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[NOT to be cited without prior approval from Justice Heath]

CORPORATE GOVERNANCE: THE NEW ZEALAND PERSPECTIVE[1]

Introduction

[1] Governance of a company is something more than its management. The concept of governance recognises a need for those charged with responsibility for the way in which a company does business to develop strategies and to ensure they are carried out through regular supervision of those entrusted to perform the day-to-day management.

[2] This paper discusses the interlocking nature of the duties owed by directors to a company and the extent to which directors may rely on third parties in discharging their obligations. My task is to consider the issues from the New Zealand perspective.

[3] "Directors direct; managers manage"; "Clients instruct; advisers advise".[2] I made those statements when giving reasons for verdicts in a (Judge-alone) criminal trial involving directors of a finance company who had been prosecuted for making false statements in prospectuses.[3] In response, Mr Rob Campbell said that the "mantra" sounded "plausible enough to be incorporated without noticeable dissent into Court judgments and director training" but suggested that it should really have said something like "Managers manage and directors manage the managers, change the managers, or take the consequences if the managers don't manage well".[4]

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1 By Hon Justice Paul Heath, a Judge of the High Court of New Zealand.

2 *R v Moses* HC Auckland CRI-2009-004-1388, 8 July 2011 (Reasons for Verdicts), at para [100].

3 Ibid, at para [74].

4 Rob Campbell, *Weekend Review* National Business Review, 24 April 2013 (last searched at www.nbr.co.nz on 1 September 2015).

[4] Mr Campbell may not have been too far away from the mark in what he said. Depending upon the size of a company, directors will be required either to manage the business themselves, or to supervise management by others. The ability of directors to rely on work undertaken by those to whom tasks have been delegated or from whom advice has been sought qualifies the last of Mr Campbell's propositions: namely, that directors "take the consequences if the managers don't manage well". I would say that directors take those consequences if they do not supervise the management of the company in the manner required by law.[5]

[5] Collier J and I have been asked to consider the likely responses of Australian and New Zealand company law respectively to certain actions taken by directors of a fictional company called Acme Computing Ltd (Acme). The questions are focussed on whether directors complied with their legal obligations and appropriately relied, in some situations, on advice received from employees and a third party adviser.

The New Zealand legal landscape

[6] The Companies Act 1993 (the Act) had its genesis in an extensive review of company law undertaken by the New Zealand Law Commission from 1987 until 1990.[6] Before that Act was passed, duties owed by directors had developed through both common law and equity.[7]

[7] In stating the purposes of its proposed reforms, the Commission said:[8]

> OUTLINE OF SIGNIFICANT REFORMS
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> 10 THE MOST SIGNIFICANT REFORMS PROPOSED ARE
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> …

5 The "reliance" provisions to which I shall refer are set out in ss 130 and 138 of the Companies Act 1993.

6 New Zealand Law Commission, *Company Law (discussion paper)* (NZLC pp 5, 1987) and *Company Law Reform: Transition and Revision* (NZLC R 16, 1990).

7 Generally, see *Grayburn v Laing* [1991] 1 NZLR 482 (HC) at 489–491.

8 New Zealand Law Commission, *Company Law Reform and Restatement* (NZLC R 9, 1989).

- Redefinition of the distribution of power within the company by direct operation of statute rather than by a deemed contract

…

- A fuller restatement in the statute of the duties and powers of directors

…

[8] The Long Title to the Act explains its purposes in relatively simple terms. Relevantly, those purposes include

[a] an affirmation of the utility of the limited liability company as a means of aggregating wealth,[9]

[b] permitting those involved in managing a company's affairs to exercise an appropriate degree of business judgment[10] and

[c] providing an accessible means of defining the relationships between companies and their directors, shareholders, and creditors.[11]

[9] The "director" is defined extensively, to include a person occupying the position of a director, "by whatever name called".[12] The primary duty of a board of directors is to manage (or supervise) the business and affairs of the company.[13] The way in which that function is expressed reflects the widely disparate sizes of a company, from the "one person" company on the one hand, to the listed company, on the other. The performance of obligations cast on directors will necessarily be assessed by reference to the nature and size of the company in question.

9 Companies Act 1993, para (a) of Long Title.
10 Ibid, para (d) of Long Title.
11 Ibid, para (c) of Long Title.
12 Companies Act 1993, s 126(1)(a). The term "board of directors" is defined by s 127. That definition captures what are called de facto or shadow directors.
13 Ibid, s 128.

[10] Although, the general nature of the management and supervision powers are expressly stated,[14] in my view the specific duties of directors run co-extensively with any common law obligations and equitable duties owed to the company.[15] Certainly, the Law Commission did not intend the statutory regime would constitute a code.[16] Further, it is arguable that the full range of fiduciary duties attaching to directors remain outside the scope of the statutory provisions.[17] In addition, duties owed by directors to persons other than the "the company" are not specifically addressed in the Act.[18]

[11] Nevertheless, the fundamental duties owed by directors to a company have been stated succinctly in the Act. This has made them more accessible to those who assume office as directors, and to those by whom they are advised. I summarise the nature of such duties:

[a] A director must, when exercising powers or performing duties, act in good faith and in what he or she believes to be the best interests of the company.[19]

[b] The duty to act in good faith and in the best interest of the company does not preclude a director from making provisions for the benefit of employees of the company, in the event that the company might, in the future, cease to carry on all or part of its business.[20]

[c] A director must exercise powers for proper purposes.[21]

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14 Ibid, s 128.

15 Generally, see *Benton v Priore* [2003] 1 NZLR 564 (HC) at para [45]–[47] and *Morgenstern v Jeffreys* [2014] NZCA 449 at para [55]. For example, a breach of fiduciary duty would be actionable against a director, even though all such duties have not been codified.

16 New Zealand Law Commission, *Company Law Reform: Transition and Revision* (NZLC R 16 1990) at 14.

17 Generally, see Watts, Campbell and Hare, *Company Law in New Zealand* (LexisNexis Wellington 2011) at para 12.1, 425–427.

18 Ibid, para 12.2, 427.

19 Ibid, s 131(1). That general duty is qualified when the company is a wholly owned subsidiary (s 131(2)), a subsidiary that is not wholly owned (s 131(3) or a company involved in a joint venture (s 131(4)).

20 Ibid, s 132.

21 Ibid, s 133.

[d] A director must comply with requirements of the Act and the constitution of the company.[22]

[e] A director must not be party to the company trading recklessly; namely, in a manner likely to create a substantial risk of serious loss to the company's creditors. Nor should he or she cause or allow the business of the company to be carried on in such a manner.[23]

[f] A director must not agree to the company incurring an obligation unless he or she believes, on reasonable grounds at the time the obligation is incurred, that the company will be able to perform the obligation when required to do so.[24]

[g] A director must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances. Without being exhaustive, the nature of the company, the nature of the decision, the position of the director, and the nature of the responsibilities undertaken by him or her must be taken into account in determining whether that duty has been performed adequately.[25]

[12] The ability of directors to rely on others takes two forms. The first is where the board has delegated certain tasks. The second is where it relies on information received from others in making its own decisions:

[a] Subject to any restrictions in the company's constitution, the board may delegate tasks to one or more directors or employee of the company other than those excluded by the Act.[26] The board remains responsible for the exercise of any delegated power, unless

22 Ibid, s 134.
23 Ibid, s 135. Generally, see *Mason v Lewis* [2006] 3 NZLR 225 (CA) at paras [44]–[52].
24 Ibid, s 136.
25 Ibid, s 137.
26 Companies Act 1993, s 130(1). Those powers that cannot be delegated are set out in Schedule 2 to the Companies Act 1993.

[i] the board believed on reasonable grounds, at all times before the exercise of the power, that the delegate would exercise the power in conformity with legal requirements and,

[ii] afterwards, the board has monitored, by means of reasonable methods properly used, the actual exercise of the power by the delegate.[27]

[b] A director may rely on information obtained from employees, professional advisers or other directors when exercising powers and performing duties under the Act.[28] The ability to act on this form of reliance is dependent on the director acting in good faith, making proper inquiry when put on notice and having no knowledge that reliance is unwarranted.[29]

[13] Both forms of reliance are premised on the need for directors to have good grounds to believe that the delegated authorities will be (or have been) exercised properly and that they have reasonable grounds to believe that third party information on which they act has been competently prepared. The pre-requisites to reliance are consistent with the fundamental obligation to exercise supervisory or management decisions remaining with the board.[30]

[14] The duty to take care and to exercise diligence and skill in the management of a company introduced a different approach to directors' duties. No longer, as was the position at common law and equity, did the extent of any duty of care depend on what an individual director had undertaken to do. In years gone by, if "a known juvenile or incompetent" had been appointed as a director "the company could not later sue on the basis of a failure to reach higher standards".[31]

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27 Ibid, s 130(2).
28 Ibid, s 138(1).
29 Ibid, s 138(2).
30 Ibid, s 130(2) and 138(2).
31 Watts, Campbell and Hare, *Company Law in New Zealand* (LexisNexis Wellington 2011) at para 16.1, 550–551. Generally, see *Re City Equitable Fire Insurance Co* [1925] Ch 407 and *Re Cardiff Savings Bank, Marquis of Bute's Case* [1892] 2 Ch 100.

[15] The new statutory provision[32] requires assessment of a director's performance by reference to an objective standard measured against what "a reasonable director" would do in similar circumstances. A degree of reliance is necessary if directors are to meet that standard. That is the reason why a board has power to delegate or to rely on reports, statements, financial data and other information provided by employees for experts.[33]

[16] All of those obligations may be enforced through civil proceedings. However, with effect from 3 July 2014, directors became (potentially criminally liable) if he or she were to exercise powers or perform duties in bad faith, with knowledge that the conduct will cause serious loss to the company.[34] If a director were convicted for such an offence, he or she becomes liable to a term of imprisonment not exceeding five years, or to a fine not exceeding $200,000.[35]

Acme Computing Ltd

(a) The facts

[17] Acme was incorporated in April 2009 and met its demise some six years later, in July 2015. Its business was entrepreneurial in nature, encompassing the development, and subsequent marketing of, a computer software programme. The type of programme under development might reasonably have been expected to capture a market in which security from hackers is a significant concern. That was the nature of the protection that Acme promoted to its potential customers.

[18] From inception, Acme had four directors, each of whom owned 25% of its share capital. Of the four, Mr Carter, Ms Lewis and Mr Benton had experience in running small businesses. We are not told whether they were limited liability companies, but I assume that they were. Dr Corday had no such experience.

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32 Companies Act 1993, s 137.
33 Ibid, ss 130 and 138.
34 Ibid, s 138A(1), inserted by s 4 of the Companies Amendment Act 2014. If a director is exercising powers in relation to the subsidiary or joint venture provisions of s 131(2)–(4) or for the benefit of employees, under s 132, no offence is committed: s 138A(2).
35 Ibid, ss 138A(3) and 373(4).

[19] Mr Pratt was employed as General Manager of Acme. The scope of his authority is unclear. Ms Lockhart, who had qualified as a chartered accountant in 2008, was employed as an in-house accountant, or perhaps more accurately, a book-keeper.

[20] It appears that the hacker protection software was being developed in 2009 and 2010. Few sales appear to have been made after development was completed. The paucity of sales seems to have been the catalyst for the decision to acquire 75% of the shares in Bohrium Media Ltd (Bohrium). Bohrium appears to have been involved in developing market strategies for similar types of businesses. Mr Carter had a 50% stake in that company.

[21] While negotiations were underway for the purchase of the 75% interest in Bohrium, Mr Carter told other shareholders that Acme would pay a premium for a company already operating in that area. As a result, it is likely that Acme paid more than true market value for the shares it acquired. The remaining 25% of the shares were left in Mr Carter's ownership. I am not asked to deal with any possible action arising out of an arguable breach of the duty of loyalty owed by Mr Carter to Acme.

[22] Bohrium's marketing programme seems to have been successful between June 2010 and March 2012, both locally and off-shore. By that time Acme's board had sufficient confidence to seek a contract with the US Defence Department. In March 2012, Mr Carter, Ms Lewis and Mr Pratt travelled to Washington DC to visit Pentagon officials. The possibility of a pilot programme was discussed. At this time, on the basis of their view of the quality of the hacker protection software, all directors of Acme believed that the company would secure a lucrative contract.

[23] While Mr Carter, Ms Lewis and Mr Pratt were in Washington, Ms Lockhart was given the task of preparing a draft set of accounts for the six months to 31 December 2011. Those draft accounts indicated a trading loss of approximately $12.7 million for that period. A balance sheet equity of $3.4 million was disclosed.

[24] Although we have not been told of the extent of indebtedness during this period, it is at least questionable that Acme could not satisfy the first limb of the

"solvency test": namely, that it was unable "to pay its debts as they [became] due in the normal course of business".[36]

[25] Ms Lockhart showed the draft accounts to Dr Corday. The latter suggested they not be sent to other directors because they would "stress them out". She was confident that the lucrative US contract would overcome the "minor shortfall". While both Mr Carter and Ms Lewis were in Washington, the whereabouts of Mr Benton is unclear; as is his participation in decision-making around this time.

[26] Ms Lockhart had been known to make mistakes when preparing financial statements. A particular concern was her propensity to mis-characterise a banking facility so that it was not shown as a current liability. However, the directors had the comfort of a respected firm of auditors, Staid & Old. Unfortunately, that firm did not identify that mistake.

[27] No contract with the Defence Department was finalised. The pilot programme has been described as a "spectacular failure". In June 2012, in enterprising mode, Mr Pratt recommended that Acme enter an agreement with Bohrium to "ramp up" marketing of the product. On his recommendation, an agreement was entered into by which Acme would spend at least $30,000 per month for Bohrium to market the product. It is unclear on what information this recommendation was made.

[28] This arrangement did not improve Acme's financial position. Goodwill had been lost through media reports about the failure of the American pilot. Not only was it difficult to entice new business but also established clients were refusing to enter into new agreements.

[29] Acme's board decided that a press release, disclosing the company's half yearly results, should be issued. Draft financial statements were sent to Staid & Old to confirm they could be released. Staid & Old advised that they had not undertaken a full audit. Rather, its report had been prepared on the assumption that information

36 Ibid, s 4(1)(a). As the value of the company's assets was greater than the value of liabilities, including contingent liabilities, the second limb of the test was satisfied: s 4(1)(b).

provided by Acme was accurate and complete. Staid & Old stated expressly that the report was only for the use of Acme's Audit and Risk Management Committee. Based on information provided to them, Staid & Old did not find any errors.

[30] On Mr Pratt's recommendation the Audit and Risk Management Committee[37] recommended the statement be approved at a meeting held on 15 February 2013. The statement was released on 25 February 2013. Later, it was discovered that Acme's financial position had been mis-stated in a manner that presented it in a more favourable light.

[31] Acme's cashflow position had become tight after the failed pilot programme. To accommodate that adverse effect, Ms Lockhart had stopped paying tax to the Inland Revenue Department. Based on the time at which Mr Pratt recommended an agreement with Bohrium to "ramp up" the marketing strategy (June 2012) the company failed to meet tax obligations from that time until 30 June 2015. On that date, Acme received a letter from the Commissioner of Inland Revenue claiming that it owed more than $19 million in outstanding tax.[38] Shortly after, on 3 July 2015, Acme was placed into a formal insolvency regime.

(b) The issues

[32] The first question is whether the directors of Acme exercise due care, diligence and skill required of a reasonable director in the circumstances.

[33] The second question is whether the directors permitted the business of Acme to be carried on in a reckless manner.

[34] The third question is whether the directors had reasonable grounds to believe that Acme would be able to perform obligations under its agreement with Bohrium.

[35] The fourth question concerns the ability of the board to rely on financial statements prepared by Ms Lockhart, Mr Pratt's recommendations about an

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37 We are not told who sat on this committee.
38 I work on the assumption that that was a default assessment.

appropriate marketing strategy and Staid and Old's review of the information provided to them by the board.

(c) Care, diligence and skill

[36] Section 137 of the Act provides:

> **137 Director's duty of care**
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> A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation,—
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> (a) the nature of the company; and
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> (b) the nature of the decision; and
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> (c) the position of the director and the nature of the responsibilities undertaken by him or her.

[37] All companies trade in a dynamic business environment. That being so, directors are entitled to the benefit of a wide discretion in matters of business judgment.[39] The conduct of a particular director must be assessed by reference to information available to him or her at the relevant time.

[38] In two recent cases, I have adopted the approach of evaluating the way in which a particular director performed his or her functions by reference to a contemporary "boardroom" analysis, in preference to a "financial autopsy" conducted in a courtroom with the benefit of hindsight.[40] In my view, that type of approach is required to give proper emphasis to the business judgment rule.

[39] The question whether a director has exercised the care, diligence and skill of a reasonable director must be assessed against the requirement that the business and affairs of a company "must be managed by, or under the direction or supervision of, the board of the company".[41] For present purposes, I assume that the "board" of

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39 Companies Act 1993, para (d) of Long Title.

40 *R v Moses* HC Auckland CRI-2009-004-1388, 8 July 2011 (Reasons for Verdicts) at para [29] and *R v Sullivan (Reasons for Verdicts)* [2014] NZHC 2501 at para [653].

41 Companies Act 1993, s 128(1).

Acme requires all four directors to act together to constitute the quorum.[42] That means that the directors would not be responsible for direct management of the company, but rather for directing and supervising its business and affairs.[43]

[40] The degree of care, diligence and skill required will depend upon the nature of the company, the nature of the decisions in issue, the position of the relevant director and the responsibilities undertaken by him or her.[44]

[41] The first inquiry is into the role that each of the directors played in the governance of Acme. To the extent that particular directors took responsibility for specific tasks, a question arises as to whether the remaining directors could properly have relied on what they did. From the information provided:

[a] I assume that Mr Carter and Ms Lewis were both executive directors of the company. I make that assumption from their involvement in the visit to discuss the proposed pilot programme with Pentagon officials. Their presence also suggests a significant understanding of the software product.

[b] Mr Benton does not appear to have played any active role in Acme's affairs. I treat him as a non-executive director. Non-executive directors do not owe different duties to the company from other directors. That is apparent from the reference to a "reasonable director" in the "care, diligence and skill" provision.[45] That position is also consistent with the division of responsibility within the board that the Act permits.[46]

[c] It is unclear whether Dr Corday played any role in the day-to-day management of the company. She had no prior business experience.

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42 Ibid, s 127(a).
43 Ibid, s 128(2).
44 Ibid, s 137. The question whether additional duties might be owed to creditors outside of the statutory regime is discussed in Watts, Campbell and Hare, *Company Law in New Zealand* (LexisNexis Wellington 2011) at para 12.2, 427.
45 Ibid.
46 Ibid, s 130. See also *R v Moses* HC Auckland CRI-2009-004-1388, 8 July 2011 (Reasons for Verdict) at paras [397] and [398].

Nevertheless, she was the director to whom Ms Lockhart turned to discuss the draft financial statements for the six months ended 31 December 2011, which disclosed the trading loss of $12.7 million.

[d] I also assume that Mr Carter had some experience in marketing, having regard to his connections with Bohrium.

[e] Ms Lewis was also involved in the March 2012 visit to Washington DC. She too is likely to have had practical knowledge of the software development programme. Otherwise there would have been little point in her having participated in that exercise.

[f] The directors established an Audit and Risk Management Committee. Its membership is unknown. But, it seems clear that the committee's role was to liaise with auditors and to assess independently the need to manage particular business risks. Usually, a committee of that type will make recommendations to a board, rather than making important decisions on its behalf.

[42] All four directors are at risk of a claim that they did not exercise due care, skill and diligence in the performance of their duties as directors. While the information provided is not sufficient to express firm opinions, the following points will require consideration:

[a] An inquiry will be required into the state of knowledge of each of the directors of the true financial position of the company at the time of the March 2012 visit to Washington. For example:

[i] What steps were taken by directors to ensure they were adequately informed about the continuing state of Acme's financial position.[47]

[47] Section 194(1) and (2) of the Companies Act 1993 requires the board to ensure that proper accounting records are kept and to establish and maintain a satisfactory system of control of the company's accounting records.

[ii] What (if any) management accounts were being provided to the directors, and how frequently?

[iii] What steps did the directors take to inform themselves of the financial position as at March 2012, given the significant trading loss of about $12.7 million that Ms Lockhart reported to Dr Corday while other directors were in Washington?

[b] Did the directors understand Acme's perilous liquidity situation at the time it embarked upon the June 2012 agreement with Bohrium designed to "ramp up" marketing of the software?

[c] What knowledge did each of the directors have (and what inquiries did they make) to satisfy themselves that the information provided, prior to the issue of the media statement to announce half yearly results to Staid & Old in mid to late 2012, was accurate?

[d] What functions were delegated to the Audit and Risk Management Committee? And, what was reported to the board?

[e] Why did the directors not know about the accumulation of a taxation liability of over $19 million, in the period leading up to June 2015?

(d) Reckless trading

[43] Section 135 of the Act provides:

135 Reckless trading

A director of a company 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.

[44] In order to be liable for breach of the "reckless trading" provision of the Act, a director must have permitted 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, or to have caused or allowed the business to be carried on in that way.[48]

[45] The concepts of "substantial risk" and "serious loss" have both been considered at appellate level:

[a] The duty not to trade recklessly is owed by directors to the company, rather than to any particular creditor.[49]

[b] The concept of "serious loss" has two elements. First, there is a need to consider whether a risk is "legitimate" or "illegitimate". The second involves an assessment of the scale of loss that might flow from a particular course of action.[50]

[c] The test is to be applied objectively; the focus is on the manner in which the company's business is carried on rather than on a particular director's belief. The issue is whether the company's *modus operandi* creates a substantial risk of serious loss.[51]

[d] Once a company is faced with the prospect of adverse trading conditions, a "sober assessment" is required by the directors of the company's likely future income and the prospects of meeting debts as they fall due. This is an assessment to be undertaken on a continuing basis.[52]

[46] Companies engaged in entrepreneurial activity will necessarily take business risks. These may be characterised as "legitimate". Provided they are within a range of reasonable decisions open to a board, they should not be impugned. However, if

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48 Ibid, s 135. The background to enactment of s 135 in its present form is discussed in *Mason v Lewis* [2006] 3 NZLR 225 (CA) at paras [44]–[46].
49 *Mason v Lewis* [2006] 3 NZLR 225 (CA) at para [48].
50 Ibid, at paras [49]–[50].
51 Ibid, at para [51].
52 Ibid, at paras [48] and [51].

an "illegitimate" risk is taken with what, by that time, should be regarded as creditors' money, directors are themselves at risk of personal action being taken against them.[53] That is because they are no longer dealing with shareholders' funds.

[47] In assessing whether the directors of Acme could be liable for reckless trading, a number of factors should be taken into account:

[a] Acme traded between April 2009 and July 2015. Its business involved developmental and marketing phases for the hacker protection software. Although it is apparent that the company faced a number of critical problems, it is not entirely clear to what extent the directors would have had knowledge of underlying facts that created an atmosphere of illegitimate risk-taking.

[b] The reasonableness of the directors' belief in the quality of Acme's software programme and the likelihood of concluding a lucrative contract with US Defence Department.

[c] So far as the period from June 2012 to July 2015 is concerned:

[i] What steps did the directors take to ascertain the financial position of the company?

[ii] If steps were taken, why did they not understand that a significant tax liability was accruing?

[iii] On what information did they base the financial information conveyed in the press release?

[48] The jurisdiction to grant a remedy for breach of the reckless trading provision is based on a different statutory provision[54] and must be considered separately from

53 Ibid, at paras [49] and [50].
54 Companies Act 1993, s 301(1).

the liability point.[55] Generally, there are three factors that will be relevant to the assessment of quantum: causation, culpability and the duration of the trading.[56]

(e) The 2012 Bohrium transaction

[49] The next question is whether the directors had reasonable grounds to believe that Acme could perform its obligations under the June 2012 agreement with Bohrium. Section 136 of the Act provides:

> **136 Duty in relation to obligations**
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> A director of a company must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.

[50] To determine this question, it would be necessary to inquire into any available evidential foundation for the proposition that Acme had sufficient liquidity at that time to meet obligations of $30,000 per month. Further, the directors would have had to consider likely future trading conditions in determining whether forecasted obligations of that sum could be paid on an ongoing basis.

[51] This issue requires consideration in the context of the ability of directors to take legitimate risk in the management of a company. The directors' duty is to inquire into the financial position of the company to form a judgment, on reasonable grounds, that the obligation being incurred can be performed. In the context of this case, directors would have required financial information satisfying them that a sum of $30,000 per month could be paid to Bohrium on a continuing basis from June 2012.

[52] In considering this issue, I highlight the following factors:

[a] The directors ought to have reassessed Acme's financial position following the "spectacular failure" of the proposed pilot project in the

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55 The importance of not conflating s 135(liability) and s 301 (remedy) was emphasised in *Mason v Lewis* [2006] 3 NZLR 225 (CA) at para [52].

56 *Mason v Lewis* [2006] 3 NZLR 225 (CA) at para [110]. See also, *Sojourner v Robb* [2008] 1 NZLR 751 (CA) at paras [53], [58] and [59] and *Morgenstern v Jeffreys* [2014] NZCA 449 at para [99].

United States. The reasonableness of a belief that Acme could meet obligations of $30,000 per month to Bohrium would need to be assessed in light of their understanding of Acme's liquidity at the time the decision was made. At that time, the contract negotiations in the United States had failed and it appears that the directors knew (or ought to have known) that existing clients were refusing to do further business with the company.

[b] Much will depend on whether any mis-statements in the information provided to Staid & Old in relation to the announcement of half yearly results were material. Generally, in a company law context, materiality is assessed by reference to whether false information was sufficiently important to reconsider whether to proceed along a particular business path.[57]

[c] Why, if the liquidity position were not such as to permit the obligation to Bohrium to be met, did the company continue to trade from June 2012 until receipt of the taxation demand on 30 June 2015? Presumably, payments were being made to Bohrium during that time.

(f) Reliance

(i) The nature of the reliance in issue

[53] There are three types of reliance in issue. The first, Ms Lockhart, involves the reasonableness of the directors' decision to rely on company accounts that she prepared in her capacity as an employee.[58] The second, Mr Pratt, involves marketing advice given by an employee.[59] The third concerns information conveyed by a professional advisor, Staid & Old.[60]

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57 For a discussion of the concept of "materiality" in the context of public offers of securities, see *R v Moses* HC Auckland CRI-2009-004-1388, 8 July 2011 (Reasons for Verdict) at paras [39]–[51].
58 Companies Act 1993, s 138(1)(a).
59 Ibid.
60 Ibid, s 138(1)(b).

[54] Sections 130 and 138 of the Act provide:

130 Delegation of powers

(1) Subject to any restrictions in the constitution of the company, the board of a company may delegate to a committee of directors, a director or employee of the company, or any other person, any 1 or more of its powers other than its powers under any of the sections of this Act set out in Schedule 2.

(2) A board that delegates a power under subsection (1) is responsible for the exercise of the power by the delegate as if the power had been exercised by the board, unless the board—

(a) believed on reasonable grounds at all times before the exercise of the power that the delegate would exercise the power in conformity with the duties imposed on directors of the company by this Act and the company's constitution; and

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

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138 Use of information and advice

(1) Subject to subsection (2), a director of a company, when exercising powers or performing duties as a director, may rely on reports, statements, and financial data and other information prepared or supplied, and on professional or expert advice given, by any of the following persons:

(a) an employee of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned:

(b) a professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional or expert competence:

(c) any other director or committee of directors upon which the director did not serve in relation to matters within the director's or committee's designated authority.

(2) Subsection (1) applies to a director only if the director—

(a) acts in good faith; and

(b) makes proper inquiry where the need for inquiry is indicated by the circumstances; and

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

[55] When a director pleads "reliance" in response to a claim based on breach of a director's duty, it is treated as an affirmative defence, the onus of proof of which is on the director.[61] A director who does not adduce direct evidence from relevant professional advisors is unlikely to be able to establish the defence solely on the basis of his or her evidence. An evidential foundation for the advice given will be necessary before the question whether reliance was reasonable can be assessed.[62]

(ii) Ms Lockhart

[56] The question is whether the board was entitled to rely on company accounts prepared by Ms Lockhart. In my view, this is a s 130 issue because, at relevant times the board:

[a] carried the responsibility for bringing into existence and retaining accounting records that correctly recorded the transactions of the company and enabled financial statements to be readily and properly audited.[63]

[b] was required to "establish and maintain a satisfactory system of control of its accounting records".[64]

[c] in the period between 2009 and 2014, had the obligation to prepare financial statements.[65]

[57] What did the board know about Ms Lockhart's ability to prepare the company's accounts? The directors:

[a] Knew that Ms Lockhart had qualified as a chartered accountant as recently as 2008, when the company was incorporated in April 2009.

61 *Morgenstern v Jeffreys* [2014] NZCA 449 at para [75]. See also *Humphrey v Fairweather* [1993] 3 NZLR 91 (HC) at 94.
62 Ibid, at paras [77] and [78].
63 Companies Act 1993, s 194(1)(a) and (c).
64 Ibid, s 194(2).
65 Financial Reporting Act 1993, s 10(1); now Financial Reporting Act 2013.

[b] Were (probably) aware of errors that she had made in financial statements in the past; in particular, the fact that she had failed on previous occasions to characterise the banking facility as a current liability.

[58] Did the board, in those circumstances, have reasonable grounds to believe that Ms Lockhart would prepare the company accounts in accordance with legal requirements? There is no evidence that they created any monitoring system to ensure that she did.

(iii) Mr Pratt

[59] The issue is whether the board was entitled to rely on Mr Pratt's advice with regard to the company's marketing strategy. This appears to be a s 138(1)(a) and (b) issue. The directors, in order to gain the benefit of a reliance defence would need to have believed, on reasonable grounds, that Mr Pratt was reliable and competent in respect of such matters and that the opinions he gave were within his professional competence.

[60] What did the board know about these matters? The board does not appear to have had any specific evidence of Mr Pratt's experience in marketing. Nor does it appear to have inquired into his relevant expertise and competence. There is no evidence of the terms on which he was employed as General Manager.

[61] Mr Pratt recommended in June 2012 that Acme enter into an agreement with Bohrium to "ramp up" its marketing of the computer programme. As a result, Acme was obliged to pay $30,000 per month to Bohrium – a material amount in the context of its business. In determining whether it was reasonable to rely on Mr Pratt's recommendation his experience and competence in that area became important. The directors would need to establish that they made proper inquiry about that. In addition, they would need to identify the extent to which Mr Pratt was questioned about his recommendation in order to determine whether their state of knowledge was sufficient to warrant reliance on it.

(iv) Staid & Old

[62] The role of an auditor is to undertake work designed to determine whether financial statements give a true and fair view of the matters to which they relate and, if they do not, to express a view about the areas in which they fail to do so.[66] Ordinarily, an auditor will rely on a representation letter from directors or senior management on key factual assumptions.

[63] Were the directors entitled to rely on a statement from Staid & Old that "they had not found any issues with the accounts" provided in respect of the proposed half yearly result announcement?

[64] It appears that Staid & Old provided the advice about the half yearly accounts in a capacity that was more akin to that of an accountant than an auditor. That firm made it clear that it had not completed an audit and that it was relying on the factual information provided by Acme. Any advice that it gave would, for reliance purposes, fall within s 138(1)(b) of the Act.

[65] As with the advice received from Mr Pratt about the marketing strategy, the directors would need to demonstrate that they had made proper inquiry into the factual matters that underpinned Staid & Old's opinion – particularly after that firm had made it clear that it was acting on the assumption that the information provided was accurate and complete.

[66] Those members of the board who were not on the Audit and Risk Management Committee may have been entitled to rely on what it had done in consequence of Staid & Old's advice but it appears unlikely that directors who were aware of the terms in which it was couched could say that they had reasonable grounds to believe that reliance was warranted in those circumstances.

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66 Generally, see *R v Moses* HC Auckland CRI-2009-004-1388, 8 July 2011 (Reasons for Verdict) at paras [88]–[91].