

**DIRECTORS' DUTIES IN AN INSOLVENCY OR NEAR INSOLVENCY
SITUATION AND REMEDIES AVAILABLE TO CREDITORS**

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[1] Consider two situations. First, A is an investor in technology start-up companies. She provides seeding funds to these fledgling companies through debt rather than equity, although she secures the right to take a 10% equity interest at a fixed price in each of the companies in certain circumstances. A knows that most of the companies she lends to will not succeed, so that she is unlikely to recover from each individual company all the funds advanced. But experience tells her that one or more of the companies will succeed, so that, overall, she will not only recover her money but also have the opportunity to take an equity position and reap even greater rewards.

[2] On the face of it, this is a rational approach to investing. A understands the risks of her investment strategy, but thinks it has the potential for great reward. Moreover, A's approach is welfare enhancing, in the sense that it provides an opportunity for technology innovators and entrepreneurs to develop their services or products and take them to market. But the directors of these fledgling companies face a range of duties, some of which seem, on the face of it, to be incompatible with A's approach to investing.

[3] Second, assume that one of the technology start-ups is successful. With astute management, it develops a range of innovative, high quality (albeit high cost) products, devotes a high proportion of its earnings to research and development, invests in up-skilling its employees and acquires the most efficient plant and equipment, which it regularly upgrades. It develops several specialist divisions. The company's products dominate the market. Having changed her debt to equity, A and the other owners decide to list the company. The listing is successful, attracting a high proportion of small, individual investors as well as some institutional investors.

¹ I acknowledge the valuable assistance of my Judge's Clerk, Andrew Pullar.

[4] However, the company begins to face competition from new entrants, whose products, while inferior to the company's, are significantly cheaper. Although the company's products remain desirable and retain strong brand recognition, the company loses market share to its competitors, and the company's share price drops. Analysts are critical of the company's performance since listing. The directors decide they must cut costs, improve cash-flows and increase dividends. In conjunction with management, they decide to reduce expenditure on research and development, acquisition and retention of skilled staff and maintaining the most efficient plant and equipment. They also sell off one of the successful divisions. Cash flows improve, dividends increase and there is an increase in the share price. Over time, however, the steps taken by the directors cause the company to lose its competitive edge – innovation reduces, products do not maintain their superiority over those of competitors and so on. Ultimately, the long term future of the company is in jeopardy.

[5] This brief paper deals with issues arising out of directors' duties to creditors. I will not attempt to address the position in each of the jurisdictions represented at the symposium. Rather, I will focus on the New Zealand position. I will, however, refer to aspects of the Canadian and United Kingdom positions as they provide interesting contrasts. And I will refer to the examples just given along the way.

Overview of the New Zealand position

[6] Traditionally, company directors were said to owe their duties to the company as a whole, which was equated with the shareholders as a whole.² Duties were not owed to others interested in the affairs of the company such as creditors (I will refer to groups of interested parties as stakeholders). The underlying concept was shareholder primacy; the directors' principal objective was to enhance shareholder value.

² See, for example, *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 (CA), at 291 per Evershed MR and K M Hayne "Directors' Duties and a Company's Creditors" (2014) 38 MULR 795 at 808. However, there are variations in the meaning given to the words "interests of the company": see J D Heydon "Directors' Duties and Companies' Interests" in P D Finn (ed) *Equity and Commercial Relationships* (Law Book Co Ltd, 1987) ch 5.

[7] However, considerable inroads have been made to this position by both legislation and judicial decisions, so that it is now reasonably well-established in New Zealand and other jurisdictions that, at least when the company faces financial stress, directors are obliged to consider the interests of the company's creditors.

[8] By way of background, New Zealand enacted new companies legislation in 1993, following an extensive process of research and consultation by the Law Commission.³ In its 1989 report on company law reform, the Commission described the existing law on directors' duties as "inaccessible, unclear and extremely difficult to enforce" and recommended its urgent reform.⁴ The Commission said that "it was time to distil the general principles from the cases and express them in a statute, to make them more accessible".⁵ The Commission noted that the Australian and Canadian company legislation contained such statements of general principle.

[9] The draft Bill proposed by the Law Commission largely reflected the Canadian model. It was subjected to a close examination by the Law Reform Division of the Justice Department, with the result that the Bill subsequently introduced into Parliament differed significantly from that recommended by the Commission. The Bill then underwent a lengthy passage through Parliament, which resulted in further significant changes. As consequence, the directors' duties provisions of the Companies Act 1993 are in some respects very different from the Law Commission's draft, which has resulted in problems of application.⁶

[10] In relation to directors' duties to creditors, New Zealand had in the Companies Act of 1933 followed the lead of the United Kingdom in enacting a provision making directors liable for fraudulent trading, as recommended by the Greene Report in 1926.⁷ This provision was carried through into the Companies Act 1955.⁸ In 1980, the relevant provision, s 320, was amended to include reckless trading in addition to fraudulent trading, as had occurred in the United Kingdom

³ Elias CJ was a member of the Commission at the time.

⁴ Law Commission, *Company Law: Reform and Restatement* (NZLC R9, 1989) at [184].

⁵ At [186].

⁶ See, for example, D L Tompkins "Directing the Directors: The Duties of Directors under the Companies Act 1993" (1994) 2 Waikato LR 13.

⁷ Report of the Company Law Amendment Committee 1925–1926 (Greene Committee), Cmd 2657. See Companies Act 1933 (NZ), s 268.

⁸ Companies Act 1955 (NZ), s 320.

following the report of the Jenkins Committee⁹ and later in Australia. Then, in 1993, the new Companies Act with rather different provisions was enacted.

[11] By way of summary, the current position in New Zealand is:

- (a) Company law is still largely based on the principle of shareholder primacy.¹⁰
- (b) Directors¹¹ will be required in certain circumstances to consider the interests of creditors, either under their statutory duty to act in the best interests of the company or under particular statutory provisions relating to reckless trading and the incurring of obligations.
- (c) The relevant statutory duties are owed to the company, not to creditors directly.
- (d) Prior to liquidation, creditors do not have a statutory mechanism to compel directors to take account of their interests in their decision-making. In particular, neither the derivative action nor the oppression claim is available to creditors (in contrast to the position in Canada).¹²
- (e) On the liquidation of a company, creditors may apply to the court for orders that directors who have breached their duties restore company property or contribute to its assets.¹³

[12] In addition, there are criminal offences which seek to protect the position of creditors. Directors may, for example, be criminally liable where they induce someone to provide credit to the company by false pretences or fraud or do anything

⁹ Report of the Company Law Committee 1962 (Jenkins Committee) Cmnd 1749 at [499]–[500] and [503].

¹⁰ See, for example, Peter Watts *Directors' Powers and Duties* (2nd ed, LexisNexis, Wellington, 2015) at 132–136.

¹¹ This term includes de facto or shadow directors: see Companies Act 1993 (NZ), s 126.

¹² See Canada Business Corporations Act, RSC 1985 c. C-44, ss 239 and 241. The oppression claim will obviously be more useful to creditors as it will focus directly on harm to their interests whereas the derivative action will focus on enforcing the company's rights.

¹³ Companies Act (NZ), s 301.

that causes material loss to a creditor with intent to defraud creditors,¹⁴ as well as for a range of other failures, including in relation to keeping proper accounts and financial statements.¹⁵ Finally, provisions relating to voidable preferences¹⁶ and transactions at an undervalue¹⁷ are likely to provide some protection for creditors, as are the provisions dealing with so-called phoenix companies.¹⁸

Directors' obligations

[13] Unless the constitution of the company provides otherwise, the board of directors is responsible for the management of a company and has all powers necessary for that purpose.¹⁹ An important component of that managerial responsibility is to monitor the financial performance of the company, including as to solvency. This is sometimes seen as one of the obligations flowing from the recognition of limited liability.

[14] As in comparable jurisdictions, directors in New Zealand have two broad duties, both stated prescriptively, namely (a) a statutory fiduciary duty and (b) a duty of care:

- (a) Under the statutory fiduciary duty, a director “must act in good faith in what the director believes to be the best interests of the company”.²⁰
- (b) Under the duty of care, a director must exercise the “care, diligence and skill that a reasonable director would exercise in the same circumstances” taking into account the nature of the company, the

¹⁴ Section 380.

¹⁵ Section 374(3).

¹⁶ Section 292.

¹⁷ Section 297.

¹⁸ Sections 386A–386F. In addition to the provisions mentioned in the text, there are numerous requirements applicable to listed companies that provide protection for creditors, eg under the Financial Markets Conduct Act 2013.

¹⁹ Section 128.

²⁰ Section 131(1). See also Canada Business Corporations Act, s 122(1)(a), Corporations Act 2001 (Cth), ss 181 and 184, and Companies Act (UK), s 172. In Hong Kong, the duty is imposed by the common law.

nature of the decision and the position of the director and the nature of his or her responsibilities.²¹

These duties are complemented by other duties such as the duty to exercise powers for proper purposes,²² the duty to comply with the Act and the company's constitution²³ and duties in relation to disclosure of interests.²⁴

[15] The orthodox view was that the obligation to act in good faith in the best interests of the company meant in the best interests of present and (possibly) future²⁵ shareholders as a whole. On this view, directors should seek to maximise shareholder value. This follows from the traditional conception of a company as being (despite its separate legal personality) a combination of its members, with the directors as being akin to trustees of the members' funds (or the company's assets).

[16] However, in *Nicholson v Permakraft (NZ) Ltd*, Cooke J (later Lord Cooke of Thorndon) expressed the view that the duties of directors to the company "may require the directors to consider inter alia the interests of creditors".²⁶ By way of example, he referred to situations where the company was of doubtful solvency or where particular conduct would jeopardise the company's solvency. It is noteworthy that Cooke J saw the directors' obligation to consider the interests of creditors as being an aspect of the duty to act in the best interests of the company, rather than a free-standing obligation. Despite the fact that Cooke J's observations were obiter dicta, they have found support in New Zealand²⁷ and elsewhere,²⁸ although they have also been strongly criticised.²⁹

²¹ Companies Act 1993 (NZ), s 137. See also Canada Business Corporations Act, s 122(1)(b), Corporations Act (Cth), s 180, Companies Act (UK), s 174 and Companies Ordinance (Cap 622) (HK), s 465.

²² Section 133.

²³ Section 134.

²⁴ Section 139 and following.

²⁵ See Watts, above n 10, at 128–129.

²⁶ *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 (CA) at 249. The other members of the Court expressly reserved their positions on this point.

²⁷ See, for example, *Lion Nathan Ltd v Lee* (1997) 8 NZCLC 261,360 (HC) at 261,382.

²⁸ See, for example, *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 (NSWCA), at 730–732.

²⁹ See, for example, Hayne, above n 2.

[17] Besides their general statutory duties, directors in New Zealand have two specific statutory duties going to the position of creditors. They are found in ss 135 and 136 of the 1993 Act. Those sections provide:

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.

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.

[18] I make four points about these provisions at this stage:

- (a) The slightly clumsy drafting of s 135 is to make it clear that the section applies to passive or inactive directors as well as to active directors; s 136, on the other hand, applies only to directors who actually participate in the relevant decision. As a result, it has been argued that s 135 creates strong incentives for non-executive directors to encourage a risk-minimising approach on the part of management, which may not be in the best interests of shareholders.³⁰
- (b) The duties are continuing ones, rather than duties which arise in particular circumstances, such as when the company is approaching insolvency. Accordingly, it is possible that the directors of an undoubtedly solvent company may be found to have breached their

³⁰ David Goddard "Directors' Liability for Trading While Insolvent: A Critical Review of the New Zealand Regime" in Ian M Ramsey (ed) *Company Directors' Liability for Insolvent Trading* (Centre for Corporate Law and Securities Regulation, University of Melbourne, 2000) ch 7 at 186.

duties where, for example, the company assumes contingent liabilities which are remote but very large.³¹

- (c) Although the duties are stated in proscriptive terms and are owed to the company rather than to creditors (or anyone else) directly,³² their effect is to require directors to consider the interests of creditors.
- (d) It is unlikely that the directors of the technology start-up companies referred to at the beginning of the paper would be able to meet these obligations, especially if, as would be likely, the companies were under-capitalised.

[19] In principle, a shareholder could enforce the duties through a derivative action, but the more likely enforcement technique will be an application by a creditor for a remedy against the directors during liquidation under s 301 of the 1993 Act. An order may be made against (among others) a director under that section where the director has misapplied or wrongfully retained property, or has been guilty of negligence, breach of duty or trust or some other default in relation to the company. It is important to note, however, that s 301 does not give rise to any substantive rights; rather it is procedural in nature, simply providing a mechanism to enforce existing rights under statute or common law. Any recovery under s 301 is likely to be payable to the company and distributed pro rata among the creditors (subject, of course, to any secured creditors),³³ although payment to the particular creditor may be justified in some circumstances.³⁴

[20] Finally, it should be noted that directors may rely (among other things) on professional or expert advice in the performance of their duties or the exercise of their powers, provided they act in good faith, make proper inquiry where appropriate and have no reason not to rely on the advice.³⁵

³¹ Goddard, above n 30, at 186.

³² Companies Act 1993 (NZ), s 169.

³³ Section 301, as interpreted in *Mitchell v Hesketh* (1998) 8 NZCLC 261,559 (HC). It should also be noted that a remedy may be available against a director following liquidation if proper accounting records have not been kept by the company: see s 300 of the Companies Act (NZ).

³⁴ See *Sanders v Flay* (HC Auckland, CIV-2004-404-6712, 25 July 2005, Heath J) at [18]–[19].

³⁵ Companies Act 1993 (NZ), s 138.

[21] The directors' obligation to consider the interests of creditors, whether arising through their general duty to act in the company's best interests or through ss 135 and 136, raises a number of interesting questions, two of which I will discuss briefly:

- (a) What is the rationale for such an obligation?
- (b) In what circumstances does the obligation arise?

[22] There are two preliminary points, however. First, shareholders and lenders (and, perhaps, other creditors) have something in common in the sense that both groups provide capital to companies. Shareholders do so in exchange for dividends, lenders in exchange for interest payments. In many situations, the interests of the two groups will coincide – if a properly capitalised company is doing well, the shareholders should do well and creditors should be paid. However, in some situations, especially where a company is approaching insolvency, the interests of shareholders and lenders and other creditors may diverge. In an insolvency, the shareholders will lose their money. Facing that prospect, they may well support the company making a high risk/high reward investment – in effect, a last throw of the dice. Creditors, on the other hand, are likely to oppose such an investment and favour a cautious approach as their interest will be in preserving the current assets of the company to permit as full a recovery as possible if the company does become insolvent.

[23] The same is true of other stakeholders, such as employees. The interests of the various stakeholder groups may align, or not align, depending on the particular circumstances. Rules about directors' obligations need to accommodate this. If they do not, there is a danger that directors will face conflicting obligations, as the Law Commission has acknowledged:³⁶

We appreciate that if directors are given competing responsibilities, accountability becomes extremely difficult: one interest can be played off against another. The draft Act therefore sets up a hierarchy which subordinates duty to other interests (for example, to existing shareholders, employees and to creditors) to the directors' fundamental duty to act in the

³⁶ Law Commission, above n 4, at [194]. The hierarchy to which the Commission refers was not, however, carried through into the Act.

best interests of the company. The hierarchy makes explicit the equation of “the company” with the enterprise itself.

However, in the context of directors’ duties, viewing a company as an enterprise independent of its stakeholders or of any particular class of stakeholder (such as shareholders) raises another problem, indeterminacy, to which I return below.

[24] The second point is that there is something of a mismatch between the remedy available for breaches of ss 135 and 136, which is a damages claim by the company, and the interests which the sections seek to protect, namely those of creditors, principally unsecured creditors. Moreover, even among unsecured creditors as a group, there may be individual creditors whose positions differ. Some creditors may lend (or provide goods or services) to the company with full knowledge that it is in a parlous financial state; others may have no such knowledge and be acting on the basis that the risk of insolvency is no greater than normal. Finally, there is a question as to the interrelationship between these provisions and the voidable preference provisions applicable on insolvency.

What is the rationale for the obligation?

[25] In *Nicholson v Permakraft (NZ) Ltd* Cooke J said:³⁷

The criterion should not be simply whether [the proposed action] will leave a state of ultimate solvency according to the balance sheet, in that total assets will exceed total liabilities. Nor should it be decisive that on the balance sheet the subscribed capital will remain intact, so that a capital dividend can be paid without returning capital to shareholders. Balance sheet solvency and the ability to pay a capital dividend are certainly important factors tending to justify proposed action. But as a matter of business ethics it is appropriate for directors to consider also whether what they do will prejudice their company's practical ability to discharge promptly debts owed to current and likely continuing trade creditors.

To translate this into a legal obligation accords with the now pervasive concepts of duty to a neighbour and the linking of power with obligation. It is also consistent with the spirit of what Lord Haldane said [in *Attorney-General (Canada) v The Standard Trust Company of New York* [1911] AC 498 (PC)]. In a situation of marginal commercial solvency such creditors may fairly be seen as beneficially interested in the company or contingently so.

³⁷ *Nicholson v Permakraft (NZ) Ltd*, above n 26, at 249.

As can be seen, in this passage Cooke J calls in aid principles from several different areas – business ethics, tort and equity.

[26] The notion that creditors have some form of proprietary interest in a company's assets at (or, possibly, approaching) the time of liquidation was the rationale accepted by the New South Wales Court of Appeal:³⁸

In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.

[27] Professor Andrew Keay also advances this rationale. By way of background, s 172(1) of the Companies Act 2006 (UK) provides that a director “must act in the way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole” and goes on to identify some (non-exclusive) matters to which a director must have regard.³⁹ Section 172(3) provides that the duty “has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of the creditors of the company”. Professor Keay writes:⁴⁰

The theoretical reason behind the existence of s 172(3) is that when a company is in financial straits the owners of the residual value of the company (the residual owners being those whose wealth directly rises or falls with changes in the value of the company) are no longer the shareholders; they have been replaced by the creditors, whose rights are transformed into equity-like rights.

³⁸ *Kinsela v Russell Kinsela Pty Ltd (in liq)*, above n 28, at 730 per Street CJ. The other members of the Court concurred in Street CJ's judgment. Street CJ expressed agreement with the dicta of Cooke J in *Nicholson v Permakraft (NZ) Ltd*. However, in *Spies v R* (2000) 201 CLR 603 the High Court said that the duty to take into account the interests of creditors was merely a restriction on the right of shareholders to ratify breaches of the duty owed to the company; the duty owed to creditors was therefore limited – one of “imperfect obligation”: at [93]–[95].

³⁹ Set out below at [50].

⁴⁰ Andrew Keay “Directors' Duties and Creditors' Interests” (2014) 130 LQR 443 at 447–448 (footnotes omitted).

[28] Requiring directors to consider the interests of creditors has powerful critics, however, including Justice Hayne, formerly of the High Court of Australia.⁴¹ In a passage with which Justice Hayne agrees,⁴² Sarah Worthington criticises the proprietary interest rationale:⁴³

Such an analysis, while superficially attractive, is fundamentally flawed. It is true that on winding-up the creditors acquire the right, for the first time, to participate directly in the administration of the affairs of the company. In addition, the liquidator, acting as the agent of the company, owes fiduciary duties to the creditors. This special position of the creditors, however, does not entail the concurrent acquisition of a proprietary interest in the assets of the company; moreover, it comes at a cost to the creditors: they are deprived of all their ordinary remedies against the company. For these reasons it is impossible to draw the analogies suggested: they are wrong when winding-up has commenced; they are inappropriate beforehand, even in a situation of marginal insolvency.

[29] Justice Hayne also addresses another justification offered to support an obligation by directors to consider the interests of creditors, namely that there is a shift in risk where a company is in financial distress, from shareholders to creditors. Justice Hayne argues that there are two problems with this “shift in risk” analysis:⁴⁴

- (a) The first is limited liability, the purpose of which is to place the company structure between the shareholders of a company and the company’s creditors so as to limit the shareholders’ liability.
- (b) The second is the fact that most creditors are creditors by choice and have the ability to bargain to protect their positions (through Romalpa clauses, higher rates of interest to reflect higher risk, prompt payment requirements, on-going monitoring of debtors’ performance and so on).

[30] The second of Justice Hayne’s points is illustrated by the example of A lending to technology start-ups. She is a sophisticated lender, well able to make her own assessments and protect her own interests. It is also illustrated by a recent news

⁴¹ Hayne, above n 2.

⁴² At 811–813.

⁴³ Sarah Worthington “Directors’ Duties, Creditors’ Rights and Shareholder Intervention” (1991) 18 MULR 121 at 141 (footnotes omitted).

⁴⁴ Hayne, above n 2, at 813.

item in the Financial Times about the effect of lower oil prices on US shale oil producers. The article said that oil producers had lost more than US\$30 billion in the first half of 2015.⁴⁵ It noted that the US shale oil industry had expanded rapidly in the last seven years, but had never covered its capital expenditure from its cash flow. Companies had issued shares, sold assets and borrowed to increase production and add to their reserves, which had led to a doubling of net debt. While banks and other lenders will continue to lend to the industry on the basis of readjusted valuations of reserves, there was likely to be a shakeup involving bankruptcies and restructurings. The point is that credit is provided to the industry by sophisticated and experienced lenders who might be expected to look after their own interests.

[31] Lenders to small companies also protect themselves. The great majority of companies in New Zealand are small, many of them one person companies (trades people etc). Institutional lending to such companies is almost invariably supported by securities given by the principal, such as a personal guarantee.

[32] However, it must be acknowledged that other creditors, such as suppliers of goods or services, may be less well-placed to protect themselves,⁴⁶ or may consistently fail to protect themselves for reasons that are understandable.

In what circumstances does the obligation arise?

[33] Interpreted literally, s 135 could place an undesirable dampener on commercial activity by making directors overly cautious and deterring them from taking legitimate business risks. Two of the purposes of the 1993 Act as set out in the preamble are:⁴⁷

- (a) to reaffirm the value of the company as *a means of achieving economic and social benefits through* the aggregation of capital for productive purposes, the spreading of economic risk, and *the taking of business risks;*

...

⁴⁵ Ed Crooks "US shale oil industry hit by \$30bn outflows" *Financial Times* (Online ed, New York, 6 September 2015).

⁴⁶ For example, Romalpa clauses are often not effective to ensure the return of goods not paid for.

⁴⁷ Emphasis added.

- (d) 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;

...

[34] As these statements indicate, the taking of business risks is a necessary element of successful corporate activity and is to be encouraged. It is therefore important that s 135 not be interpreted in a way that unduly restricts legitimate risk-taking activity. On the other hand, there seems to be widespread acceptance that some limits must be placed on risk-taking activity.

[35] In its recommendations in relation to reckless trading, the Law Commission was concerned not to inhibit unduly the use of the corporate form as a vehicle for the taking of business risk.⁴⁸ This concern was well expressed by Professor LS Sealy:⁴⁹

Any reformulation of directors' duties to take account of the interests of creditors and others has to accommodate the concept of risk, and allow for the fact that directors must be free to take risks and to judge what risks their business should take. We must not lose sight of the fact that it is the principal function of the limited-liability company, and of company law, to facilitate this risk-taking; without it, the world's railways would not have been built and we would have had no Industrial Revolution, no modern technology.

Accordingly, the Commission proposed the following wording for s 135:⁵⁰

A director of a company must not agree to the company entering into a contract or arrangement or acting in any other manner *unless he or she believes at that time on reasonable grounds that the act concerned does not involve an unreasonable risk of causing the company to fail to satisfy the solvency test.*

The solvency test involves both trading solvency and balance sheet solvency: a company must be able to pay its debts as they become due in the normal course of business and the value of its assets must be greater than its liabilities (including its contingent liabilities).⁵¹

⁴⁸ Law Commission, above n 4, at [214].

⁴⁹ LS Sealy "Directors' 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural" (1987) 13 Mon LR 164 at 181.

⁵⁰ Law Commission, above n 4, at p 241 (emphasis added).

⁵¹ Companies Act 1993 (NZ), s 4(1).

[36] As can be seen, the Commission's wording of s 135 contained what was effectively a "reasonable business judgment" test: a director did not breach the section if he or she believed on reasonable grounds that the action did not involve an unreasonable risk of causing the company to fail to satisfy the solvency test. However, s 135 as enacted does not include such a test and, on the face of it, draws no distinction between legitimate and illegitimate commercial risk-taking.

[37] The explanation for this may be that the effects of 1987 share market crash were still influencing legislators when the Companies Act was being considered in the early 1990s and they believed that a more stringent approach than that recommended by the Law Commission was desirable. This process of change in the course of the legislative process resulted in the following comment from Justice David Tompkins:⁵²

In its present form [s 135] is the product of the unsatisfactory course that was adopted for this reform. The Commission's version proposed that directors be liable for "an unreasonable risk of causing the company to fail to satisfy the solvency test". Thus reasonable risks could be taken. That was deleted by the Justice Department, and a "reckless" test substituted. That in turn was axed by the Justice and Law Reform Select Committee, from which the section in its present form emerged. It is not surprising that such a piecemeal method of law reform has produced a rather uncertain result.

[38] Whatever the explanation for the current wording, it certainly provoked some strong reactions from business leaders and academic commentators, well illustrated by the title of one academic commentary – "Corporate Directors' Personal Liability for 'Insolvent', 'Reckless', and 'Wrongful' Trading: A Recipe for Timid Directors, Hamstrung Controlling Shareholders, and Skittish Lenders"⁵³ The two concerns at the heart of this critical reaction were that the provisions would undermine the principle of limited liability and unduly restrict entrepreneurial activity.

[39] Arguably, the language of s 135 does allow for some assessment of potential reward as against the risk of loss. In particular:

⁵² Tompkins, above n 6, at 26–27.

⁵³ Dale A Oesterle, "Corporate Directors' Personal Liability for 'Insolvent', 'Reckless', and 'Wrongful' Trading: A Recipe for Timid Directors, Hamstrung Controlling Shareholders, and Skittish Lenders" (2001) 7 NZBLQ 20.

- (a) The words “likely to create a substantial risk of serious loss” indicate that directors’ conduct must be assessed as at the time it occurs. The assessment is a forward looking one – hindsight’s 20/20 vision is to be avoided.
- (b) The risk of loss must, reasonably viewed, be “substantial” at the time the conduct occurs. This language accommodates the fact that business decisions often involve some risk of loss. The key to the assessment is whether, at the time of the conduct, the risk of loss significantly outweighs the prospect for reward. A risk of loss may not be substantial if the likelihood of gain is high. Moreover, the risk must relate to a “serious” loss. Presumably what is serious in this context must be assessed against the nature and circumstances of the company at the time of the conduct.

However, words such as “substantial” and “serious” are general in nature and provide little real guidance. Moreover, the problem remains that some business enterprises are inherently risky, yet potentially innovative and exciting – the risks are high, but so are the potential rewards. How is this to be accommodated under s 135?

[40] Under the reckless trading provision in force prior to the 1993 Act, the courts (at least implicitly) drew a distinction between the taking of legitimate business risks and illegitimate business risks.⁵⁴ The courts seem to be adopting the same approach in relation to s 135, so that only the taking of *illegitimate* business risks will fall within the section.⁵⁵ A judicial gloss has been placed on the statutory language to meet the concerns expressed by Professor Sealy, the Law Commission and others.

[41] The courts have identified a range of factors to assist with determining whether a business risk was legitimate, including:

⁵⁴ See *Re South Pacific Shipping Ltd (in liq) Traveller v Löwer* (2004) 9 NZCLC 263,570 (HC) at [123]–[124]; upheld on appeal: *Löwer v Traveller* [2005] 3 NZLR 479 (CA).

⁵⁵ *Mason v Lewis* [2006] 3 NZLR 225 (CA); see also, for example, *Walker v Allan* (HC Nelson CP13/00, 18 March 2004) at [184]–[186], *Jordan v O’Sullivan* (HC Wellington CIV 2004-485-002611, 13 May 2008) at [38]–[44], *Delegat v Norman* [2012] NZHC 2358 at [105] and [115], *Goatlands Ltd (in liq) v Borrell* (2007) 23 NZTC 21,207 (HC) at [34]–[36] and *Cool Cars (Wholesale) Ltd (in liq) v Sharma* [2014] NZHC 256, (2014) 15 NZCPR 362 at [37]–[39].

- (a) Whether the risks were reasonably foreseeable.
- (b) Whether the risks were fully understood by those whose funds were at risk.
- (c) Whether the directors acted consistently with orthodox commercial practice.
- (d) Whether the directors relied on professional or expert advice or other material.
- (e) Whether the directors went too far in attempting to trade their way out of trouble.⁵⁶

[42] There is a question, however, as to whether judges are well placed to distinguish between legitimate and illegitimate business practices, given that many New Zealand judges have little commercial experience. Applying that distinction, however, the directors of the technology start-ups mentioned at the outset of this paper would presumably be held not to have breached ss 135 or 136. The risks associated with technology start-ups are well known. A, whose funds are at risk, fully understood the nature of the risks when she lent to the companies, but elected to go ahead in the expectation that she would ultimately make profits overall.

Canada

[43] In *Peoples Department Stores Inc (Trustee of) v Wise* the Supreme Court of Canada rejected the view articulated by Cooke J in *Nicholson v Permakraft (NZ) Ltd* that the directors' duty to act in the best interests of the company means that the directors have an *obligation* to consider the interests of creditors when the company is facing circumstances of financial stress.⁵⁷ Rather, the Court held that it is *legitimate* (ie, not mandatory) for directors to take account of the interests of stakeholders including creditors when considering what is in the best interests of the

⁵⁶ This seems to state a conclusion rather than a useful consideration.

⁵⁷ *Peoples Department Stores Inc (Trustee of) v Wise* 2004 SCC 68, [2004] 3 SCR 461. See also *BCE Inc v 1976 Debentureholders* 2008 SCC 69, [2008] 3 SCR 560.

company. The Court accepted that the traditional view of the “best interests of the company”, which gave primacy to shareholders’ interests, should no longer be applied; rather, the best interests of the company meant maximisation of the company’s value.⁵⁸ The Court said that “in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, *inter alia*, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.”⁵⁹ However, the Court went on to say that the shifting stakeholder interests that follow the fluctuations in a company’s fortunes do not affect the content of the directors’ fiduciary duty, which is owed at all times to the company. “The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders”.⁶⁰

[44] The Supreme Court did accept, however, that directors owe creditors a duty of care.⁶¹ This extension of the traditional position that the directors’ duty of care was owed to the company has received some criticism.⁶² But it is important to recognise that the Court emphasised that the duty had significant limits. The Court noted that many important business decisions are necessarily made under pressure of time and on the basis of limited information. Accordingly, decisions which are ultimately unsuccessful may nevertheless be reasonable and defensible when made. As a result, a robust “business judgment rule” was required. The Court identified two elements to the rule:⁶³

- (a) the first relates to the decision-making process and requires directors to act prudently and on a reasonably informed basis;
- (b) the second involves examining whether the decision was reasonable in light of all the circumstances known to the directors or about which they ought to have known.

⁵⁸ *Peoples Department Stores Inc (Trustee of) v Wise*, above n 57, at [42].

⁵⁹ At [42].

⁶⁰ At [43].

⁶¹ At [57].

⁶² See, for example, Stéphane Rousseau, “Directors’ Duty of Care after *Peoples*: Would it be wise to start worrying about liability?” (2005) 41 Can Bus LJ 223.

⁶³ *Peoples Department Stores Inc (Trustee of) v Wise*, above n 57, at [67].

The Court also made it clear that courts are not well equipped to second-guess business decisions and should be reluctant to do so.⁶⁴ Applying this approach to the cost-cutting decisions of the directors in the second of the examples given at the outset, their decisions might, viewed with hindsight, have had a lasting detrimental effect on the company's fortunes, but it would be difficult to say that they were not reasonable decisions when made.

[45] As will be clear, the Court adopted a wider, more pluralistic, view of the best interests of the company than the generally accepted common law view based on shareholder primacy. In the second example referred to at the outset, the directors were presumably focussed primarily on the interests of the existing shareholders when they made their cost-cutting decisions. Had they taken a wider view of the relevant interests, they may have taken other steps which, in the longer term, would have maintained and enhanced the company's competitive edge.

[46] It is, of course, important that the decision in *Peoples* be seen in context. An important part of that context is that the derivative action and the oppression claim are available to creditors in Canada, which is not the case in New Zealand. The fact that these remedies are potentially available to a wide range of "complainants" suggests that the Canadian legislation reflects a pluralistic view of the interests that directors should consider, which presumably influenced the Court, although the availability of these remedies to creditors was one of the reasons given by the Court for not extending the directors' fiduciary duty to them.⁶⁵

[47] On the other hand, as I understand it, Canada does not have a wrongful trading provision along the lines of s 214 of the Insolvency Act 1986 (UK), which allows a liquidator to apply for a court order that a director contribute to the company's assets where the director knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation.⁶⁶

⁶⁴ See [64]–[66].

⁶⁵ *Peoples Department Stores Inc (Trustee of) v Wise*, above n 57, at [48]–[53].

⁶⁶ See Jassmine Girgis "Deepening Insolvency in Canada?" (2008) 53 McGill LJ 167 at 174. The Australian equivalent is s 588G of the Corporations Act (Cth). New Zealand has s 301, but as noted above at [19], it simply provides a procedure for various parties to enforce statutory or common law duties owed to the company.

This may explain why the Court thought it necessary to extend the directors' duty of care to creditors.

[48] In *Peoples*, the Supreme Court rejected the traditional conception that the best interests of a company means the best interests of the shareholders as a whole,⁶⁷ and in *BCE Inc v 1976 Debentureholders*, articulated a conception of a company as an on-going commercial enterprise, independent of its stakeholders, viewed as a good corporate citizen.⁶⁸ While the Court acknowledged that the company and the shareholders were entitled to maximise profit and share value, it said that they could not do so by treating individual stakeholders unfairly.⁶⁹ This raises the question whether the directors in the second example given at the outset treated their employees unfairly when they reduced expenditure on research and development and on maintaining a skilled workforce in order to produce improved results for existing shareholders.

[49] Edward Iacobucci argues that a duty framed in this way is indeterminate and provides no guidance to directors.⁷⁰ He says:⁷¹

The corporation is a legal fiction that serves as a nexus for stakeholders seeking to enter into contractual or quasi-contractual relations with one another. There are a host of interactions between stakeholders and the corporation. To name a few, shareholders and lenders provide capital in exchange for dividends and interests payments; employees provide labour in exchange for wages; suppliers provide inputs in exchange for payments; and customers get goods and services in exchange for payment. The corporation serves as the intermediary between the stakeholders allowing each to incur obligations to one another indirectly through the corporation itself. Legal personality provides an invaluable contractual tool that would be otherwise unavailable. But to speak of the legal fiction that is the corporation as having "best interests" is nonsensical.

He then expresses "some sympathy" for the shareholder primacy view⁷² but goes on to point out that his concerns about indeterminacy are reduced somewhat by the courts' willingness to defer to the directors' business judgment.

⁶⁷ *Peoples Department Stores Inc (Trustee of) v Wise*, above n 57, at [42].

⁶⁸ *BCE Inc v 1976 Debentureholders*, above n 57, at [66].

⁶⁹ At [64].

⁷⁰ Edward Iacobucci "Indeterminacy and the Canadian Supreme Court's Approach to Corporate Fiduciary Duties" (2009) 48 Can Bus LJ 232.

⁷¹ At 235 (footnote omitted).

⁷² At 241, n 27.

[50] In this context it is worth referring to the position in the United Kingdom. Section 172 of the Companies Act 2006 (UK) provides:⁷³

172 Duty to promote the success of the company

- (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company *for the benefit of its members as a whole*, and in doing so have regard (amongst other matters) to—
 - (a) the likely consequences of any decision in the long term,
 - (b) the interests of the company's employees,
 - (c) the need to foster the company's business relationships with suppliers, customers and others,
 - (d) the impact of the company's operations on the community and the environment,
 - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
 - (f) the need to act fairly as between members of the company.
- (2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.
- (3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

[51] This provision reaffirms shareholder primacy, but makes it subject to a subsidiary obligation that the directors must “have regard to” a range of stakeholder interests when considering what is in the best interests of the company. This has been described as the “enlightened shareholder value” approach and is said to represent a modest development of the common law.⁷⁴ Arguably, an important advantage of the approach is that, while it retains an ultimate focus on the interests of a particular group of stakeholders (shareholders), thus avoiding indeterminacy, it encourages directors to take a longer term perspective to their company’s operations: in the long term, a company’s shareholders are likely to do better if the directors consider a

⁷³ Emphasis added.

⁷⁴ See the discussion in Paul L Davies and Sarah Worthington *Gower & Davies Principles of Modern Company Law* (9th ed, Sweet & Maxwell, London, 2012) at [16-64]–[16-69].

wider set of interests and take a socially responsible attitude rather than a short-term, profit-maximisation approach.

Issues

[52] There are a various issues that we might discuss. I will identify three:

- (a) What is the best way to interpret the phrase “the best interests of the company”. Are the interests of the shareholders as a whole the focus? Or the interests of the company as an enterprise independent of its stakeholders? Or is there a compromise position?
- (b) Do creditors really need special protection, given the mechanisms available to them to protect their own interests?
- (c) If protection is justified in principle, should it be tailored to the individual circumstances of particular creditors’ dealings with the company, so that a creditor who supplied services with full knowledge of the company’s financial condition would not receive the same protection as one who knew nothing of the company’s condition when the services were supplied?