CORPORATE COLLAPSE - Pitfalls for Directors, Auditors and Bankers

CORPORATE COLLAPSE - A DIRECTOR'S VIEW

MICHAEL SMITH

(ORAL PRESENTATION OF PAPER PREPARED BY DR ROBIN CONGREVE)

Lion Nathan Limited, Auckland

The thesis I would like to develop this morning is that the traditional intervention of the law in relation to directors' duties does too much in one sense and not enough in another : that as a means of regulating directors' behaviour, the legal response is limited and even more flawed as a means of guiding and shaping directors' behaviour to the standards which are thought to be desirable.

Capitalism is all about risk and reward. The management of these risks and the allocation of reward is at the heart of directors' responsibilities. Ideally, the market prices risk, and reward, or loss, follows accordingly. When things go wrong, or worse, disastrously astray, those affected will call into question the judgments that have been made in balancing the interests of equity, debt and management. In my view, the law provides something less than the ideal context in which to judge the overall standards by which directors should balance the various interests under their control. Of necessity, the law judges with the benefit of hindsight, and applies standards that may be relevant at the time at which the case is heard rather than the time at which events happened, often years earlier.

Take the statement of Ormiston J: "Some of the more disastrous liquidations of recent years would not have occurred", he said, "if companies had been more rigorously administered by directors."

The sting is in the qualification that companies would still have gone into liquidation, but "those companies would have stopped trading and gone into liquidation at a much earlier stage."

There are cases when this is true - where trading continues for all the wrong reasons and no good reasons : in the worst cases, simply to put off the evil day when lifestyles must change and publicity must be faced - or worse.

In more frequent and less extreme cases, the judgment Ormiston J calls for is, as always, more easily made with the benefit of hindsight and with a very clear view of whose interests are to be preferred. That early receivership is best may well be right in

retrospect, when the terms of trade have steadily declined and asset value fallen. Is it always so obvious when the future is unknown and when not only creditors' interests but also those of equity and employees are to be taken into account? Liquidation or receivership is the comfortable response, particularly for classes of secured creditors. As a means of realising maximum value for a business or its assets, receiverships are often less than satisfactory and sometimes worse than that. The very fixed and limited role of the receiver and his inherent lack of accountability is in stark contrast with the wider and more difficult role of the director of an ongoing enterprise, even one which is in difficulties.

A recent example of the law's intervention in New Zealand is the prosecution of former Rada directors for allegedly issuing a false prospectus. When Prorada was floated, the prospectus indicated that Rada had committed itself to subscribe for a substantial part of its capital. At the time the prospectus was issued, Rada had subscribed for shares to be paid up on the same day that the subscriptions for the public issue were due. At the time, Rada did not have the cash to pay the call, nor did it have committed funding lines. It had had discussions with its bankers and had been given more than adequate comfort. The call was paid, albeit after the usual delays that accompany a large refinancing transaction.

Years later the actions of directors were called into question in criminal proceedings. The stated commitment of Rada was said to be "misleading" because there was no cash or committed funding lines and notwithstanding that the call was actually paid. Although the prosecution was unsuccessful, the defendants were put to the considerable cost, inconvenience and professional embarrassment of establishing in criminal proceedings that their behaviour at the time was more than acceptable. The attitudes of disappointed investors, together with the change in the general investment environment, intervened between the time of their actions and the time of the proceedings. There was every risk that post-1987 attitudes to the availability of funding would be applied to the actions of directors taken at an entirely different time.

Possibly it is just because the law operates in the way that it does, that when it comes to providing general standards, as distinct from particular legal consequences, it asks so little. Certainly it has in the past. Recent New Zealand experience provides a typical example of this.

The Governor of the Reserve Bank recently delivered a paper reviewing some of the conclusions that can be drawn from the ***DFC*** experience. Among other features, Dr Brash referred to DFC's poor information systems and credit policies. While not unique to DFC, there are some important aspects in Dr Brash's comments. DFC had applied for a bank licence. The Reserve Bank's prudential supervisors sought extensive information : for quite some time, DFC directors had been overhauling its information systems and management processes. The ongoing effort led the directors to the conclusion that DFC could not continue in the light of the detailed information being produced in that area.

The point relates not just to DFC in particular, but rather to reflect on the type of event, against which a judicial statement can be made:

> "Even in a small company a director should ask for and receive figures, albeit of a basic kind, on a more or less regular basis. If that is sought and it reveals no difficulty, and the director has no other reason to suspect the company may not be able to pay its debts as they fall due, then the director may be shown to have acted reasonably."

With respect, I do not accept this statement as being remotely correct and, contrary to Professor Baxt, I do not find it "chilling" if it accurately states the law.

Asking for and receiving figures, albeit of a basic kind, is a useless process if what is given is fundamentally flawed. The "figures" may well be totally misleading : in the case of DFC, it would appear that they were, for the reasons given by Dr Brash. The directors' prime responsibility is to ensure that they, ***first***, can define the issues which the management information systems are required to address. That takes special knowledge of the particular business and the risks that it particularly may face. ***Second***, the directors are responsible for ensuring that management is knowledgeable about those issues and is routinely applying the system in making decisions and reporting their efforts to the board, and, ultimately, to the shareholders. ***Third***, the directors must ensure that the management is independently tested by controls and internal audit checks. Without each step, a director has no basis for any view about what "the figures" say.

The passage quoted simply begs the real question about directors' duties. The operation of "the law" provides no real assistance for a director. Again, DFC is illustrative of the utility of a prescription : the prescriptions in the Reserve Bank Act about exposures, risk management, credit controls and audit procedures provide a touchstone against which to measure directors' performance.

As I write this commentary, it has been announced by one of Britain's large liquor and food groups that its profit for the year will be substantially reduced because of a 147 million pound loss caused by its Treasury and foreign exchange speculation. Because the Finance Manager, apparently deliberately, breached authorised dealing limits, he was summarily dismissed. The point is that there were authorised limits : the breach was plain on the day because of good systems and controls. Directors cannot prevent losses - even disastrous losses. But they do have to set limits and ensure that controls exist. This did not save the directors in the case referred to above - the Chairman and Chief Executive have been retired early without compensation. The standards of the market place can, at times, be harsher than any legal requirements.

The clearer the expectations of the various interests that make up a company, the more specific the risks that they accept and do not accept, the easier it is for directors to balance those interests and for them to be assessed on their performance. In the case of equity, this occurs when the company itself spells out for its shareholders the expectations, the direction of its business and the risks that it intends to take in achieving those goals.

In the case of debt, there is more of a two-way exchange. The lender takes more interest in the business of the borrower and provides reference points for the measurement of performance. This means that there is a much greater exchange of information and the borrower is much more aware of the tolerances of the lender and the limits of performance that are expected of him.

Some years ago, in New Zealand at least, the "relationship" in banking tended to be at a personal level and not focused on the business of the borrower and the expectations of the lender. Lenders often had only a general understanding of the business needs and limitations of the borrower and took too much comfort from the apparent value of property and other assets securing the borrowing. When the value of those assets diminished, not only was security lost, but often the viability of the borrower itself disappeared.

It is hardly surprising that in those circumstances the expectations of borrower and lender were frustrated. The lenders because they did not appreciate they ability of the borrower to repay principal and/or service the loan; the borrowers because they thought, or assumed, that the lender ***did*** understand. Often, bankers took what amounted to an equity risk for banking and sometimes a very slim banking margin. The bankers lost and so, too, did many of the borrowers. They were simply not able to respond to the new conditions that the bankers imposed in harder times.

In more recent banking practice, both lender and borrower are made much more aware of each other's position. The lender will require trigger points and spell out consequences of breaches. Its approach will be more that of a quasi partner - at the low risk/low reward end of the spectrum - but still part of the borrower's business.

These changes in banking practice provide, in a sense, a code of behaviour agreed by the parties to govern their relationship. The directors can then manage the company in the context of the expectations that have been more or less clearly defined.

All this leads me to the point of having to disagree with Bob Baxt about the need for a code of conduct. This I am happy to do from a distance of 12,000 miles!

Accepting the complexity that Bob admits, the traditional legal response to directors' duties is too episodic, too confused, too limited in its response and often just simply too late.

A code of conduct need not be a substitute for the law. It can provide reference points against which the law can operate. It can provide a contemporary standard and provide it in advance. Importantly, it can be just as appropriate for the running of successful companies as for their management when they fail. A code need not be complete and cannot be definitive, but it can do more than the law to guide directors and provide appropriate measures against which, if necessary, they may subsequently be judged.