “fairness”. As discussed by the author elsewhere,¹⁰⁷ this unnecessary divergence undermines the legitimate expectation that directors act in a reasonable manner and complicates the process of review. If a civil penalty regime were adopted in New Zealand, which is recommended, an equivalent provision to s 1317S should not be adopted. A civil penalty should be an option for the corporate regulator to consider when, in particular, the conduct does not trigger criminal liability. There is no need for this option to be complicated by introducing a defence that waters down the standard of review down to honesty and fairness.

Ultimately it is contended that the above discussed constraints suffice to ensure that a director will not face an unreasonable risk of criminal or civil penalties when management decisions go wrong.

B Corporate risk taking

Another common sentiment expressed in the face of proposals to increased directors’ accountability is the benefit of corporate risk taking¹⁰⁸ and the need to encourage entrepreneurial

¹⁰⁶ See further *ASIC v Plymin* 2003 21 ACLC 1237; *Elliott v ASIC* 2004 22 ACLC 458.

¹⁰⁷ See Cassidy, “Models for Reform: Directors’ Duty of Care in a Modern Commercial World?” (2009) 3 University of Stellenbosch Law Review 373 at 379-380.

¹⁰⁸ Bell Gully, “Criminal Sanctions – doing business under threat of prison” (<http://www.bellgully.com/resource.03015.asp>.); “A securities law expert wants changes to controversial new rules which could criminalise directors’ action, saying it could be detrimental to the economy and deter capable people from standing for boards” (www.radionz.co.nz/news/business/130134.); Fletcher, “Directors’ bill too strict – law firm” (http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10832966); See also Eisenberg, above n 92, at 964; Eisenberg, above n 23, at 444-445. The argument is particularly made in the context of the debate surrounding whether directors should be able to rely on a business judgment rule defence to escape liability.

spirit.¹⁰⁹ The June 2010 Discussion paper specifically noted that the directors' duties regulatory regime must not discourage reasonable risk taking.¹¹⁰ The fear that directors would become unduly risk-averse under a civil penalty regime was one of the key reasons for its rejection.¹¹¹

This point has again been used as a basis for distinguishing directors from other professionals and arguing the former should be shielded from liability. It has been suggested that directors make decisions in an "environment where shareholders may expect risks to be taken and where prudence does not necessarily produce the best results."¹¹² This is said to be in contrast to doctors or lawyers where the "patient or client expects that the doctor or lawyer will exercise prudence."¹¹³ The notion is that it is in shareholders' interests than directors make risky decisions.¹¹⁴ In essence, "the bigger the risks, the bigger the profits."¹¹⁵ It is contended that this accords the notion of risk taking a positive quality which may not be shared by all investors. It paints shareholders as sophisticated opportunistic risk takers.¹¹⁶ To suggest that shareholders are not risk adverse¹¹⁷ is inaccurate. This is not the model with which but a handful of shareholders would meet. 'Mum and dad shareholders' of 'blue chip' companies such as BHP Billiton Ltd and ANZ Banking Ltd could hardly be generalised as "accustomed to business and not adverse to risk."¹¹⁸ This characterisation of shareholders also fails to acknowledge the role of shares in long and medium term investment. It must be remembered that recent decades of such 'entrepreneurial spirit' has cost many New Zealand investors their life savings and employees their livelihoods.¹¹⁹ Investment in a company should not be treated as akin to investment in the futures market or outright gambling.

¹⁰⁹ Burgman and Cox, "Corporate Directors, Corporate Realities and Deliberative Process: an Analysis of the Trans Union Case (1986) 11 J Corp Law 311 at 326-327.

¹¹⁰ MED, above n 8, at 181, [107], 184 [124] and 186 [137]. See also Cabinet Paper, above n 8 at [204]; Commerce Committee Report, above n 32, at 2.

¹¹¹ MED at [137]. See also Cabinet Paper at [204].

¹¹² V Priskich, "A Statutory Business Judgment Rule in Australia: Proposals and Policy" (1999) 27 ABLR 38 at 42.

¹¹³ At 42.

¹¹⁴ Eisenberg, above n 92 at 964. See also Eisenberg, above n 23 at 444.

¹¹⁵ See the example provided by Eisenberg, above n 92 at 964 and Eisenberg, above n 23 at 444.

¹¹⁶ Priskich, above n 114 at 42; John Farrar, "Honesty, Duty of Care and Business Judgment" (1992) *Butterworths Corporations Law Bulletin* No 25

¹¹⁷ Priskich at 42.

¹¹⁸ Priskich at 42; J Farrar, "Honesty, Duty of Care and Business Judgment" (1992) *Butterworths Corporations Law Bulletin* No 25.

¹¹⁹ See MED, above n 8 at [134]; Cabinet Paper, above n 8 at [205]; Commerce Committee, above n 8 at 7. See also Yahanpath and Cavanagh, above n 8 at 2.

The characterisation of shareholders as sophisticated risk takers is based, in essence, on an inappropriate reversal of the burden of corporate responsibility, as it effectively requires shareholders to monitor the board's risk taking activities. It assumes that the shareholders can make corporate decisions and that there is a direct correlation between the extent of their knowledge and success in corporate investment. This view fails to appreciate that under s 128(1) and (2) *Companies Act 1993*¹²⁰ management of the corporation lies with the board, not the shareholders: s 128(1) and (2) *Companies Act 1993*.¹²¹

Ultimately, there is an implicit assumption in this argument that the courts are unable to distinguish between reasonable business risks and unreasonable business risks. As the June 2010 Discussion paper notes, the courts have shown they are able to distinguish between reasonable and illegitimate risk taking in the context of the reckless trading provisions.¹²²

C Discourage appointments as directors

One of the most common arguments raised against proposals for strengthening directors' duties, is the notion that penalising breaches of directors' duties will discourage individuals from accepting board positions. To this end the June 2010 Discussion paper stated that directors' duties and their enforcement must not discourage people taking up appointments as directors.¹²³ The Discussion paper asserted that there needs to be a balance and, specifically, the combination of "prohibitions, enforcement and penalties" should not discourage individual from accepting appointments as directors.¹²⁴ Thus suggestions for reforms of directors' duties, including specifically the criminalisation of breaches of directors' duties¹²⁵ and the introduction of a civil

¹²⁰ See *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34; *John Shaw and Sons (Salford) Ltd v Shaw* [1935] 2 KB 113; *Massey v Wales* (2003) 21 ACLC 1978.

¹²¹ See *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34; *John Shaw and Sons (Salford) Ltd v Shaw* [1935] 2 KB 113; *Massey v Wales* (2003) 21 ACLC 1978.

¹²² MED, above n 8, at [124].

¹²³ At [107].

¹²⁴ At [107].

¹²⁵ Bell Gully, "Criminal Sanctions – doing business under threat of prison" (<http://www.bellgully.com/resource.03015.asp>); Fletcher, "Top legal firms knock company law changes" (www.nzherald.co.nz/news/print.cfm?objectid=10837561); "A securities law expert wants changes to controversial new rules which could criminalise directors' action, saying it could be detrimental to the economy and deter capable people from standing for boards" (www.radionz.co.nz/news/business/130134.) In the Australian context see Damon Kitney, "Go Easy on directors, says retiring corporate regulator" *The Australian*, 30 March 2011 (www.theaustralian.com.au); David Goldman, "Directors beware! Creditor protection from insolvent trading" (2005) 23 C&SLJ 216; The Treasury, *Review of Sanctions in Corporate Law* (Corporations and Financial Services Division, Canberra, 5 March 2007) at [2.18]. See further

penalty regime,¹²⁶ are often met with the suggestion that the flow on effect will be that it will become difficult to attract qualified directors.¹²⁷

Again this assertion can be tested against expectations in other professions. Would qualified directors be any more fearful of being held criminally liable for egregious breaches involving recklessness and dishonesty than qualified persons in any other field of profession? Returning to the earlier parallel, doctors also face criminal liability for extreme breaches of duty under the *Crimes Act 1961*, yet such has not led to a downturn in interest in this profession. Rather, there is an expectation on those entering into a profession that one will not be dishonest and reckless and hence fears of criminal liability will be in all but rare cases unfounded. Most importantly, despite similar assertions in the face of the Australian reform proposals, the introduction of potential criminal liability for breaches of directors' duties under s 184 *Corporations Act 2001* did not see the board rooms across the ditch empty out. Equally the introduction of the above discussed penalty regime did not have the negative impact suggested by these commentators.

Ultimately, it would be wrong to relieve directors from liability for such extreme breaches simply because of concerns that without this 'safety net' persons will be unwilling to take up directorships. Rather the law should be concerned with ensuring that those who accept such positions act responsibly and it is this aim that underlies the recent trends in Australia to increase, rather than decrease, the standard of conduct and review and the consequences of breaching such standards.

V Conclusion

The current proposals to provide the FMA with public enforcement powers are to be applauded. The current directors' duties regime under the *Companies Act 1993* is unsatisfactory. As the MED found the private enforcement nature of the New Zealand regime has meant that directors' duties are under-enforced.¹²⁸ In particular, the inability of FMA¹²⁹ to pursue directors for even egregious breaches has left many serious breaches of directors' duties unpunished. Thus the

Michelle Welsh, "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions."

¹²⁶ MED, above n 8, at [137]; Cabinet Paper, above n 8 at [206].

¹²⁷ Eisenberg, above n 23 at 445. See also Alastair Bull, "Case no encouragement to potential directors – Thomas" (<http://www.guide2.co.nz/money/news/business/case-no-encouragement-to-potential-directors-thomas/11/18426>).

¹²⁸ MED, above n 8 at [122].

¹²⁹ Pursuant to the *Financial Markets Authority Act 2011*.

current proposals to provide the FMA with public enforcement powers are a positive step forward. The arguments put forward by commentators who are against the changes are not convincing and are not supported by the response in Australia post the introduction of criminal consequences for the breach of directors duties.

Specifically in regard to the criminalisation of breaches of directors' duties, as is evident from the above mentioned prosecutions under the *Crimes Act 1961* and *Securities Act 1978*, criminal prosecutions attract a higher degree of publicity than civil proceedings and as a consequence arguably increase the degree of general deterrence.¹³⁰ As noted above, the 2011 Cabinet Report asserted that criminal offences attracting possibly substantial fines or considerable terms of imprisonment were appropriate to both punish and deter such conduct.¹³¹ As noted above, there is a great need in New Zealand to restore public confidence in the capital markets. Arguably, by making directors more accountable, the public may be more willing to consider this form of investment.

However, the reforms do not go far enough. In particular it is suggested that criminal breaches should not be confined to these two directors' duties. As discussed above, in Australia, in addition to possible criminal breaches of the duty to act in good faith in the company's interests (s 184(1)(c)) and the insolvent trading provisions (s 588G(3)), under s 184 (2) and (3) *Corporations Act 2001* (Cth) criminal liability also extends to the duties not to improperly use the directors' position and corporate information.¹³² It is also contended that there is no reason to exclude from criminal prosecution of a breach of the duty of care (s 180(1)).

Further these changes would be complemented by the introduction of a civil penalty regime as in Australia. As indicated above, to date this has been rejected by the New Zealand reform bodies.¹³³ However, the author suggests a reconsideration is warranted as this would provide the FMA with another useful weapon in its armory, particularly when breaches are not serious enough to not attract criminal liability.

¹³⁰ See Vicky Comino "Civil or criminal penalties for corporate misconduct: Which way ahead?" (2006) 34 ABLR 428 at 437-438; Watson and Hirsch, above n 9, at 103.

¹³¹ Cabinet Paper, above n 8 at [192].

¹³² Note, a dishonest breach of s 208, which in essence prohibits, *inter alia*, a public company giving a related party, such as a director, a financial benefit is an offence under s 209. These provisions are contained in a specific regulatory regime in Chap 2E *Corporations Act 2001* (Cth) and are not considered in this paper.

¹³³ MED, above n 8, at [136] and [138]; Cabinet Paper, above n 8 at [206].