DIRECTORS' DUTIES APPROACHING INSOLVENCY AND WHAT THEY MEAN FOR FINANCIERS

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1. INTRODUCTION

1.1 The period when a company is in or nearing insolvency is often referred to as the "*twilight period*". During that period, certain transactions entered into by the company are vulnerable to attack and may give rise to personal liability on the part of the directors or others involved in the management of the company.

1.2 Breaches of directors' duties during the twilight period may impact financiers in a variety of ways, including as creditors or by way of lender liability. Therefore, it is important to understand:

(a) What are directors' duties in the twilight period?

(b) How can financiers mitigate the risk of exposure to liability or loss as a result of a breach of directors' duties?

(c) What other issues may arise for financiers in this context?

1.3 Although directors need to take care in relation to fulfilling their duties at all times, and particularly in the face of insolvency, courts do not expect that a company must cease trading immediately upon becoming insolvent:[1]

> "*No-one suggests that a company must cease trading the moment it becomes insolvent (in a balance sheet sense). Such a cessation of business may inflict serious loss on creditors and, where there is a probability of salvage, such loss can fairly be regarded as unnecessary. The cases, however, make it perfectly clear that there are limits to the extent to which directors can trade companies while they are insolvent (in the balance sheet sense to which I referred) in the hope that things will improve. In most of the cases, the time allowance has been limited, a matter of months.*"

1.4 The UK Supreme Court cited the following passage when considering the meaning of inability to pay debts:[2]

> *"A balance has to be drawn between the right of an honest and prudent businessman, who is prepared to work hard, to continue to trade out of his difficulties if he can genuinely see a light at the end of the tunnel, and the corresponding obligation to 'put up the shutters', when, by continuing to trade, he would be doing so at the expense of his creditors and in disregard of those business considerations which a reasonable businessman is expected to observe*."

1.5 Directors' duties should be considered in the context of this underlying acceptance of commerciality and legitimate business risks.

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1 Re *South Pacific Shipping Ltd* (in liq) (2004) 9 NZCLC 263, 570 (HC). See also Madsen-Ries and Vance v Petera [2015] NZHC 538 [24 March 2015]

2 *BNY Corporate Trustee Services Ltd & Ors v Neuberger* [2013] 3 All ER 271 at [7], citing the Report of the Review Committee on Insolvency Law and Practice (1982) (Cmnd 8558), better known as the Cork Report, at 216, reflecting the view of Professor Goode.

2. DIRECTORS' DUTIES

Sources

2.1 Directors owe duties under the common law, in equity, and under sections 131 to 138 of the Companies Act 1993 (**Act**). In addition, directors may have administrative duties under the Act, and further duties under the constitution or a director's contract.

2.2 Although there has been some academic uncertainty as to whether the statutory duties under the Act were intended to be a code, the judicial approach has been to treat them as a restatement of general law duties, in an endeavour to promote accessibility to the law.[3]

2.3 Therefore, common law and equitable duties continue to exist in parallel with statutory duties, and will continue to be relevant:

(a) As an aid to interpretation, except when the Act modifies general law duties.

(b) To the extent that the Act does not provide for a particular duty or remedy.

(c) For registered overseas companies. Directors of such companies do not have the statutory duties that directors of New Zealand companies have. It is thought, however, that they will have general law duties similar to statutory duties, at least so far as New Zealand operations are concerned.[4]

2.4 Statutory duties cannot be contracted out of via the constitution.[5] The constitution may, however, enhance or define directors' duties, for example by specifying what is in the company's best interests for the purposes of section 131 of the Act.

Core duties

2.5 Directors' duties are owed whether the company is solvent or not. In many cases, however, they will only be enforced after the company has become insolvent.

2.6 When a company is approaching insolvency, the most relevant duties are likely to be:

(a) The duties not to trade recklessly or while insolvent (sections 135 and 136 of the Act).

(b) The duty to act in good faith and in the best interests of the company (section 131).

2.7 Other fundamental duties are the duties to:

(a) Exercise powers for a proper purpose (section 133, equity).

(b) Comply with the Act and the company's constitution (section 134).

(c) Exercise care, diligence and skill (section 137, common law).

2.8 Directors' duties are generally owed to the company, rather than shareholders or creditors. The Act also, however, provides for certain duties owed to shareholders, including:

(a) duties to disclose interests and dealings in the company's shares (sections 140 and 148), and

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[3] For example, *Benton v Priore* [2003] 1 NZLR 564 at [46]; *Sojourner v Robb* [2006] 3 NZLR 808 at [100].
[4] Insol International "Directors in the Twilight Zone II" (William Clowes Ltd, Suffolk, 2005) at 517.
[5] Companies Act 1993, s 31.

(b) the duty to comply with the Act and the company constitution (section 134).

Reckless trading

2.9 Section 135 of the Act states that a director has a duty to the company not to trade recklessly. It provides that a director must not:

(a) *Agree* to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or

(b) *Cause or allow* the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

2.10 "The duty in s 135 reflects a director's fundamental duty to protect the interests of creditors when the company approaches insolvency." [6] The duty is owed by the directors to the company and not to creditors.

2.11 Section 135 is not intended to penalise directors merely for taking legitimate business risks. In fact, the preamble to the Act reaffirms the economic and social value of a company "*taking business risks*". It is only the taking of illegitimate business risks that will warrant a finding of reckless trading.

2.12 In determining whether a business risk is legitimate, the following issues will be relevant:

(a) Was the risk fully understood by those whose funds were in peril?[7]

(b) Was the conduct of the director in question in accordance with orthodox commercial practice?[8]

(c) If a company is facing insolvency, has the director put in place carefully thought through strategies for salvaging the situation, rather than embarking upon a usual course of conduct?

(d) Did the director adopt acceptable governance measures and undertake an analysis of potential risks?[9]

2.13 In considering whether a business risk is legitimate courts in recent cases have asked whether there was, upon the company entering "*troubled waters*", "*a sober assessment*" by the directors "…*of an ongoing character as to the company's likely future income and prospects.*"[10]

2.14 As noted above, it is not necessary for a company to cease trading the moment it becomes insolvent in a balance sheet sense. It may be possible to trade out of its difficulties or otherwise recover from the deficiency.[11] It is also important to distinguish between insolvency and temporary lack of liquidity. The latter may not necessarily equate to insolvency if the debtor is able to realise assets or borrow funds.[12]

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[6] *Mizeen Painters Ltd (in liq) v Tapusoa* [2016] NZAR 423 at [40]. Recent applications of that principle occur in *Sojourner v Robb, Boutique Tanneries Ltd (in liquidation) v Handley*, and *Morgenstern*: *Mizeen Painters Ltd (in liq) v Tapusoa* [2016] NZAR 423 at [40]
[7] *Re South Pacific Shipping Limited (In Liq)* (2004) 9 NZCLC 263, 570 (HC).
[8] *Re South Pacific Shipping Limited (In Liq)* (2004) 9 NZCLC 263, 570 (HC).
[9] *Löwer v Traveller* [2005] 3 NZLR 479 (CA).
[10] *Mason v Lewis* [2006] 3 NZLR 225 (CA).
[11] *Re Ralls Trading Ltd (in liq)* [2016] EWHC 243 (Ch) at [168], citing *BNY Corporate Trustee Services Limited v. Eurosail-UK2007-3BL PLC* [2013] 1 WLR 1408 (UKSC)
[12] *Madsen-Ries v Donovan Drainage*, [2016] NZCA 301, at [59]; *Sandell v Porter* [1966] HCA 28;

2.15 There are obvious limits, nevertheless, to the extent to which directors can trade companies while they are insolvent in the hope that things will improve.[13] Courts have observed that in situations in which a company has little or no equity directors will need to consider very carefully whether continuing to trade has realistic prospects of generating cash which will allows for the servicing of pre-existing debt and the meeting of commitments which such trading will inevitably attract.[14]

2.16 The term "*a substantial risk*" appears to indicate that the section is not concerned with minor risks or risks that are unlikely to cause serious loss to the company's creditors. The probability that there will be loss and the extent of that loss would seem to be key indicators of whether there has been a breach of the section.[15]

2.17 A substantial risk does not require a likelihood. The reference to "likelihood" in section 135 is directed simply to the creation of risk, not the magnitude of the risk once created.[16] In *Goatlands*,[17] Lang J held that a risk of loss in the order of one in four (25%) was a substantial risk.

2.18 In deciding whether particular conduct is inappropriate under section 135, the Courts will take an objective approach.[18] The subjective belief of a director will not excuse the breach of a director's duty under section 135.[19] A director does not need to have acted knowingly to fall within section 135, which means that even directors who have not taken an active role in the business of the company may be held liable for reckless trading.[20]

2.19 The test focuses on the manner in which a company's business is carried on and "*whether that modus operandi creates a substantial risk of serious loss*".[21]

2.20 In short, directors need to ensure that they conform to the expected level of care in taking reasonable steps to safeguard the interests of creditors in their commercial decisions.

Insolvent trading

2.21 Section 136 provides that a director of a company must not agree to the company incurring an obligation unless the director believes at the time on reasonable grounds that the company *will be able to perform* the obligation when it is required to do so.

2.22 Although there is overlap between the duty when incurring obligations and the duty not to trade recklessly[22] (particularly in that both involve illegitimate risks), the focus of the two sections differs. The duty not to trade recklessly focusses on a course of action or the general conduct of the business, whereas this duty focuses on specific obligations incurred or particular transactions.[23]

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[13] *Re South Pacific Shipping Ltd (in liq)* (2004) 9 NZCLC 263, 570 (HC). See also *Madsen-Ries and Vance v Petera* [2015] NZHC 538 [24 March 2015]
[14] *Richard Geewiz Gee Consultants Ltd (in liq) v Gee* [2014] NZHC 1483 [30 June 2014] at [101].
[15] *Cool Cars (Wholesale) Ltd (in liq) v Sharma (aka Kumar)* [2014] NZHC 256 at [35].
[16] Campbell, Watts and Hare, Company Law in New Zealand, 2011 at p. 598.
[17] *Goatlands Ltd (in liq) v Borrell* (2007) 23 NZTC 21, 107 (HC).
[18] *Fatupaito v Bates* [2001] 3 NZLR 386.
[19] *Thompson v Innes* (1985) 2 NZCLC 99,463.
[20] *Statewide Tobacco Services Ltd v Morley* (1990) 8 ACLC 827 (Vic SC).
[21] *Mizeen Painters Ltd (in liq) v Tapusoa* [2016] NZAR 423 at [39] (formal proof).
[22] *Mizeen Painters Ltd (in liq) v Tapusoa* [2016] NZAR 423 at [44].
[23] *Bay Kiwifruit Contractors Limited (in liquidation) v Ladher* [2015] NZHC 63 [3 February 2015] at [46], *Mizeen Painters Ltd (in liq) v Tapusoa* [2016] NZAR 423 at [44] and *Richard Geewiz Gee Consultants Ltd (in liq) v Gee* [2014] NZHC 1483 [30 June 2014] at [108].

2.23 A director's belief under section 136 must be held on reasonable grounds. The director's belief at the time is a subjective test, although the decision must be made on reasonable grounds, which is an objective test.

2.24 In terms of whether a belief is reasonably held[24]:

> "*it is likely that a belief will be prima facie unreasonable where the company is insolvent at the time the obligation was incurred, unless for some reason the company's insolvency was not then apparent, or otherwise there were grounds for thinking that the company would become solvent by the time the obligation was to be performed*."

2.25 As such it will be difficult for a director to base a belief that the company will be able to perform the obligation on a lack of the relevant knowledge. The director should have information that justifies his or her belief that the company will be able to perform. Absolute certainty that the obligation would be performed is not required.

2.26 The director is however required to believe that there is no apparent risk that the company will not be able to perform the obligation.[25]

2.27 While both sections 135 and 136 are concerned with conduct by directors that may cause loss to creditors, there are significant differences between them. The use of the words "cause or allow" section 135(b) suggests that liability may extend to passive directors who take a hands-off approach to the management of the company's affairs.[26] By contrast section 136 only applies to directors who "agree" to the company incurring an obligation. Thus it may not apply to directors who were not involved in the decision-making. As section 135 simply refers to carrying on "the" company's business, arguably the section is aimed at the totality of the company's activities, rather than one isolated transaction. This is in contrast to section 136, which seems to be concerned with specific transactions.[27]

2.28 In *Fatupaito v Bates*[28], the liquidators of a company sought an order requiring contribution under s 301 from a director alleging breaches of sections 135 and 136. The company was in financial difficulties and the director of the company purported to appoint the company's accountant as a receiver; the appointment was defective. The accountant allowed the company to continue to trade. The company subsequently went into liquidation. The Court held that the accountant was a director pursuant to section 126[29] and that the accountant was in breach of sections 135 and 136, as he ought to have known that the prospects of continued trading were such that there was a substantial risk of serious loss to creditors by continuing to trade and he was aware that the company was insolvent at the time and it was not reasonable for him to believe that the obligations incurred by the company would be able to be met as they fell due.

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[24] Campbell, Watts and Hare, Company Law in New Zealand, 2011 at p. 607.
[25] *Cool Cars (Wholesale) Ltd (in liq) v Sharma (aka Kumar)* [2014] NZHC 256 at [50] (summary judgment application).
[26] Section 128(1) of the Companies Act 1993 requires that the business and affairs of the company must be managed by or under the supervision or direction of the board of directors.
[27] *Personal Liability of Directors and Claims against Directors*, Greg Blanchard, Ben Russell and Paul Chisnall – Insolvency Workshop 2009.
[28] *Fatupaito v Bates* [2001] 3 NZLR 386
[29] Section 126 is discussed at [6.9] below.

Duty to act in good faith

2.29 Section 131 of the Act requires that a director, when exercising powers of performing duties, must act in good faith and in what the director believes to be the best interests of the company.

2.30 This is a fiduciary duty of loyalty:

(a) Good faith requires honesty, but is not confined to honesty.

(b) Even a decision that is potentially beneficial to the company's business is likely to be challengeable if the director's dominant motivation is spite or self-interest.

(c) The mere fact that a director might benefit, or acted carelessly or negligently, does not establish a breach of duty, absent mis-motivation.

(d) Disloyalty means intentional or reckless disregard of the company's interests.

2.31 The test is subjective; it is up to directors to determine what is in the best interests of the company.

Creditors' interests

2.32 When a company is solvent, the interests of the company are generally identified as the interests of shareholders as a whole (and not just majority shareholders)[30].

2.33 When a company is insolvent or nearing insolvency, however, the interests of the company include the interests of creditors and can prevail over those of the shareholders. This makes sense:

(a) Shareholders in a solvent company are viewed as the residual claimants of the company's assets and the residual risk bearers.[31]

(b) When a company is insolvent, however, creditors have a right to distribution from the assets ahead of shareholders, and therefore become the residual claimants in a practical sense.[32] They can also expect a Court to give greater weight to their views than those of shareholders, when deciding who should be a liquidator in an insolvent liquidation.[33]

(c) In the twilight period, the best interests of the company include discharging obligations to creditors before rewarding shareholders.[34]

2.34 It is also consistent with the broader approach of the courts to focus on the interests of those affected by the insolvency and, in that context, to have less regard to, or ignore, the rights of those not affected, because they will be paid in full (typically, secured creditors) or override or cram down the interests of those who are out of their money.[35]

2.35 The duty to consider the interest of creditors when a company is insolvent or approaching insolvency developed as a common law duty, and is now said to be implied into s 131. It was

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[30] *MacFarlane v Barlow* (1997) 8 NZHC 261,470
[31] Frank Easterbrook and Daniel Fischel *The Economic Structure of Company Law* (Harvard University Press, 1991).
[32] ss36(1)(c) and 313 of the Companies Act 1993;
[33] *Ireland Developments Ltd v 123 Global (NZ) Ltd (in liq)*, [2010] NZCCLR 5, at [21].
[34] *Sojourner v Robb* [2006] 3 NZLR 808 (HC) at [102].
[35] *Re Bluebrook Ltd* [2009] EWHC 2114 (Ch) (11 August 2009) at [23]-[26] (creditors' scheme of arrangement); *Re Nexus Energy Ltd, Robb v Sojourner* [2007] NZCA 493, [2008] INZLR 751, [2008] NSCCCR 872 at [25] (subject to deed of company arrangement) [2014] NSWSC 1910 (DOCA)

acknowledged in New Zealand by President Cooke in the 1985 case of *Nicholson v Permakraft*.[36] Since then, courts have been eager to put definitive limits on it.

2.36 In particular, in *Robb v Sojourner*, the Court of Appeal referred to *Nicholson v Permakraft*, as well as Australian and English judgments, in confirming that the duty to take into account the interests of creditors is merely a restriction on the right of shareholders to ratify breaches of the duty owed to the company.[37] The Court quoted Gummow J in *Re New World Alliance Pty Ltd:*[38]

> "*It is clear that the duty to take into account the interests of creditors is merely a restriction on the right of shareholders to ratify breaches of the duty owed to the company. The restriction is similar to that found in cases involving fraud on the minority. Where a company is insolvent or nearing insolvency, the creditors are to be seen as having a direct interest in the company and that interest cannot be overridden by the shareholders. This restriction does not, in the absence of any conferral of such a right by statute, confer upon creditors any general law right against former directors of the company to recover losses suffered by those creditors . . . the result is that there is a duty of imperfect obligation owed to creditors, one which the creditors cannot enforce save to the extent that the company acts on its own motion or through a liquidator*."

2.37 Note that under the Act, in a liquidation either a liquidator or creditor has standing to commence proceedings against directors for breach of duty.[39] This is a procedural section that creates no new rights.[40]

2.38 By contrast, in 2012, a majority of the Supreme Court of Western Australia Court of Appeal in the *Bell Group* litigation purported to extend the duty to have regard to the interests of creditors:[41]

(a) The *Bell Group* litigation ran for over 20 years. The issue on appeal was whether a syndicate of 20 banks could retain the moneys it had obtained realising securities given by the Bell Group at a time when the Bell Group was insolvent. Among other things, the Court had to determine whether, by giving the securities, the directors breached fiduciary duties owed to the companies.

(b) The 2 to 1 majority of the Court of Appeal espoused two propositions that have been criticised by commentators:

(i) First, that directors have an elevated duty at general law to protect creditor interests when making commercial decisions in the twilight period to ensure a *pari passu* outcome to creditors, as opposed to merely considering creditor interests as one of a number of stakeholder groups. That proposition:

(1) Is a radical departure from previous authorities in Australia, as well as other jurisdictions including New Zealand and the UK.

(2) Creates a positive obligation to *give effect* to creditor interests, rather than merely *considering* them.

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[36] *Nicholson v Permakraft* [1985] 1 NZLR 242 at 249.
[37] *Robb v Sojourner* [2007] NZCA 493, [2008] 1 NZLR 751, [2008] NZCCLR 8 at [25].
[38] *Re New World Alliance Pty Ltd* (1994) 51 FCR 425 at 444 – 445.
[39] Companies Act 1993, s 301, discussed at [3] below.
[40] *Benton v Priore* [2003] 1 NZLR 564; *Kings Wharf Coldstore Ltd (in rec and in liq) v Wilson* - (2005) 2 NZCCLR 1042, at [109].
41 *Westpac Banking Corporation v The Bell Group Ltd (in liq) [No 3]* [2012] WASCA 157.

(3) Subordinates the interests of the company to sharing *pari passu* between unsecured creditors.

(4) Encourages liquidation over restructuring in good faith, which may have a harmful effect on the economy. As I discussed, companies are not expected to stop trading immediately on becoming insolvent when the business could be rescued.

(ii) The second proposition is that the courts will no longer show deference to the business judgment of directors who honestly believed that they were acting in the best interests of the company to ensure that creditor interests were protected. That proposition is a departure from the non-interventionist tradition, which:

(1) Acknowledges the limitations of judicial capacity to second-guess commercial decisions and the undesirability of judging with hindsight.[42] As the Court of Appeal has said - "*Outside the area of human rights the law is slow to interfere with decision-making by experts*."[43]

(2) Is a hallmark feature of commercial law, adopted in many jurisdictions, including New Zealand[44].

2.39 The *Bell* case settled before it was heard by the High Court, and the majority's propositions have not been adopted in New Zealand courts. Nor would the WACA decision, as it related to the business judgment rule, be consistent with the existing NZ case law, or the long title to the Act - the purposes of the Companies Act, stated in its long title, include:

> "*…(d) encouraging efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management power…*"

2.40 The result is that, in New Zealand, the obligation to act in the good faith and in the best interests of the company means that, when a company is approaching insolvency, directors must consider the interests of creditors as one, but not the only, stakeholder group. Similarly, shareholders cannot ratify breaches of duty after the point in which they cease to have an economic interest in the company. Creditors, to the interests of which directors must have regard, include secured creditors.[45]

2.41 The common law duty in England may go further.[46] Lord Templeman expressed it in the following way:

> "*But a company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. The conscience of the company, as well as its management, is confided to its directors. A duty is owed by the directors to the company and to the creditors of the*

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42 *Latimer Holdings Ltd v SEA Holdings NZ Ltd* [2005] 2 NZLR 328 (CA).
43 *Air New Zealand Ltd v Wellington International Airport Ltd* [2009] 3 NZLR 713 (CA), per Baragwanath J, at [153].
44 See, for example, Latimer Holdings Ltd v Sea Holdings New Zealand Ltd [2005] NZLR 328.
45 *Kings Wharf Coldstore Ltd (in rec and in liq) v Wilson* - (2005) 2 NZCCLR 1042, at [103]
46 *Winkworth v Edward Baron Development Co Ltd and others* [1987] 1 All ER 114, at 118 (UKHL)

company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors."

2.42 See also *Re HLC* (and other authorities cited in the judgment):[47]

> "*The power in question is to deal with the Company's assets in the course of trading. The proper purpose for which that power was delegated to its director(s) is to advance the Company's business and commercial interests. As to both, compare Extrasure Travel supra at [140]. Furthermore, and notwithstanding Mr Roe's contrary submission, it seems to me necessarily to follow from the common law principle (preserved post-codification by s.172(3) CA06) concerning directors taking into account the interests of a company's creditors, that the proper purposes for which the said power may be exercised must, where that duty is triggered, necessarily then include advancing the interests of that company's creditors*."

Receivers

2.43 Guidance can also be taken from section 18 of the Receiverships Act 1993, which provides for the general duties of receivers. Relevantly:

(a) A receiver must exercise his or her powers in good faith and for a proper purpose (section 18(1)).

(b) A receiver must exercise his or her powers in a manner he or she believes on reasonable grounds to be in the best interests of the person in whose interests he or she was appointed (section 18(2)).

(c) To the extent consistent with that, "*a receiver must exercise his or her powers with reasonable regard to the interests of…unsecured creditors of the grantor*" (section 18(3)(c)).

2.44 In *Downsview Nominees Ltd*, Richardson J in the Court of Appeal relevantly noted that:[48]

> "*It is implicit in those observations that the legal duties resting on the receiver and manager are not owed exclusively to the holder of the debenture under which the receiver was appointed. Inevitably there are other interests involved. As agent for the company the receiver has some obligations to it. He cannot be oblivious to the interests of the other secured creditors and even unsecured creditors who are directly affected by the commercial decisions he makes in the receivership.*"

2.45 That principle, which has express statutory recognition in the Receiverships Act, is consistent with the directors' duty to consider creditors' interests when a company is in the twilight period, but before any receiver has been appointed. In both cases, creditors have a stake in a company which may be rescued or may go into a formal insolvency procedure.

2.46 A financier has no liability for the actions of a receiver unless it interferes with the receivers' actions.[49] Likewise, when its customer is in the twilight zone.[50]

2.47 Note also that when a company in in liquidation, the liquidators have a duty to ensure that receivers does not do anything prejudicial to the interests of unsecured creditors.[51]

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[47] *Re HLC* [2013] EWHC 2876, at [99]; *Gwyer v London Wharf (Limehouse)* Ltd [2002] EWHC 2728, at [74];West *Mercia v Dodd* [1988] BCLC 250, 252.
[48] *First City Corp Ltd v Downsview Nominees Ltd* [1990] 3 NZLR 265; (1990) 5 NZCLC 66,303 (CA). The Privy Council decision in *Downsview* is the leading case on receiver's duties.
[49] *Medforth v Blake & Ors* [1999] 3 All ER 97.
[50] *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* [2011] NSWCA 109. See [6.10] ff below.

Defences to reckless trading and insolvent trading actions

2.48 There are limited defences for reckless or insolvent trading.

Reliance on advice

2.49 Relevantly, section 138 of the Act provides that a director may rely on reports, statements, financial data or advice prepared by certain persons, including a *professional* advisor or *expert* in a matter believed on reasonable grounds to be within that person's competence. Arguably, that could include a banker.[52]

2.50 Reliance is only permitted if the director:

(a) acts in good faith;

(b) makes enquiries when required by the circumstances; and

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

2.51 Although the Act recognises that it is necessary for directors to rely on information provided by others from time to time, to satisfy section 138, they must maintain a general overview of company operations and continue to question and test information that is put before them. Indiscriminate reliance on the advice of others may expose directors to liability.

2.52 Reliance on such advice may be raised as an affirmative defence to a breach of duty.[53]

2.53 Section 138 was also relevant to determining whether a defence was available under section 40 of the (now repealed) Financial Reporting Act 1993 (**FRA**), although it did not create a standalone defence.[54] Relevantly:

(a) In the Feltex litigation[55], directors of Feltex Carpets Ltd were charged under section 36A of the FRA for issuing a statement containing interim financial information for its half-year results that failed to comply with applicable reporting standards. The directors had relied on professional accounting advice from a reputable firm and had taken various other steps to ensure that accounting standards would be complied with. The District Court held that the directors were entitled to rely on professional or expert advice, under and within the terms of section 138 of the Act, and in relying on that advice, the directors had discharged the onus of proving, for the purposes of (now-repealed) section 40, that they had taken "*all reasonable and proper steps*" to ensure that the reporting requirements would be complied with. The directors were found not guilty.

(b) In the Apple Fields litigation,[56] the directors of Apple Fields were prosecuted under the FRA for failing to file audited financial statements for three years. The directors had received and relied on accounting advice that they should file consolidated statements for the group, but

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[51] *Petterson v Gothard (No 3)* [2012] NZHC 666 at [46]–[48], referring to Blanchard and Gedye The Law of Private Receivers of Companies in New Zealand (3rd ed, LexisNexis, Wellington, 2008) at [12.01], for description of liquidators' role as "an official and independent watchdog" on the receiver.
[52] *Robbins Herbal Institute v Federal Taxation Commissioner* (1923) 32 CLR 457, at paragraph 3: " *Thus many vocations may fall within the accepted and ordinary use of the word* [profession]*; such, for instance, as those of […] bankers, and so forth*.
[53] *Morgenstern v Jeffreys* [2014] NZCA 449, at [75]-[76]
[54] *Financial Markets Authority v Prain* [2015] NZDC 2319 (DC); *Schroeder v Financial Markets Authorit*y [2016] NZHC 4.
[55] *Ministry of Economic Development v Feeny and Ors* DC AK CRI-2008-004-029199 [2 August 2010]
[56] *Financial Markets Authority v Prain* [2015] NZDC 2319 (DC); *Schroeder v Financial Markets Authorit*y [2016] NZHC 4; *Prain v Financial Markets Authority* [2016] NZCA 298.

could not get the financial statements from subsidiary Noble Investments Ltd, so knew that any accounts filed would not be compliant. The District Court found that the two directors had not done all they could to ensure the financial reports were filed, and should have sought legal advice about whether Apple Fields could compel Noble to provide the necessary information. The Court also said that section 138 of the Act could not be imported into the FRA to provide a defence. The High Court accepted that section 138 did not constitute a defence under the FRA, but said the fact that a director is entitled to rely on reports, statements and financial data, in the circumstances spelt out under section 138, must be relevant to the FRA enquiry. There will be circumstances when reliance on professional advice may be sufficient to establish the defence, but it will always be a fact-specific enquiry. In this case, the High Court considered that "taking "*reasonable and proper steps*" did not include a requirement to take legal advice, and had the directors done so, it would have made no difference to the outcome. Therefore, the issue of reliance on advice did not actually arise. Leave to appeal to the Court of Appeal has been granted.

Delegation of powers

2.54 Section 130 of the Act provides for delegation. A director may have a defence when:

(b) the board of directors of the company has delegated relevant powers to a committee of directors, a director or an employee of the company; and

(c) the director believed on reasonable grounds that the delegate would exercise it in conformity with the duties imposed on directors by the Act and the company's constitution; and

(d) the board monitored, by means of reasonable methods properly used, the exercise of the power by the delegate.

2.55 Where a power of the board has been properly delegated, the delegate will be regarded as a director for the purpose of duties imposed by the Act.[57]

Safe harbours

2.56 Directors of Australian companies have similar duties under the *Corporations Act 2001* (Cth) to those outlined above. In Australia, a "*safe harbours*" defence to the duty in section 588G to prevent insolvent trading has been proposed.

2.57 Two models for the defence have been proposed, each aimed at relieving directors of liability for incurring debts when the company is insolvent if the director has taken certain steps to return the company to solvency within a reasonable period of time:

(a) The defence under Model A would be available if:[58]

> *…at the time when the debt was incurred, a reasonable director would have an expectation, based on advice provided by an appropriately experienced, qualified and informed restructuring adviser, that the company can be returned to solvency within a reasonable period of time, and the director is taking reasonable steps to ensure it does so.*

[57] Section 126.
[58] Australian Government, *Improving bankruptcy and insolvency laws* (April 2016) at 11.

(b) In contrast, Model B would act as a carve out to the application of section 588G (which prevents insolvent trading)[59]. As a consequence, section 588G would not apply:

(a) if the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; and

(b) the person held the honest and reasonable belief that incurring the debt was in the best interest of the company and its creditors as a whole; and

(c) incurring the debt does not materially increase the risk of serious loss to creditors.

2.58 An equivalent safe harbours defence has not yet been proposed in New Zealand. New Zealand's insolvent trading laws are different and seemingly less strict than Australia's.

2.59 Arguably the structure of New Zealand's duties gives directors here greater scope to restructure businesses and continue trading than their Australian counterparts. The approach here is broadly based on risk assessment, rather than the binary approach in section 558G of the Corporations Act.

2.60 Against that statutory backdrop have New Zealand directors been any more active in restructuring and saving businesses than their Australian counterparts? I don't have that evidence. Nonetheless what is clear at an anecdotal level is this:

(a) The voluntary administration process is a white elephant process. With the exception of the likes of the Solid Energy group, in recent times there have been very few successful adoptions of the process.

(b) Many SMEs end up in liquidation without any earlier insolvency process having been attempted; as they do in Australia.

(c) Again, anecdotally, returns to unsecured creditors are routinely modest if anything at all.

(d) The National Enforcement Unit informed RITANZ in Wellington last year that it is highly unlikely to prosecute due to difficulties in securing convictions, so the worst regulatory outcome for most might be a banning order.

2.61 From all of which we can conclude that despite the differences in incentives and in the statutory framework for insolvent trading between the two countries it seems that directors in Australia and New Zealand behave in a similar way when it comes to the decision, if and when to trade on or to pull down the shutters: - the twilight period.

2.62 Nonetheless the benefits are clear at both a micro level and macro level, of avoiding losses and restructuring rather than burying businesses. The benefits of a safe harbour defence to insolvent trading are as strong here as they are in Australia. We should certainly be looking at a similar change here, in my view. The key question it seems to me is what incentives are there for directors to engage?

3. ENFORCEMENT / REMEDIES

3.1 Perhaps the most obvious way that bankers may be affected by a breach of directors' duties is as a creditor of the company. Therefore, enforcement or duties and remedies for breach are relevant.

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[59] *Corporations Act 2001*, section 588G.

Compensation under the Act

3.2 As discussed, directors' duties to act in good faith and not to trade recklessly or while insolvent are owed to the company, and not to the shareholders or creditors.

3.3 In an application relating to a breach of directors' duties a shareholder or creditor cannot in the normal course obtain compensation payments directly. Remedy for a breach is to be sought by the company, or by a shareholder on behalf of the company (with the leave of the Court by a derivative action under section 165).

3.4 Post-liquidation, however, as noted, section 301 of the Companies Act can be invoked by a liquidator, a creditor or a shareholder of the company to bring actions against directors (and others) where, among other things, such directors (and/or others) have misapplied, retained, or become liable or accountable for money or property of the company, or been guilty of negligence, default, or breach of duty or trust in relation to the company. In fact, most claims seeking redress for breaches of sections 135 and 136 are brought by liquidators under section 301.[60] After liquidation, the authorities and powers of directors are superseded by the liquidators'. The liquidators are required to review the directors' actions during the twilight period and, when relevant, bring proceedings for the benefit of creditors to compensate for any loss to the company.

3.5 The Court may grant relief directly against the directors in their personal capacity with the liability of the directors usually extending from the time that the company was in peril and the reckless actions were taken by the directors. The Court is given a wide discretion under section 301(1)(b)(ii) to order the director to "*contribute such sum to the assets of the company by way of compensation as the Court thinks just*".

3.6 However, the Courts have recognised that the compensation must "*relate to the loss the company has suffered as a result of the acts or omissions underpinning the relevant breach of duty*".[61] Contrast this with the availability of a contribution from a related company to an insolvent company, for which a causative link between the conduct complained of and loss suffered is not to be determinative of whether a contribution order should be made.[62] This latter statutory claim is available only in New Zealand and Ireland.

3.7 In assessing an appropriate level of compensation, the net deterioration of the company's financial position is taken as the starting point, with the quantum being further adjusted according to whether it is just that the director pay that sum.[63] Potential liability is not confined to debts, but can include damages liabilities that are incurred by the wrongful trading.

3.8 Once that figure has been ascertained, courts typically consider three factors when determining whether to make an order under s 301[64]:

(a) the duration of the conduct that gave rise to the breach of duty,

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[60] Section 301 provides a procedural mechanism through which the Court can order relief for breaches of duty: see *Schuler v Grant and Khov as Liquidators of Independent Livestock Agents Limited (In Liquidation)* CA27/2013 [2014] NZCA 91 [24 March 2014] at [334] citing *Arataki Properties Ltd (in liq) v Craig* [1986] 2 NZLR 294 (CA).
[61] *Madsen-Ries and Vance v Petera* [2015] NZHC 538 [24 March 2015] at [94] and Mizeen Painters Ltd (in liq) v Tapusoa [2016] NZAR 423 at [57].
[62] *Steel & Tube Holdings Ltd v Lewis Holdings ltd & Ors* [2016] NZCA 366 at [52]; Companies Act 1993, ss 271-272.
[63] *Mason v Lewis* [2006] 3 NZLR 225 (CA).
[64] *Mason v Lewis* [2006] 3 NZLR 225 (CA) at [110]; *Goatlands Ltd (in liquidation) v Borrell & Ors* (2007) 23 NZTC 21,107, (2006) 3 NZCCLR 726 at [121]; Re Bennett, Keane & White Ltd.

(b) the extent to which the conduct caused loss to the company; and

(c) the overall culpability of the conduct. Culpability is linked to the deterrent nature of the provision, and recognises that "*at one end of the range the nature of a director's involvement will be blind faith or muddleheadedness, while at the other end there will be actions or instances of inaction which are plainly dishonest*".[65]

3.9 However, claims under s 301 have been dealt with in a relatively broad brush way, reflecting the equitable nature of the remedy.[66]

3.10 Examples of compensation awards under s 301 include:

(a) In *Goatlands*,[67] The High Court held that the directors breached their duties under sections 135 and 137 of the Act. In awarding compensation under sections 301, the Court considered that it would be just and equitable for the directors to be required to make a contribution that broadly represented the extent to which they took an illegitimate risk in deciding to use the GST refund before they knew whether Goatlands would be able to complete the purchase. It calculated that risk as 25%, and the directors were required to contribute 25% of the company's indebtedness.

(b) In *Madsen-Ries v Petera*,[68] the High Court considered that the directors breached their duties under sections 131, 135, 136 and 137 by permitting the company to trade for a period when they knew that it could not meet its tax debts, and by using company funds for their own purposes when they could have used it to pay tax. The Court did not consider it appropriate to award compensation for the use of company funds, as the liquidators would be able to pull that money back, so the company should not recover twice. Although the company was unable to pay tax from September 2005, the directors were only required to pay compensation from March 2006 (although not the final two PAYE payments), when they should have taken management steps to confirm whether the company could pay creditors, and then formulate a plan on how to deal with it.

3.11 Any damages or compensation must be paid to the company in insolvency for distribution to all creditors in accordance with their statutory priorities. A cause of action for breach of directors' duty is actionable in the name of the company. It therefore comprises an asset of the company that would be caught by a financier's GSA. The benefit of the cause of action would therefore be payable to, or assignable by the financier in the first instance.[69]

3.12 The limitation period for proceedings for breach of statutory duty is generally six years from the date on which the cause of action accrued. In torts where damage is the gist of the action, time runs from the damage. Where damage is the cause of action or part of the cause of action, the period of limitation runs from the date the damage occurs and not of the act which causes the damage. Where the damage can be characterised as economic loss the damage is not sustained until the

[65] *Löwer v Traveller* [2005] 3 NZLR 479, (2005) 9 NZCLC 263,889, (2005) 2 NZCCLR 283 (CA) at [83]; *Thompson v Innes* (1985) 2 NZCLC 99,463.
[66] *Mason v Lewis* [2006] 3 NZLR 225 (CA) at [118].
[67] *Goatlands Ltd (in liq) v Borrell* (2007) 23 NZTC 21,107, (2006) 3 NZCCLR 726.
[68] *Madsen-Ries v Petera* [2015] NZHC 538.
[69] *In re Buick Sales Ltd* [1926] NZLR 24.

economic depreciation in value is actually recognised or ought to have been recognised by a reasonable person.[70]

General law remedies

3.13 As discussed, statutory duties exist in parallel to general law duties. As such, the company or liquidators may claim remedies for breaches of general law duties. For example:

(a) Damages may be claimed for breach of the common law duty to exercise reasonable care and skill.

(b) The usual remedy for the breaches of fiduciary duties to act in good faith and in the best interests of the company, to avoid conflicts of interest and to not misappropriate funds, is an account of profits.

3.14 Given the discretionary nature of compensation under section 301, the comparative certainty of general law remedies may be preferred.

Criminal remedies

3.15 Although the focus is civil liability, directors may also face criminal sanctions if they breach their duties.

3.16 Under the Act, a director commits a criminal offence when he or she:

(a) Acts in bad faith, believing that the conduct is not in the best interests of the company *and* knowing that this will cause serious loss to the company (section 138A).

(b) Dishonestly allows an insolvent company to incur debt *and* the director knew of the existing insolvency or that the company would become insolvent (section 380).

3.17 Importantly, these criminal offences require an element of both dishonesty and knowledge. The provisions were only introduced in 2014, with some controversy:

(a) On the one hand, it was hoped that criminal sanctions would deter serious wrongdoing, increase accountability and show the public's moral reprobation towards such behaviour.

(b) On the other hand, critics warn against stifling innovation and risk taking, and deterring people from becoming directors. However, criminal sanctions are reserved for serious, intentional offending. Australia had similar provisions.

3.18 A director who commits one of these offences is liable on conviction for a fine of up to $200,000 or prison term of up to five years. Proceedings for criminal offences are brought by the Registrar of Companies.

3.19 In addition, director might commit offences under other legislation, including the Crimes Act 1961 and the FRA, in conjunction with breaches of directors' duties.[71]

[70] Laws Of New Zealand: Limitation at [22] and [86].
[71] The relevance of the *ex turpi causa* doctrine is discussed from [4.8] below.

4. LIABILITY INSURANCE

4.1 The Act permits a company to indemnify directors, including to obtain directors' and employees' liability insurance (**D&O**) policies. These may offer cover for "*wrongful acts*", typically breach of duty while acting as a director or employee. Policies usually exclude cover for conduct by which the insured party has gained profit or advantage or conduct that is criminal or fraudulent or knowingly unlawful.

4.2 The *Steigrad*[72] decision of the Supreme Court is the most significant case concerning liability insurance of recent years ruling that a company's claim to insurance money under a $20 million Directors and Officers Liability and Company Reimbursement Insurance Policy had priority over the payment of defence costs to directors under that policy.

4.3 Section 9(1) of the Law Reform Act 1936 imposes a statutory charge on insurance money payable to an insured to indemnify the insured for damages or compensation payable to third party claimants. The Supreme Court ruled that there is "*strong textual support for the proposition that the charge arises at the time the event giving rise to liability occurs and that it secures whatever the full amount of the liability (if any) to the third party ultimately turns out to be*". The Supreme Court said that, as a matter of policy, defence costs should not be allowed to deplete the insurance money available to a successful third party, because in substance this would require the claimant to fund the insurer's unsuccessful defence.

4.4 Reimbursement to the directors of their defence costs is not within the statutory charge. It is immaterial under the statute that the contractual obligation to pay the directors' defence costs arises when the costs are incurred and that liability on the claim for damages is not yet determined or payable. The Supreme Court noted that the effect of the charge is that payments under the insurance policy to meet the directors' defence costs can be met only at the peril of the insurer when there is insufficient insurance cover under the limit of the policy to meet both insurance obligations.

4.5 There is now a possibility that that the insurer may be required to pay the third party claimant the full amount of the charge (up to the policy limit), as well as the insured's contractual right to be paid defence costs. The Supreme Court left it for the High Court to determine this point.

4.6 It is also worth noting that monies payable under a statutory liability policy are not susceptible to a charge under section 9 of the Law Reform Act.

4.7 Moving forward, directors will need to ensure that they preserve their ability to seek the payment of their defence costs by taking out separate policies or policies with separate indemnities for third party liability and defence costs.

Illegal acts – impact on D&O cover

4.8 A director cannot recover under a D&O policy if he has acted in a way designed to cause loss to the company. An insured cannot claim under a contract of insurance if he has to rely on his own

[72] *BFSL 2007 Ltd & Ors (In Liquidation) v Steigrad* [2013] NZSC 156.

illegality or quasi-criminality[73], or seeks to profit from that conduct (the doctrine of *ex turpi causa non oritur actio*).[74]

4.9 The widely accepted formulation of the legal principle of *ex turpi causa* is that of Lord Mansfield CJ in *Holman v Johnson:*[75]

> "*No court will lend its aid to a man who founds his cause of action upon an immoral or illegal act. If, from the plaintiff's own stating or otherwise, the cause of action appears to arise ex turpi causa… there the court says he has no right to be assisted. It is upon that ground the court goes; not for the sake of the defendant, but because they will not lend their aid to such a plaintiff.*"

4.10 One policy reason underpinning *ex turpi causa* is the need for consistency and coherence of the law and integrity of the legal system[76]. Put simply, for the law to censure certain conduct, and then assist those who have committed that conduct, creates an illogical inconsistency in the law:[77]

4.11 The application of the principle in an insolvency setting was considered recently by the UK Supreme Court in *Jetivia SA v Bilta (UK) Ltd*, the Court considered rules of attribution and the application of *ex turpi causa* in the context of VAT fraud perpetrated by the directors of Bilta and assisted by Jetivia and its director. [78] The question for the Court was: if the directors of a company involve the company in a fraudulent transaction, is the company barred by virtue of the illegality defence from suing those directors and their accessories for losses caused by their breach of fiduciary duty?

4.12 Jetivia relied on the case of *Stone & Rolls Ltd v Moore Stephens*[79] to argue that the company was barred from bringing such a claim. In *Stone & Rolls* the auditors of a company whose sole director had used the company to perpetrate fraud were successful in relying upon the illegality defence to bar a claim by the liquidators against the auditors for negligence in failing to detect the fraud. Bilta's liquidators sought to distinguish *Stone & Rolls* (on the basis that the fraud in that case was against a third party and not the company itself) and argued that company directors who have been fraudulent should not be able to rely on their own fraud in order to defend themselves against a claim by the company.

4.13 The Supreme Court unanimously dismissed Jetivia's appeal, holding that the illegality defence did not bar the company's claims against the directors and their accessories. The Court considered that the finding in *Stones & Rolls* that dishonest directors, and those assisting them, cannot rely on their own wrongdoing to escape liability, was distinguishable in this case on the basis that the acts of such directors cannot be attributed to the company. The Court was eager to limit the application of *Stone & Rolls* to its specific fact scenario, namely cases in which a claim was being brought by a company against a third party, rather than against fraudulent directors themselves.

4.14 If there has been illegal or quasi-criminal conduct on the part of director s then D&O cover or any indemnity from the company would not be enforceable by those directors. Furthermore, if the directors' actions were not attributed to them in their capacity as directors then D&O cover would

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[73] *Les Laboratoires Servier & Anor v Apotex Inc & Ors (Rev 1)* [2015] 1 All ER 671, at [25] and following
[74] *Robert Merkin, 'Directors' and Officers' Insurance and the Global Financial Crisis' (Australian Insurance Law Association Geoff Masel Memorial Lectures, 2009).*
[75] See *Leason v Attorney-General* [2014] 2 NZLR 224 at [91] referring to *Holman v Johnson* (1775) 1 Cowp 341 at 343.
[76] See *Leason v Attorney-General* [2014] 2 NZLR 224 at [103].
[77] Ibid at [103] referring to *Hall v Herbert* [1993] 2 SCR 159 at 176 and at [104] referring to *Miller v Miller* [2011] HCA 9 at [15].
[78] *Jetivia SA v Bilta (UK) Ltd [2015] UKSC 23*.
[79] *Stone & Rolls Ltd v Moore Stephens* [2009] UKHL 39

not even engage, potentially, in any event. Either way, if *ex turpi* applies then directors will not be able to rely on indemnities in defending actions for breaches of duty, nor will it enable them to avoid liability.

5. PROTECTED DISCLOSURES

5.1 The number of prosecutions and convictions of company directors in New Zealand following the Global Financial Crisis highlighted that behaviours of boards in certain sectors, such as, for example, finance companies was criminal. The current trial of several former directors of two failed finance companies illustrates my point well. According to the Crown in opening, the men deliberately misled investors by failing to disclose related party transactions that benefited them rather than the companies. The Crown also alleges that they then deliberately misled investors and potential investors in Viaduct Capital and Mutual Finance over a series of related party transactions for their direct benefit and to the detriment of the companies.

5.2 Not all defendants are convicted. One director of a different failed finance company, who was also a commercial lawyer of over thirty years' experience (and whose firm did the legal work for the company), persuaded a High Court that he had not read the prospectus the subject of the prosecution. Hence he was unaware of the flaws contained within it. As surprising a result as that might appear at first blush, that director escaped conviction, when other board members did not.

5.3 A question posed in an excellent paper by Hirsch and Watson[80] is whether the Protected Disclosures Act 2000 ("*PDA*") should be amended to incorporate more private sector conduct that is currently provided for. The authors correctly note that the PDA is very public sector focussed. They use the examples of the directors of finance companies as a foundation for their argument for change.

5.4 In my view their thesis is an attractive one. When company directors breach duties, whether in a civil and/or criminal way, then there will often be staff members co-opted to give effect to dishonest or negligent decision-making. Currently, those staff members have few options, especially if the conduct does not pass the criminal threshold, as will be the case with most director duty breaches. The PDA provides protection for confidential disclosure of '*serious wrongdoing*' (as defined in s3 of the PDA) to the organisation in accordance with internal procedures, in the first instance and to an 'appropriate authority' (Crown agencies, including the Serious Fraud Office) if senior people within the organisation are implicated in the alleged wrongdoing.

5.5 The importance of this issue to the commercial community is reflected in the support of ASIC for a research project currently being conducted across Australia (and New Zealand).[81] It has apparently sent the details of the project to 31,000 businesses across Australia.

5.6 If laws are to be expanded to provide more private sector focus, and to cover wrongdoing that is not necessarily criminal, then one important question that arises is to whom should protected disclosures be able to be made. If the private sector were to be better provided for would the range of organizations to receive protected disclosures be expanded? As the Registrar of Companies has

[80] Rebecca Hirsch and Susan Watson "Blowing the Whistle on Protection for Corporate Whistleblowers: A Lacuna in New Zealand Law" (2010) 16 BZBLQ 393.
[81] http://whistlingwhiletheywork.edu.au/

a supervisory role for companies (including through the National Enforcement Unit (NEU)), primary responsibility for receiving and investigation protected disclosures should logically fall to it. Whether the NEU has the resources to do so is an important question.

5.7 Two groups with the economic and legal muscle to deal with such are the Tax departments and banks. But would it be fair to impose on banks an obligation to investigate confidential allegations of wrongdoing at a customer? Banks are well- resourced businesses with in-house capability to deal with fraud and insolvency as well as panels of external service providers equipped to deal with such risks. Banks also have a direct financial interest in the success or failure of their customers. Nevertheless in a different customer fraud context; viz. cheque frauds, courts have consistently stated that banks are not required to act as amateur detectives.[82] It would therefore seem to be an unreasonable additional statutory burden to impose this obligation to receive and investigate protected disclosures on banks. The preferred course would be to ensure that the NEU was adequately resourced to take the necessary steps.

6. LEGAL RISKS TO LENDERS

6.1 When a borrower faces financial difficulty, it may be in the lender's interests to assist the borrower in attempting to save the business, rather than exercising its rights under the loan agreement and enforcing any security it has. The modern "rescue culture" encourages financer to explore the possibility that a customer may be able to trade its way out of financial difficulty, rather than withdrawing financial support prematurely.[83]

6.2 Therefore, it is foreseeable that as a company approaches insolvency, a financer's involvement in the company will increase. For example, a bank may decide to:

(a) Appoint an Investigating Accountant to review the customer's financial circumstances.

(b) Require the customer to provide asset information or a business plan.

(c) Appoint a monitoring agent (either an employee or independent business expert) to attend board meetings or visit the customer's premises.

(d) Amend a security and other banking arrangement.

(e) Provide professional advice, including in relation to business restructuring and the sale of assets.

6.3 In doing so, financiers must take care to ensure that their actions do not:

(a) Benefit the financier to the detriment of the customer's other creditors.

(b) Expose the financier to liability as a shadow director or for breach of duties owed to the customer or third parties.

Vulnerable transactions

6.4 The Act contains provisions enabling a liquidator of the company to, set aside certain transactions having preferential effect, voidable charges, transactions at an undervalue and transactions which

[82] Scrutton LJ in *Lloyd's Bank Ltd v Chartered Bank of India, Australia and China* [1929] 1 KB 40
[83] EP Ellinger & Ors *Ellinger's Modern Banking Law* (Oxford University Press, 5 ed, 2011) at 796.

appear to give an advantage to persons who have a special relationship with the company where those transactions were entered into during the twilight period. [84]

6.5 The periods in respect of which certain types of transactions are vulnerable are as follows:

(a) 2 years before formal insolvency:

(i) Insolvent transactions (section 292) – i.e. transactions having preferential effect

(ii) Voidable charges (section 293) – i.e. charges, where immediately after the charge was given the company was unable to pay its due debts

(iii) Transactions at undervalue (section 297)

(b) 3 years before formal insolvency:

(i) Transactions for excessive or inadequate consideration with directors and certain related parties (section 298)

(c) No time limit:

(i) Securities and charges issued by the company in favour of directors and certain related parties (section 299)

(ii) Transactions to defraud creditors (sections 344-350 of the Property Law Act 2007)

6.6 Therefore, financers should be aware that any transactions made to them in the twilight period may be vulnerable to attack, particularly if the financer encouraged the transaction or the purpose of the transaction was to improve the financer's position over other creditors.

6.7 Under section 296 of the Act, a court must not set aside a transaction or change if the person who received the recovery acted in good faith a reasonable period would not have suspected, and that person did not have reasonable grounds of suspecting that the company was, or would become insolvent and the person gave value or altered their position in the reasonable belief that the transaction or change would not be set aside. Practically, however, banks will rarely be able to avail themselves of that defence because they will likely have too much knowledge about the company's financial affairs.

6.8 Relevant examples include:

(a) A guarantee by a company to a bank to benefit financially troubled sister company, which is a classic example of an undervalue transaction.

(b) The taking of (additional) security to secure payments to a related company, director or person in a special relationship will constitute a breach of s 299.[85]

6.9 Banks with general security agreements need also to be live to directors transferring secured assets to third (related) parties when a customer is in the twilight zone. For example, the financier faces a risk of loss of priority, if the transferee then borrows money secured against the transferred assets.[86] An original secured party has 15 days from the date it acquires sufficient knowledge to register a financing change statement under the PPSA to do so. Otherwise it losses priority to any

[84] Sections 292 – 299 of the Companies Act 1993.
[85] See for example *Petterson v* Browne [2016] NZCA 189.
[86] Section 88 Personal Property Securities Act 1999

security interest granted by the transferee that secures advances made or contracted for. The secured party loses priority to the extent of those advances from the expiration of the 15th day until the original secured party registers a financing statement.

Shadow directors

6.10 A financer who becomes too involved in the affairs of company approaching insolvency might find himself or herself liable as shadow director for breaches of directors' duties.

6.11 ‘Director’ is defined inclusively in section 126(1) of the Act. It includes:

(a) 'De jure' director: validly appointed under section 150 of the Act. Strictly speaking, only de jure directors are meant to exercise directors' powers and duties.

(b) 'De facto' director: although not actually appointed, a person who is held out by the company, and purports to act, as a director.

(c) Shadow director: a person on whose instructions or directions the appointed directors are required or accustomed to act.

6.12 The English Court of Appeal has described a shadow director as someone who: [87]

> “…*does not purport or claim to be a director. On the contrary, he claims not to be a director. He lurks in the shadow, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself. He is not held out as a director by the company*”.

6.13 A shadow director may sometimes be thought of as a puppet master controlling the 'de jure' directors. But in its wider sense it can also mean a person who provides financial or management assistance to the company.

6.14 New Zealand courts have accepted that a bank could, in the right factual circumstances, act as a shadow director, although no bank has yet been held liable as such.[88] A shadow director (unlike a 'de jure' director) does not have to be a 'natural person'.[89]

6.15 The following guidance can be taken from the few New Zealand cases in which this issue has been considered, as well as a significant body of case law in the UK and Australia:

(a) The mere provision of advice in a professional capacity will not trigger shadow director liability (section 126(4)). Some form of active participation is required.

(b) It must be shown that "*all the directors, or at least a consistent majority of them,*" had been accustomed to act on the directions of the alleged shadow director.[90]

(c) Banks are entitled to protect their interests. In particular, lenders can, to some extent, impose conditions on the provision of ongoing finance. For example:

(i) In the English case of *Ultraframe*, the Court accepted a submission from counsel that:[91]

[87] *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180.
[88] *Krtolica v Westpac Banking Corporation* [2008] NZCCLR 24 (HC); *Vance v Jeffreys* [2014] NZHC 1932.
[89] *Gillies Bakery Ltd v Gillespie* [2013] NZHC 1608, affirmed in *Gillies Bakery Ltd v Gillespie* [2015] NZCA 93.
[90] *Lord v Sinai Securities Ltd* [2004] EWHC 1764 (Ch).
[91] *Ultraframe (UK) Ltd. v Fielding & Ors* [2005] EWHC 2506 (Ch), at [1268]

> "*…it is critical to distinguish the position of a lender (whether or not also a shareholder) from that of a director. A lender is entitled to keep a close eye on what is done with his money, and to impose conditions on his support for the company. This does not mean he is running the company or is emasculating the powers of the directors, even if (given their situation) the directors feel that they have little practical choice but to accede to his requests. Similarly with customers who may, because of their buying power, be able effectively to dictate conditions to their suppliers (or the other way around). In other words a position of influence (even a position of strong influence) is not necessarily a fiduciary position. To find otherwise would place a wholly unfair and unnatural burden on men of business.*"

(ii) In the UK case of *PFTZM Ltd*, the Court noted that the bank was protecting its interests by imposing conditions, and it was open to the customer whether to agree to those conditions.[92] Of course, the practical reality is that if customers want to retain ongoing financing, they will accept those conditions, unless they can find other funding sources, which typically are difficult to secure when a company is in the twilight zone.

(iii) In *Antico*, the New South Wales Supreme Court considered that imposing conditions as to the application of funds, requiring increased disclosure of company affairs, requiring new security and requiring the sale of some assets were permissible conditions.[93]

(iv) In the Australian case of *Buzzle*, the liquidator failed to have the financier held liable as a shadow director for allowing the company to continue to trade beyond a point when the financier knew that the company was insolvent.[94]

(d) Banks, cannot however, cross the line to take effective control of the business. This is ultimately a question of fact and degree:

(i) Involvement might have a cumulative effect. The Court in *Re Tasbian Ltd* recognised that the imposition of conditions might not amount to control when viewed in isolation, but would when considered together.[95]

(ii) Further, some conditions are more likely to expose a bank to risk. Red flags include:

(1) Controlling a customer's bank accounts and deciding which creditors will be paid and in what order.[96]

(2) Major strategic decisions such as delaying a takeover, abandoning a planned acquisition or selling a related company.[97]

(e) Banks are entitled to provide professional advice, but they should allow directors to maintain independent judgment as much as possible. In *Krtolica*,[98] a guarantor attempted to avoid liability under a guarantee by arguing, among other things, that Westpac had acted as a

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92 *In re PFTZM Ltd* [1995] BCC 280.
93 *Standard Chartered Bank of Australia v Antico* (1995) 131 ALR 1.
94 *Buzzle Operations Pty Ltd v Apple* (2011) 277 ALR 189 (NSWCA)
95 *Re Tasbian Ltd (No 3)* [1992] BCC 358 (UK).
96 *Re Tasbian Ltd (No 3)* [1992] BCC 358 (UK); *In re PFTZM Ltd*, at 284, 290.
97 *Antico; Vance v Jeffreys [2014] NZHC 1932 – (*summary judgment application).
98 *Krtolica v Westpac Banking Corporation* [2008] NZCCLR 24 (HC.

shadow director by participating in the running of a creditor preference scheme by the principal debtor, Seamart, as it attempted to trade its way out of insolvency. The High Court found no evidence that Seamart's sole director was required or accustomed to act on Westpac's directions. Rather, the director was responsible for all of the company's strategic and policy decisions, and exercised independent judgement in all areas of business, including by approaching potential investors, negotiating lease and supply agreements and rejecting an offer to purchase the business. The bank protected its interests as it was entitled to do, but did not take over the operation of the company.

6.16 Section 126 is not an empowering provision – it does not vest in a shadow director all of the powers and authorities of an appointed director.[99] Rather, it means that a shadow director can be held liable for certain breaches of directors' duties, including insolvent or reckless trading and the duty to act in the best interests of the company (ie, the duties in sections 131-141 and 301).

Banker duties

6.17 Aside from liability as shadow directors, banks may find themselves the subject of an action by the company, when it is a customer of the bank, or a third party as a consequence of involvement with a company approaching insolvency.

6.18 Although there is limited case law or commentary, the threshold for such liability is likely to be the same or similar to the threshold for liability as a shadow director.

The company

6.19 Generally, banks are not required to provide advice to their customers on business or banking transactions and typically avoid doing so. In *Cantara*, Associate Judge Smith said:[100]

> *"As Asher J noted in Bank of New Zealand v Geddes,[101] banks in New Zealand will examine a transaction from the point of view of their own purposes. In doing so they take on no duty to the person who is seeking the loan to advise or warn. In an ordinary lender/borrower transaction, the relationship is commercial, with the two sides openly having different interests that they compromise in a bargain for their mutual financial advancement — the bank to make interest on the advance, and the customer to have the use of the money."*

6.20 If a bank undertakes to do give advice, however, and the customer subsequently suffers loss, liability could arise in tort, in equity, the Fair Trading Act 1986 (FTA) and the Financial Advisers Act 2008 (FAA):

(a) **Tort**: The applicable legal principles are, in summary:[102]

(i) In general a bank is not under a legal obligation to provide advice or explain the nature and effect of a proposed arrangement. But if it gives advice, then it must do so using reasonable care and skill.[103]

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[99] *Arcadia Homes Ltd (in liq) v More to this Life Ltd* [2013] NZCA 286 at [34]-[35].
[100] *Cantara Ltd v Bank of New Zealand* [2015] NZHC 2775 at [154].
[101] *Bank of New Zealand v Geddes* HC Auckland CIV-2008-404-8082, 28 May 2009 at [23]-[25].
[102] Finch & Anor v Lloyds TSB Bank Plc [2016] EWHC 1236 (QB), at [46]; *Warne & Elliott,* Banking Litigation (1999), at 36
[103] *Banbury v Bank of Montreal* [1918] AC 625 (HL) at 654, referred to in *Bank of New Zealand v Geddes* HC Auckland CIV-2008-404-8082, 28 May 2009 at [26]; *Woods v. Martins Bank Limited* [1958] 1 QB 55 per Salmon J at 71; *Bankers Trust International Plc v. PT Dharmala Sakti Sejahtera (No.2)* [1996] CLC 518 *per* Mance J as he then was at 533; *National Commercial Bank (Jamaica) Limited v. Hew* [2003] UKPC 51 per Lord Millett at [22]; and *Paget, Law of Banking*, 14th Ed., Para 29.7.

(ii) Whether a duty of care in tort is owed in any particular case will depend upon the application of one or more of the usual three tests:

(1) The assumption of responsibility coupled with reliance test.

(2) The three-fold-test (reasonable foreseeability of loss, sufficient proximity between the parties and whether it is in all the circumstances fair just and reasonable to impose a duty).

(3) The incremental test – having regard to the exchanges which cross the line between, and the dealings of, the parties considered in their context.[104]

(iii) In approaching the question using the methodology referred to in (ii) above, there is a distinction to be drawn between the provision of advice in the context of a commercial relationship and assuming responsibility for that advice.[105] A bank's liability for negligent advice may be negated, however, by an appropriately worded disclaimer accompanying the advice.[106]

(b) **Fiduciary duty**:

(i) A fiduciary relationship arises when one party is entitled to repose trust and confidence in the other.[107] There is no presumption of a fiduciary relationship between banker and customer.[108]

(ii) A fiduciary relationship will arise, however, if the banker "crosses the line" between a normal business relationship and a relationship of dominating influence.[109] That line may be crossed if the bank assumes an investment advice role and reliance by the customer is evident. All the circumstances will be relevant including whether the bank introduced the parties, whether it advised the customer when in a situation of conflict, whether the customer was sophisticated, and whether the customer received independent professional advice.[110] The fact that the arrangement between the parties was of a purely commercial kind, and that they had dealt at arm's length and on an equal footing has been regarded as an important, if not decisive, fact in indicating that there is no fiduciary duty.[111]

(iii) If a fiduciary duty does exist, the banker has an obligation to avoid conflicts of interest, including between itself and the customer, and the customer and other customers of the branch.

(iv) In addition, as discussed above, directors owe fiduciary duties to the company, including to act in good faith and in the best interests of the company. A bank will be liable for dishonest assistance if it assists a breach of trust when it knows, or is wilfully

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[104] See *JP Morgan Chase Bank v. Springwell Navigation Corp* [2008] EWHC 1186 (Comm) *per* Gloster J as she then was at [48]-[52] and *Standard Chartered Bank v. Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm).
[105] see *JP Morgan Chase Bank v. Springwell Navigation Corp* (ante) at [374].
[106] *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465, [1963] 2 All ER 575 at 583.
[107] *Chirnside v Fay* [2006] NZSC 68 at [51] and [80].
[108] *Forivermor Ltd v ANZ Bank of New Zealand* [2011] NZCA 129 at [61] and [62].
[109] *Shotter v Westpac Banking Corporation* [1988] 2 NZLR 628 (HC) at 324.
[110] *Taylor v Bank of New Zealand* [2011] 2 NZLR 628 (HC) at [127].
111 Alison v Westpac Banking Corporation HC Wellington CP 59/93, 12 July 1996 at 40, citing Hospital Products Limited v United States Surgical Corporation (1984) 156 CLR 41 at 70 and 119.

blind to the fact, of the breach of trust. It will be liable for knowing assistance if it knowingly receives a benefit as a result of a breach of trust.[112] Arguably, this could include restructuring arrangements or preferential payments that benefit the bank at the expense of the company / creditors.

(c) **FTA**:

(i) The FTA prohibits misleading and deceptive conduct in trade.[113] In essence, these provisions are concerned with misrepresentations.

(ii) Although the FTA cannot be contracted out, disclaimers such as entire agreement clauses are relevant to determining whether the conduct in issue was causative of loss. In particular, when commercial contracting parties agree that pre-contractual representations were not relied on, courts will not generally find that they were, absent public policy reasons.

(iii) FAA: Section 33 of the FAA provides that a financial adviser, when providing a financial adviser service, must exercise reasonable care, diligence and skill, having regard to the nature and requirements of the client, the nature and circumstances of the advice, and the type of financial adviser.

6.21 The High Court case of *Cantara* is a useful illustration of those principles in practice.[114] Cantara Farms Ltd borrowed $4.55 million from the bank to buy a piece of farmland, and then leased the farmland to Cantara Ltd. It was a bad purchase: Cantara Ltd made yearly losses working the land, and the farm was eventually sold at a loss of approximately $1.2 million.

6.22 Cantara claimed that the bank was guilty of negligent misstatements, misleading and deceptive conduct, and breached duties of care and a fiduciary duty. In particular, Cantara said that:

(a) The bank actively promoted the purchase of the land, including by saying a valuation was not required and proposing a security arrangement, and represented that the purchase price was realistic when it was not. In doing so, it assumed the role of business adviser and subordinated Cantara's interests to its own (the bank had a mortgage over the farm).

(b) The bank also produced budget forecasts for the group which contained errors, and failed to properly assess the financial position of the group.

(c) Cantara relied on the forecasts, budgeting and advice to its detriment.

6.23 In granting summary judgment to the bank, Associate Judge Smith made the following interesting comments:

(a) The bank was protecting its own interests, as it was entitled to do, by putting forward a security proposal and not requiring a valuation of the land. It was not reasonable for Cantara to treat that as advice as to the merits of the purchase.[115]

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[112] *Westpac Banking Corp v Savin* [1985] 2 NZLR 41 (CA)
[113] Sections 9-14.
[114] *Cantara Ltd v Bank of New Zealand* [2015] NZHC 2775.
[115] At [87], [91].

(b) The (forecasting and budgeting) provided by the bank had an appropriate disclaimer. Further, the information was directly within Cantara's knowledge and could have been checked. Again, it was not reasonable for Cantara to rely on that analysis.

(c) The bank had no duty to advice a customer to obtain independent advice.

(d) The parties were commercial entities dealing at arms' length. There was no element of domination.[116]

(e) It is not uncommon for rural banks to be asked to provide a loan in respect of a purchase of land over which they have a mortgage. That does not necessarily give rise to a conflict of interest, particularly when the purchaser's and vendor's accounts are with different branches.[117]

Guarantors

6.24 Persons other than customers may also claim against the bank. In particular, when a company goes into liquidation, guarantors may be called up to satisfy unpaid debts. It is foreseeable that guarantors may then attempt to off-set their losses by claiming a breach of fiduciary or tortious duties against the bank.

6.25 Banks do not owe an absolute duty of disclosure to guarantors. Rather, the fiduciary duty is to inform the guarantor "*only of something which has taken place between the bank and its customer which would not normally be expected"*. Otherwise, the banker is only required to disclose to the guarantor matters that affect the credit of the customer if asked to do so.[118]

6.26 Further, a banker does not have a duty to advise on the risks of providing a guarantee.

6.27 An example of guarantors claiming against a bank is *Unka*, in which the guarantors argued that the bank had acted negligently, breached fiduciary duties and breached the FTA by making representations about the benefits of a particular agreement and not proactively managing the risks under that agreement. The High Court held that there was no arguable case for those alleged duties.

7. CONCLUSION

7.1 In summary, the key messages from the above are that:

(a) In the twilight period, directors must be careful not to breach their duties or to engage in vulnerable transactions. In particular, directors are at risk of breaching the duties not to trade recklessly, not to trade while insolvent, and to act in good faith and in the best interests of the company. Those duties must, however, be considered in the context of the commercial benefit of legitimate business risks. The business judgment rule is still alive and well in New Zealand, and it is not necessary that a company must stop trading immediately upon insolvency.

(b) When a company is approaching insolvency or is insolvent, creditors become stakeholders in the company. As such, the duty to act in good faith and in the best interests of the company

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[116] At [122]-[124].
[117] At [117].
[118] *Shivas v Bank of New Zealand* [1990] 2 NZLR 327 at 362-364.

includes considering the interests of creditors. This is not a duty owed to creditors, and does not mean that directors must forego good faith restructuring in order to share *pari passu* between creditors.

(c) Remedies are available at general law and under the Act for breaches of directors' duties. The most useful of these is likely to be the ability of liquidators, shareholders and creditors to seek compensation under section 301 of the Act. Reliance on professional advice may excuse a breach. Directors may also face prosecution for criminal offences. Directors may not be protected under company indemnities or D&O insurance policies for breaches of their duties.

(d) Financers may themselves be liable as shadow directors for breaches of directors' duties. In general, a bank is entitled to protect its interests, but should not go so far as to be effectively controlling the company.

(e) Financers may also face a suit from the company or third parties such as guarantors for advice provided to a company in the twilight period. A duty of care may attach in tort, in equity or under statute if the financier assumes responsibility for their advice. It must then take reasonable care in giving the advice.

(f) There are a number of areas that remain to be developed fully in the courts, or by the legislature, including the relevance of public disclosures and a potential safe-harbours defence. The legal environment continues to evolve and develop post-GFC.