CORPORATE COLLAPSE - Pitfalls for Directors, Auditors and Bankers

THE RIGHT HONOURABLE SIR ROBIN COOKE KBE

President, New Zealand Court of Appeal
Wellington

Mr Chairman and friends in banking and the law pertaining to banking: Thank you Mr Chairman for that build-up, though I fear it will only serve to create expectations likely to be dashed. The subject of my address this morning will appear from its content. That is to say, it will be rambling and formless, with very little gist, mainly a collection of nuances. To digress at once, in a typed judgment once in the New Zealand Law Reports, I once used the expression "nuances". It was said: "We will not deal with all the nuances of the elaborate argument that we heard." And this was too much for the typesetters, it was rendered: "We will not deal with the nuisances of the elaborate arguments that we heard", which was perhaps a better way of expressing the idea!

I began by speaking of friends in banking and the law and I undoubtedly have some, and value them, in both those categories and would be glad to acquire others because, in the long run, in life friends perhaps matter more than most things. But I doubt whether I will add significantly to their number this morning, and the reason for saying so is simple. For many years in a quite different field - administrative law - I have been saying that by and large it all comes down to the proposition that administrators must act fairly, reasonably and in accordance with the law. Some of those concerned with administrative law do not much like that - some academics because it makes the law seem too simple, some administrators and politicians because it makes the law seem too severe.

So it may be with commercial law in general, and the law pertaining to directors, auditors and bankers in particular. Those assuming responsibilities in the firing line in such fields are quite often heard to complain that the law is insufficiently certain, to ask for black-and-white rules as to what they should or should not do. This is, of course, really impracticable, an idle hope. In this field as well, though here only very broadly speaking, the law expects you to act fairly and reasonably with due regard to the impact of what you are doing on those closely affected, and without transgressing any more technical rules of law that may have been evolved - by statute or court decisions - to serve those broader ends. In commercial law there is no lack of these more detailed rules. They arise from the accumulated experience of practical problems thrown up by litigation and disputes over the years. Possibly some of this more technical law is not easy, but I doubt whether any significant part of it is too rigorous.

It may be worth proffering to this conference this challenge. Show us the case where, rights of appeal having been duly exercised, any director or auditor or banker has been

held liable in damages for any loss which he or she ought not fairly to bear. If such a case can be shown, I for one, and I imagine all my New Zealand judicial colleagues (they may be tougher in Australia, of course), would be entirely ready to re-examine any court evolved doctrines to see whether or not they are erroneous or over-strict and should be abandoned.

It is a commonplace that a rule which is certain in its application is much easier to apply than a rule which allows for judgment and justice in the individual case. Thus in England now strong debate is in progress over whether life imprisonment should remain the mandatory judicial sentence for murder, leaving the executive government free to exercise full discretion on the actual length of sentence to be served; or whether the judge should, on evidence and submissions publicly heard and sifted, determine at least the normal period of imprisonment actually to be exacted. That parallel is somewhat remote from the present white collar atmosphere. Yet it is relevant.

From a judge's point of view it is far easier to say that anyone found guilty of murder by a jury should automatically be sentenced to life imprisonment or that the requirement of s92 of the New Zealand Property Law Act 1952 as to a month's notice before the exercise of a mortgagee's rights should be read in a restricted way so as not to protect persons jointly liable for the debt. But, a more humane or more sophisticated society may ask for a rather deeper or more understanding judgment: and that is when the judicial function is most challenging and most exacting - and possibly most useful.

So too there are few in their private and domestic lives who in truth live by a rigid adherence to inexorable rules. When it comes to matters which touch us most deeply, we all exercise a broader judgment. Without necessarily admitting it, we do in practice temper strict codes of conduct to the dictates of human nature. Charles Lamb said that lawyers were children once. Without fear of contradiction, one can say the same of directors, auditors and bankers. Yet when they are acting as directors, auditors or bankers, they or those advising them quite frequently are heard to say that they yearn for the imposition of rules of liability that above all else are certain: so that they "know where they stand". There is a danger though that carried too far this legitimate feeling could degenerate into a form of opting out of responsibility, a willingness to settle for an easy "rule of thumb" solution rather than a just one. Certainty is a good thing in commercial as in other fields, but to borrow a phrase from Lord Atkin, in a different context, justice is a better.

Still, in commercial relations, what is fair or just can be especially difficult to decide. Ramifications are such that a main element in fairness is that all concerned should understand and be bound by the ground rules. Perhaps it is in how precise the ground rules should be that the eternal debate will exist. It will be of interest to find out at this conference whether there is any respect in which the ground rules have become too onerous, all things considered, for bankers, auditors or directors.

On the bench where for the time being I sit in Wellington, my colleagues and I see a constant stream of commercial cases, as well as of course a multitude of cases in various other fields, but sadly, it is a sign of the times that commercial litigation and appeals in matters such as the enforcement of securities and guarantees have become much more common. One reflection that this prompts is how many grey areas there still are in commercial law after all these years. The mass of case and statute law as society grows more complex does not seem to produce more certainty, but rather more complication. Another reflection is how rarely even institutions as efficiently organised and controlled as banks seem to get everything unquestionably right with their lending

documentation and enforcement procedures. There always seems to be some irregularity which the hard-pressed debtor can argue about. Technical defences abound, we in the courts do our best to be robust; but slipshod paperwork can make it hard for us. I have not come here this morning, however, to deliver a disciplinary lecture or to complain. I am only saying that it turns out that bankers and their staff are as human as the rest of mankind.

You will not expect me, I hope, to say much about controversial issues yet to come before us in the courts such as other speakers at this conference may be expected to highlight. Judicial responsibility in an area where very large sums of money, careers and reputations may be at stake means that one must try to be scrupulous to avoid any appearance of pre-judgment. What I can more safely do is to share with you some of the relevant experiences I have had in sixteen long years in the Court of Appeal.

Before doing so, however, it will not be trespassing into the hazardous zone, I hope, to make a few comments on the pending Companies Bill, which your programme shows to have been the subject of knowledgeable discussion yesterday afternoon. Neither I, nor (as far as I know) any of my colleagues, have had any direct input into this legislation. Nor would we expect to do so. Such occasional offerings as serving judges can make on the altar of law reform have to be irregular, and like conference papers, prepared by snatching time from more directly pressing duties. In general, the Bill appears to contain useful changes in company law. In its provisions as to directors, it embodies ideas similar to those that I have been putting about commercial law generally. The criteria are expressed in terms of broad principles, not detailed rules.

Thus it declares that a director must act in good faith and in what the director believes to be the best interests of the company. Also the director must exercise a power for a proper purpose. Clauses 109 and 111 so state. These statements are truisms, but none the worse for that in a measure which, although rightly not excluding concurrent common law (clause 116), will inevitably serve to a large extent as a code. I agree with what the Law Commission say about the likelihood that the courts will regard the Act as the text of first resort (pp xxii-xxiii, Report No 16, 1990). I am disposed to agree, however, with the explanatory note to the Bill that the Commission's suggestion of a hierarchy of duties, is best avoided. One cannot safely postulate that a duty to that elusive and developing concept "the company" will always be more fundamental than a duty not unfairly to prejudice a particular class of shareholders - or even creditors. The suggestion that it is wrong or unwise to declare that a director must act for a proper purpose seems surprising. Admittedly the concept of proper purpose must be fairly elastic, but surely it would be unacceptable to leave directors free to act for an ***improper*** purpose.

The Bill does not include the Commission's proposal that, subject to limiting clauses in the constitution of the company, the director must have reasonable grounds for a belief that what is done is in the best interests of the company. Probably though this difference is of small practical importance, as clause 115 provides in any event that directors must exercise reasonable care, diligence and skill. On that point the Commission and those responsible for the Bill are happily and, I believe, rightly agreed.

It is understood that representations have been made to the Justice and Law Reform Committee of the House of Representatives by some responsible and influential lawyers with a view to substituting a more complicated, yet lighter test, of in effect gross negligence. Reference has been made to a Business Judgment Rule in the United States and a somewhat similar proposal under consideration in Australia. But have not

the Bill and the Commission got it about right? Reasonable care in all the circumstances is hardly an onerous standard and in practice it will fall to be applied by judges (not juries) who are unlikely to be swayed to find for plaintiffs by sympathy.

It would seem too that the Bill is justified in expecting specialist directors to show the reasonable expertise required in their particular field. After all, it is usually because of their special qualification that they have become directors. On the other hand, as a safeguard against any possibility that the declared duties may operate stringently in individual cases, it might be better, as the Commission proposed, to carry forward the existing power of the courts to grant relief. Indeed it is arguable that the requirement to show reasonableness as well as honesty as a condition of relief, (Companies Act 1955, s468) is not quite logical and could be dropped.

After that foray into the future, let me return to the past and the safety of anecdote. The longest hearing of any appeal in the New Zealand Court of Appeal so far has been one lasting eight weeks. It produced a judgment of exactly 100 pages, very long indeed by our standards, but not quite as extraordinary by current High Court standards, (I refer to the High Court of New Zealand, of course), while for the current Labour Court, it seems, no eyebrows at all would be raised. That judgment is not reported and there was ample justification for not reporting it, since it turned mainly on the facts (although, by the way, the same can probably be said in the end of the great majority of cases). It is a judgment of a court presided over and given in the name of the President of that day, Sir Clifford Richmond - surely as accomplished and analytical lawyer as any this country has produced. The other members happened to be myself, as the then junior permanent Court of Appeal judge, and Mr Justice White, now in retirement Sir John White, who was the High Court judge seconded at that time to join the Court of Appeal for criminal cases. The case arose from appeals against convictions and sentences after a trial lasting nearly three months before Mr Justice Somers - later a member of the Court of Appeal and now Sir Edward Somers and in manifestly happy Canterbury retirement - before a judge and jury. The trial took place in Auckland - there is nothing unusual in that. What was unusual was that the Court of Appeal sat in Auckland, in the now discarded Princes Court premises for the hearing of the appeal, largely because of the roomful of documentary exhibits. It was an experience from which one learnt a range of lessons, one of which is to be found reflected in the New Zealand statute books. The defendant in most cases tried on indictment now has the opportunity of applying for trial by judge alone. It was the ***JBL*** case in 1978 and I must be careful in talking about it for there may still be unhealed wounds. Many people lost money in the collapse of the companies and the principal protagonist made the expiation of serving a sentence.

Reading the ***JBL*** case judgment again for the purpose of this session, it was borne home on me how many years I have been slaving away on the bench and in the legal profession, and what changes there have been in that time. New Zealand lawyers present in the audience will realise what I mean when I say that one of the appellants in that case was represented by Mr R.K. Davison QC. Well the wheel has turned quite a lot since then.

As seems often to be the case in major investment company failures, the central figure was evidently a strong and dominating figure, practising a thoroughgoing business philosophy. As it is put in the judgment, and we thought carefully before venturing on anything which could seem even slightly lighthearted for it was a very serious case. "The mere thought of an unencumbered asset or an idle credit of any kind appears to have been anathema to him." But he believed, and there are still quite a lot of others who say

he was right, that if his plans for expanding the group overseas, and he had already expanded to an office in Macquarie Street, and activities in Australia, and he was about to expand into England - that if he had been not interrupted in that, all would have come right in the end. Interrupted they were, however, by a receivership, one bank taking this step because, contrary to an arrangement, a certain cheque was not paid into an account with it, but into an account opened with another bank. Banks, understandably, do not like that sort of thing.

I do not propose to discuss the case in so far as it concerned the main defendants, but it is worth making the point that as regards the other defendants - who might be described somewhat loosely as the professional directors - the court found it necessary to take the comparatively, indeed very unusual, step of setting aside the jury verdict. There were a number of charges, but the most serious were conspiracy to mislead the investing public by falsely representing that the group companies were in a sound financial position. Those were the words of the indictment. There was much debate in argument about what is a sound financial position. The difficulty of retrospectively pinpointing with reasonable accuracy what was a company's position at a particular date - and, even more importantly how it appeared then to an individual director - causes one to question whether the solvency test in the Companies Bill is going to be sufficiently easy to apply.

In the end, however, the court was satisfied in the ***JBL*** case that the position had become so precarious that the jury were fully entitled to find unsoundness, whatever exactly that term may mean. The case against the professional directors foundered on the nature of the charges. The prosecution had elected to charge conspiracy, but there was a lack of evidence of the extent to which these defendants had been taken into confidence, while the possibility that they conspired ***inter se*** without the key figure seemed wholly unreal. The verdict may have been partly able to be explained by the circumstance that the Crown had called a sequence of unfortunate investors who had lost money in the crash, probably including (I do not now remember) widows, certainly including orphans (I am an orphan myself and such people attract my sympathy). We thought that there was some risk that the jury, who had an almost impossible task - bear in mind that there was literally a roomful of exhibits for the Court of Appeal to pore over - in a case quite unsuitable for trial by jury, might not have been able to concentrate on the true issues. As already mentioned, that position at least has been put right by the introduction into the Crimes Act of a provision giving the court power to order trial by judge alone on the application of the defendant or by consent; and quite a number of such trials, regrettably, there have been.

Of other relevant cases which I happen to have been involved in, I have the impression that you might like a few words to be said about two in particular - ***Scott Group Limited v McFarlane*** ([1978] 1 NZLR 553) and ***Nicholson v Permakraft*** ([1985] 1 NZLR 242).

In ***Scott Group*** there had been a takeover of a public company whose duly filed accounts showed it to be asset-rich but somewhat disappointing in current earnings: a classic target for a takeover. The auditors made the elementary mistake of accepting the counting of a certain asset twice for the purposes of the certified balance sheet. The purchasing company which undoubtedly had relied on the filed accounts, claimed that it had paid too much. In the purchasing company's action against the auditors, negligence was ultimately not seriously in issue: the real issues were duty of care and damages. Four judges considered the case. Possibly no two of them were completely agreed, but the view of Quilliam J at first instance, that there was no duty of care, was shared by Richmond P on appeal, on the ground that there was not a special relationship or an assumption of a duty by the auditors to the particular purchaser, of

whose intentions they had no knowledge. Sir Owen Woodhouse and I took a different view: there was a plain risk of a takeover by someone, and the virtual certainty that in that event the certified accounts would be relied on. The auditors had not disclaimed liability to persons other than the company or its members, which appears to be perfectly possible.

Nevertheless, the appeal failed because it seemed to me that the purchaser had suffered no damage recoverable in tort. The shares acquired were truly worth the price paid, so there was no loss. It is true that the profit would have been greater if the accounts had been correct, but only if there had been a contract between the purchaser and the auditors would the purchaser have enjoyed a right against the auditors to be put in that position. Woodhouse J took a broader approach to damages and it appears that Quilliam J might well have done the same if he had found a duty of care. Let it be freely acknowledged that in insisting on the tort measure and possibly a conservative application of it, I had in mind the desirability of a control mechanism to prevent such actions getting out of hand.

The decision of the majority of the Court of Appeal in ***Scott Group***, that the certifying auditors were under a duty of care to a takeover purchaser, having regard to the degree and magnitude of the risk, may well represent the current law of New Zealand. The House of Lords has taken a different view in ***Caparo Industries plc v Dickman*** ([1990] 1 All ER 568). It is conceivable that the New Zealand Court of Appeal may be asked at some stage by some litigant to change the law of New Zealand to adopt the House of Lords position. You will appreciate that I should not comment on any such issue.

Nicholson v Permakraft arose from an action by a liquidator in the interests of unsecured creditors to recover from the directors the amount of a capital dividend paid out some two years before the company failed. In the High Court White J upheld the liquidator's claim of breach of duty and declined to grant relief to the prime movers. The hearing of the appeal was at one stage adjourned specifically in order to give counsel the opportunity of preparing further submissions on the issues of philosophy or policy involved. The court had the benefit of careful arguments from Mr Ian McKay and Mr Richard Craddock QC. In the end the appeal succeeded on the facts: at the time of the distribution the company was apparently solvent and the decisions of the directors were reasonable and not unfair to creditors. That different assessment of the facts between the trial and the appellate court brings out how finely balanced these issues revolving around "solvency" can be in marginal cases. If it turns out that the company was in truth insolvent, the distribution has been at the expense of creditors. In the light of the arguments and the authorities, I essayed some general propositions in my judgment but my respected colleagues were more cautious.

The Companies Bill seeks to cope with this problem by a solvency test, coupled with a requirement of belief by the directors on reasonable grounds that it is complied with. It may well be that this will produce substantially the same practical result as any of the ***Permakraft*** judgments. I have already predicted that it will not be easy to apply. But perhaps it is the best that can be done. The other point to be mentioned about the Bill in this connection is that it was noted in ***Permakraft*** (at 250) that in particular circumstances directors or their company could so act as to come under a duty of care to particular creditors under ordinary common law principles. There appears to be nothing in the Bill to exclude this possibility.

In the draft programme which I received some time ago, there was mentioned that this morning some time would be allowed for questions from the floor. I wish rather to take

the opportunity of exploiting a captive expert audience by seeking ***answers*** from the floor. And answers to a problem which we struck only this week in an appeal heard on Tuesday; please tell me how we should decide this case.

The defendant is an agricultural consultant: he carries on a consultancy practice advising on farm matters. He carries on business through his one man company. So as not to expose him to undeserved publicity, let us give him a fictitious name and call him say, Salomon. He had a long-running contract made in the name of his company, A Salomon Limited, to advise the plaintiff, who is a Queen Street farmer. The plaintiff's raspberry crop was coming on well, but there was a problem with couch grass. Those of you who are gardeners will know that Round-up is a powerful herbicide, well suited to kill couch grass, but having the same effect on raspberry plants! Salomon, acting under the contract between his company and the plaintiff, advised the plaintiff to spray Round-up (so the High Court Judge found on the facts) without telling the plaintiff to mow near and under the plants first, so that the spray would not come into contact with foliage from the plants. The crop was duly destroyed. The company is liable in contract for the negligent failure to advise properly, an omission in the giving of advice as found by the judge. Is Salomon personally liable in tort? If a clear answer is forthcoming this morning, I shall regard this occasion as amply justified.