Directors' Risks

Theory & Application

waterstone
INSOLVENCY

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1 History of the Company

1.1 The development of the English Company

A company is an interesting concept. It isn't a physical thing but rather a complex set of legal rights and established customs. From antiquity there has been a need to establish a trading entity that would survive the demise of the individual trader and the modern company is the process of a complex evolution.

The medieval Europeans developed a number of trading relationships, the most common being the Commenda, a type of trust initially developed in antiquity by the Romans, where one party put up the capital for a project but did not take either the responsibility or the liability for it. In effect they were a silent partner who lent the money and were entitled to a pre-agreed share of the profits but the manager was the key decision maker.

However, this practice was not fully adopted across the English Channel although some of the concepts were, slowly, incorporated into commercial practice. Most English business forms were various types of partnerships arrangements of increasing complexity.

The most common of these was the Deed of Settlement Companies. These were similar in practice to today's partnerships, which are still commonly used today for law practices. Every partner is bound by the establishing Deed but importantly, each partner is liable for all of the company's debts.

England, like other European nations at this time, was reluctant to create a legal entity separate from the individuals behind it and the only way one could be established was with a Royal or Parliamentary Charter. Even so, the members behind the organisation were still ultimately liable for its debts.

1.2 The Joint-Stock Companies

The first company known to issue tradable shares was the Amsterdam based Dutch East India Company. The English equivalent was the East India Company, formed in 1,600, founded with a Royal Charter issued by Queen Elizabeth the First.

The Queen granted the a charter to over two hundred wealth investors, formally named the:

> **Governor and Company of Merchants of London trading into the East Indies.**

The charter established that what was created was:

> *...one body and corporate and politick, in deed and in name… and shall be, at all times hereafter, persons able and capable in law, and a body corporate and politick and capable in law…*

The meaning was that this was not a collection of the over two hundred investors, whose assets could be called upon if required to cover its debts. This was a body corporate, a term still used today, separate from its owners, who were not liable for her debt.

1.3 The South Sea Debacle

The evolution of companies in England took a century long turn down a dead-end as a result of the South Seas Company's success and subsequent misfortunes.

The company was established in 1711 by an act of Parliament. It struck a deal with the British Parliament to take over a large tranche of English Crown debt. Holders of up to £9,000,000 of debt were compelled to swap this debt for shares in the South Seas Company. The Crown then agreed to pay the company interest on the debt and struck favourable repayment terms for the principle.

The former bond holders could then sell these shares. To sweeten the deal Parliament gave the company a monopoly over English trade with the South Seas; essentially the slave trade with South and Central America.

Sadly, (for the South Sea Company anyway) the slave trade wasn't lucrative. Worse, other similar companies began appearing on the scene seeking to duplicate its success. These other firms didn't have the backing of parliament, they were merely Deed of Settlement entities trading without limited liability protection but they were competing with the South Seas Company for investors and driving down the value of the company's stock price.

Cape Coast Castle, Ghana. This building was a key processing site for slaves heading to the new world.

At its peak, in 1717, the South Seas Company sold 13,000 slaves to South and Central America. On average 11% of slaves died during the voyage.

Britain outlawed slavery in 1807.

In response, to help prop up the value of the South Seas Company, Parliament passed the so called Bubble Act in 1719; the *Royal Exchange and London Assurance Corporation Act*.

This Act banned the incorporation of any business other than that granted a charter by either the Crown or Parliament. As a result, with other trading opportunities removed, the share price for the South Seas Company rocketed from £100 in 1719 to nearly £1,000 by 1921, before settling back to a more comfortable £80 several months later.

It was an appalling piece of legislation and it remained on the books until 1825. However, the importance of the legislation wasn't in what it banned, but in what it permitted. The Act specifically stated that nothing in it would:

> *Prohibit or restrain the carrying on of any…trade in partnership in such manner has hath hitherto usually and may be lawfully done according to the Laws of this Realm now in force.*

The idea was to prevent companies with tradable shares being established unless either Parliament or the Crown approved them, not to end all forms of business. The prevailing private form of business in 1719 was the Deed of Settlement Company and the Bubble Act cemented them.

1.4 The Deed of Settlement Companies

The Bubble Act froze in place the forms and complex customs that had evolved up to that point and the most important was the Deed of Settlement form of business. Such firms were often called private companies, as opposed to the public companies that had a Parliamentary or Royal charter; nomenclature still in use today.

Because these private firms were a form of partnership there were three critical problems:

1. Members (or partners) were personally liable for the costs incurred by the business

2. The sale of member's interests in the agreement was complicated by this fact

3. It was difficult to take legal action on behalf of the partnership and equally complex to take legal action against it.

The problem was that each time a member joined or left the partnership there was a new set of either plaintiffs or defendants. A member who sold their shares wasn't free of a potential liability for something that the business did when they were a shareholder. It was messy.

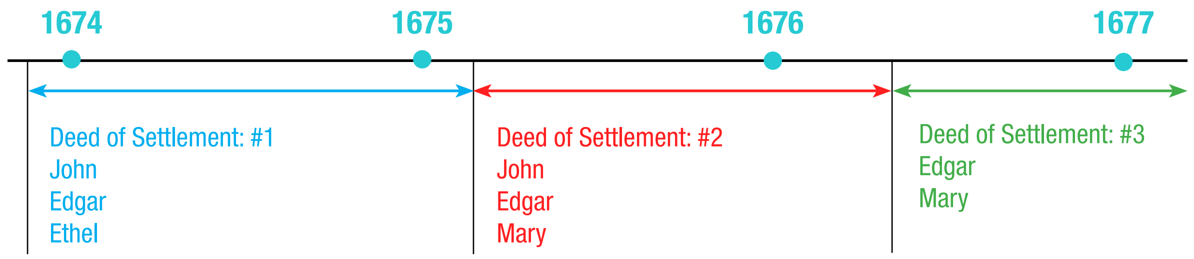
Despite these restrictions English trade muddled along with anyone seeking to enter business risking considerable personal liability. There were some creative attempts to contract out of personal liability but the problem remained, however, that to invest in a business meant taking ultimate personal responsibility for it.

A member or shareholder of a private company could find themselves liable for the entire debts of the business even though they had no control and owned only a small percentage of the enterprise.

Attempts to avoid personal liability proved to be easier for passive investors than for those who took an active role in managing the enterprise however any evidence that the investor was to enjoy in the proceeds of the profits was sufficient for that person to be deemed by the courts as a member of the partnership and therefore personally liable for all of its debts.

Investing was a risky business and there was considerable dissatisfaction, especially as more complex forms of commerce were being developed in continental Europe. Britain was being left behind.

John's Butchery & Bakery: Action Upon Thyme



Deed of Settlement Companies were partnerships. Each time a member (or partner) left, the legal relationship changed. If you had a claim against John's Butchery & Bakery in 1674, it was against John, Edgar and Ethel.

1.5 The advance of Company legislation

Eventually, the Bubble Act was scrapped in 1825, having retarded British commerce for over a century. However, little changed in practical terms until the passing of the Joint Stock Companies Act 1844.

This Act left the existing practices in place but helped formalise the process by allowing for the public registration of the Deeds of Settlement, allowing private companies to finally develop a legal identity separate from their owners.

A significant legislative change occurred in the 1855 Limited Liability Act and the more comprehensive Companies Act of 1856. The 1856 Act reflected the commercial realities that were developing and allowed for companies registered under the Joint Stock Companies Act to have shareholders were legally separate from the company and whose liability was limited to their investment.

These reforms weren't without protest and many were unhappy at the move away from unlimited liability. Those championing the reforms would not have been comfortable with the ease with which companies can be formed and reformed today.

An important feature under the 1856 Act was that companies required at least six shareholders. Any less and it was to be considered a partnership with the implications of unlimited liability. The Act was updated several times, including a major re-write in 1862.

However, old habits die hard. Despite parliament allowing for the registration of the Deed of Settlement Companies and making the provision for limited liability for shareholders of registered companies, most enterprises remained either unregistered Deed of Settlement Companies or partnerships of varying complexity.

1.6 The 1862 Companies Act

In 1862 the British Parliament properly dealt with companies and this act laid down the formal basis that companies could be established. A few of the relevant changes were:

- A company must have seven shareholders
- The company must have a defined purpose
- Shareholders were not personally liable for the debts of the company
- Directors had power over the company but no specific duties as we understand them today.

However, rather than seek the advantages of limited liability now available under this act, most people in commerce continued to agitate for a form of limited liability within the prevailing Deed of Settlement companies or partnerships that remained the dominant form of enterprise.

Registered companies, therefore, remained interesting but uncommon and it is possible that most people reading the 1862 Act would have believed that in most cases the shareholders would face liability for the debts of the company.

It is for this reason that the case of Salomon and Salomon was so important.

1.7 Aron Salomon v A Salomon and Company 1892

Aron Salomon was a Whitechapel shoe manufacturer and trader. Business was brisk and Salomon's sons wanted to become shareholders in the family business.

Aron Salomon incorporated his business. After extensive marketing research he came up with the catchy name of A Salomon and Company Limited. The name of the company is important because it has proved far more enduring that the company. The new company was required under the 1862 Companies Act to have seven shareholders and it did:

	# of shares
Aron Salomon	20,001
Mrs Salomon	1
Daughter	1
Son #1	1
Son #2	1
Son #3	1
Son #4	1

Aron may have been parsimonious but he wasn't sexist. He didn't just give the business away either. It was sold for £39,000; £29,000 in cash and £10,000 was vendor financed secured by a floating charge over the business. Sadly, a series of industrial disputes that accompanied general economic downturn led to A Salomon and Company to come under pressure and a gentleman who would have otherwise gone unnoticed by history, Edmund Broderip, provided the company a loan of £5,000 and was assigned Aron Salomon's debenture as security.

Still, events continued to conspire against the firm and Broderip appointed a receiver who successfully recovered sufficient assets to repay his loan, at which point the security and the £5,000 balance reverted to Aron Salomon and the receivers became liquidators.

It was at this point that things became interesting. The company had:

Assets:	£6,000
Unsecured Creditors	£7,000
Salomon Security	£5,000
Shortfall	(£6,000)

The liquidators sued Salomon for the shortfall and the unsecured creditors asserted a priority to Salomon's security.

Critically, both the High Court and the Court of Appeal agreed with the liquidators and unsecured creditors. This is important because it probably reflects the thinking of most of those in the commercial community and perhaps reflects why it took thirty years from the passing of the 1862 Act before this issue was properly tested.

The Court of Appeal in particular declared that Salomon was abusing the limited liability protection afforded him by the 1862 Act, that the company was nothing more than a proxy from him, the shareholders were not independent from him and the company was nothing more than:

> *…a trustee improperly brought into existence by him to enable him to do what the statute prohibits. It is manifest that the other members of the company have practically no interest in it, and their names have merely been used by Mr. Aron Salomon to enable him to form a company, and to use its name in order to screen himself from liability.*

This decision perhaps made sense on the context of 150 years of complex trusts arrangements and convoluted attempts by investors to reap the benefits of being a *member* without the burdens of liability. However, this wasn't what Parliament had said. Parliament had said if the company had the required seven shareholders it was a different legal entity.

The matter made its way to the House of Lords who didn't muck about and as Lord Halsbury wrote:

> *I have no right to add to the requirements of the statute, nor to take from the requirements thus enacted. The sole guide must be the statute itself… Either the limited company was a legal entity or it was not.*

Another Lord, Baron Macnaghten, wrote:

> *The company is at law a different person altogether from the subscribers to the memorandum; though it may be that after incorporation the business is precisely the same as it was before...*

> *By means of a private company…. a trade can be carried on with limited liability, and without exposing the persons interested in it in the event of failure to the harsh provisions of the bankruptcy law.*

> *The unsecured creditors of A. Salomon and Company Limited, may be entitled to sympathy, but they have only themselves to blame for their misfortunes. They …had full notice that they were no longer dealing with an individual, and they must be taken to have been cognisant of the memorandum and of the articles of association*

It matters that both Lord Halsbury and Baron Macnaghten were politicians. Both had been elected to the House of Commons before being elevated to the House of Lords and Halsbury served three times as Lord Chancellor (similar to the Attorney General). They naturally were inclined to believe that Parliament meant what it said and judges, especially lower court judges, shouldn't second guess parliament.

The case is often referred to as Salomon v Salomon and has become shorthand for the idea that a company is separate from those behind it.

However, the Salomon case did not deal with any liability that Mr Salomon had to his business. There was no allegation that he was reckless or had acted with financial irresponsibility; only that he should not be allowed to hide behind that the plaintiffs held was the fiction of his company.

1.8 A director's liability: City Equitable Fire Insurance

1.8.1 Thomas Lister: 4th Baron Ribblesdale

In 1925 the English courts delivered what would prove to be the high watermark in protecting directors from the losses of their companies. It is a case that would almost certainly be decided differently if heard today.

But before we deal with the minutia of this case let's take a moment to appreciate one of its chief protagonists, Thomas Lister: the 4th and last Baron Ribblesdale.

Lord Ribblesdale, captured here when he was only 36, in a portrait named simply: The Ancestor, began his stint in the House of Lords at age 26. For several years he served as Queen Victoria's personal representative; a position with the unusual title of Master of the Buckhounds; an office that dates back to 1528.

He also served in the military as a Captain in the Rifle Brigade and for the last 16 years of his life as a Trustee of the National Gallery. He lost one son in a long forgotten British campaign in Somaliland and another on the bitter harvest at Gallipoli. His second wife, Ava, was an American divorcee from the immensely wealthy Astor family.

Ava should have waited as her husband Jack went down with the Titanic and his new wife, Madeleine inherited a fortune.

Some credit him as basis of George Bernard Shaw's Professor Higgins in Pygmalion and is eloquently described by Margot Asquith, socialite and wife of Prime Minister Asquith:

> *"Tommy is one of the few people in the world that have shown me gratitude. I cannot pass my brother-in-law's name here in my diary without some reference to the effect which he produced on us when he first came to Glen. He was the finest looking man that I ever saw, except old Lord Wemyss, he had been introduced to my sister Charity at a ball in London, when he was twenty-one and she eighteen.*
>
> *His fine manners, perfect sense of humour and picturesque appearance captivated every one; and, whether you agreed with him or not, he had a perfectly original point of view and was always interested and suggestive."*

Thomas Lister was a quintessential English Aristocrat. Sadly for Lister, the loss of two sons and a wife tipped him into depression and he became resident at the Cavendish Hotel, an upmarket if not fully respectable establishment.

At the time all respectable firms liked to have a *Lord on the Board* and City Equitable Fire Insurance was on the look-out. City Equitable was acquired in 1914 by a Mr Gerard Bevan, also a regular at the Cavendish. Lister was soon recruited as a board member.

Bevan, meanwhile, was busy bankrupting City Equitable by syphoning off over a million pounds to fund his own hopeless investments that all failed.

Thomas Lister, enamoured with his new wife had rediscovered some spring in his step and paid as much attention to Bevan's activities at City Equitable as the other respectables on the board; which was none at all.

By 1921 the business failed and Bevan, after a brief hiatus on the run, was hauled back and sentenced to seven years for his sins. He did his time and unbroken left England with his French mistress to run a distillery in Cuba.

Thus was the stage set for the liquidators of City Equitable to challenge the directors of the business. They had failed, clearly, to supervise Bevan and should bear some liability the firms collapse.

1.8.2 City Equitable and the gentleman director

Liquidators in 1925 were no more popular than they are today. Gerard Bevan and City Equitable may have been widely recognised as disreputable but that could not be said for Lord and knights of the board.

There was no allegation of fraud or dishonesty, merely negligence, against the directors.

Lawyers representing the defendants presented the articles of the company that specifically protected directors from the failings from other directors. Their defence was that it was Bevan's fault and that the other honest directors could not be held liable.

The court agreed and established a *Subjective Test;* the liability was to be determined by the skill and awareness of the specific director. This would contrast with an *Objective Test;* which would ignore the talents of the individual director and look at what a competent and reasonable director should have known and been doing.

A director, the court in 1925 declared:

> Must act honestly
>
> Must exercise such skill and diligence that a reasonable man might take in managing his own affairs
>
> Need not exhibit in the performance of his duties a greater degree of skill that may reasonably be expected from a person of his knowledge and experience
>
> Is not bound to give continuous attention to the affairs of the company
>
> In regard to delegated duties, he is entitled to rely on the persons so delegated unless there is grounds for suspicion

In essence, gentleman like Thomas Lister aren't expected to soil their manicured hands with the grubby business of commerce. They weren't expected to understand the nature of the business that they were directors of, and they certainly weren't expected to have to exercise oversight over those tasked with the daily toil of actually running the business.

This case, if heard today, would get a different result. The most important difference between 1925 and today is the shift between the Subjective Test and an Objective one.

A gentleman member of the House of Lords could hardly be expected to soil his delicate fingers with the grubby details of commerce.

1.8.3 The Subjective and the Objective Test

A Subjective Test can be summarised as:

What can we expect that specific director to have known and done in the circumstances?

An Objective Test can be summarised as:

What can we expect a director to have known and done in the circumstances?

Part of the issue in the City Equitable case was that parliament had not laid down any specific duties for a director. Directors were just there, as persons who controlled the company. They were not trustees, something the courts understood well.

In City Equitable the court said:

It is indeed impossible to describe the duty of directors in general terms, whether by way of analogy or otherwise. The position of a director of a company carrying on a small retail business is very different from that of a director of a railway company. The duties of a bank director may differ widely from those of an insurance direct, and the duties of one insurance company director may differ from those of a director of another.

Parliament had not defined the role of a director and the courts were reluctant to impose duties where none had been specifically designated.

In both New Zealand and in the United Kingdom the law moved decisively towards enshrining directors duties in legislation. In New Zealand the 1955 Act outlined very specific duties, duties that remain essentially unchanged today.

2 New Zealand Historical evolution

2.1 The 1955 and 1993 Acts

It is about this time in the story that New Zealand begins to make its own way and our Parliament began developing its own legislation, although remaining in many ways in lock-step with developments back in the Motherland.

In the 1955 Companies Act, Parliament designated a specific set of duties that a director had to its company. These were passed on to the 1993 Act. It is significant that the duties are not to the creditors, or the shareholders of the company, but to the company itself. This is an important distinction.

It is easy to consider that these duties, listed below, were designed fresh by parliament and inserted into the Act, but they were in many ways a reaction to the City Equitable case and the application of general trust duties to directors.

Now the obligations of the directors to their companies were laid out in parliamentary black and white.

2.2 The Duties

Below is the list of the key duties outlined in the 1993 Act.

Section 189 and 194: Keeping Accounting Records

Directors must keep the following records:

The Constitution, if there is one

Minutes of the last 7 years of shareholders and board meetings

An interests register

Names and contact details of all current directors and shareholders

Accounts, accurate and in English, for the last 7 years

Section 131: Acting in good faith

Directors must act in good faith; generally defined as acting in the interests of the company and not themselves or related companies. However, it is permissible for a director of a 100% owned subsidiary to act in the interests of the parent if the subsidiaries constitution allows.

Section 133: Exercising directors powers to be for proper purpose

On the statute books; a self-explanatory but rarely invoked section

Section 134: Directors to comply with the Companies Act and the Companies Constitution

Again, on the statute books and self-explanatory but minimal case law.

Section 135: Reckless Trading

Directors must not:

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.

Section 136: Duty in relation to obligations

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.

Section 137: Duty of care

A director of a company, when exercising their powers or performing duties:

must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation,—

the nature of the company; and

the nature of the decision; and

the position of the director and the nature of the responsibilities undertaken by him or her

2.3 Breaches of director duties – Defences

The only real defence to an action against a director for breaching duties is section 138 of the Companies Act. This defence is rarely used and almost never succeeds.

The 138 defence: stage 1

The first stage of the defence allows a defence for a director who relied on reports, statements, and financial data and other information prepared or supplied, and on professional or expert advice given by either:

An employee of the company; or

A professional adviser or expert; or

Any other director or committee of directors.

The director must believe that this person or persons are competent in the areas that they relying on them for. This is a subjective test as it comes down to what that specific director knew.

The 138 defence: stage 2

However, the 138 test has two elements and the director must achieve both. If they have, as above, relied correctly on advice, then they will also have needed to have:

Acted in good faith; **and**

Made proper inquiry where the need for inquiry is indicated by the circumstances; **and**

Have had no knowledge that such reliance is unwarranted.

The director must satisfy all three limbs to rely on the protection under section 138 of the Act.

2.4 The Catch-All: Section 300

It is common, however, for directors to claim that they cannot answer the liquidators questions because there are no or inadequate accounting records.

This can aid a director who can hide behind the lack of documents as the liquidator cannot prove that the company is insolvent and the records are in the directors' head. It can also make recovering the assets of the company difficult because the asset list, records of debtors and other areas of potential recovery are lost or not available.

The Company's Act has a nice catch-all: Section 300. This allows the court to hold the director liable for losses that were due to the inadequate accounting records.

For this section to apply the company must be in liquidation and not have kept adequate accounting records (as defined by Section 194 of the Act) and that this lack of records contributed to either:

the company's failure; or

creates substantial uncertainty as the true state of the company's financials; or

substantially hinders the orderly liquidation of the company

Once this has been established it is at the courts' discretion to hold one or more of the directors personally responsible for as much of the losses of the company as the court sees fit.

2.5 The Consequences

If a director breaches their duties this does not make them automatically liable for the debts of the company. It in only a pre-requisite for potential liability.

Section 301 of the Companies Act gives the court discretion to order that the person who breached their duties to:

…repay or restore the money or property or any part of it with interest at a rate the court thinks just

Helpfully, Section 301 does not apply just to directors. It also covers past or present managers and administrators of the business, although such actions are incredibly rare.

Section 301 allows a liquidator or in some cases a disgruntled creditor to sue a director to recover some or all of the losses of the company.

2.6 Legitimate and Illegitimate risk

Business is risky. There is no expectation that a director does not take risks and where the dividing line between risks that trigger a breach of a director's statutory duty under Sections 135 and 136 isn't always clear.

Most of the cases that have come to court have been ones where the liquidator has been confident because the trading pattern has been exceptionally irresponsible.

2.7 Assessing liability

There are two essential approaches that the courts take when dealing with breaches; breaches of trust and breaches of duty.

A breach of trust

When dealing with a breach of trust the courts fall back on ideas of Equity. Breaches of good faith, such as Section 131, cause the courts to treat the director as a trustee of a trust. A director is considered as a trustee of not only the company's assets but if the company falls into insolvency then they are no longer just trading with the company's assets but the creditors as well.

Once considered a trustee trust law applies. One is that a trustee is not permitted to profit, directly or indirectly, from their position as trustee.

This can catch directors unawares.

A breach of statutory duty

However, breaches of statutory duty, such as Reckless Trading under Sections 135 and 136, cause the courts to consider the following three elements:

Causation

The link between the breach and any loss to the company

Duration

How long the breach persevered, especially in Reckless Trading cases

Culpability

A subjective look at what the director knew and how they acted

3 Some case law

3.1 Section 131: Aeromarine Limited - Robb v Sojourner

This case is a good example of the consequences of being a deemed trustee.

Aeromarine Limited was in the boat making business and was part of a complex tangle of businesses owned by Mr Trevor Robb and his lovely wife, Christine. Mr and Mrs Robb were the only directors and shareholders of the company.

Trevor, on the right, is still actively in Aeromarine; the business is a Timaru success story.

The court found "Mr Robb is a decent man, not someone who would deliberately break the law." But still found against him.

Aeromarine Limited arranged to build a large catamaran for Cliff Sojourner and work began in earnest in 2002. Sojourner was required to make substantial payments in advance.

Alas, work wasn't going well and by late 2002 the project was in trouble. However, Aeromarine had a number of other projects, including work for Designline, a bus company as seen above.

The Robbs elected to sell the assets, including the goodwill, of Aeromarine Limited to a new company, Aeromarine Industries Limited. The price was $218,000, including a provision of $50,000 for goodwill. Most of this money went to retire a shareholder GSA but left Aeromarine Industries with a nice asset list and suite of customers.

Aeromarine Limited was then placed into liquidation by the shareholders.

Cliff Sojourner was having none of it and took the Robbs to court. The goodwill for Aeromarine was worth as much as $750,000 by his estimates and the directors had breached Section 131 of the Companies Act by not acting in the best interests of the company.

However, the Robbs argued, they *were* acting in the interests of the company. It risked insolvency on the director's analysis, they didn't want to trade recklessly and Sojourner wasn't technically a creditor at the time they did the sale. Because the company was solvent when the assets were sold the directors were dealing with their own assets and were not trustees for the wider body of creditors.

The court looked into the finances of the business to conclude that the business was in fact insolvent; this was a finding of fact which was required before the directors could be deemed trustees and caught by the laws of Equity.

As so often happens in these cases the judge darted back into English history:

> *The principle that directors must act in good faith and in what they believe to be the best interests of the company is a formulation … developed by the Courts by analogy with the duties of trustees. Historically this came about because prior to the Joint Stock Companies Act 1844 (UK) most joint stock companies were unincorporated and depended for their validity on a deed of settlement vesting the property of the company in trustees…*
>
> *If a director believes that the duty to act in the best interests of the company is a duty always to act in the best interests of the shareholders, and never in the interests of the creditors, in a situation of doubt as to the solvency of the company, the director cannot be said to be acting in good faith. Creditors are persons to whom the company has ongoing obligations. The best interests of the company include the obligation to discharge those obligations before rewarding the shareholders.*

Mr and Mrs Robb, the court found, were not acting in good faith. This isn't the same thing as acting dishonestly. However, by undervaluing the goodwill:

> *Mr and Mrs Robb were not acting in good faith when selling the old company's business to the new company. The fact that they personally thought they were acting in the interests of the company is irrelevant in this context*

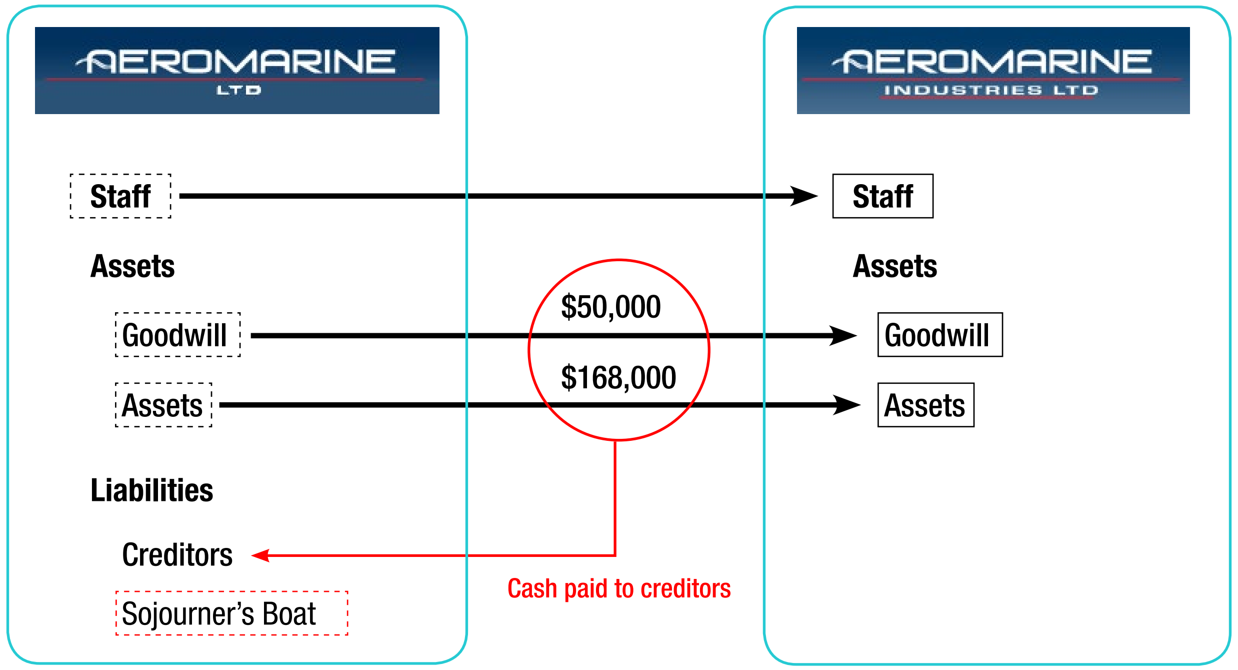
The new company did rather well in its first year, confirming in the court's mind that the sale of the assets were under value. The Robbs were judged as if they were trustees of a trust and not directors protected by limited liability.

By breaching their obligation to act in good faith they stood before the court as trustees and the old rules of Equity applied. The Robbs had profited from their role as trustees. They were ordered to pay:

The liquidator enough to cover all of the unsecured creditors of the company

Interest

Costs of the liquidator



3.2 Section 135: South Pacific Shipping

Background

One of the first large reckless trading cases in New Zealand involved a shipping company, South Pacific Shipping. The issues of Causation, Culpability and Duration were considered and applied.

The company was founded in 1992 and German citizen Klaus Lower was a director and majority shareholder. By 1994 the business had grown in size but was very poorly managed. It was losing money yet remained able to stay afloat, literally and figuratively, mostly due to the indulgence of its creditors and the fact that it was getting paid within 14 days but had negotiated extended credit with its major suppliers to 90 days.

Being based in Germany, Mr Lower found that there was a tax advantage to have the vessels owned by a German entity linked to him and leased back to South Pacific Shipping.

A key date in the life of this company was a board meeting on the 18th of April 1994. There was no adequate accounting but the two directors, including Mr Lower, decided to charter an additional three boats from Mr Lower's related party. By the end of 1997 the company's losses had grown to 39m and it collapsed into liquidation the following year.

Findings of fact

The High Court made the following findings of fact:

- The company was insolvent at all relevant times but especially from the 18th of April 1994
- The company should not have traded beyond the 18th of April 1994
- Losses from 18th April 1994 to liquidation were $18m, excluding related party debt
- Mr Lower benefitted by several million dollars from his involvement with the related party leases
- The company's accounting records were inadequate

Mr Lower was, the court found, in breach of his duties under Section 135, (although in this case its predecessor under the 1955 Act) not to trade recklessly. They next needed to consider what sanction to apply to Mr Lower and considered the three elements; Causation, Culpability, Duration.

Causation

Causation is the link between the decision to continue trading beyond April 1994 and level of indebtedness of the company at liquidation. What matters isn't the total losses, but the increase of losses between when the director should have ceased trading and when he did. This isn't, as we shall see, what the director is liable for, merely a starting point. In this case that number was $18m.

Culpability

How much of the responsibility of this failure to make the decision to cease trading falls on the particular director in question. Essentially, how blameworthy was Mr Lower in this situation.

The range here can vary from disinterested ignorance to wilful dishonesty. The court can apply a punitive element to their decision based on the behaviour of the director. In this case the court was heavily critical of Lower for failing to ensure proper accounting and monitoring of the business and the decision to actually expand the business when it was in dire financial shape.

Lower also had a conflict of interest that appeared to have influenced his decision to keep the business trading when a dispassionate and sober assessment would have been to cease trading.

Duration

How long the director continues on trading can influence the court. In some cases the courts have given directors a period of grace, around six months usually, to either come to grips with their appointment or a change in circumstances.

If the business environment suddenly changes there isn't an expectation that the company will close immediately, but if it is clear that all hope is gone the business should close its doors.

In this case the business traded for five years after the court concluded it should have ceased trading.

Consequences

The court found:

> *"Given his wish to... trade despite insolvency... he ought to have been prepared to put his own money up by capitalising the company to an extent that was appropriate given the risks he was taking with creditors' money."*

Finally, the court came up with this calculation:

Starting point: total losses from April 1994 to liquidation		$18,000,000
Deduction for uncertainty in the judge's numbers		($6,000,000)
	Sub Total	$12,000,000
Credit for industry business risk to be borne by creditors: 30%		($3,600,000)
Directors' Liability		$8,400,000

Theory and Application

According to the liquidator's reports, the costs of getting this judgement, which went to the Court of Appeal, was a staggering $2.3m, the liquidation settled with Mr Lower for a paltry $1.8m.

3.3 Section 135 and 136: Goatlands

Background

Mr and Mrs Borrell were goat farmers. They had a farm in Whatawhata but wanted to shift to Horotiu.

Both of these towns are in the Waikato. Neither has any redeeming features.

The Borrells, in 2001, established a company called Goatlands and signed a sale and purchase agreement for $922,000 to purchase a lovely bit of land in Horotiu and, as was the custom back in the early years of this century, this transaction entitled them to receive a payment from the Inland Revenue of 12.5 percent of the purchase price even though Goatlands had not actually spent the money. Goatlands had 12 months to settle.

However, neither the Borrells nor Goatlands had the cash to pay the $922,000. The plan was to subdivide the Horotiu property and use that money to do the deal.

Well, property development is a tricky game and the subdivision took longer than expected, there was no money and the Horotiu deal fell through.

Now, here was the problem. Once the sale fell over the IRD was entitled to its money back, but Goatlands had spent it. The company was placed into liquidation.

There were two creditors of Goatlands that the court considered

The IRD for the core debt	$111,000
The IRD for interest and penalties	$ 26,000
A Roofing Contractor	$ 700

The Plan and the Reality

The Borrells plan was simple. In the twelve months they had to complete the deal they would demolish the milking shed on their current farm, move the goats to the new farm and erect a new shed. At the same time they'd complete the subdivision and with the freed up cash settle the Horotiu property.

The IRD's refund cheque would be invested in the subdivision.

What actually happened was that they demolished the old milking barn, had nowhere to milk their goats who dried up, the market for rural land went flat and they defaulted on the Horotiu property.

Reckless Trading: Section 135

The Borrells breached 135, Reckless Trading. By spending the IRD's money they were gambling with creditor's money. They lacked sufficient capital to handle even a small hiccup in their plans. The Borrells invoked Section 138 by claiming that they took advice from a local real estate agent who said the plan was a good one and that there was only a five percent chance that things could go wrong.

The court sided with the liquidator. The Borrells estimated, after the event, that there was merely a five percent chance that their plan would fail. The court decided that the risks were much higher and that the Borrells could have taken a less aggressive approach but didn't, preferring to let the company's creditors take the risk.

Duty to Obligations: Section 136

Section 136 is quite prescriptive. A director cannot allow the company to incur a liability if the director believes, on reasonable grounds, that the company will be able to meet that obligation.

The problem for the Borrells was that several things had to go right for them in order that Goatlands would be able to complete the purchase. They were relying on their Whatawhata properties to sell, in essence relying on unknown third persons to respond. The property in question was rural, the market wasn't as liquid as perhaps urban property could be expected to be and the land needed to be subdivided before it could be sold.

There was a number of balls in the air and the obligation is that the director believes that the company will be able to meet the obligations, not that it might be able to meet it.

The liquidators won on this ground too.

Goat Farming can be a thankless industry.

The Consequences

The issues of Causation, Culpability and Duration were considered but only Culpability applied because the single decision that was in question was the purchase of the property and there was no doubting the causation.

The Borrells didn't act dishonestly. They spent $30,000 of their own money on the Horotiu property which was lost and endeavoured to complete the deal and the failure was ultimately caused by matters beyond their control.

The chances of failure, according to the judge's determination, were 25%. On this basis the Borrells were required to contribute to the liquidators 25% of the total outstanding creditors owing to company.

3.4 Section 300: Walker v Ariyathas

There isn't a lot of case law on Section 300 but the most notable is Robert B Walker and Selvathas Ariyathas.

Ariyathas ran a diary in Mt Roskill that also did a bit of importing which caused it to accrue some debt to Customs. They didn't pay and Customs appointed Mr Walker as a liquidator.

Upon his appointment Walker noticed that there was significant discrepancies in the accounts, especially around the accounts presented to the bank and that which was given to the IRD. However, when Walker pressed for more recent and accurate records Ariyathas responded that he could not provide them because he had destroyed some of the key records.

Destroyed them.

As the judge said in his oral judgement

> *"He was unable to offer any explanation for such an extraordinary act…*
>
> *I have no doubt that the company's failure to comply with its requirements in relation to records not only contribute to the company's inability to pay its debts, but also resulted in substantial uncertainty as to its assets and liabilities positon and substantially impeded Mr Walker's early liquidation of the company."*

Ariyathas was found liable for the full one million dollars of the company's debts. He is now bankrupt.

4 Fair Trading Act

Commercial dealings with financially struggling companies are fraught with danger that prudent creditors are keen to seek reassurances over. Typically these creditors will seek reassurances from the directors as to that company's financial health.

It is common for a director to assure creditors that the company is in rude health only for the company to fail. The creditors are left jostling for position to receive what in most cases is a small proportion of their debt owed. The director then sits smugly behind the corporate shield of limited liability and walks away from the now smouldering ruins of his company. Or does he?

If a director makes a misleading or deceptive statement to a creditor that induces that creditor into taking steps based upon the belief that statement is true, the director may be personally liable for the loss the creditor suffers.

Directors are not immune from liability for misleading or deceptive statements under section 9 of the Fair Trading Act 1986 ("FTA").

Section 9 of the FTA states that:

> *No person shall, **in trade,** engage in conduct that is misleading or deceptive or is **likely to mislead or deceive.***

The company is the legal person carrying out the business activity. The question of whether a director was in fact in trade was discussed by the Court of Appeal in Body Corporate 202254 v Taylor (2008) which confirmed that a director, for the purposes of this section, is in trade.

The case involved litigation by the affected owners of a single development of leaky houses and was based on a marketing brochure which the owners alleged contained misrepresentations as to the design and workmanship of the houses by the director.

In their decision, the court endorsed a broad approach in interpreting whether a director was in trade, maintaining that the definition of in trade in the FTA could easily encompass a person who is not trading on their own account. Further, they held that the director's relevant conduct was in trade as it occurred in the context of his occupation within the company.

For a director, despite the fact that he has made this statement in his capacity as director of the company, if it can be shown that the director has crossed the threshold of merely passing on information to adopting and personally expressing that information, he may fall within the grasp of section 9 of the FTA.

An example of where the court have found a director to fall within the scope of the FTA was in Hill Country Beef NZ Limited v Sharplin (1996). This case demonstrates a creditor successfully bringing an action under the FTA against a director who had given personal assurances as to a company's financial health.

Hill Country Beef NZ Limited ("Hill Country") supplied processed meat to butchery company, Fresh Freezer Foods Limited ("FFF"). Raymond Sharplin was a shareholder and director of FFF and successfully negotiated with Hill Country for the supply of large quantities of meat.

After a series of late payments and dishonoured cheques Hill Country requested a meeting to discuss FFF's financial difficulties. Mr Sharplin attended the meeting and gave assurances to Hill Country that FFF's future prospects were bright and payment for supplies would be forthcoming. In reality, FFF was facing an impending financial crisis.

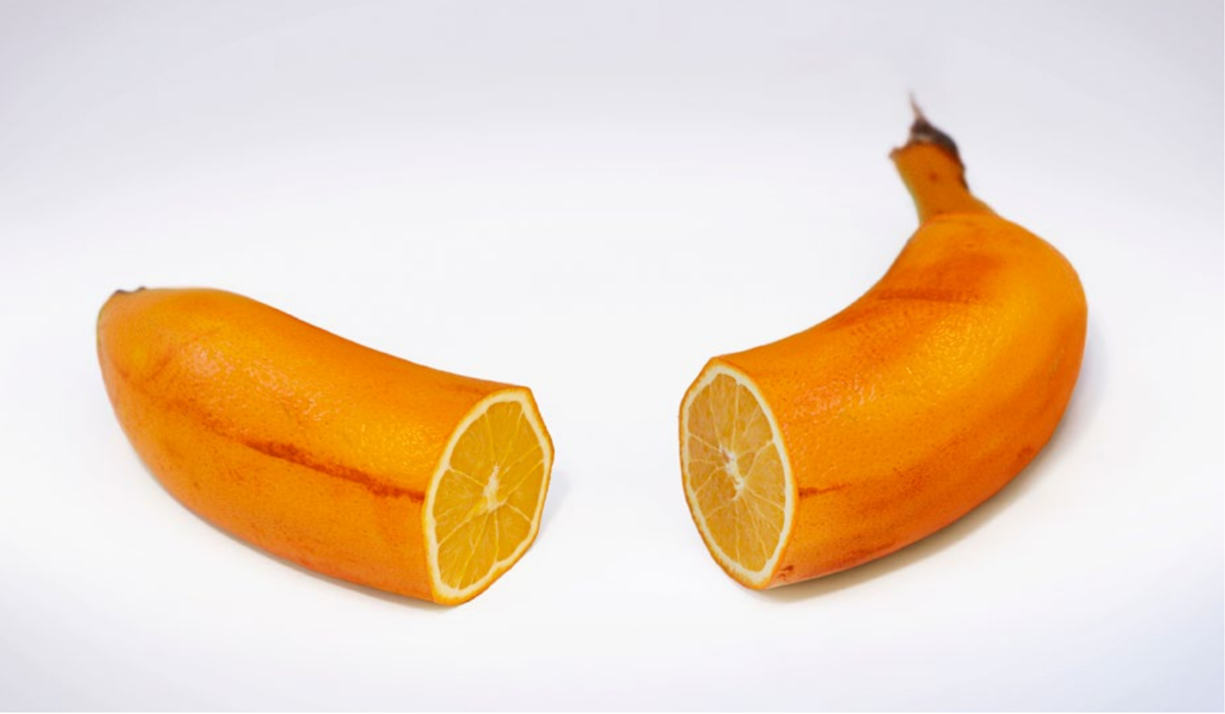
At a second meeting of the parties, Mr Sharplin asserted continued optimism that FFF was financially sound. This dialogue continued until inevitably FFF was placed liquidation. Hill Country pursued a claim against Mr Sharplin personally under section 9 of the FTA for misleading and deceptive conduct.

Mr Sharplin was found liable for breaching the FTA. When discussing the liability of directors under the FTA, Gallen J considered that agents of a company will not normally be liable for merely acting under instructions or passing on company information without assuming any personal responsibility.

In this case Mr Sharplin, crucially, gave personal assurances as to FFF's financial position which induced Hill Country to continue to supply meat without any real prospect of being paid. As there was no reasonable grounds to support these statements, he had clearly misled Hill Country and was in breach of the FTA.

What directors must consider carefully prior to engaging in dialogue with a creditor is what information they disclose. A director must either have reasonable grounds for making an assertion, particularly in relation to their company's financial health, or an honest belief that the assertion is true. An absence of either reasonable grounds or honest belief will open the potential for the director to become liable for their statements under the FTA.

Conversely, a creditor who suspects a customer may be in financial difficulty should take active steps early to obtain further information from the company's directors to confirm its financial stability. A word of caution however as creditors who do take these steps but do nothing with the information open themselves up to potential claw backs from a liquidator.



5 But wait: who is a director?

A common assumption is that if your name is not on the company's office website then you are not a director. This is a mistake. The companies act, Section 126, defines a director pretty widely. In part it reads:

> In this Act, director, in relation to a company, includes—
>
> *a person occupying the position of director of the company by whatever name called;* ***and***
>
> *a person in accordance with whose directions or instructions a person … may be required or is accustomed to act;* ***and***
>
> *a person in accordance with whose directions or instructions the board of the company may be required or is accustomed to act*

5.1 De jure, defacto and shadow directors

A 1994 English case, Re Hydrodam (Corby) Ltd, involved the liquidators of a subsidiary of a larger private equity outfit headed up by a certain Baron James of Blackheath. Baron James, like Thomas Lister, was a Conservative member of the House of Lords; the peerage a reward for saving the British Millennium Dome project, but unlike Lister his elevated status didn't save him.

The allegation was that Baron James was the actual person who made all of the decisions of the failed subsidiary.

This is a judgement that has been quoted and adopted in the New Zealand courts:

> *A de facto director…is one who claims to act and purports to act as a director, although not validly appointed as such. A shadow director, by contrast, does not claim or purport to act as a director. On the contrary, he claims not to be a director. He lurks in the shadows, 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.*

5.2 Vance, Lamb and Simpson

The background

The case of Vance, Lamb and Levin is an excellent summary of some of the issues we have canvassed.

The Cuba Trust was formed to do property development. The trustees were property developer Fiona Lamb and lawyer John Simpson.

The Cuba trust was established in 1997 and the first order of business was the acquisition of 36 Upland Road Kelburn. This was done with a number of mortgagees.

The idea was to subdivide the land, building a unit at the front and two apartments at the back.

The development went through some hurdles and by late 1999 it was in trouble. The lawyer for one lender stated bluntly that they were "..heading for financial disaster."

Still, Fiona Lamb struggled on and the trustees agreed to sell the front unit from the Cuba Trust to Mrs Lamb in December 1999. There was enough cash to clear some of the secured debt but not enough to pay the IRD who were left sitting on a $34k shortfall.

About this time a new player, a Mr Donnelly, entered the scene. He was one of the secured lenders but he now provided some additional funding and took an equity stake in the development.

By this time the lawyer, John Simpson, was getting nervous and after some discussions he arranged for Upland Nominees Limited to be incorporated in early 2001. He was the sole shareholder and Fiona Lamb was the director.

The company was made the corporate trustee for the Cuba Trust, replacing Lamb and Simpson.

Lamb and Donnelly then arranged to sell the two front units to themselves. They obtained a valuation that placed the value somewhere between $931k and $1035k and sold the units to themselves for $930k.

This was enough cash to retire the secured debt but not enough to pay the IRD. Because Upland Nominees was the new corporate trustee, the company was the registered owner of the property and became liable for the unpaid GST.

By the time the case came to court, there was over $100,000 of core debt and a further $100,000 of penalty and interest.

The case against Lamb

David Vance, a liquidator from Deloitte, claimed that Lamb breached Section 131 of the Companies Act on two counts:

> First, by making Upland Nominees accept the corporate trusteeship of the company when there were outstanding liabilities
>
> Second, Selling the property below value.

The court dismissed the first claim but only because there were no outstanding debts. This was a narrow factual finding. Had Vance been able to demonstrate that there were debts that were incurred then Lamb would have been found liable.

The second count succeeded. The court decided that selling for a thousand dollars below the minimum level was not acting in the best interests of the company.

Thus the liquidators got over the first hurdle. They proved that the director caused a breach. However, they now faced the murky area of judicial discretion in Section 301; the court gets to decide what level of compensation that the director should be compelled to pay.

The liquidators asked that the director be liable for the entire level of the failed company's debt. The court disagreed. The loss caused by the breach was not the unpaid tax, but rather only the difference between what the asset should have been sold for and what it was sold for.

The judge took the midpoint of the valuation range of $931k and 1,035k: 983k. He then deducted the actual sale price, $930k, and found that this was what the director was liable for $52,000.

The case against Simpson

Claims against shadow directors are rare and hard to establish. Very few have been taken in New Zealand. The court was quick to dismiss the case against the lawyer Simpson. Although liable as a trustee for his involvement prior to the incorporation, he was not found to be a deemed or shadow director.

Simpson was not directing the company, Lamb was. Lamb was not a proxy for Simpson and although Simpson had been a trustee of the Cuba Trust prior to Upland Nominees taking over that role, he was clearly not the actual person running the company.

The meaning of Vance, Lamb and Simpson

There are two key messages to take from this case.

The first is that to be a shadow director you need to be actually controlling the company; exerting influence isn't enough. There have been other cases, notable Krtoloca v Westpac where the director claimed that Westpac exerted so much influence that the bank was in effect acting as a director. The court rejected this claim, as with the case against Simpson, on the facts. However, the court did accept that a Bank could, in principle, exert so much effective control that they were be considered shadow directors.

The second is the low penalty imposed on Lamb. By selling the asset to herself she gained a substantial commercial advantage and when the court finally got around to holding her to account it took the most lenient and reasonable route it could. There was no punitive element to the ruling. There was no award to the liquidators for their time in taking the case. Nothing. All Lamb had to do was repay the amount that her actions had cost the company and benefitted her, and pay court costs.

Given the remarkably low number of times that directors get held to account, and how unlucky Fiona Lamb was, selling the two front units to herself and her business partner was morally suspect but economically sound.

5.3 Salthouse Marine

The background

The Salthouse Marine Limited (Salthouse) is an excellent case because it canvasses so many issues. Equally, however, it is a complex case with a number of moving parts, but it worth taking the time to have a close look at.

Salthouse was a boat builder, had been for a number of years. One of its clients was a Mr Christopher Norman, a distinguished and very wealthy naval architect based in Perth. Salthouse was led by its director and shareholder, the wonderfully named Ms Julie Salthouse.

Julie Salthouse

Every time the business built another boat it would create a subsidiary. The company established for Mr Norman's boat was Boat 90 Limited, although the practice only seems to have started with Boat 73 Limited but it ended with Boat 93 Limited, as we shall soon see.

With one thing and another the Salthouse business was in some financial trouble and it owed the now infamous Capital + Merchant finance company nearly $7m.

It was at this point, in late 2008, that Norman purchased the Capital + Merchant debt off the finance company's receivers. The price was just under $700k but Salthouse still owed Norman the full $7m.

Norman agreed to extended credit terms and also to provide the business extensive working capital. In return he took over the GSA and half of the company for good measure. He also became a director of Salthouse in December 2008. He did not, however, become the director of any of the subsidiaries created to build the actual boats.

The business continued to limp along, making losses every year and one of the biggest customers was Mr Norman himself and his boat, The Luana, which was due for completion in early 2010.

Jim Delegat and Boat 93 Limited

Jim Delegat is a highly successful wine merchant in Auckland. He was interested in purchasing a boat of Salthouse and in the process of his investigations he visited Norman in Perth to examine a similar boat.

"You won't be disappointed" Norman told Delegat.

Jim Delegat was suitably impressed and in November 2009 contracted with the freshly minted Boat 93 Limited to build himself a lovely boat. He took a security over Boat 93 Limited,

Jim Delegat

but not Salthouse Marine. Salthouse Marine guaranteed that Boat 93 Limited would complete the work and between November 2009 and January 2010 Delegat paid in $1.2m to Boat 93.

Boat 93 ceased work the following month when Norman placed Salthouse Marine into receivership. Because Delegat had a GSA over Boat 93 he took the partly completed hull, worth somewhere between $150 and $450k.

A key issue in dispute was that most of the cash paid in to Boat 93 Limited by Jim Delegat was promptly advanced to either Salthouse Marine Limited or several other subsidiaries. At the time of receivership a million dollars of Mr Delegat's cash had been advanced to the shareholder or other firms connected to it.

Christopher Norman and Boat 90 Limited: The Luana

Meanwhile, work on Norman's boat 90, now christened The Luana was proceeding at pace. The boat was launched in January 2010. It wasn't complete but was sea-worthy.

What did Norman do during his two years on the board?

Norman was based in Perth. He wasn't involved in the day to day of the business. Julie Salthouse was on the ground and she had been involved in the business previously. Norman wasn't a director of any of the subsidiaries. He did, however, take an interest in the affairs of the business. He was a boat broker in Perth and actively sought out sales for the business. His company, Yachts West Limited, agreed to take a commission on any sales he brought to the business and he contributed over three million dollars in cash to the business during the time he was involved.

Once Salthouse Marine went into receivership, Norman was the largest creditor by a substantial margin. He lost all of his investment.

The decision to appoint a receiver was, Norman claimed, due to a lack of sales and particularly when a number of sales he and Ms Salthouse were very confident would materialise failed to come in.

Delegat's allegations

Jim Delegat sued Norman on three grounds.

1) He was a defacto or shadow director of Boat 93 Limited
2) He breached his duties to Boat 93 and Salthouse Marine and could therefore be held liable under Section 301
3) He breached the Fair Trading Act by his assurance to Delegat that "you won't be disappointed."

Was Norman a Director of Boat 93?

The court was unequivocal. Norman was not a shadow director of Boat 93. Although he was a 50% shareholder in Salthouse Marine, held a GSA over the company and at a shareholder meeting had a casting vote if needed, what matters was how the business actually ran.

The court noted that Norman would have been a director if:

> *Ms Salthouse may have been required to act or was accustomed to act in accordance with Mr Norman's directions or instructions. … There needs to be clear evidence that the person was either the sole person directing the affairs of the company or if there were others who were true directors that he or she was acting on an equal footing with the others in directing the affairs of the company.*

On the facts, however, the court decided that despite his ability to exercise control over Boat 93, Mr Norman did not exercise that control and that Julie Salthouse, the sole director of Boat 93, had the actual control over the subsidiary.

Did Norman breach his duties to Salthouse Marne Limited?

Importantly, Jim Delegat took this action himself under Section 301 of the Companies Act. Normally a claim for breaching directors duties is left to the liquidators but 301 specifically allows for the creditors to take this action themselves and this is what Jim Delegat did. Because Salthouse Marine had guaranteed the performance of Boat 93, Delegat could claim in the liquidation of Salthouse Marine.

However, the claim is based on duties that the director owes to the company, not to the creditors.

The court looked at a number of factors and one of the allegations was that Norman allowed the company to continue to trade, especially the taking of the deposit for Boat 93, in order to complete his own boat, The Luana, which was launched only weeks before the receivership.

However, the court found in favour of Norman because:

> *There was no evidence he had acted in bad faith*
>
> *During the period of his directorship the level of external creditors fell considerably, by $1.7m*
>
> *There was no specific example of a creditor in Salthouse Marine who had a debt incurred that Norman could not reasonably expect would be paid.*
>
> *Norman had valid expectations that the business could trade back to health due to the level of probable sales and it was the failure of these sales that lead to his decision to appoint a receiver*

Norman's closet run was Section 136, incurring an obligation without reasonable belief that the company can meet that obligation. The commitment by Salthouse Marine to Jim Delegat over the performance of Boat 93 failed only because the judge was convinced that Norman acted honestly. Norman clearly came across well on the stand. The judge commented:

> *In giving evidence, Mr Norman impressed me as a reputable businessman who would not have permitted SML to enter into the contract with the Trust as guarantor without believing, on reasonable grounds, that SML would be able to guarantee the completion of the yacht. In that regard, I reject absolutely any suggestion that Mr Norman had an ulterior motive in taking Mr Delegat's money, namely, to complete his own yacht.*
>
> *I infer that Mr Norman would also have continued to fund SML if anyone else had purchased a yacht over the 2009-2010 summer period.*

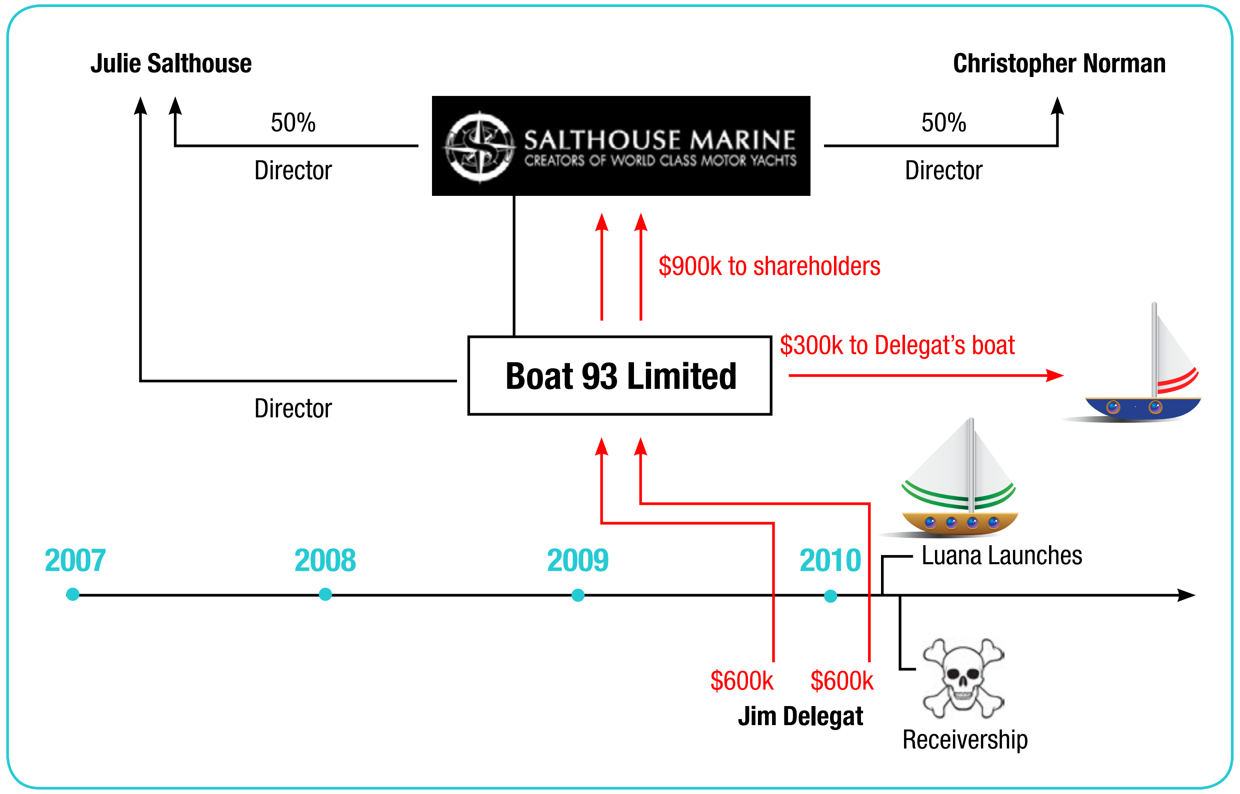
Did Norman breach The Fair Trading Act?

No. The judge was influenced that the comment, "you won't be disappointed" was not a misrepresentation made by Norman in his capacity as a director of the company but rather he was referring to the quality of the boat.

Lessons from the Salthouse Marine case

Norman was fortunate here. The judgement could have easily gone against him and it is clear that his performance on the stand went a long way to carrying the day. This case in some way harks back to Thomas Lister.

Prudent directors acting honestly and diligently can expect some sympathy from the courts.



6 The Economics

Company directors worry too much about the risks of reckless trading. There are half a million companies registered with the Companies Office, a little under half of them actively trade.

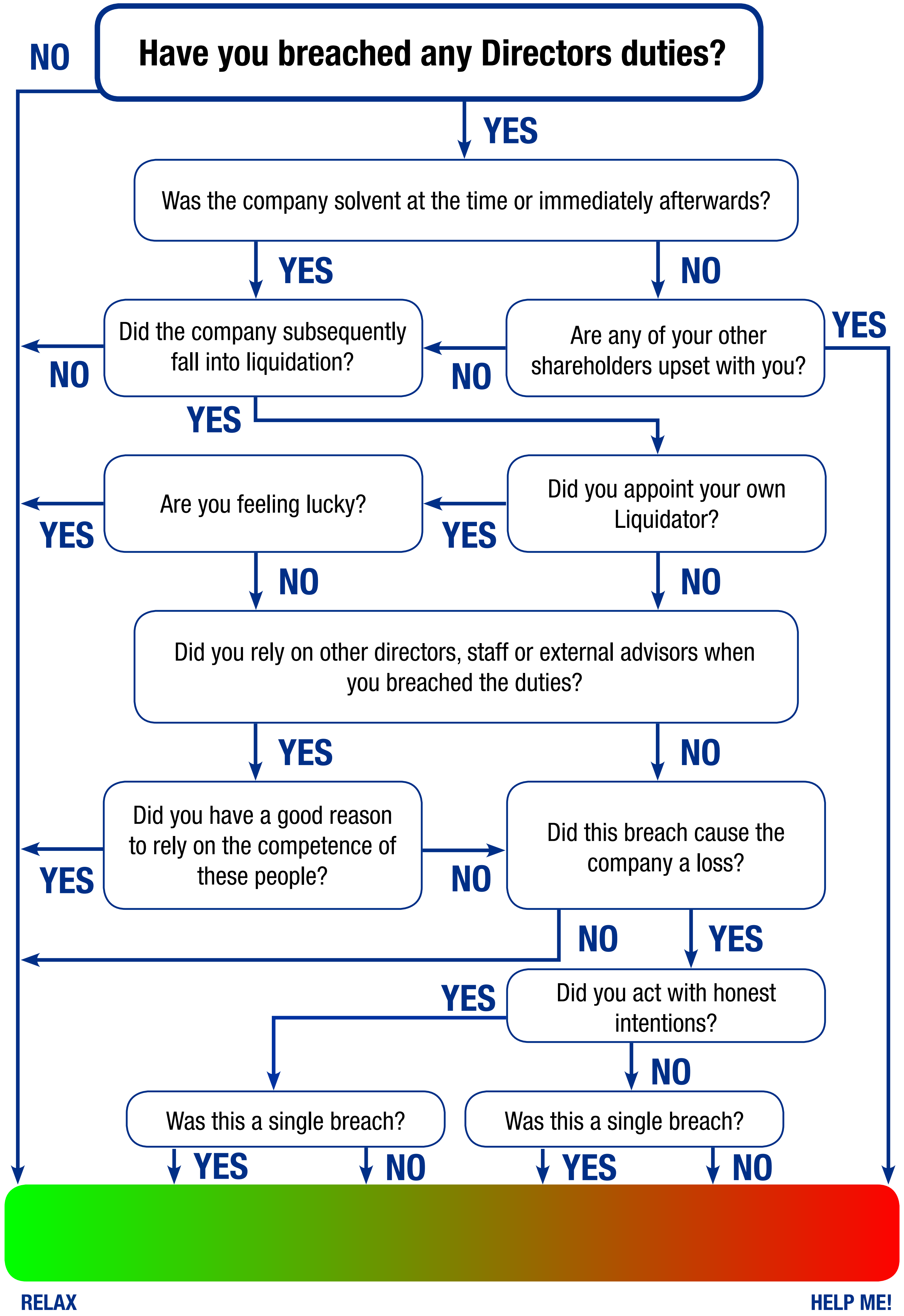
There varies between three and four thousand liquidations in a typical year. Most are voluntary liquidations and there is an expectation that shareholder appointed liquidators are less likely to hold a director to account than a court appointed one.

Of those appointed by the courts, only a few liquidators aggressively pursue directors breaches with less than 30 cases a year being taken.

Of those who are taken, there is no punitive or exemplary damages imposed.

In simple terms, if a director breaches their duties there is a very small chance that they will ever be held to account and even if they are the courts will only ever have to repay, legal costs aside, a maximum of the losses caused to the company. A company in most cases that they would derive all of the benefit from.

Some predators can be slow to act.



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