

Duties of directors under the Companies Act 1993

In this and future editions of *The Legal Lounge* I will outline some of the statutory duties and obligations that apply to directors and officers of corporate entities under a variety of statutes, and the potential civil liability and criminal sanctions that could follow if these duties or obligations are breached.

In this edition I focus on the statutory role and duties of directors under the Companies Act 1993, and current proposals for legislative changes in this area, including the introduction of new criminal offence provisions for breach of some of these duties.

Companies Act 1993 – broad framework

The Companies Act 1993 (the Act) simplified the statutory requirements for the incorporation and organisation of companies, and set out to clearly define the relationships between companies and their directors, shareholders and creditors.

It is possible to form a company consisting of as little as one shareholder and one director, and the process for incorporating under the Act is relatively simple and cost effective. A company may adopt its own constitution and, subject to certain mandatory requirements, may modify and alter the rules that would otherwise apply in the Act. For example, the rights and interests attached to shares or different classes of shares can be altered in the constitution. If a company does not adopt a constitution, the rights and interests of shareholders will generally be governed in accordance with the default provisions in the Act.

The Act also provides a legal process for a company to go into voluntary liquidation, or for its shareholders or creditors to apply to the Courts to place a company into liquidation, and provides a statutory process for realising and distributing the assets of the company.

While it is generally understood that the “limited liability” protection afforded to shareholders or directors of companies may be negated by contract, for example, by requiring personal guarantees or security over personal assets, there is in my observation much less understanding of the obligations and duties of directors under the Act, and the extent to which breach of those duties could lead to personal liability of directors for the debts of the company.

Statutory role and purpose of company directors

Section 128 of the Act stipulates that the business and affairs of a company “*must be managed by, or under the direction or supervision of, the board of the company*” (in other words, the directors).

One of the stated objectives in the Long Title to the Act is “*to encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management power*”. The Act accordingly provides directors with wide powers to govern and manage the affairs of the company, but also imposes a range of duties on directors, in order to achieve this objective.

Directors' duties

In exercising any powers or duties under the Act, directors must –

- act in good faith and in what the director believes is the best interests of the company (s131)
- exercise their powers for a proper purpose (s132)
- not act or allow the company to act in breach of the Act or its constitution (s 133)
- not agree to, cause or allow the company to trade recklessly (s135)
- not agree to the company incurring obligations that it cannot perform (s136); and
- exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances (s137).

Consequences of breach of directors' duties

Directors' duties under the Act are fiduciary in nature. That is, they are obligations of loyalty and fidelity owed primarily to the company and its shareholders, rather than the public at large. However, breach of the duties in s135 and s136 could also give rise to an actionable civil claim by a shareholder, creditor or liquidator against the directors.

For example, if a director realises that a company is in serious financial hardship, but causes or permits the company to trade and incur debts in a manner that is likely to cause serious loss to some or all of its creditors, this could result in the personal liability of one or all directors for certain debts incurred by the company, in the event of liquidation.

A company or any of its shareholders could also apply to the Court to seek a declaration that a director or the Board has failed to comply with one or more duties, and seek to enforce certain conduct by the director or the Board, and in some circumstances, to remove a person as director. The Shareholders Association has in recent years filed such actions against publicly listed companies.

Liability of "silent" directors for breach of Companies Act duties

It is not uncommon in New Zealand for many small family businesses to comprise of a husband and wife as joint shareholders and directors of a company, even although often one spouse is not actively involved in the business. While there may in some cases be commercial or other reasons for both spouses being appointed as directors, in my experience, it is often just a historic arrangement, or based on an incorrect assumption that it is necessary to have two directors to form a company. In those cases, I would suggest that it would be prudent to revisit the wisdom of the "silent" spouse continuing as a director. In *Re BM & CB Jackson Ltd (in liquidation); Benchmark Building Supplies Ltd v Jackson* (2001) 9 NZCLC 262, the High Court held that a wife who had not been actively involved in the company was none the less still obliged to meet her obligations under the Companies Act, including the obligation not to trade recklessly, and thus was along with her husband, held personally liable for losses arising from the breach of s135 during a period when the company continued to trade despite worsening circumstances.

Effect of designating powers and functions to certain directors

It is possible to designate the active spouse or business partner as the managing director, and to define or even stipulate in the constitution that the managing director has all of the powers exercisable by the board. However, this may still not be sufficient for other directors to escape personal liability if the managing director has mismanaged the finances and caused substantial loss to creditors. In *Re Nippon Express (NZ) Ltd v Woodward* (1998) 8 NZCLC 26 the managing director had been engaging in fraud. Although the other directors were not fraudulent and had not acted in bad faith, they were also held to be personally liable as they had failed to make proper enquiries where the Court considered that the circumstances had required it.

The Courts are clear that, even although directors may delegate certain powers and functions to other directors or management, directors cannot absolve themselves of their duties under the Act. In assessing liability under s 135 and s 136, the Courts often refer to the requirement under s137 to exercise due care and diligence. Where a director is found to have fallen below this standard in relation to their duties under s 135 and s 136, personal liability is likely to follow.

It is important that other directors continue to monitor and supervise the conduct of more active directors, to ensure that they cannot be left open to criticism that they have not made sufficient enquiries or taken action where they knew, or ought to have known, that the business or affairs of the company were not being managed correctly. Failing to do so could lead not only to breaches of Companies Act duties, but also potential criminal or civil liability under other statutory regimes. This will be the subject of future editions of *The Legal Lounge*.

“Shadow” and “deemed” directors

Any person involved in the management of the affairs of a company should also be aware that the Act contains a number of provisions which relate to “shadow” directors, or in which the High Court may “deem” a person to have been acting in the capacity of a director in relation to certain business transactions or activities. In those cases, the Court can hold such persons responsible to the same duties that apply to directors under the Act, and consequently, can attach liability to those persons for breach of those duties. In organising the structure and affairs of the company, care should be taken to ensure that significant decisions affecting the business are made by the directors, and that persons who are not intended to be subjected to the duties and liabilities of directors are not inadvertently caught out by these provisions.

Current proposal to criminalise some directors’ duties

Parliament is currently in the process of adopting changes to the Companies Act 1993 and Limited Partnerships Act 2008. One of the most significant changes could see the introduction of criminal offence provisions in the Companies Act, for knowingly acting against the best interests of the company; or knowingly breaching s135 of the Act, knowing that serious loss will be suffered if the business continues to be carried on or conducted in a reckless fashion. These changes are yet to be enacted and have been subject to some criticism. They were first proposed as part of the fallout from the finance company collapses, but it is now thought that the creation of the Financial Markets Authority and enactment of its associated powers and offence provisions has largely dealt with those concerns. None the less, it appears likely that these offence provisions will be enacted.

Comment

Any person who takes on the role of director, or performs functions that could be deemed to be carried out as a director, should be aware of the duties under the Companies Act 1993, and the potential liability that could arise if those duties are breached. In situations where a “silent” spouse has no active involvement in or knowledge of the business affairs of a company, serious thought should be given to whether that person should continue to hold the role of director. Even where a spouse may be involved in a “non-executive” capacity, for example by carrying out administrative or routine accounting functions, other mechanisms exist to remunerate or recognise the interests of that spouse without exposing them to unintended risks and potential personal liability for the debts of a company. If you have any concerns about this, you should contact the writer or your legal adviser for further advice.

Angela Beazer is a lawyer and Director of AMC Legal Services Ltd, a law firm specialising in aviation and public law matters. Previous articles from *The Legal Lounge* series may be viewed at www.amclegal.co.nz

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