Banking & Financial Services Law Association

The 26th Annual Banking and Financial Services Law and Practice Conference

Sheraton Mirage Resort, Gold Coast

31 July -1 August 2009

Director Duties and insolvent trading – the existing law and its effects

James Douglas
Partner
Minter Ellison Rudd Watts
Wellington

Observations on New Zealand's Reckless Trading Regime

James Douglas

BFSLA Conference: 1 August 2009

New Zealand: Reckless Trading

- The Companies Act 1993 “codified” the established common law and equitable duties:

  - duty to act in good faith and best interests (section 131)

  - duty to use powers for proper purposes (section 133)

  - duty to exercise reasonable care, diligence and skill (section 137)

New Zealand: Reckless Trading

- The 1993 Act also created two bespoke statutory duties associated with insolvency:

  - duty not to carry on business in a manner creating a substantial risk of serious loss to creditors (section 135 – “reckless trading”)

  - duty not to incur obligations unless it is believed on reasonable grounds that they can be performed (section 136)

New Zealand: Reckless Trading

- Section 135 obliges directors not to allow:

  "the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to creditors"

- When the test is parsed out, the conduct must give rise to:
  - a better than evens chance
  - of creating a substantial (not negligible) risk
  - of serious (material) loss
  - to creditors (insolvency)

New Zealand: Reckless Trading

- It is hard to resist the proposition that section 135 is an insolvency-specific subset of the duty of reasonable skill and care

- The test is objective

- The duty does not reflect a reckless knowledge standard

- The duty of skill and care also requires regard to be had to the interests of creditors in the zone of insolvency

- The need for a <u>serious</u> risk of <u>substantial</u> loss is not inconsistent with a negligence standard – the risk and extent of harm are both relevant in determining whether a duty of care arises

New Zealand: Reckless Trading

- Judicial concern has been expressed that section 135 may discourage enterprise by setting the bar for liability too low:

  - *Mason v Lewis* (CA, 2006):

    "The section has been strongly criticised as potentially unduly deterring directors from taking business risks …"

  - *Re Condrens* (HC, 2008):

    "*less clear is … the relationship between the specific duties of directors and the recognition that one purpose of the limited liability company is to allow for the taking of business risks*."

New Zealand: Reckless Trading

- In this context, section 135 can be contrasted with section 320 of the 1955 Act, which required reckless knowledge:
    - *Re South Pacific Shipping* (HC, 2004):

      "*Reference as to what reasonable directors would have done or foreseen can easily lead to a process of thinking in which liability is imposed for negligence and not recklessness*"

      "*His behaviour departed so markedly from orthodox business practice and involved such extensive and unusual risks to creditors that it can fairly be stigmatised as reckless.*"

New Zealand: Reckless Trading

- The same standard has been adopted for sections 135 and 136, despite the absence of a reckless knowledge requirement:

  - *Re Condrens* (HC, 2008):

    "*I do not consider that their conduct departed so markedly from orthodox business practice and involved such extensive and unusual risk that it can fairly be stigmatised as reckless.*"

    "*It would … be surprising … if a director's behaviour was to be assessed against a materially different standard depending on whether a particular obligation was incurred as part of a continuing series of transactions or … as part of a stand-alone transaction.*"

New Zealand: Reckless Trading

- When this judicially formulated test is compared with the text of sections 135 and 137, it is easy to see why there is uncertainty:

(1) *The director's conduct departed so markedly from orthodox business practice and involved such extensive and unusual risk that it can fairly be stigmatised as reckless*

(2) *The director allowed the business to be carried on in a manner likely to create a substantial risk of serious loss to creditors*

(3) *The director failed to exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances*

New Zealand: Reckless Trading

- Further uncertainty results from the courts' power to relieve directors from liability on a relative culpability basis

- Claims in liquidation are usually prosecuted under section 301 of the Act - a streamlined application procedure entailing an essentially equitable judicial discretion to order contribution

- The courts have held that the degree of culpability is to be taken into account in assessing quantum under section 301, <u>despite</u>:
  - the legislature's abolition of the courts' wider discretion to relieve honest and reasonable directors from liability; and
  - the non-mandatory nature of the section 301 procedure

New Zealand: Reckless Trading

- The law lacks coherence:
  - We have bespoke statutory provisions that are being interpreted to require an extreme form of negligence
  - It is unclear how this standard reconciles with the common law standard of care and skill, preserved in section 137
  - We have a Judge-made basis for discretionary relief from liability, but only in respect of section 301 applications
  - Result: uncertainty for directors and insolvency officeholders

New Zealand: Reckless Trading

- The statutory test has created more rather than less uncertainty
- If the desire is to raise the liability bar in the interests of protecting enterprise, clear legislation to that effect is required
- Alternatively, get rid of bespoke statutory tests and leave it to judicial development of the common law negligence standard
- Under either scenario, the law needs to deal coherently with the courts' discretion to relieve from liability