TRANS-TASMAN REGULATION OF FINANCIAL INVOLVEMENT OF DIRECTORS - The Aftermath of the Corporate Collapse

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INTRODUCTION

It gives me much pleasure to be on the platform following Tony Hartnell, the Chairman of the Australian Securities Commission, because of the traditionally good relationship that has existed between our two Commissions. We have certainly enjoyed the co-operation of the Australian Commission on many fronts, particularly in recent years, with the degree of cross-Tasman involvement of our countries. There has been a degree of mutuality between our two Commissions which is to the benefit of us here in New Zealand.

Tony did mention to me as we chatted briefly before the session this morning some of his problems and one of them being the problem of knowing where to spend money. I assured him that that was not a problem that I faced at all in New Zealand and I was interested to see in his opening remarks that he referred to progress on three bills currently before the House in Australia which makes me only sadly reflect on the fact that we have a great deal of difficulty with one Bill here in New Zealand at the moment. Of course I refer to the Companies Bill and getting further progress on that. That is a Bill that I want to return to in the course of my address this morning.

It was with some trepidation that I agreed to address a gathering of particularly bankers and those involved in the financial sector at this time in New Zealand when one has regard to the rather traumatic events that have affected the financial sector in New Zealand, over the last two or three years. But I was heartened by news coming from Australia over the last few months since then which means that we are at least in good company and are not on our own in some of the problems that this sector has been facing. I think the value of a conference like this is that it does help us to share our experience and to move forward from that.

THE IMPACT OF THE SHAREMARKET CRASH OF 1987

I think if you look back over the last three years since the events of October 1987 there can be very little doubt that the share market crash at that time has had a major impact on the New Zealand share market and indeed on all our public companies. I do not think any other market has suffered quite such a sustained collapse of confidence as we have had in New Zealand. The facts published by the New Zealand Stock Exchange

speak for themselves. The graph in Appendix I graphically indicates the performance of our markets since 1986 through to 1990 - taken from the Stock Exchange annual report at the end of last year. It is heartening to know that the graph is beginning to move up again. I am sure those here who are involved in the Telecom float are particularly heartened to notice that. The graph in Appendix II also reflects sadly on recent events in New Zealand, again from the Stock Exchange annual report. The graph indicates the very marked reduction of capitalisation on our Exchange and of funds which have been raised not only in equity issues, but in debt issues also. If our economy is going to move forward again in New Zealand we have got to reverse that trend. Some of the thinking that comes out of this weekend might help to throw some light on that situation.

It would be naive for me to suggest that inadequate regulation is the only reason for this sustained loss of confidence in the New Zealand sharemarket, but it is certainly clear that small and indeed not only small but institutional investors are staying out of the market. A succession of horror stories to emerge at periodic intervals after the 1987 crash provide examples of inadequate financial reporting, abuse by directors of their position, the exiting from companies of controlling shareholders on an unequal basis, and these have received wide publicity. It would be difficult to suggest that they have not contributed in some way to the mood within the market. Indeed, it would be interesting if someone did an analysis of our market performance against some of the significant events that have occurred over the last three years at certain significant points in our market graph and it would be interesting to plot the curve against them.

Putting in a plea quite recently, Mr Paul Collins, one of our leading company directors said this: "We have seen disgraceful things happen in Australia and New Zealand during the past four years. And people are saying that nothing is being done about it. So let's beef up the laws. It is at boardroom level where regulations can be enforced, where the policing of management should happen. They have got people on various charges at the moment that are nothing to do with the real disgraces. Only a fraction of what we all know." Mr Collins there seems to be saying that we have a very sad story to tell in New Zealand and a lot of it is yet untold. But he also goes on to put the responsibility very firmly on boards of directors and to say that is where the heat needs to go and if you have the right decisions being made at that level that the situation will correct itself. Mr Collins does not see greater regulation or better laws as remedying the situation. That is perhaps something that we could consider in our discussion later. Is better policing at boardroom level sufficient or does this have to be backed by a legal regime - by a statement, a prescription of standards and some procedures for enforcement?

Since 1987 we have in New Zealand taken some hesitant steps to review the law relating to companies and securities regulation. The only legislation to be enacted so far in the securities area is the Securities Amendment Act 1988 which deals with insider trading in relation to public issuers and also the introduction of procedures for disclosure of interests held by substantial security holders. Included in that legislation is also a regime which I will touch on later for the regulation of the futures market.

In addition, we have had legislation dealing with the prosecution of fraud in the corporate sector, the Serious Fraud Office Act 1990, and we have also had legislation providing for the administering of companies under threat - the Companies Investigation and Management Act 1989. But I do not propose to go into that legislation here.

We now have a Companies Bill which provides a complete overhaul of the Companies Act 1955. It is now before parliament and before a parliamentary select committee. The focus of this session will be on some of the provisions of that Bill which I think provides

quite a radical restatement of approach, quite a new approach to dealing with directors' interests, directors' remuneration and loans, and financial involvement on the part of directors.

I think it is in that area that there have been particular concerns on the part of investors. I think if one was to take a survey of investors the principal area of concern would be the area of abuse or misuse by directors of their position, particularly in relation to financial involvement. And there have been far too many instances in New Zealand in recent years of manipulation of companies' assets and of corporate information for reasons of personal advantage or prestige or power struggle. And we have seen them not only on this side of the Tasman. These have often been facilitated by the ready access that there was, at least prior to 1988, to borrowed money.

MISUSE OF THEIR POSITION BY DIRECTORS

The revelations continue to come through. I do not need to touch on some of the cases that are currently before the courts and some which have recently been the subject of court judgment. Perhaps I will mention one, and that is the recent decision of Mr Justice Anderson in ***Kerrindale Finance v DFC Ventures*** (CP 1080/89 11 April 1991, Auckland), the case where the judge was particularly critical of the conduct of a former chairman and managing director of DFC, and it was a case of a financial advantage to the chairman in relation to the transaction which the court was examining.

I believe that New Zealand is entitled to a better standard of performance from its leading directors and I think that the provisions of the Companies Bill being directed to that end really do deserve careful study.

DIFFERENT LEGISLATIVE APPROACHES

It is here I think that there is a difference in approach between Australia and New Zealand. It is interesting if one thinks back to one's student days when our company law developed generally in the same stream. Indeed when I first lectured in company law it was to Australia and to the various reports that were coming out of the Eggleston Committee that we looked in New Zealand for guidance and we tended to follow the pattern that was emerging there - both of our systems being based on the earlier United Kingdom legislation.

But there has been a divergence since. In Australia the approach is highlighted by the recent Corporations Law referred to by Mr Hartnell. There we have what one could call a "black letter" law approach - some 1557 sections of a prescriptive nature in two large volumes, dealing in a detailed way with the regulation of companies and the way they are to operate in the various types of market: the securities industries, the futures market and so on.

Contrast the position with the approach now being taken in New Zealand. The Law Commission's Draft Companies Bill and indeed the Bill introduced into parliament in New Zealand has only 285 sections (although if one had to make a fair comparison of course with the Australian legislation you would have to include reference to the 70-odd sections of the Securities Act and schedules to that Act and possible further legislation dealing with takeovers which are included in the Australian provisions). But even when you include that additional legislation the comparison is obvious. The New Zealand approach is one where there is a tendency to rely to a much greater degree than in Australia on self-regulation by market institutions with the Securities Commission having

a sanction through an authorising and a monitoring role. One can see that in comparison perhaps with the Securities Industries Act in Australia with the absence of corresponding legislation here and the entrusting of that area to a large degree to the Stock Exchange. Again, in relation to the futures industry, there is a substantial Futures Industry Code across the Tasman. Compare that with Part III of our Securities Amendment Act, just a few sections giving the Securities Commission power to authorise a futures exchange and regulate those persons who can practise within the industry and leaving it to a substantial degree to the Exchange itself to administer.

When we look at the legislation in this area we note again the difference in approach. In New Zealand the Companies Bill does follow the Australian approach by now enacting a statement of directors' fiduciary duties and there has been some debate in New Zealand which I will not go into at this point between the differences in approach between the Law Commission and the new Companies Bill.

STATEMENT OF DIRECTORS' FIDUCIARY DUTIES

We have in the new Bill a legislative statement in relation to fiduciary duty in clause 109. We have clause 123 which makes legislative provision in regard to the use of corporate information, and clauses 124 and 125 in relation to directors' share dealing.

So we have followed the Australian pattern to that extent by including in our new legislation a statement as to the fiduciary obligations of directors. I believe that regulation in this area in New Zealand has been generally welcomed. As I have mentioned, the events of the share market crash threw the focus particularly on misuse by directors of their position and there has been a need for parliament to respond.

I throw out the question as to whether there is the same need for legislation in the area of directors' duty of care. There has been a good deal of debate in New Zealand over the provisions in the Companies Bill dealing with the duty of care and whether too high a standard of care is expected of directors in the statements that appear in the Bill. I do not want to go into that area in my paper because I want to look more closely at remuneration and loans to directors, but just to provide a personal view it does seem to me that a company law which contains no statement and left it entirely to the courts to develop the law in relation to the standard of care of directors would be failing in its function. I think we do need to clearly indicate to boards of directors that there are certain levels indeed in the area of care as well as in the area of honesty and fiduciary duty which need the backing of a legislative statement. But at the same time I think the legislation does need to make it clear that as Mr Hartnell pointed out in the old case of ***Dovey v Corey*** ([1901] AC 477), there is a large area of business judgment and business decision and risk taking which ought properly to be left to the judgment of the board, and that it is going to unnecessarily restrict enterprise and inhibit persons from taking office on the boards of our companies if we are to move too strongly into that area of business judgment; the legislation needs a statement to make it clear that there is a freedom for decision making in that respect.

REMUNERATION AND LOANS TO DIRECTORS

I now want to move on to look briefly at two sections that we have in our New Zealand legislation which I think are of particular interest - these are two provisions in the new Companies Bill. The first dealing with remuneration and loans to directors. Our Bill here takes a very new approach and I think it contrasts really with that which Tony Hartnell mentioned in his paper where in responding to the apparent need for increased

regulation in this area the Australian approach has been that the present provisions are inadequate and need to be expanded. The specification needs to cover new situations. The Law Commission and the Companies Bill take quite a different approach. In the new clause 136 very considerable discretion in this area is given to the board of directors. The board of a company, subject to any restrictions in the Constitution, may authorise payments of remuneration, compensation for loss of office, and loans to directors or the giving of guarantees if the board is satisfied that the making of the payments or loans of the giving of the guarantee is fair to the company.

This brief section also requires that disclosure must be made in what is called the "Interests Register" which every company must keep in which directors' interests are to be recorded and that register is to be made available at annual meetings of the company and can be searched by shareholders. Directors who vote in favour of authorising the payment or the loan or guarantee are to sign a certificate stating that in their opinion the entering into of the contract is fair to the company and the reasons for that opinion. If these procedures are not followed or if there were no reasonable grounds for the director's opinion, the director who has received the benefit under the transaction may be held personally liable in civil proceedings to the company for the amount received by him or her except to the extent that he or she proves the payment, loan or guarantee was fair to the company at the time it was made or given.

In other words, the Law Commission's approach here is to remove the existing prohibition on loans to directors and confer on the board freedom to make loans or give guarantees and the directors then take the risk that if the transaction is not found to be fair and reasonable it may be challenged by shareholders with the risk to the director concerned that the transaction may be set aside.

So the responsibility goes on the board. I can hear Mr Collins perhaps applauding at that point. It is no longer necessary in the Law Commission's approach for the general meeting of shareholders to approve payments or the level of remuneration to boards of directors. I expect the Stock Exchange is going to have some views on that matter and will no doubt require levels of remuneration to be approved at general meeting level, but unless required by the Company's Constitution it is not required in terms of the Companies Bill. Directors therefore are in a position where they face the music if they provide a certificate which can later be challenged and it can be shown - and the onus in this respect generally rests on the shareholder concerned - that the transaction is not fair or reasonable.

The clause I think is too narrow in its scope at present and I take up Mr Hartnell's point in relation to the Australian legislation that there is a need to expand into the range of financial transactions. Recent events I think have shown us just the very wide respect in which the net needs to be thrown. So the clause does need to cover, for example such matters as the use of the company car, superannuation benefits, purchase of goods at a discount, allocation of shares under a share scheme, and so on. And I think if there is to be consistency in the Bill then these additional forms of non-cash benefits have got to be brought into the clause.

If that were done I can almost hear the gravelly voice of our former Chairman, Mr Patterson, in his comments on a celebrated decision of our courts or one that he regarded as celebrated, and that was ***Holt v Holt*** ((1987) 3 NZCLC 100107), where a governing director took a very substantial benefit by reason of having a controlling A share from the company. The Court of Appeal there stated in one of its judgments: "The controlling shareholder is not entitled in law to oppress the others, but there is a middle

area where he can cultivate the company for his benefit." I think the opportunity to cultivate the company for the directors' benefit is going to be much more limited under the new regime.

OTHER SELF-INTERESTED TRANSACTIONS

I shall touch just momentarily on another very interesting section which is that dealing with other self-interested transactions. The proposals of the Law Commission have here been adopted in clauses 117 to 122 of the Companies Bill. These clauses again require disclosure and entry in the Interests Register, and then go on to provide that the company may avoid an interested transaction within three months of a transaction being disclosed if the company does not receive fair value under it. Whether or not the company receives fair value is a matter to be determined on the basis of information known to the company and to the interested director at the time the transaction was entered into.

Again, it should be noted that there is no provision for the general meeting of shareholders to consent or ratify actions by the board of this kind. Shareholders cannot consent to a director benefiting from a transaction by receiving more than fair value under it. Unanimous approval of shareholders would be required to do that. A minority therefore cannot be overridden under this particular scheme. I think it is doubtful that many company directors realise the radical nature of these proposals. The board on the one hand is given complete freedom. It is constrained only by the need to disclose in the Interests Register and to the board and then the risk is taken that if the transaction be unfair it may be set aside. I can see a great deal of controversy arising of course in determining whether or not a transaction is unfair. Those are slippery words, and I think that the courts may well have difficulty in individual cases. One could refer to one New Zealand decision, that of ***Floral Holdings Ltd v Rothmans Industries*** ((1986) 3 NZCLC 99832), a conflict of interest allegation. It would be extremely difficult on the facts of that case to determine whether of not there was any unfairness. The director certainly received a benefit but then so did the company.

IS THERE A ROLE FOR THE SECURITIES COMMISSION?

Finally, in all of this is there a role for the Securities Commission? I can hardly stand here and ignore that question. The Companies Bill relies on shareholders to take advantage of the higher standards of accountability imposed on directors, and the process in the Bill here is by seeking appropriate relief through the courts. I suggest that the experience in New Zealand under existing legislation which has left shareholders to assert their rights through the common law, has not been encouraging. The Companies Bill does provide for improved enforcement procedures by way of personal actions against directors and representative actions (clauses 143 and 149). But I question whether that is enough? The question I throw out in the final section of my paper, and I will have to leave you to brood on for yourselves, is whether there may be a role here for the Securities Commission? These I hasten to indicate are my own thoughts and are not those of the Commission as a whole. So I am flying something of a kite at this point, by suggesting that there is a role here for the Securities Commission, can we remain with Mr Collins in the area where we put the heat on the board of directors and leave it to them to get things right, or do we need the involvement of a regulatory agency which can in appropriate cases approve the appointment of a barrister or solicitor to provide an opinion on whether reasonable cause of action exists on the basis of which the company could be required to take action? I refer in my paper to the kind of procedure which exists already in the Insider Trading provisions of ss17 and 18 of the Securities Amendment Act 1988, but I emphasise again that those are my thoughts and I certainly welcome your reaction to them.

APPENDIX I

NEW ZEALAND STOCK EXCHANGE

Changes to capital

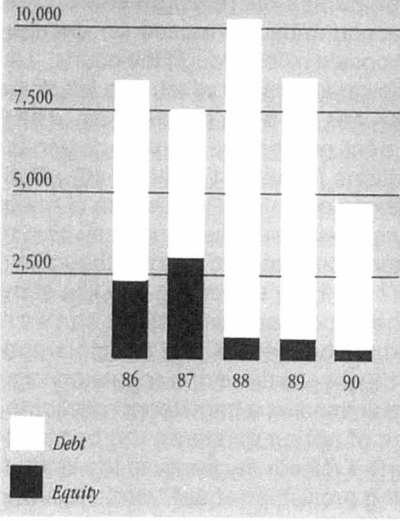
During the year ended 31 December 1990

SUMMARY OF 1990 OVER 1989

- *The value of equity raised by pro rata cash issue declined 69% from $821 million to $255 million.*
- *The value of equity raised by new issues declined from $258 million to $29 million.*
- *Funds raised by the issue of debt securities declined by 47% to $4442 million.*

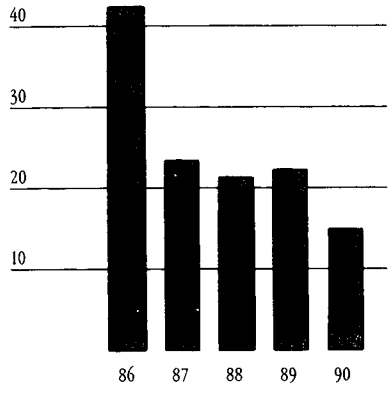
Equity and debt raising

(By year – $ millions)



APPENDIX II

Market capitalisation
(At 31 December. In $ billion)



NZSE Gross Index
(At year end. Base - 30 June 1986 = 1,000)