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Small and Medium Entities are not well catered for

By

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The Companies Act 1993 and Directors' Duties: Small and Medium Entities are not well catered for

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Abstract

In 1993 New Zealand passed into law the Companies Act. The Act was a combination of work done by the New Zealand Law Commission and the Justice Department. It was anticipated that the Act would provide all the information necessary to enable a prospective director to understand what was required in incorporating and winding up a company, as well as the requirements to be met whilst doing business using that form. This paper contends that the Act does not contain the Law Commission's original intentions in terms of directors' duties, compliance with which is argued to be the *quid pro quo* of the right to incorporate, where the company is a small or medium entity. The paper further contends that amendments to the Act are necessary to take account of the needs of small and medium entities and suggests possible amendments, in light of case law emphasising the need for directors to maintain a company's solvency, where failure to do so can trigger personal liability for directors.

1. INTRODUCTION

The Companies Act 1993 ("the Act") was designed as a comprehensive "one-stop shop" approach to company law in New Zealand, with the relevant law made accessible and comprehensible. All companies would, through the new legislation, be able to access the requirements for incorporation, internal organisation, and winding up of companies. The Law Commission ("the Commission") accordingly referred to the initial draft legislation as a "core" Companies Act: "The Companies Act should be the statement of first recourse" (New Zealand Law Commission, 1989, para 122).

The element of internal organisation includes what are categorised by this paper as the "core" directors' duties. These duties consist of sections 131 – duty of good faith and acting in the best interest of the company; 134 – duty to comply with the Act and the constitution if a company has one; 135 – reckless trading; 136 – duty not to incur obligations; and 137 – duty of care. A further issue in the context of these duties is the relationship of the solvency test in section 4 of the Act to these core duties.

The Commission's intention for its draft legislation was to the effect that those needing to know what their rights and obligations are should not be driven immediately to seek legal advice (New Zealand Law Commission, 1989). The position of this paper is that these core duties, evolving as they did over time into a form that is argued to be inconsistent with the original objectives of the Commission, are now difficult to understand, and in effect, unclear and inaccessible. In particular, it will be argued that the position of directors of what are known as "SMEs" -small and medium entities which are defined as having fewer than 19 full time employees (Ministry of Economic Development, 2005) - is more difficult than that of other directors, as a result. Additionally, judicial interpretation of the core duties has added further to the level of inaccessibility, given that case law, unlike statute which is public law, is not generally available. Accordingly the paper will proceed with this perspective in mind. The purpose of this research therefore is to consider a redrafting of the core directors' duties and the solvency test to more closely align them to the objectives of the Commission, with the effect that it can truly be said that the statutory provisions can be the "statement of first recourse" for directors of SMEs.

The first part of the paper will look at recent empirical data from the Ministry of Economic Development (MED), Statistics New Zealand (SNZ) and information from the United Kingdom, which is currently undertaking a review of company law. The MED data relates to small and medium entities, of which small and medium companies form a part. The SNZ report provides more detail on business type. The findings and recommendations of the relevant reports will be analysed to identify the issues which provide the background and context for this research. In particular, the MED research will show that it is SMEs, which are often short on funds and knowledge, that are most in need of assistance with compliance issues.

The next part of the paper will deal with the legislative history of these provisions by reference to Commission reports Numbers 9 and 16, the Companies Bill 1990 No – 1 and No – 2, the Justice and Law Reform Select Committee ("the Committee") Report, and the Act, to set out a "timeline" of the changes made to the provisions from the initial Commission draft. A summary of the evolution of the provisions discussed in this paper is found in Appendix 1.

Part three of the paper will consider the implications of case law interpreting the duties, and the difficulties involved with this aspect. Decisions from New Zealand Courts will be looked at, leading to an analysis of the findings in terms of the central thesis of this paper. In particular, the decision of Baragwanath J. in *Mountfort v Tasman Pacific Regional Airlines* (2006) 1 NZLR 104 will be considered in detail for its significance in terms of directors' duties and the link from those duties to the solvency test. This decision seems to have brought the importance of the solvency test "full circle" in terms of the original aims of the Commission. Yet the importance of case law is not necessarily appreciated by those who do not have the resources to ensure full compliance with the Act, because of the private nature of such decisions.

Finally, based on the forgoing, recommendations for changes to the Act will be made. These changes are designed to fit with the objectives of the Commission to make the Act a document of first recourse in terms of compliance with company law. Consideration will also be given to assistance that can be provided to promoters of SMEs at the time of incorporation to help directors meet the obligations owed to the companies under the Act.

2. EMPIRICAL AND OTHER DATA

The most recent empirical data on the form of SMEs in New Zealand are found in the latest Ministry of Economic Development (MED) Report entitled "SMEs in New Zealand: Structure and Dynamics". The report considers the position of SMEs as at February 2004 and defines SMEs as entities employing fewer than 19 employees, although no distinction is made between companies and other business forms. Nonetheless as this report includes companies in the definition of "businesses" the definition will be adopted as indicative of the situation of many small companies. However Statistics New Zealand (SNZ) notes that of all business enterprises in existence in February 2005 (numbering 334,340) 51% of those were registered companies (Statistics New Zealand, 2005). The New Zealand Stock Exchange (at the time of writing) records a total of 342 companies associated with its various registries (New Zealand Stock Exchange), meaning the percentage of registered companies which fit the SME criteria is significant.

It is noted in the SNZ Report that there was a slight (3.1%) increase in the number of enterprises in New Zealand between February 2004 and 2005. A total of 63% of all enterprises are found to have no employees, the percentage rises to 96% if enterprises employing fewer than 20 employees are included. The number of employees may include the proprietor/s if they are paid wages or a salary by the enterprise. In the year February 2003 to February 2004, according to the MED report, businesses with few than 20 employees had 95% of firm entries, and 93.7% of firm exits (Ministry of Economic Development, 2005, p.29), indicating the highest "churn" of businesses is to be found in the smallest enterprises. It was similarly stated in a recent White Paper on company law reform by the Department of Trade and Industry that in the United Kingdom over 90% of companies have five or fewer shareholders. The Paper also notes that "Where the law is hard to understand, there are significant costs, uncertainty and risks and compliance is reduced."(Department of Trade and Industry, 2005). That understanding is now forming the basis of proposed reform of company law in the United Kingdom, with the focus of the reform being to simplify the law for small companies – a "Think Small First" approach. This paper is seeking, in terms of core directors' duties and the solvency test, to take a similar approach in New Zealand.

Characteristics of SMEs are also discussed in the MED Report. A quote taken from the Australian Government's *Small Business in Australia* 2001 Report referred to by the MED states, "…that small businesses tend to be characterised by independent ownership and operations; close control by owners or managers who contribute most, if not all, the operating capital and undertake the principal decision-making of the firm."(Ministry of Economic Development, 2005, p.4). Of the enterprises with fewer than five employees, many will have a working proprietor, which is defined by the MED as: "Either a sole proprietor or partner who is engaged actively in the business, or a shareholder in a limited liability company actively engaged in its management." (Ministry of Economic Development, 2005, p.37). If a shareholder is "actively engaged" in the management of a business which operates as a company, he or she is likely also to be a director under section 126 of the Act, given that section 128 of the Act charges directors with the obligation to manage, or oversee the management, of the company. There is accordingly a need to firstly understand, and then comply with, the core directors' duties set out in the Act.

Less empirical but arguable equally persuasive findings are contained in the August 2004 Report of the Small Business Advisory Group. The purpose of the Group and its Report is to make recommendations to Government on issues relating to SMEs. Some 19 recommendations were made, and of these, recommendation two relates in particular to the difficulties small business owners have in "multi-tasking" the requirements which come with running a business. This recommendation states that the Government should:
Provide funding to SMEs with growth potential to engage an Advisory Board to assist them in the governance of their business. The Advisory Board would typically comprise 2-4 people capable of bringing to the business an impartial eye and expertise that the founder/owner does not possess (Small Business Advisory Group, 2004, p.i).

The Report's recommendations are linked to the characteristics of small businesses which the Board found to be common to most of these entities. Included in the list of characteristics are the following:

- have an owner/manager with little formal business experience or few generic business skills
- have the owner as the only person in a managerial position, and no board or formal governance arrangements
- operate on trust, rather than on systems and contracts

- operate flexibly, on a "reasonable person" basis, rather than on an informed and strict observance of regulations
- not be aware of the regulations to which it is expected to adhere
- close within three years of its inception, not infrequently in circumstances that could easily have been prevented (Small Business Advisory Group, 2004, pp.3-4).

These characteristics can easily be related to non-compliance with statutory directors' duties. For example, if a company does not have a constitution, section 28 of the Companies Act requires that the Act become the company's constitution. Directors must therefore familiarise themselves with all of the requirements of the Act in order to ensure they are meeting their obligations under section 134 – duty to comply with the Act and the constitution. It is a reasonable conclusion that the Report writers' intention in recommending the implementation of an Advisory Board may have been to ensure that some of the preventable business failures are in fact prevented from occurring, although no cost/benefit analysis of this hypothesis appears to have yet been done. However it is argued that the amendments to the directors' duties and solvency test suggested by this paper will be a more accessible and potentially much less expensive option than that proposed by the Small Business Advisory Group.

3. LEGISLATIVE EVOLUTION

The Commission was concerned with finding a balance between the benefits of the company form to the New Zealand economy, and preventing abuse of that business form by those who were not minded to utilise the form ethically (New Zealand Law Commission, 1989). So the Commission's draft legislation [1] proposed that directors be responsible for the management of the company, whilst at the same time imposing restrictions on directors in terms of duties owed to the company. Restrictions on the powers of directors to carry out the purposes of the Companies Act set out in the Long Title of the draft Act are therefore linked directly to the management of the company. The two most important purposes in this regard are:

(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; and
(b) to encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgement while at the same time providing protection for shareholders and creditors against the abuse of management power.

[1] Sections from which will be referred to as LCR1 section…

The direct beneficiaries of the proper management of the company and its assets are the shareholders, but the wider benefits of the company form accrue to stakeholders such as creditors, and society as a whole. Protection is through the use of stated directors' duties owed not to shareholders and others, but to the company. "Efficient and responsible management" of companies by directors will result in benefits to shareholders, who have entrusted the care of their investments to directors, because it is increases in the value of those investments, and the expectation of income being derived from them that fits with the aim of "achieving economic and social benefits…" referred to in the Long Title of the Act.

However before there can be the exercise of management powers and consideration of directors' duties, a company must be incorporated. The Commission was concerned to maintain the concept of a separate legal entity, the entity that stands apart from the human actors involved with it, which was established by the principle laid down in *Salomon v Salomon* [1897] AC 22. Section 15 of the Companies Act 1993 places this principle into a statutory form. It is argued that in the context of a small company in particular, directors often have difficulties in knowing where the company "leaves off" and their personal interests "take over". The basis for such a conclusion is shown in the findings of the Small Business Advisory Group referred to above. The Act makes it clear that directors are not free to manage the company as if incorporation never occurred. Hence the Commission explicitly requires compliance by directors with what are now sections 131 to 145, and did not contemplate shareholders being able to adopt a constitution permitting directors to contract out of compliance with those obligations (New Zealand Law Commission, 1989).

The standards of behaviour required of directors are set out in sections 131 to 145 of the Act. They are in effect the *quid pro quo* of allowing the company form to exist. The situation is one where Parliament has said that there are limits on the use of that form by requiring a director to act in a manner that maintains a distinction between the interests of the company and those of the director. The situation of conflicts between the interests of the director and those of the company may only be resolved by putting the company' s interests first, informed consent from the company, or in extreme cases, resignation. Failure to resolve conflicts can result in the director being personally liable for debts of the company, as is shown in the case law below.

3.1 New Zealand Law Commission Reports and Proposals

a) Company Law Reform and Restatement

The Commission was invited by the Minister of Justice in 1986 to report on the current state of company law, and consider what reforms, if any, were required to be made. After two discussion papers, covering company law (in 1987) and personal properties securities (in 1988), the resulting feedback and submissions led to the first Report of the Commission being tabled in June 1989. The conclusion of the Commission was that reform of capital maintenance provisions and imposition of director accountability justified the creation of a new companies statute. Amendments to the existing law would not be sufficient. The Commission noted that "The major reforms proposed in this Report… are incompatible with the structure of the present Act" (New Zealand Law Commission, 1989).

The report took the form of introductory chapters setting out policy considerations and summaries of the main recommendations, followed by draft legislation and explanatory commentary. The proposed legislation was balanced between creating provisions which deal with the incorporation, administration and termination of companies, and legislating to prevent, as far as possible, abuse of the company form "without unacceptably eroding the benefits of use of the company form"(New Zealand Law Commission, 1989).

Statutory directors' duties were incorporated into the proposed legislation in the context of the power of directors to manage the company. Such duties had previously been found through a combination of the 1955 Act, the company's Memorandum and Articles, and case law. Directors' duties start with, as stated in paragraph 497 of the report:

> The fundamental duty to act in the best interests of the company [which] means that transactions entered into by the directors must be of adequate benefit to the company. That will apply to both transactions for value and ex gratia payments, such as charitable donations. It is clear that the company has the power to make donations… but the directors' powers are not unlimited. They are subject to the constraint of the best interests of the company and benefit to existing shareholders.

Mention of shareholders in the context of the exercise of management powers by directors is a reference back to the Long Title of the Act, and reiterates that the ultimate beneficiaries of the management of a company by directors are the shareholders. Accountability of directors to the company and the shareholders is thereby confirmed. Nonetheless the Commission

Report frequently refers to the fundamental duty of directors as being to act in good faith, and in the best interests of the company. The test is expressed as an objective one, and the relevant duty formulated as follows:

> LCR1Section 101 Fundamental duty
> The fundamental duty of every director of a company, when exercising powers or performing duties as a director, is to act in good faith and in a manner that he or she believes on reasonable grounds is in the best interests of the company.

The word "reasonable" is not defined, that determination being left to the Courts, where the expertise in making such decisions lie. However the outcome in any particular case would be determined by the facts.

> The Law Commission agrees that it is proper to permit a substantial area of discretion to those who manage a company and who must be entrusted with discretionary powers. The test for intervention, where a decision is made in good faith, is one of reasonableness. No more precise test is practicable (New Zealand Law Commission, 1989, para 139).

LCR1 section 104 introduces what is argued to be a redundant obligation:

> Compliance with constitution and this Act
> A director of a company must not act or agree to the company acting in a manner that contravenes the constitution of the company or this Act.

Two other sections in the draft Act promulgated by the Commission provide further clarification of what is required by the fundamental duty. These are LCR1sections 105 – Solvency; and 106 – Standard of care of directors. Of particular interest is the placing of compliance with the solvency test in the context of directors' duties. By doing so, the Commission is stating that directors must at all times consider the solvency of the company as a "core" requirement of the management of the company, "…directors are liable if they take unreasonable risk with the solvency of the company or where they trade knowing the company to be insolvent" (New Zealand Law Commission, 1989, para 214).

The solvency test proposed by the Commission is found in LCR1section 3(3) and says:

> A company satisfies the solvency test if
> (a) it is able to pay its debts as they become due; and
> (b) the realisable value of the company's assets is greater than the aggregate of the present value of its liabilities, whether contingent or otherwise.

> Section 105 Solvency
> (1) 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 the 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.

(2) A director of a company must not agree to the company incurring an obligation unless he or she believes at that time on reasonable grounds that the company will be able to perform the obligation when required to.

LRC1Section 105 does not forbid the director from acting in a manner whereby the solvency test will be breached, only to believe on reasonable grounds that there is no "unreasonable risk" that the company will breach section 3(3). Such an approach is consistent with the purposes of the draft legislation in terms of allowing director discretion to take reasonable business risks. If the risk is small then the action can arguably be in the best interests of the company and be taken in good faith. However if the risk is such that the outcome of the transaction will put the solvency of the company in peril, then an argument that the best interests of the company were being served is unlikely to succeed. The requirement in terms of incurring obligations is self-evident.

LRC1section 106 is, as the Report states, "an attempt to overcome deficiencies in the common law by imposing duties of diligence and skill."(New Zealand Law Commission, 1989, para 519). It reads:

> Every director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence and skill reasonably to be expected of a director acting in like circumstances.

The difficulty with this section is in knowing whether there are elements of subjectivity introduced through the consideration of a director's actions in the light of what a reasonable director acting in like circumstances would do. The overriding context of the duty is however an objective one. Courts have traditionally considered a director's actions in the light of the circumstances presented, and would, as with LCR1section 101, be in a position to make a judgement. For example, concerning the leading case of *Daniels v Anderson* (1995) 13 ACLC 614 it has been concluded, "There the NSW Court of Appeal set a proactive duty of care for directors involving participation, familiarisation, monitoring and inquiry." (Gillies, 2004, p.933). The section does, though, provide a link to LCR1section 105 whereby a careful, diligent and skilful director must reasonably be required to give consideration to the solvency test before agreeing to pay money or incur debt. This in turn can be related back to the fundamental duty to act in the best interests of the company, by not risking the solvency of the company. Insolvency threatens the efficiency of the company and is arguably not responsible management.

b) Company Law Reform: Transition and Revision

This Report (New Zealand Law Commission, 1990) 2 was the result of consultation on the first Report, and had the purpose of "fine-tuning" some of the sections of the original draft legislation, and proposing transitional provisions to be enacted if the reformation of New Zealand company law was to proceed.

In this report, the fundamental duty, LCR2 section 101, is in substantially the same form as in the earlier incarnation. The difference between the two versions is that the latter separates the two requirements of the duty putting them in separate subparagraphs. Changes were made though to take account of the joint venture situation, thus a director may be allowed to act not in the best interests of the joint venture company, but of a shareholder or other entitled person, provided the company constitution permits such an exception.

Amendments were also made to the solvency test provisions, by the addition of the concepts of "normal course of business" for payment of debts; "reasonable in the circumstances" for valuations of assets; and "realisable value", which is defined. Directors are therefore given a degree of latitude to determine the best way in which to value assets for the balance sheet limb of the test. Whichever valuation method is chosen, however, it must be "reasonable in the circumstances". "Realisable value" is defined as what would be paid for the asset by a "willing but not anxious buyer", which conceivably relates to the market value of the asset rather than any "book" value.

The duty to comply with the Act and the Constitution (LCR2 section104), the solvency section (LCR2 section 105), and the standard of care for directors (LCR2 section 106) remained unchanged in the second Commission Report.

[2] Sections from which will be known as LCR2 section…

3.2 The Companies Bill

a) Bill No 50 - 1

The next stage was the Companies Bill 1990 No 50 - 1. 3 The Explanatory Note describes the basis of the Bill as being the Commission's draft legislation, but notes that it does not adopt all of the Commission's recommendations. Changes made included the failure to adopt the characterisation of what became CB1clause 109 as a fundamental duty, and the removal of the objective aspect of the section. So the requirement for a belief on reasonable grounds became redundant, and decision-making by a director is done in terms of what he or she considers to be in the best interests of the company. Directors would continue having to act in good faith. The reason for this approach is stated to be confirmatory of "the approach of the courts in not reviewing the merits of individual business decisions" ("Companies Bill," 1990(a)) – referred to as the "business judgement doctrine" and summarised by Farrar as the idea "that the courts should not second guess business judgements taken in good faith" (Farrar, 2005, p.139).

The most obvious impact of such a change is the move away from the intention of the Commission to create a hierarchy of duties. The purpose of the Commission ranking duties was "in order to avoid a confusing conflict between them"(New Zealand Law Commission, 1990, p.xxii). In other words, directors would have it made clear to them that there are some duties which are paramount in terms of compliance. With such a change in focus, the fundamental duty became a "first amongst equals", arguably losing its distinctiveness as the "overarching" duty of a director. Berkahn and Trotman commented on this result that "In the absence of any explanation for this decision the result is a set of enacted duties which are, in many cases, no more precise than their common law predecessors" (Berkahn & Trotman, 2002, p.227).

The duty of care was redrawn, becoming CB1 clause115, to add a requirement that a director with particular skills or expertise must bring those to bear in the conduct of their role as director, and do so with the skill and care a reasonable director with those skills and expertise would exercise if in the same position.

[3] Clauses from this version of the Bill will be referred to as CB1clause.

Other changes made in the Bill include:

- The inclusion of a duty relating to the exercise of powers for proper purposes, stated to be as important a duty as the "fundamental duty" (CB1clause 111).
- The reforming of the solvency section into two separate duties – directors must not agree, cause or allow the business of the company to be carried on recklessly (CB1clause 113) and directors must not agree to the incurring of a debt without reasonable grounds for believing the company can meet that obligation (CB1clause 114). The clauses no longer make the link between the actions of the director and the solvency test.
- The addition of a new clause stating that statutory directors' duties are in addition to those duties imposed by the general law (CB1clause 116), something the Law Commission was at pains to avoid, by the creation of a statutory restatement of directors duties.

However the purposes of company law set out in the draft Long Title were adopted in the Bill.

The solvency test became CB1clause 4 and was simplified. The two limbs of the balance sheet test (based on the "realisable value" of the assets) and liquidity test were retained, and "realisable value" defined as "the price that would be paid for that asset by a willing buyer to a willing seller." A director's discretion to determine the method by which an asset could be valued was removed however, on the basis that directors must, in any event, have reasonable grounds for being confident the solvency test will be met.

It is also a duty of directors to keep records, such that the financial position of the company can be assessed without undue difficulty, at any time. This provision, without stating so overtly, would require directors to know, or be able to know, the value of company assets at any given time, as part of the assessment of the financial viability of the company.

The "fundamental" duty became CB1clause 109, reading as follows:

> 109. Duty of directors to act in good faith and in best interests of company – A director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company.

Removal of the reference to "reasonable grounds" leaves directors with what is arguably a complete defence. If a director makes a claim that a particular action was considered by him or her to be in the best interests of the company and was undertaken in good faith, then absent obvious fraud, or gross negligence, it is unlikely a Court would "second guess" the decision making process (the business judgement doctrine). Thus the outcome for the company would be "just one of those things" regardless of the losses suffered. The difficulties for a director of determining clear guidelines in this regard will be looked at in the context of analysis of the case law.

Changes to the director's duty of care were also significant. This section was amended to read:

> CB1clause115. Directors' duty of care – (1) Subject to subsection (2) of this section, a director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances.
> (2) A director who is in a profession or occupation or who possesses special skills or knowledge, must, when exercising powers or performing duties as a director, exercise the care, diligence, and skill that a reasonable director in that profession or occupation or possessing those special skills or knowledge would exercise in the same circumstances.

With hindsight, it is possible to foresee the special danger posed by this change to professionals such as accountants and lawyers who are often asked by their clients to become directors of newly formed companies, for their expertise in business law or practice. They would be present for their special skills, rather than their ability to provide management skills. Failure to exercise the particular standard of a profession on any given occasion could result in significant personal liability. Retaining the objective element by way of including the concept of a "reasonable director" does however counter-balance the change to CB1Clause 109 which removed the objective test of a director's actions. If it could be proved that a director was negligent, or insufficiently diligent, then liability could be imposed even where a director had acted honestly and in good faith.

b) The Justice and Law Reform Select Committee Report; Companies Bill No 50 - 2

It was noted in the Committee's Report (New Zealand Parliament, 1992) that there were significant delays in passing the Bill through the various stages, when the Report was tabled in early 1993. The Bill was originally introduced into the House on 4 Sept 1990 but the Select Committee did not make significant progress on it until 1 Apr 1992, and the Act was not assented to until 28 Sept 1993 coming into force on 1 July 1994. Nonetheless, significant consideration was given to the Bill, no doubt due to the large number of submissions (over 100) received, and the 39 reports requested of the Justice Department by the Committee.

The committee's examination of the bill has resulted in it recommending a number of amendments. Some represent a substantive change to the principles contained in the bill, others introduce new material considered to be necessary. Other amendments merely clarify or simplify the intent of the provisions (New Zealand Parliament, 1992, p.2).

One of these substantive changes was that the scope of the second part of the solvency test was widened, in response to evidence of "perceived problems in applying the test"(New Zealand Parliament, 1992). Yet arguably such problems could only be theoretical; the test itself not having been subjected to "real life" practice. As a result of the two specific Justice Department reports on the solvency test, and submissions received, the Companies Bill No 50 - 2 4 amended subclause (2) of the solvency test as follows:

> CB2 clause4. Meaning of "solvency test" – (2) …whether the value of a company's assets is greater than the value of its liabilities, including contingent liabilities, the directors –
> (a) must have regard to –
> (i) The most recent financial statements of the company that comply with section 176 of this Act or section 10 of the Financial Reporting Act 1992, as the case may be; and
> (ii) All other circumstances which affect, or may affect, the value of the company's assets and the value of its liabilities, including contingent liabilities:
> May rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

These changes were to take account of the four matters considered by submitters to pose difficulties with the solvency test proposed by the Commission. The four aspects were:

> the meaning of "realisable value"; the requirement to take into account "contingent liabilities"; the requirement to determine the present value of liabilities, including contingent liabilities; and the omission of an express reference enabling a company's financial statements to be taken into account when applying the test. (New Zealand Parliament, 1992, p.4)

Changes to subsection (2) beg the question of what a director must do if there is no annual report of which to take notice. This would be the case in the first year of operation of the company, to as far as five months into the next financial year. The point is of relevance from a practical perspective in terms of consequences for new companies who often, in the first year, set up the contracts and debt equity the company relies on to generate income. If

[4] Clauses from this Bill will be referred to as CB2 clause….

company assets have been offered as security for debt equity, then there will be a valuation of sorts, but the difficulty with personal property as opposed to real property is the speed at which the value decreases. This prescriptive and arguably complicated approach does not match the much simpler way in which the solvency test was constructed by the Commission. The solvency test is one of the fundamental protections shareholders and creditors have against potential loss of their investment or financial input, and it importance cannot be underestimated.

It is also argued that the Committee misunderstood the purpose of the solvency test. As stated by Goddard, this was hardly surprising given the circumstances of discussion of the Bill. He noted that, “The Committee did an excellent job in the circumstances – but select committees have neither the resources, nor the expertise, nor the time, to develop and draft complex commercial legislation” (Goddard, 2002, p.151).

Reference is made in the Committee report to the solvency test applying to all transactions transferring wealth from the company to shareholders. Then in the next paragraph the Committee states that the solvency test “is intended to protect creditors and, where only some shareholders benefit, to protect the non-participating shareholders”(New Zealand Parliament, 1992). The second version of the Bill, drafted in response to the recommendations of the Committee, uses the words, in clause CB2 clause4 (2), “in determining *for the purposes of this Act*… whether the value of a company’s assets is greater than the value of its liabilities…” (emphasis added).

This wording is particularly significant, as will be discussed, given the decision in *Mountfort* v *Tasman Pacific Regional Airlines*. In his article, Goddard refers to the fact that the Department of Justice Law Reform Division staff who instructed the Companies Bill to be drafted may have had a “strained” relationship with the Commission and did not therefore take full advantage of the Commission’s specialist knowledge of the policy context in which its recommendations were made (Goddard, 2002). If such was the case, then it is not surprising that the Bill was drafted somewhat in isolation and that the objectives of the Commission were overwhelmed to a degree.

Such disappointment is made clear when the proposed amendments to the solvency test and the loss of the direct link to the solvency duty are considered. It is the case that if a director is to carry on the company's business a determination must be made that the company is solvent. Personal liability will follow if the company is not solvent, because, as the case law demonstrates, it is not in the best interests of the company to trade whilst insolvent. It is argued that had proper consideration been given by the Committee to the reason why the Law Commission drafted LCR1section 105 in the manner it did, and to the practical impact of the amendments made to the solvency test, and the original solvency duty, then there would have been a clear statement of first recourse as far as directors' duties are concerned.

CB2 clause 109 remained in substantially the same form. It was amended further to take account of subsidiary companies, but only in situations where the constitution provides for contracting out of the "standard" requirement. Accordingly the additional requirements were most likely not going to affect a small company. As regards CB2 clause 115, the amendment included in the Bill as introduced to Parliament was removed, on the basis that directors are appointed to conduct business, not to give professional advice (New Zealand Parliament, 1992). So the clause was amended again, to read:

> CB2115. Director's duty of care – A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation, -
> (a) The nature of the company; and
> (b) The nature of the decision; and
> (c) The position of the director and the nature of the responsibilities undertaken by him or her.

This draft of the duty survived the next stage and is found in the Act as CA section 137.

c) The Companies Act 1993 [5]

The position of this paper is that the provisions of the Act are not in line with the original objectives of the Commission. In proposing fundamental reform of company law, the Commission was considering the position of the very large percentage of companies which fell into the SME category. Hence the expressed hope that directors of such companies would be able to "fend for themselves" in terms of compliance with the law. However the provisions being considered in the draft legislation Commission's draft legislation, originally short and relatively straight forward, have become lengthy and complex.

[5] Sections from the Companies Act are referred to as CA section…

For example, where a company does not have a constitution, CA section 28 states that the Act then becomes the company's constitution. It is completely understandable that the director of a small company would have difficulty with compliance when, as an example CA section 4 – the solvency test – requires looking at four other sections just to be sure that he or she understands what this section means, before considering what is required to put the section into practice. Use of somewhat old-fashioned words such as "diligence" found in CAsection 137 also have the potential for confusion – if a director has to consult a dictionary to determine whether he or she is complying with a statutory duty, it is not likely to happen.

One further point concerning the second version of the Companies Bill is the continuation of what is now CA section 134 by the Select Committee. This section requires of the directors compliance with the Act and the company constitution, which, as pointed out earlier, may in fact be the Act itself. It is a self-evident, fundamentally understood rule that compliance with statutory law is not an option. That has always been the case. A director who does not act in the best interests of the company or in good faith is therefore in breach of CA section 131 and in breach of the statute, so it seems redundant to legislate for further specific compliance.

The passage of the Act from draft legislation in the first Commission report to the final form took some four years, with further complications from a compliance perspective being added at every stage through the lengthening of sections, and the addition of new provisions. Given that this is a fundamental piece of legislation for New Zealand, supposedly designed to be sufficiently flexible to govern the operation of the widest possible spread of companies, it should be accessible, and written in language that makes sense to the director of the smallest company as well as the largest. It is submitted that the Act does not achieve this aim, support for which conclusion is present in the list of characteristics found by the Small Business Advisory Group report in relation to small businesses. Recommendations are made in the final part of this paper to address identified deficiencies in directors' duties.

4. CASE LAW

Since the implementation of the Act, the Courts have had many opportunities to consider the meaning of the sections being considered in this paper. The actions of directors are looked at where an application is made by a shareholder under the derivative action provisions.

However the more common context for such cases is that where the liquidator is using powers under CA section 301. An example of this situation is the recent High Court decision in *Mountfort v Tasman Pacific Airlines of NZ Ltd* (*Mountfort*) which concerned an application by a liquidator for a pooling order against a holding company (referred to as Airlines) in the situation of the subsidiary's (referred to as Regional) insolvency. Cases involving directors' duties do not normally concern groups, however in the course of the decision the main focus of the court became the issue of the solvency test, and its application to directors' duties.

In *Mountfort* Baragwanath J. identified two main legal issues, the first of which is particularly relevant to the situation of SMEs. He framed this issue in the following manner: "(1) what is the policy of the Companies Act 1993 concerning insolvent trading and the effect of the replacement of the former capital maintenance regime by provisions restricting trading while insolvent;"(*Mountfort*, 2005, para 5).

Justice Baragwanath initially looked at the meaning of the solvency test found in CA section 4. He was faced with competing arguments in this regard. Airlines had two experts presenting evidence, and to confuse matters further, each of the experts took a different view of the matter. His summary of the approaches of Regional and Airlines was thus: "There is a dispute as to the significance of the solvency test. Regional submitted that there is a general obligation of directors to maintain solvency. Airlines challenged the existence of such a general obligation" (*Mountfort*, 2005, para 10).

In considering his findings on the importance of the solvency test, Baragwanath J made reference to the decision in *CIR v Chester Trustee Services Ltd* [2003] 1 NZLR 39 where it was held at para 42, pp 405-6 that:

> The very purpose of the [1993] legislation creating a legal entity distinct from its directors and shareholders is to allow it to engage in business activities entailing risk without exposing shareholders to greater liability than the value of their investment. The condition of the privilege is that the company be able to pay it due debts.

Justice Baragwanath went on to say:

> While not stated in terms, I am satisfied that the "general obligation [under the former legislation] to maintain the company's capital" recorded by Richardson J in *Nicholson v Permakraft* at p 255 has now been superseded

> by what may be expressed as a general albeit imperfect obligation not to trade while insolvent, which is to be inferred from the whole scheme of the Act. (*Mountfort*, 2005, para 20)

Then,

> Such conclusion is consistent with the explicit obligations now stated in ss131 (to act in good faith in the best interests of the company (or holding company)), 135 (not allow substantial risk of serious loss), 136 (need for belief on reasonable grounds in ability to perform obligations). (*Mountfort*, 2005, para 21)

In summary, the Court found that both limbs of the test must be satisfied if the obligation for the company to remain solvent is to be met therefore trading whilst insolvent "may justify some departure from the s15 protection" (*Mountfort*, 2005). Baragwanath then went on to consider the authorities which relate to claims against directors for breach of duty. He adopted the "legitimate risk" benchmark, finding that to be consistent with the purposes of the Companies Act. It is not a legitimate risk to adopt a policy to trade while insolvent, and to do so will breach CA section 131. A legitimate risk is "one it was open to a reasonable director to believe amounted to a reasonable risk" (*Mountfort*, 2005, para 26).

> [Directors] are to be judged by a standard that is deferential to them in assessing what a reasonable director would have known and done in the fog of uncertainty that commonly attends business judgements. But if the applicant establishes against such a test that the directors should (and, *a fortiorari*, would) have known the company was insolvent, the premise of entitlement to trade with limitation of liability has gone (*Mountfort,* 2005, para 31).

The link between the relevance of solvency and the fundamental duties of directors to act in the best interests of the company, and with due skill, care and diligence, is appropriately made clear. It is what the Commission wished to do by framing directors' duties to include NZLC1 section 105. A director could not act in the best interests of the company, or exercise skill, care and diligence, by conducting the business of the company in such a manner that it has become insolvent. The finding of Baragwanath J that Airlines was in fact insolvent *ab initio* due to the unwillingness of the shareholder/directors to properly capitalise the company was a finding of breach of CA sections 131 and 137. That finding was relevant because the Court held that it was Airlines' insolvency which was ultimately responsible for Regional going into liquidation.

Baragwanath J. was not the first to use the benchmark of a "legitimate/illegitimate risk". Although the link to directors' duties through this concept is obvious, the core duties discussed in this paper, as Baragwanath noted, cannot necessarily be distinguished from one another in any particular situation. The case of *Re Cellar House Ltd (in liquidation); Alt cit Walker v Allen,* unreported, Noted [2004] BCL 454, shows that it is possible through one basic failure (in this case the lack of accurate record keeping) to be liable under most, if not all, the core duties. Causes of action against the managing director included failure to keep accounting records; reckless trading; and breaches of CA sections 131 and 137. The latter two causes of action were based on the reckless trading alleged in the second cause of action. France J. had the opportunity to consider the decision in *South Pacific Shipping Ltd v Traveller and Waller* (2004) NZCLC 263,570 on reckless trading, which had been handed down only a month before *Cellar House* was heard. She noted that:

> In that case, William Young J considered Bisson J.'s observations [in *Thompson v Innes* (1985) 2 NZCLC 99,463] and discussion amongst commentators on what is now s135 and concluded:
> "[123] …I am of the view that it is only the taking of illegitimate business risks which warrants a finding of reckless trading."(Re *Cellar House Ltd (in liquidation); Alt cit Walker v Allen*, 2004, para 184).

Only section 135 was considered in the *South Pacific Shipping Ltd* decision, and the court found the decision to trade on using only creditors' funds as working capital was the equivalent of an illegitimate business risk. If the company could not satisfy the solvency test because it had no assets of its own then the protection of limited liability should be forfeit (McArthur & Foster, 2005). To take such a course of action is not, as McArthur and Foster conclude, good governance and compliance with "orthodox commercial practices" (p. 8). That idea, it is argued, should be the overriding principle that is taken from the case law, being even more fundamental than meeting the solvency test. Failure to satisfy the solvency test cannot be orthodox commercial practice because it opens the company up to the corporate veil being lifted and individual directors being made personally liable for losses suffered by creditors. A decision to breach the solvency test is also, as the cases show, a breach of the core directors' duties, and yet this principle is not made clear in the current form of the duties. It is not to be expected that directors of SMEs will try themselves, or have a professional undertake the task for them, to consider the implications of case law on any given decision they are considering making. The findings of the Small Business Advisory Group show there is sufficient difficulty in meeting the requirements of the regulatory framework in which SMEs operate, without adding the question of interpretation of that framework into the mix. This may well be the result of directors of small companies having to "multi-task" in order to create an income for the company, and eventually themselves.

However ignorance of the law is not an excuse that any court will accept from a director of a company, a fact that reinforces the need to rewrite the core duties and the solvency test so that the true position is clear.

5. RECOMMENDATIONS

The proposition of this paper is that simplification of the existing law relating to directors' duties is, in the absence of a specialist SME statute such as the South African Close Corporations Act 1984, the most effective way to assist the directors of small and medium sized companies. It is a truism that most large companies in New Zealand started out as small companies, and it is also true that the companies which collapse each year are mostly the smallest ones. So a new model of legislation in this arena is required to assist those who most need to discover what their obligations are.

Such a model is already available in the Personal Property Securities Act 1999. That Act was drafted in a manner that allowed for explanatory material in the form of examples and discussion to be included with the statutory provisions. The examples are simple but clear and demonstrate the practical applicability of the relevant section. As this statute has a great deal of relevance to the operation of a small company which often requires debt equity the suitability of the model is further increased. Statutory directors' duties could be reframed in the form suggested below, with explanatory material by way of examples of the commonly found instances of potential difficulty. Amendments would also allow for the application of section 5 of the Interpretation Act 1999, so that a judge could take account of the additional material.

a) Solvency Test

It is proposed that an amendment to the solvency test in section 4 would firstly be required. If, as was held in *Mountfort,* compliance with the solvency test is crucial to the right to continue trading as a company, the issues raised earlier must be considered. Both the cash flow test and the balance sheet test must be satisfied, but the complications arise with regard to the balance sheet test and the manner in which a value is to be assigned to company assets. An annual report may not always be available, and in any event, the financial statements of a company may be limited in the case of a small entity. Depreciation is deducted from the purchase price to determine the “book” value, but that value commonly bears no relation the “realisable value” that was originally included in the solvency test. Directors of small entities commonly do not obtain formal valuations of assets before the financial statements are prepared, and given that the accounts are rarely audited, there is little oversight of the financial statements, which are done for tax purposes rather than reporting purposes.

Further support for this approach is to be found in the reference by the Court of Appeal in the case of *Shell (Petroleum Mining) Co Ltd et al v Todd Petroleum Mining Co Ltd* (unreported) CA 70/05, Court of Appeal, 3 August 2005. The Court referred to the finding in *Cudden v Rodley* (unreported) CA/67/99, Court of Appeal, 31 March 1999, which held in relation to a major transactions case that it is:

> authority for the proposition that the concept of value in s 129 is intended to reflect the market value of a company’s assets, in relation to which audited financial statements (in that instance showing fixed assets at their historical cost less depreciation) may be less than persuasive (para 62).

If the issue for section 129 is a major transaction involving more than half the assets, and the value of the assets is to be the market value, there should be consistency in approach with regards to the solvency test. Therefore the section should be amended to make that point clear, which was what the Law Commission intended in its original draft.

It is therefore proposed to redraft the solvency test in the following manner:

4. Solvency Test –

(1) For the purposes of this Act, a company satisfies the solvency test if –

(a) the company is able to pay its debts as they become due in the normal course of business; and

(b) the realisable value of the company’s assets is greater than the value of its liabilities, including contingent liabilities.

(2) In subsection (1) of this section, “realisable value”, in relation to an asset, means the price that would be paid for that asset by a willing buyer to a willing seller.

(3) In determining the realisable value of the company’s assets, the directors may have regard to –

(a) the most recent financial statements of the company that comply with section 10 of the Financial Reporting Act 1993 or the annual report prepared in accordance with section 208 of this Act

(b) valuations of assets or estimates of liabilities that are reasonable in the circumstances.

The explanatory material accompanying the section would then make reference to the fact that compliance with the solvency test is fundamental to the ability to operate the business as a company. It would need to say that before money is paid out of the company or debts incurred by the company consideration must be given to whether the company is solvent. This could be as essential as the decision to take drawings or an increase in the salary or wages paid to a director, or entering into contracts to supply or purchase goods or services. The emphasis of the advice would, however, need to be aimed at enabling a director to determine whether a decision was being made in the company's interest or the director's interest when money issues are being considered, given that the legitimacy of the company's existence depends on it being a legal entity separate from the director/s. Reference could also be made to good governance being enhanced by compliance with the solvency test, and the fact that it is not a legitimate business risk or orthodox commercial practice to trade whilst the company is insolvent.

b) Directors' Duties

It is recommended that the provisions found in sections 131, 134, 135, 136, 137 and 138 can be redrafted into only two sections. Sections 134 – requirement to comply with the Act and the constitution – and 138 – use of information and advice – can be repealed. As noted above, it is a given that compliance with a statute is required. In terms of the constitution, if a company has one, then it would not be in the best interests of the company if the director acted against the terms of the constitution. Therefore that aspect of compliance can be absorbed into what will be called the fundamental duty. Section 138 allows for a director to rely on information and advice provided by third parties or experts. However this reliance is only justified if the director has acted in good faith, a repetition of the requirement in section 131. The Act already provides for directors to allow the involvement of others in management duties (section 128) and section 376 provides a defence to a claim for breach of directors' duties if the director proves they took all reasonable steps to comply. There is no reason why section 138 could not be subsumed into this defence, because it only comes to the fore where it is alleged there has been negligence or lack of care. If it is reasonable and proper to rely on others for information and advice, then a judgement can be made in the context of the defence raised by the director.

In terms of what the Law Commission referred to as the fundamental duty, the recommendation here is to effectively combine sections 131 and 137 as follows:

Fundamental duty – (1) The fundamental duty of every director of a company, when exercising powers or performing duties as a director, is to act in good faith and in a manner that he or she believes on reasonable grounds is in the best interests of the company.

(2) In acting in the best interests of the company, a director must, when exercising powers or performing duties, use the skill care and attention a reasonable director would exercise in the same circumstances taking into account, but without limitation, -

(a) the nature of the company; and

(b) the nature of the decision; and

(c) the position of the director and the nature of the responsibilities undertaken by him or her.

The explanatory material would, possibly by using examples relating to companies of different sizes and types, emphasise again the distinction between acting in the director's interest and what is the company's interest. It would be necessary if using examples to point out that the more responsibility a director has, the more care and attention is required. However provision may have to be continued for the joint venture and subsidiary exceptions to the fundamental duty that currently exist. One possibility for doing so would be to have a multi-faceted exception to subsection (1), conditional upon reflection in the constitution of the ability to act in a manner contravening s131(1).

It is then proposed to reinstate LCR1 section 105 from the Commission's draft legislation. The need to do so is argued to be more pressing since the decision in *Mountfort* – as noted above with respect to the solvency test, the importance of enabling directors or promoters to understand that the solvency of his or her company is paramount. The draft that became sections 135 and 136 in the Companies Act does not make that link clear, as the Law Commission had. The balance must be in favour of allowing a director to act in a manner anticipated by the purposes of the Act, but it would be up to a Court to determine at what point the line between solvency and insolvency is crossed. Actions of the director are then considered in light of that finding. Practically speaking that is what happens now, but as the Act is intended to be the statement of first recourse, such a clear link may well assist with alleviating some of the negative findings of the Small Business Advisory Group noted above.

With regard to explanatory material, reference back to section 4 would be necessary, together with examples of the kinds of things that constitute obligations, contracts and acts. Again the distinction between what a director might decide is necessary – taking drawings to pay an unexpected personal debt for example – and what is in the best interests of the company – not putting the company in a position where the company accounts cannot be paid on time – needs to be made. The decision in *Ocean Boulevard Properties Limited v Everest* (2000) NZCLC 262,289 also provides a good example. In that case the lease for the premises was signed at a time when the directors of the company had no idea where the funds to pay for the lease were going to come from.

However with all the duties proposed, it is essential that the explanatory material, or examples, make it abundantly clear that breach of the duties may result in personal liability for the director. In line with *Mountfort*, the difference between a legitimate risk and one that is likely to put the solvency of the company at risk needs to be emphasised - if the risk taken is not legitimate, the corporate veil will be lifted.

It is appreciated that there may not be sufficient scope to include all the explanatory material sought to be included here. The examples provided in the Personal Property Securities Act are succinct. One option may therefore be to include a fact sheet or other material with the certificate of incorporation. The ease with which a company may be incorporated – it can be done online for a total cost of $60.00 - is also an aspect of the need to provide additional explanatory material – no reference to any professional advice is required so literally anyone can set up a company and as such, it is not surprising many small companies do not take the opportunity to create a constitution, or even purchase a "pre-prepared" one. Appropriate material by way of an appendix to the Act could be considered, a Court could then take into account that such information had been provided, when looking at an allegation of breach of directors' duties.

6. CONCLUSION

Directors of SMEs are in an invidious position. Unlike those who act as directors of listed entities for example, directors of SMEs are in many cases indistinguishable from the company, and as a result must "multi-task" all the requirements of running a business. It is not surprising that the activity of earning a living gets in the way of regulatory compliance when the extent of the regulatory framework is considered. A full assessment of that framework is outside the scope of this paper. However concentrating on directors' duties and the solvency test, breaches of which are sufficient to enable the court to lift the company veil and expose the director to personal liability has resulted in an argument that the duties and test need to be reframed.

Recommendations for the form of the proposed change have been submitted, along with a recommendation that other actions be taken to ensure that directors are cognisant of their responsibilities in this regard. The need is to recognise there is a problem and try to provide solutions. Adam Smith noted the problem in 1776:

> The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company (Smith, 1904).

Empirical, anecdotal and court data a show the solution to date has not been entirely successful. This paper shows one possible way to address the some of issues confronting SME's and their directors.

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Appendix One

Table of Destinations

Law Commission Report No 9: Company Law Reform & Restatement	Law Commission Report No 16: Company Law Reform: Transition & Revision	Companies Bill 1990 No 50-1	Companies Bill 1990 No 50-2	Companies Act 1993	
Section 3 (3)	Section 3 (3)	Clause 4	Clause 4	Section 4	Solvency Test
Section 101	Section 101	Clause 109	Clause 109	Section 131	Duty to act in best interests of company
Section 104	Section 104	Clause 112	Clause 112	Section 134	Duty to comply with Act & constitution
Section 105 (1)	Section 105 (1)	Clause 113	Clause 113	Section 135	Reckless Trading
Section 105 (2)	Section 105 (2)	Clause 114	Clause 114	Section 136	Duty not to incur obligations
Section 106	Section 106	Clause 115	Clause 115	Section 137	Duty of care, skill and diligence

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