Corporate Governance and the Regulation of Conglomerates

Commentator:
Rob McInnes
Partner
Minter Ellison Rudd Watts
Wellington

INTRODUCTORY COMMENTS

Time constraints necessarily mean that I must be selective in my commentary on Professor Baxt's paper. In view of that, I do not intend to comment materially on either:

what Richard Coleman has said regarding the Financial Services Reform Act ("FSRA");

or

much of what has been said by Professor Baxt on recent case law developments in connection with the difficulties confronting directors with conflicting interests.

FSRA: While I do not intend to comment on the impact of the FSRA, for the benefit of those conference delegates who (like me) are New Zealanders, I note that although there is no suggestion at present that legislation similar to the FSRA will be enacted in New Zealand, it is realistic to expect that the points that Richard Coleman has made regarding FSRA will impact on practices within New Zealand banks and financial services organisations. In particular:

- of New Zealand's five main banks, four are, or are owned by, an Australian bank (Westpac, ANZ, BNZ/NAB, ASB Bank/CBA);
- many of the directors and senior management of New Zealand banks are Australian bankers;
- despite the different regulatory and prudential regimes applicable to New Zealand banks, group policies in areas such as risk management may mean that New Zealand practices will be influenced by the requirements of the FSRA, and the issues that Richard Coleman has addressed.

Directors Duties: With regard to the conflict issues that confront directors, the Companies Act 1993 (NZ) is not a code, and much of the case law which Professor Baxt has addressed is likely to influence the development of the law in New Zealand. My comments will therefore focus less on the case law, and more on the New Zealand statutory provisions Professor Baxt has mentioned.

My Principal Focus: Having regard to those matters, I intend principally to focus on two areas in respect of which I hope that a New Zealand perspective may be useful to conference delegates. They are:

New Zealand case law developments in respect of the conflict-related issues which Professor Baxt has mentioned, as they may affect conference delegates that are lawyers;

the New Zealand statutory provisions regarding directors duties in respect of the issues which Professor Baxt has addressed.

THE CONFLICT ISSUES IN PROFESSIONAL PARTNERSHIPS – THE NZ PERSPECTIVE

Professor Baxt has already referred to the decision of the House of Lords in *Prince Bolkiah v KPMG* [1999] 2 AC 222 ("*KPMG*"). As the New Zealand Court of Appeal has adopted a different approach to the issues from that which found favour in *KPMG*, I hope it may be of interest if I expand on the New Zealand approach.

The divergence between *KPMG* and the corresponding New Zealand case law begins within a condensed time frame. The decision of the House of Lords in *KPMG* was given on 18 December 1998, slightly less than 4 months after the decision of the New Zealand Court of Appeal in *Russell McVeagh v Tower Corporation* [1998] 3 NZLR 641 ("*Russell McVeagh*"). In that four month period, *Russell McVeagh* was first followed by the English Court of Appeal in *KPMG*, and then disapproved by the House of Lords in the same case.

The facts in *Russell McVeagh* can be summarised as follows:

- In 1995, the Wellington office of Russell McVeagh was instructed by Tower Corporation to advise on a taxation issue.
- In 1996, the Auckland office of Russell McVeagh was requested by Guiness Peat Group ("GPG") to advise on a proposal which, if successful, would have resulted in a reverse takeover of Tower.
- The Wellington and Auckland offices of Russell McVeagh conferred, and decided there was no conflict preventing them from acting, bearing in mind the comparatively specific nature of Tower's taxation instructions.
- Russell McVeagh completed Tower's taxation instructions by April 1997. GPG's proposal did not develop to the stage that it came to the notice of Tower, until September 1997.

- Tower commenced proceedings seeking an injunction to prevent Russell McVeagh from continuing to advise GPG, including because the tax-related information known to Russell McVeagh due to their earlier instructions from Tower might be of benefit to GPG.

In the High Court, an injunction was granted to restrain Russell McVeagh from acting for Tower, essentially on the basis that while the Court appears to have felt that there was little risk of confidential information held by Russell McVeagh becoming known to GPG, nevertheless a reasonable person might perceive such a risk, which the High Court considered to be a sufficient basis for an injunction.

The Court of Appeal allowed Russell McVeagh's appeal against that decision. In doing so, the Court of Appeal considered that the test to be applied was whether there was any "real or appreciable" risk that confidential information previously received by Russell McVeagh from Tower might be disclosed to GPG. After considering the measures put in place by Russell McVeagh to prevent that from occurring, the Court of Appeal decided that no real or appreciable risk of disclosure existed.

The Court of Appeal held there was no presumption for, or against, a law firm continuing to act in such circumstances, and was willing to review the nature the information held on file by Russell McVeagh and the firm's internal procedures, before concluding that there was no "real or appreciable" risk of disclosure[1].

In reaching that conclusion, the Court of Appeal had regard to the comparatively small size of the New Zealand market for legal services, and noted that:

> *"New Zealand is still comparatively small, and in some professional areas the availability of expert advice is limited. That availability should not be unduly restricted by Court-imposed control or sanctions which are not required in the overall interests of justice to protect individual rights."*

I will return to that comment later, but at this stage note that while New Zealand is a relatively small jurisdiction, it is nevertheless larger than some Australian States, for whom the approach of the New Zealand Court of Appeal in *Russell McVeagh* may therefore be of particular interest.

As noted above, within 4 months of the decision in *Russell McVeagh*, *Prince Bolkiah v KPMG* was decided by the House of Lords, which rejected the approach of the New Zealand Court of

[1] A feature of *Russell McVeagh*, which I have not noticed in any other decision, was that the firm no longer held Tower's file, it having been moved to the High Court and made subject to a suppression order. The inability of the firm to physically access the detail on file was clearly a factor influential with the Court of

Appeal in *Russell McVeagh*. In delivering the principal judgment in the House of Lords, Lord Millett said:

> *"I would also reject the approach taken by the New Zealand Court of Appeal in Russell McVeagh McKenzie Bartleet & Co v Tower Corporation, 25 August 1998 and adopted by the Court of Appeal in the present case. In my opinion the balancing exercise which was undertaken was inappropriate."*

Instead, the House of Lords appears almost to have adopted a presumption against professional firms, of the kind which the New Zealand Court of Appeal had declined to recognise. Thus Lord Millett stated that:

> *"...the Court should intervene unless it is satisfied that there is no risk of disclosure"*

and noted that a professional firm finding itself in this position had a "heavy burden" to discharge in showing that no such risk existed.

Undertakings to maintain "chinese walls" so as to protect confidential client information were amongst the factors taken into account by the New Zealand Court of Appeal in *Russell McVeagh*. However, the House of Lords adopted a more pessimistic approach to the ability of professional firms to successfully maintain "chinese walls", saying:

> *"There is no rule of law that chinese walls or other arrangements of a similar kind are insufficient to eliminate the risk. But the salient point must be that, unless special measures are taken, information moves within a firm."*

Consequently, the "chinese walls" promised by KPMG were held insufficient to allow them to continue to act for the Government of Brunei in respect of matters potentially connected to those on which they had previously advised Prince Bolkiah.

There are thus clear differences between the approach of the New Zealand Court of Appeal in *Russell McVeagh*, and the approach of the House of Lords in *KPMG*. They continue to exist in New Zealand, as I will illustrate below.

Australian case law since 1998: The only case since 1998 in which an Australian Court had to decide whether to follow the *KPMG* approach or that in *Russell McVeagh*, appears to be the decision of the Supreme Court of Western Australian in *Newman v Phillips Fox* [1999] WAR 309 [2]. Notable aspects of the *Newman* decision include –

Appeal. In the words of Henry J, "retention in memory .. of these particular figures... would seem as a matter of common sense to be extremely remote."

2 I exclude the interesting *Spincode* decision mentioned by Professor Baxt, as it was decided on different principles from those in *KPMG* and *Russell McVeagh*.

the issues arose as a result of one party's lawyer joining the firm acting for the other party, effectively bringing the sensitive knowledge with him[3];

the Court followed the House of Lords in *KPMG*, and held that to prevent an injunction being granted, there must be "no risk" of disclosure of confidential information.

While the court did not expressly disapprove of *Russell McVeagh, Newman* may suggest that the Australian Courts will prefer the stricter approach of *KPMG* to the approach taken in New Zealand in *Russell McVeagh*.

What has happened in New Zealand since 1998: There have been two striking features of the post-1998 New Zealand experience in this area –

after *Russell McVeagh*, the New Zealand Courts have shown a willingness to evaluate the facts and reach conclusions both as to the likelihood of client information being leaked, and as to the relevance of the original client's information to the subsequent instructions;

perhaps surprisingly given that *Russell McVeagh* is if anything "pro-lawyer", actions in which an original client seeks to prevent its former advisors from accepting subsequent instructions from another party appear to have increased.

With regard to the latter point, delegates may find the following decisions to be of interest:

Clear Communications v Telecom Corporation of NZ (1999) 14 PRNZ 474;

Crichton v Harteveld (High Court of NZ, Christchurch Registry, 4 July 2000, CP 178/99);

Browse Petroleum Pty Limited v Cue Energy Resources Limited (High Court of NZ, Wellington Registry, 17 May 2001, CP 37/01 and CP 83/01).

It is of interest to note that those decisions involved three of New Zealand's largest law firms, while the *Russell McVeagh* decision and the *Equiticorp* case footnoted above involve another two. Collectively, that suggests that only one of New Zealand's 6 largest firms appears not to have been involved recently in litigation of this kind.

In my view, that tends to confirm that the Court of Appeal in *Russell McVeagh* was correct to observe that to adopt a less flexible approach of the kind taken in *KPMG* might, in a relatively small jurisdiction, ultimately serve to limit the ability of the commercial community to access firms with relevant experience and expertise.

---

3 A situation which also arose in *Equiticorp Holdings Ltd v Hawkins* [1993] 2 NZLR 737.

DIRECTORS' DUTIES – THE NEW ZEALAND STATUTORY PROVISIONS

I turn now to comment on the New Zealand statutory provisions to which Professor Baxt has referred, and which he has described as being more generous and flexible than the corresponding provisions of the Corporations Law in Australia.

It may be useful first to set out the text of section 131 of the Companies Act 1993 (NZ)–

> *"**131. Duty of directors to act in good faith and in best interests of company***
>
> ***131(1)[Duty]*** *Subject to this section, a director of a company, when exercising powers of performing duties, must act in good faith and in what the director believes to be in the best interests of the company.*
>
> ***131(2)*** ***[Wholly-owned subsidiaries]*** *A director of a Company that is a wholly-owned subsidiary may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of that company's holding company, even though it may not be in the best interests of the company.*
>
> **131(3)** ***[Subsidiaries not wholly-owned]*** *A director of a company that is a subsidiary (but not a wholly-owned subsidiary) may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company and with the prior agreement of the shareholders (other than its holding company) act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interest of the company.*
>
> **131(4)** ***[Joint venture company]*** *A director of a company that is carrying out a joint venture between the shareholders may, when exercising powers or performing duties as a director in connection with the carrying out of the joint venture, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of a shareholder or shareholders, even though it may not be in the best interest of the company."*

Although I certainly agree with Professor Baxt when he describes those provisions as more generous than the corresponding provisions of the Corporations Law, as I hope my following comments may illustrate, section 131 has by no means eliminated the need for directors, bankers and their lawyers at all times to be mindful of the issues addressed by Professor Baxt. In explaining why, it is easiest to address each subsection of section 131 separately.

Section 131(1) – General rule: This is essentially the same in effect as section 181 of the Corporations Law, and requires no further comment.

Section 131(2) – wholly owned subsidiaries: This is much the same in effect as section 187 of the Corporations Law. If there is a difference, it is that section 187 of the Corporations Law expressly states that a director of a subsidiary company may only act in the interests of its holding company where the subsidiary company is solvent. That is not explicit in the text of section 131(2) of the Companies Act, but is effectively addressed elsewhere in the Act.

Section 131(3) – less than wholly owned subsidiaries: Section 131(3) allows directors of less than wholly-owned subsidiaries to act in the interests of their holding company even if not in the interests of the subsidiary company, **so long as** minority shareholders in the subsidiary company agree. At first sight, this certainly appears more generous and permissive than the corresponding Australian law.

However, in practice I do not think that section 131(3) has been particularly helpful to directors of New Zealand companies, to their banks, or to the legal advisors of either of them. That is because obtaining consent to the relevant action from minority shareholders is seldom easy, particularly if they are numerous. However, if consent can be obtained, in New Zealand problems of the kind to which Professor Baxt has referred may be avoided in circumstances in which they may conceivably still cause difficulties in Australia.

The *Maronis* decision[4] to which Professor Baxt has referred is a useful illustration of the limitations of section 131(3) of the Companies Act, including because Maronis was in fact a New Zealand company. (However, the provisions of section 131 did not apply, since the events at issue in the *Maronis* decision arose before the Companies Act 1993 came into force).

If section 131 of the Companies Act 1993 been in force at the time, might the result in *Maronis* have been different, if the directors of Maronis had also sought and obtained minority shareholders approval to the relevant transactions?

As to that –

the minority shareholders were not shareholders in Maronis itself, but rather in its immediate holding company, Girvan NZ. It is by no means clear whether, or how, section 131 applies to a less than wholly-owned subsidiary which does not itself have minority shareholders;

in any event, the immediate holding company of Maronis, Girvan NZ, was a listed company at the time, and the 26% minority was widely held. In all likelihood, in those circumstances it would not have been practically possible for the directors of Maronis to have sought, or to have obtained, the approval of **all** minority shareholders, which is what the section requires.

4 *Maronis Holdings Ltd v Nippon Credit* (2001) 38 ACSR 404

A further limitation on the usefulness of section 131(3) of the Companies Act (and also section 131(2)) is that while it may permit directors of a subsidiary to act in the interests of a holding company, the section is drafted so as only to apply vertically, not horizontally.

In other words, the section does not appear to permit actions by a subsidiary company that are taken in the interests of a fellow subsidiary in the same group – unless of course benefit to a fellow subsidiary involves benefit to the common holding company, as it may often do.

To illustrate, if the borrower in *Maronis* had not been the group holding company, but had instead been a fellow subsidiary of Maronis, section 131(3) of the Companies Act (NZ) may have been of no assistance to the directors of Maronis, even if it had applied at the time.

Section 131(3) is also of no assistance to a director in respect of actions that are for the benefit of another company that is not in the same group, even if ultimately controlled by the same persons.

An example is the situation in the well known *Rolled Steel* case[5], where the debtor company and the company providing security were ultimately controlled by the same persons, but were not members of the same group of companies. That situation is encountered quite frequently in practice, but section 131(3) of the Companies Act is of no assistance.

For these reasons, corporate banking transactions in New Zealand continue to feature much the same "corporate benefit" certificates from directors of the relevant companies as they did before section 131 came into force, and lawyers advising either directors or lenders continue to draw attention to the same risks as those highlighted by decisions such as *Maronis* and *Rolled Steel*.

Section 131(4): Finally, I will refer to section 131(4), which allows directors of a company that is "carrying out a joint venture between the shareholders" to act in the interests of a shareholder in the joint venture, even if not in the interests of the company itself.

Unfortunately, the Companies Act does not define what a "joint venture" is. While many lawyers may feel that they know a "joint venture" when they see one, ultimately section 131(4) confronts them with the need to form a view as to whether or not a "joint venture" exists, and to consider judicial attempts to define a "joint venture" such as that of the High Court of Australia in *United Dominions Corporation Limited v Brian Pty Limited* (1985) 60 ALR 741, 746. In that case, the High Court said –

> *"The term joint venture is not a technical one, with a settled common law meaning. As a matter or ordinary language, it connotes an association of persons for the purpose of a particular trading, commercial, mining or other financial undertaking or endeavour, with a view to mutual profit..."*

5 Rolled Steel Products (Holdings) Ltd v British Steel Corp [1985] 3 All E.R. 52

to define a "joint venture" such as that of the High Court of Australia in *United Dominions Corporation Limited v Brian Pty Limited* (1985) 60 ALR 741, 746. In that case, the High Court said –

> *"The term joint venture is not a technical one, with a settled common law meaning. As a matter or ordinary language, it connotes an association of persons for the purpose of a particular trading, commercial, mining or other financial undertaking or endeavour, with a view to mutual profit..."*

It will be evident that a great many companies might arguably be "joint ventures" in terms of such judicial explanations of the concept of "joint venture". For that reason, in practice section 131(4) is often of limited assistance to directors of New Zealand companies, to lenders, and to their respective advisors.

In short, while section 131 of the Companies Act may at first sight appear helpful to directors confronted with the difficulties that have been described by Professor Baxt, section 131 is often not helpful in actually resolving those difficulties.

Rob McInnes
6 June 2002