

**Criminalising breaches of directors' duties: What is wrong with clause 4 of the Companies and Limited Partnerships Amendment Bill?**

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A dissertation submitted in partial fulfilment of the degree of Bachelor of Laws (with Honours) at the University of Otago.

October 2012

## **Acknowledgements**

I would like to thank my supervisor, Shelley Griffiths, for her endless guidance, supervision and motivation.

I would also like to thank Mum for her eye for detail and her constant support, Dad for his always-practical advice, and Louis Chambers for his insightful discussions.

And finally, I would like to thank my flatmates, family and friends for keeping me grounded throughout this process.

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## Introduction

Clause 4 of the Companies and Limited Partnerships Bill<sup>1</sup> proposes to amend the Companies Act 1993<sup>2</sup> to impose criminal liability for certain breaches of directors duties. Directors who breach the duty in s 131 to act in good faith and what the director believes to be the best interests of the company, will be criminally liable if they knew that breach was seriously detrimental to the interests of the company. Directors who breach the duty in s 131 by agreeing to, causing or allowing the business of the company to be carried out in a manner likely to create a substantial risk of serious loss to creditors, will be criminally liable if they knew that breach would result in serious loss to creditors. Directors convicted under this section would be liable to a term of imprisonment not exceeding five years, or to a fine not exceeding \$200,000.<sup>3</sup>

The amendment would significantly change New Zealand's approach to the enforcement of directors' duties. Instead of relying on private enforcement by shareholders and liquidators, the state would play a significant role in the enforcement of directors' duties. Furthermore, breaches of directors' duties would cease to have only civil consequences. The "morally loaded sledgehammer"<sup>4</sup> that is the criminal law would await directors in breach of their duties.

A demonstrable lack of thought has gone into this amendment, which appears to be a knee-jerk response to the collapse of a number of finance companies late last decade, and an attempt by the Government and Parliament to create the impression that it is taking seriously the director misconduct that contributed to those collapses.<sup>5</sup> Rather than accepting this poor example of legislating, this paper will take a principled approach to the amendment. It will answer two questions: is there a case for criminalising breaches of directors' duties; and if there is, is the amendment drafted appropriately? The first question will be the focus of chapters two through five. Chapter six will address the second question.

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<sup>1</sup> Companies and Limited Partnerships Amendment Bill 2011 (344-1), see Appendix 1.

<sup>2</sup> See Appendix 1 for relevant sections of the Companies Act 1993.

<sup>3</sup> Section 373(4) Companies Act 1993.

<sup>4</sup> A P Simester and W J Brookbanks *Principles of Criminal Law* (3rd ed, Brookers, Wellington, 2007) at 719; A P Simester and Andreas von Hirsch *Crimes, Harms, and Wrongs: On the Principles of Criminalisation* (Hart Publishing, Oxford, UK, 2011) at 10.

<sup>5</sup> Clause 4 of the Bill received cross-party support in its first reading, see (24 July 2012) 682 NZPD 3852.

There are two characteristics of the amendment to highlight. First, it creates two new criminal offences, and this begs the question, when is it appropriate to expand the criminal law? The criminal law is an intrusive and draconian regulatory tool that can convict and imprison; it should not be deployed lightly. Chapter two will consider what the criminal law has to say about when it is appropriate to create a new criminal offence. Chapter three will apply this analysis to the proposal to criminalise breaches of directors' duties.

Secondly, this is not just the creation of a new offence. It is an amendment to the Companies Act 1993. Therefore, it is essential to consider the amendment from a company law point of view. What effect will the amendment have on the policies and principles underpinning the Act? The Companies Act 1993, and particularly the part of the Act concerned with directors' duties, sets a careful balance between a number of competing interests. The introduction of criminal liability for breaches of directors' duties has the potential to distort this balance. This will be the focus of chapters four and five.

At the end of chapter five this paper will conclude on whether there is a case for the criminalisation of directors' duties. Chapter six will consider the wording of clause 4 of the Bill (proceeding on the basis that Parliament is still intent on criminalising breaches of directors' duties). Will the new offences catch the conduct targeted by the framers of the Bill, and not more, or does the Bill set the threshold for liability too high or low? This will be the focus of chapter six.

Having considered all these factors, this paper will present a view on how (of, if) the Bill should proceed, and whether it needs further amendment.

## Chapter 1: Background to the proposal

### *A Why the proposal?*

Companies are diverse entities. They can range from the one shareholder property owning company with no employees<sup>6</sup> to the large multinational corporation with thousands of shareholders and employees, specialist management and significant political influence. Regulating such a diverse group inevitably will create challenges.

New Zealand addresses this challenge by making a clear split between company and securities law. All of New Zealand's 563,856<sup>7</sup> companies must comply with the Companies Act 1993.<sup>8</sup> Companies that issue securities to the public ("issuers") must comply with the Companies 1993 and on top of that the Securities Act 1978.<sup>9</sup> Companies that issue securities to the public are by their nature large public companies. Two obvious examples are companies listed on the stock exchange,<sup>10</sup> and finance companies.<sup>11</sup> The framers of the Law Commission Report that led to the Companies Act 1993 were very aware that by shifting matters peculiar to public companies into the Securities Act 1978, the Companies Act 1993 would be better able to focus on the small company (or small-to-medium enterprise (SME)).<sup>12</sup> As a result, the small company is the prototype for the Companies Act 1993.<sup>13</sup>

Driving the current amendment to the Companies Act 1993 are the finance company collapses of last decade, and the mismanagement that contributed to them.<sup>14</sup> Finance

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<sup>6</sup> 69% of companies in New Zealand have no paid employees (Ministry of Economic Development *SMEs in New Zealand: Structure and Dynamics 2011* (September 2011) ) at 5.

<sup>7</sup> As at 30 June 2011 (Companies Office "Statistics" (2012) <<http://www.business.govt.nz/companies/about-us/statistics>>.

<sup>8</sup> In fact, companies only exist pursuant to the Companies Act 1993. The Companies Act 1993 creates the existence of the company form, and it regulates its use (see Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989) at [12]-[14]).

<sup>9</sup> Securities law in New Zealand is in the process of a total re-write, with the Financial Markets Conduct Bill 2011 (342-2) before Parliament set to replace the Securities Act 1978.

<sup>10</sup> These companies issue "equity" to the public; they are publicly owned.

<sup>11</sup> Finance companies issue "debt securities" to the public.

<sup>12</sup> Law Commission, above n 8 at [148] (also see [17], [18]). Also see Law Commission *Company Law Reform: Transition and Revision* (NZLC R16, 1990) at 10.

<sup>13</sup> John Farrar "Enforcement: A Trans-Tasman Comparison" [2005] NZ L Rev 383 at 384

<sup>14</sup> Both the Ministry of Economic Development (MED) and the Minister of Commerce pay special attention to finance companies, see Ministry of Economic Development *Review of Securities Law: Discussion Paper* (June 2010) at [133], [134] and Office of the Minister of Commerce "Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform" (February 2011) at [205], [209]. Both the Minister of Commerce, Hon Craig Foss MP and David

companies issue securities to the public in the form of “debt securities”. They are a very small subset of the companies that are regulated by the Securities Act 1978 (and an even smaller subset of the companies that are regulated by the Companies Act 1993).

The Securities Act 1978 has had significant teeth in relation to offers by finance companies to the public. The host of prosecutions under s 58 of the Securities Act 1978 demonstrates this.<sup>15</sup> However, the Securities Act 1978 (and the regulatory architecture around it) was ineffective in regulating finance company behaviour after the allotment of securities.<sup>16</sup> This perceived gap in the law is a factor driving the current amendment. Public enforcement of directors’ duties is a potential mechanism to plug this gap.

However, two things have changed since the finance company collapses of late last decade. In 2009, in response to these events, supervision of finance companies (so called non-bank deposit takers) moved to the Reserve Bank.<sup>17</sup> Finance companies are now regulated as if they were banks (though offers by finance companies to the public must still comply with the Securities Act 1978). The banking regulatory regime is very different and stricter than the regulatory regime provided by the Companies Act 1993 and Securities Act 1978.

In 2011, the Financial Markets Authority (FMA) replaced the Securities Commission as the regulator of securities law in New Zealand.<sup>18</sup> Section 34 of the Financial Markets Authority Act 2011 gives the FMA power to enforce breaches of directors’

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Parker MP focus almost exclusively on finance companies when discussing the amendment at the Bill’s first reading (Mr Parker makes special mention of Rod Petricevic, see (24 July 2012) 682 NZPD 3852).

<sup>15</sup> Section 58 provides criminal liability for a misstatement in a prospectus by a director of company issuing securities to the public. The prosecutions of finance company directors were brought under this provision, examples include the Nathans’ Finance (*R v Moses* (HC Auckland CRI-2009-004-1388, 2 September 2011), and Bridgecorp prosecutions (*R v Petricevic* HC Auckland CRI-2008-004-29179, 25 March 2011). Also see Bell Gully “Submission to the Commerce Select Committee on the Companies and Limited Partnerships Amendment Bill 2011” at 3.

<sup>16</sup> Office of the Minister of Commerce, above n 14 at [209] states that there was a lack of any offence provision to deal with “certain types of conduct by directors covered by directors’ duties after the allotment of securities.”

<sup>17</sup> The Reserve Bank of New Zealand Amendment Act 2009 inserted s 157C into the Reserve Bank of New Zealand Act 1989 to make this change.

<sup>18</sup> The Financial Markets Authority Act 2011 made this change.

duties<sup>19</sup> against directors of “financial markets participants”.<sup>20</sup> In the company context, financial markets participants are companies that issue securities to the public.<sup>21</sup> The effect of this is that New Zealand already has public enforcement of directors’ duties in relation to issuers. Combine this with Reserve Bank supervision, and it is fair to say that the Parliament has addressed many of the concerns relating to finance companies. Yet Parliament is ploughing ahead with the proposal.<sup>22</sup>

### ***B Directors’ duties***

One characteristic of the company form is the separation of ownership and control. The owners of a company are its shareholders, whilst management is vested in the board of directors.<sup>23</sup> This separation creates a problem – directors may exploit their position for their own benefit, they may fail to exercise their powers with sufficient effort or skill, or they may take excessive risks (with other people’s money).<sup>24</sup> Company law addresses this problem by imposing directors’ duties. In New Zealand, these are the duties in ss 131-138 of the Companies Act 1993. They are mandatory duties<sup>25</sup> that are owed to the company,<sup>26</sup> requiring directors to act in good faith and in the best interests of the company,<sup>27</sup> to act for a proper purpose<sup>28</sup> and in accordance with the company’s constitution,<sup>29</sup> not to take excessive risks,<sup>30</sup> and to discharge their duties with reasonable care, diligence and skill.<sup>31</sup> Clause 4 of the Bill provides criminal liability for breaches of ss 131 (duty to act in good faith and the best interests of the company) and 135 (reckless trading).

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<sup>19</sup> Section 34 gives the FMA power to enforce breaches of “financial markets legislation” (s 34(2)(a) FMA Act 2011) which includes the Companies Act 1993 (see s 4 and Schedule 1); also see Financial Markets Authority *FMA Enforcement Policy* (2011). See Appendix 1 for s 34 FMA Act 2011.

<sup>20</sup> Section 34(1)(a) FMA Act 2011, “financial markets participants”, is defined in s 4; also see Susan Watson and Rebecca Hirsch "Empty Heads, Pure Hearts: The Unintended Consequences of the Criminalisation of Directors' Duties" (September 2011) 17 NZBLQ 97 at 103.

<sup>21</sup> See s 4 FMA Act 2011. There are other examples of financial markets participants that are not companies.

<sup>22</sup> The proposal received wide spread support in its first reading (see (24 July 2012) 682 NZPD 3852).

<sup>23</sup> Section 128 Companies Act 1993.

<sup>24</sup> See Ministry of Economic Development, above n 14 at [108].

<sup>25</sup> Peter Watts "Part C: Directors' Duties" in Peter Watts, Neil Campbell and Christopher Hare (eds) *Company Law in New Zealand* (LexisNexis, Wellington, 2011) at 426, 427.

<sup>26</sup> See s 169(3) Companies Act 1993.

<sup>27</sup> Section 131.

<sup>28</sup> Section 133.

<sup>29</sup> Section 134.

<sup>30</sup> Sections 135 and 136.

<sup>31</sup> Section 137.

How best to approach directors' duties is one of the "major preoccupations of company law".<sup>32</sup> Directors' duties lie at the apex of two of company law's competing goals: one is promoting efficient and innovative management; the other is deterring mismanagement.<sup>33</sup> There are two factors to the directors' duties equation – one is their content, the other is their enforcement. The combination of the two influence how company directors behave. While there is considerable debate in New Zealand over the appropriate content of directors' duties,<sup>34</sup> clause 4 of the Bill does not address this question, and so neither will this paper. The focus of this paper is the enforcement of directors' duties. Who should enforce breaches of directors' duties, and with what sanction?

The Companies Act 1993 currently relies on private enforcement of directors' duties, by shareholders and liquidators (other than in relation to financial markets participants – the overwhelming majority of New Zealand's companies are not financial markets participants). The proposed amendment would see the state playing an increasingly significant role in the enforcement of directors' duties. Additionally, directors in breach of their duties could face criminal, as well as civil, liability.

Both the duties in ss 131 and 135 are owed to the company,<sup>35</sup> therefore, the proper plaintiff for breach of these duties is the company itself.<sup>36</sup> The problem is that directors control the management of the company, which includes the decision to litigate.<sup>37</sup> This creates an obvious tension.<sup>38</sup> The Companies Act 1993 overcomes this tension by creating a number of mechanisms that allow shareholders and liquidators to enforce breaches of directors' duties. The main mechanism for shareholders is the statutory derivative action provided by s 165 of the Companies Act 1993. A derivative action is an action brought by an individual shareholder in the name of, and on behalf of, a company regarding an injury suffered by the company.<sup>39</sup> It involves a

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<sup>32</sup> J O Orojo "Company Law: Directors and the Company they Keep" [1990] NZLJ 436 at 436.

<sup>33</sup> See Companies Act 1993 Long Title (d).

<sup>34</sup> Particularly the reckless trading duty in s 135. See for example, *Re South Pacific Shipping Ltd (in liq)* (2004) 9 NZCLC 263,570 (HC) at [128]-[130], and Peter Watts *Directors' Powers and Duties* (Lexis Nexis, Wellington, 2009) at chapter 10.

<sup>35</sup> Section 169 Companies Act 1993.

<sup>36</sup> *Foss v Harbottle* (1843) 67 ER 189 (the Companies Act 1993 does not change this rule: see Christopher Hare "Part D: Shareholder Rights and Remedies" in Peter Watts, Neil Campbell and Christopher Hare (eds) *Company Law in New Zealand* (LexisNexis, Wellington, 2011) at 717, 718. Also see s 165(6) Companies Act 1993.

<sup>37</sup> *Hedley v Albany Power Centre Ltd (In Liquidation)* [2005] 2 NZLR 196 (HC) at [36]-[37]; Hare, above n 36 at 718.

<sup>38</sup> *Hedley v Albany Power Centre Ltd (In Liquidation)* at [36]-[37]; Hare, above n 36 at 718.

<sup>39</sup> Companies Act 1993 s 165(1)(a); Lynne Taylor "The Derivative Action in the Companies Act 1993: An Empirical Study" (2006) 22 NZULR 333 at 334; breaches of directors' duties are a common

two-stage process whereby a shareholder applies to the High Court for leave, and then if granted leave, the shareholder brings the substantive claim. There is a presumption that the company will fund the proceedings,<sup>40</sup> and the Court has the discretion to order any award to be paid straight to the shareholders rather than to the company.<sup>41</sup> The derivative action is virtually the only way to enforce breaches of directors' duties against directors of solvent companies that are not issuers.<sup>42</sup>

When a company is insolvent, however, liquidators can enforce breaches of directors' duties under the wide power provided by s 301 of the Companies Act 1993.<sup>43</sup> In practice, many breaches of directors' duties only come to light after insolvency, and so liquidators are often the ones enforcing breaches of directors' duties.<sup>44</sup>

### *C The Australian approach*

Australia provided the inspiration for the Ministry of Economic Development's (MED) proposal.<sup>45</sup> Under s 184 Corporations Act 2001 (Cth), directors can be liable for reckless or intentionally dishonest breaches of the duty to act in good faith in the best interests of the corporation, and the duty to act for a proper purpose.<sup>46</sup> Though the government is under an obligation to further the harmonisation of business laws

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example of an injury suffered by a company (see *Hedley v Albany Power Centre Ltd (In Liquidation)* at [37]).

<sup>40</sup> Section 166 requires the Court to order the company to pay the costs of the proceedings unless it would be "unjust or inequitable" for it to do so. In practice, it will not order the company to fund the action (for example if the company is in deadlock, or if the company is insolvent). See *Frykberg v Heaven* (2002) 9 NZCLC 262,966 (HC) at [45], [52]; Taylor, above n 39 at 355, 362.

<sup>41</sup> Section 167 Companies Act 1993.

<sup>42</sup> The unfair prejudice remedy provided by s 174 could also provide a mechanism for shareholders to enforce breaches of directors' duties. A breach of duty could be evidence of unfair prejudice (see Hare, above n 36 at 801, 802). Additionally, the FMA's s 34 power is a mechanism to enforce breaches of directors' duties but only in relation to issuers.

<sup>43</sup> Section 301 also gives shareholders and creditors the power to enforce breaches of directors' duties if the company is insolvent, but in practice the power is mainly used by liquidators, as any money recovered goes into the general pool of assets for distribution, rather than to a shareholder or creditor bringing the claim. See Lynne Taylor "The Regulation of Director Involvement in Phoenix Companies under Sections 386A to 386F of the Companies Act 1993" (2008) 23 NZULR 111 at 114, 115; Watts, above n 25 at 602.

<sup>44</sup> Office of the Minister of Commerce, above n 14 at [202].

<sup>45</sup> See Ministry of Economic Development, above n 14 at [116]-[121]; Business New Zealand considered harmonisation with Australian law on directors' liability desirable (see Business New Zealand "Submission to the Commerce Select Committee on the Companies and Limited Partnerships Amendment Bill 2011" at 2).

<sup>46</sup> See Appendix 1. Also see Ministry of Economic Development, above n 14 at [117]. In addition, s 588G Corporations Act 2001 (Cth) makes it an offence to allow an insolvent company to incur an obligation if that failure was dishonest.

with Australia,<sup>47</sup> harmonisation of company laws is not such a priority.<sup>48</sup> The purpose for harmonisation of business laws is facilitating trade.<sup>49</sup> Companies with different internal structures and rules are able to trade with one another without difficulty.<sup>50</sup> Furthermore, Australian company law is “obese and user-unfriendly”,<sup>51</sup> and Australia takes an “excessively penal” approach.<sup>52</sup> In the company law context, having a culturally specific companies regime that reflects the nature and dynamics of companies in New Zealand is more important than harmonisation with Australia.<sup>53</sup> Finally, even with its heavy-handed approach, Australia has had its share of corporate collapses on a far greater scale than New Zealand.<sup>54</sup> The Australian provisions do not have a proven track record that New Zealand should envy.<sup>55</sup> Therefore, the fact that Australia provides criminal liability for breaches of directors’ duties is not good reason for New Zealand to do so.

#### ***D Other relevant provisions***

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<sup>47</sup> Australia New Zealand Closer Economic Relations Trade Agreement (signed 14 December 1982, entered into force 1 January 1983); Memorandum of Understanding between the Government of Australia and the Government of New Zealand on the Coordination of Business Law (signed 31 August 2000).

<sup>48</sup> Law Commission, above n 8 at [151]-[153]. The Law Commission considered in detail the implications of the Memorandum of Understanding between the Government of Australia and the Government of New Zealand on the Harmonisation of Business Law (signed 1 July 1988) (now replaced by the MOU in n 47), and concluded that harmonisation of company laws should not be a priority. Indeed the Memorandum of Understanding between the Government of Australia and the Government of New Zealand on the Coordination of Business Law (signed 31 August 2000) recognises that a single approach in all areas of business laws is not necessary or desirable.

<sup>49</sup> See Memorandum of Understanding between the Government of Australia and the Government of New Zealand on the Coordination of Business Law (signed 31 August 2000); and Law Commission, above n 8 at [150]-[153]. For this purpose, harmonisation is much more of a priority in areas such as competition law, securities law and takeovers law. Also see David Goddard "Convergence in Corporations Law - Towards a Facilitative Model" (1996) 26 VUWLR 191 at 198.

<sup>50</sup> Goddard, above n 49 at 198.

<sup>51</sup> John Farrar *Corporate Governance: Theories, Principles and Practice* (3rd ed, Oxford University Press, Melbourne, 2008) at 7. The Australian Corporations Act 2001 (Cth) has 1537 provisions compared with New Zealand’s Companies Act 1993 with 398 provisions.

<sup>52</sup> At 7. Farrar describes how Australian company law is influenced by “either Ned Kelly or his jailer”.

<sup>53</sup> At 7.

<sup>54</sup> In recent years, examples include the collapse of the insurance company HIH and telecommunications company One.Tel (see Joshua Blackmore "Evaluating New Zealand's Evolving Corporate Governance Regulatory Regime in a Comparative Context" (2006) 12 *Canta LR* 34 at 45, 46).

<sup>55</sup> Len Sealy considers Australia’s company laws to have “more bark than bite” (Len Sealy "Corporate Governance and Directors' Duties" (May 1995) 1 *NZBLQ* 92 at 97).

There are a number of other provisions in the Companies Act 1993 and Crimes Act 1961 that could overlap with the proposal in clause 4 of the Bill. Whilst not strictly speaking an enforcement mechanism, breaches of directors' duties could well provide the basis for a management ban.<sup>56</sup> Sections 382-385 provide for management bans, which disqualify persons from being directors. The FMA and the Registrar of Companies can both impose management bans.<sup>57</sup>

In addition, there are other provisions in the Companies Act 1993 and Crimes Act 1961 that could potentially catch the behaviour targeted by the proposed amendment. Section 380 of the Companies Act 1993 provides criminal liability for fraudulent trading. This makes it an offence for a director to do anything, with intent to defraud that will cause material loss to a creditor.<sup>58</sup> There is potential for considerable overlap between this prohibition and the proposal to criminalise breaches of s 135.<sup>59</sup>

Similarly, a number of provisions in Part 10 of the Crimes Act 1961 could apply to serious breaches of directors' duties.<sup>60</sup> Section 220 prohibits theft by a person in a special relationship and may well account for many breaches of s 131.<sup>61</sup> Section 240 applies to causing loss by deception, and s 242 applies to false statements by a promoter.<sup>62</sup>

There are three points to highlight from this chapter. The first is that though there is currently no criminal liability for breaches of directors' duties, there are a number of provisions that could catch the sort of conduct targeted by the Bill. Secondly, while the Companies Act 1993 relies on private enforcement, the state still plays a role in

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<sup>56</sup> Acting in a reckless or incompetent manner in the performance of one's directors' duties could be grounds for a ban under s 383(1)(c)(iii).

<sup>57</sup> The FMA and RC's can impose management bans for up to five years where a person was wholly or partly responsible for a company's financial difficulties. As well, the FMA, RC and a number of other parties can apply to the Court for a ban for up to 10 years under s 383 (see Katy Millington "Lifetime bans for errant directors?" [2010] NZLJ 94 at 94). The rationale behind management bans is protecting the public though bans do have a punitive effect (see Millington, at 94; *First City Corporation Ltd v Downsview Nominees Ltd* [1989] 3 NZLR 710 at 766; *Davidson v Registrar of Companies* HC Wellington CIV-2010-485-76, 27 August 2010 at [91]).

<sup>58</sup> Section 380(3) Companies Act 1993.

<sup>59</sup> Bell Gully, above n 15 at 3. See further in chapter six.

<sup>60</sup> Watson and Hirsch, above n 20 at 100.

<sup>61</sup> This was the basis of one of the charges for the Capital + Merchant Finance directors, catching related party transactions that s 131 also targets (see *R v Douglas* [2012] NZHC 2271). Also see Peter Watts "Criminal penalties and professional negligence" [2011] CSLB 51 at 52; Bell Gully, above n 15 at 3.

<sup>62</sup> Section 242 was one of the grounds for conviction of Bridgecorp directors Rod Petricevic and Rob Roest (see for example *R v Petricevic*); Bell Gully, above n 15 at 3; Office of the Minister of Commerce, above n 14 at [208].

the monitoring of company conduct, particularly in relation to companies that are issuers, through the FMA's s 34 power, the administration of management bans, and the enforcement of the criminal provisions mentioned above. Finally, Parliament has already dealt with some of the problems that the amendment seeks to address.

## Chapter two: Principles of the criminal law

Clause 4 of the Bill will extend the reach of the criminal law. Currently, the consequences of breaches of directors' duties are only civil. The Bill proposes criminal liability for certain breaches of these duties. The criminal law is a blunt and coercive instrument. Its sanctions of conviction and imprisonment are draconian. It is no ordinary regulatory tool. This begs the question, when is it appropriate for Parliament to deploy the criminal law and create a new offence?

### *A A principled approach lost*

The short answer is that Parliament creates a new offence when Parliament considers it appropriate.<sup>63</sup> History tells us that Parliament expands the criminal law when it is politically appropriate to do so, rather than because of any principled inquiry.<sup>64</sup> The determinants of the criminal law include everything from “political optimism”, “campaigns in the mass media” to “the activities of various pressure groups”.<sup>65</sup> The unprincipled expansion of the criminal law led Glanville Williams to the conclusion that it is not possible to distinguish crimes from other wrongs based on their content,<sup>66</sup> and prompted Andrew Ashworth to question whether the criminal law is a lost cause.<sup>67</sup>

Not only are the contours of the criminal law politically determined, but worse still, the political process pushes the criminal law in one direction – outwards. The political process often puts pressure on politicians to “be *seen* to be doing something”,<sup>68</sup> and create the “impression” that they are taking misconduct seriously.<sup>69</sup> It acts as a “one-

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<sup>63</sup> In New Zealand, Parliament is sovereign (see for example s 3(2) of the Supreme Court Act 2003 and s 15(1) of the Constitution Act 1986); *Berkett & Ors v Tauranga District Council* [1992] 3 NZLR 206 (HC).

<sup>64</sup> Andrew Ashworth "Is the criminal law a lost cause?" (2000) 116 LQR 225 at 226; Andrew Ashworth *Principles of Criminal Law* (5th ed, Oxford University Press, Oxford, 2006) at 22, 52; Erik Luna "The Overcriminalization Phenomenon" (2005) 54 Am U L Rev 703 at 711. Even the Legislation Advisory Committee Guidelines chapter on when to create a new criminal offence recognises that “ultimately the proper scope of the criminal law involves political and ethical judgments.” (See Legislation Advisory Committee *Legislation Advisory Committee Guidelines: Guidelines on Process and Content of Legislation 2001 edition and amendments* (May 2001)).

<sup>65</sup> Ashworth, above n 64 at 226; Ashworth, above n 64 at 52; John Coffee describes a similar sentiment in the US context: John C Coffee "Paradigms Lost: The Blurring of the Criminal and Civil Law Models. And What Can Be Done about it" (June, 1992) 101(8) The Yale Law Journal 1875 at 1881.

<sup>66</sup> Glanville Williams "The Definition of Crime" (1955) 8 CLP 107 at 123.

<sup>67</sup> See Ashworth, above n 64.

<sup>68</sup> Ashworth, above n 64 at 23 (emphasis added).

<sup>69</sup> Ashworth, above n 64 at 25.

way ratchet” geared towards increasing the criminal law.<sup>70</sup> This is the genesis of what some describe as “overcriminalisation”. Overcriminalisation has been a cause for concern across the common law world.<sup>71</sup>

Corporate law is not immune from this phenomenon. After almost every downturn or high-profile corporate collapse, there is public pressure on politicians to come down hard upon “delinquent directors” whose mismanagement is said to have caused such collapses.<sup>72</sup> The natural response of the political process is to “tighten up the rules and beef up the penalties”.<sup>73</sup> The result is that corporate collapses often drive corporate law reform.<sup>74</sup> The proposed amendment is a perfect example of this. It is a knee-jerk response by the Government and politicians to harness the strong public desire for “revenge” against the finance company directors.<sup>75</sup> However, many question the extent to which heavy sanctions prevent corporate mismanagement.<sup>76</sup> Corporate

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<sup>70</sup> Luna, above n 64 at 715; similarly Husak observes a “the seemingly inexorable trends toward enacting too many criminal laws and punishing too many persons.” (Douglas Husak "The Criminal Law as Last Resort" (2004) 24(2) Oxford Journal of Legal Studies 207 at 208). John Coffee describes this as a process of “reflexive criminalization” (Coffee, above n at 1881).

<sup>71</sup> See for example Luna, above n 64; Ashworth, above n 64; Coffee, above n; Kenneth Mann "Civil Sanctions: The Middleground between Criminal and Civil Law" (1992) 101 Yale LJ 1795; Husak, above n 70; Chapman Tripp "Submission to Commerce Select Committee on the Companies and Limited Partnerships Amendment Bill 2011 (Criminalisation of breaches of certain directors' duties)" at [29]; Law Commission (UK) *Criminal Liability in Regulatory Contexts: An Overview* (Consultation Paper No 195, 2010).

<sup>72</sup> Len Sealy "Directors' duties revisited" (2001) 22(3) The Company Lawyer 79 at 81; Sealy, above n 55 at 95; Dale E 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 at 25, 42. For an example of this sentiment, see Antoinette Sernia and Mei-Ling Barkoczy "Directors Beware: Corporate Sanctions and Defences, a Matter for Review?" (2009) 16(1) Murdoch University Electronic Journal of Law 134 at 140 who argue (in relation to the global financial crisis of late last decade) “[u]ndeniably, what has emerged on the Australian home front is evidence of corporate collapses linked to the pressing need for accountability and close scrutiny of corporate behaviour.”

<sup>73</sup> Sealy, above n 55 at 101.

<sup>74</sup> Regulation Taskforce 2006 (Australia) *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (January 2006) at 88; Sealy, above n 72 at 82; Sernia and Barkoczy, above n at 140. Australia’s stringent corporate law regime is thanks to its history of corporate collapses (Peter Fitzsimons "Australia and New Zealand on Different Corporate Paths" (1994) 8(2) Otago LR 267 at 268); Goddard, above n 49 at 194, 195.

<sup>75</sup> For example see Bob Jones "Put white collar crims in the stocks" *New Zealand Herald* (online ed, Auckland, 28 August, 2012) . Jones states “[t]he sole reason for locking up white collar offenders is revenge.”

<sup>76</sup> Len Sealy "Company Law: Directors and the Company they keep" [1990] NZLJ 434; Sealy, above n 55 at 95; Michael Walls "Where are we now, and how did we get here?" (Paper presented at the New Zealand Society of Accountants and New Zealand Law Society: The Company Law Conference,

mismanagement happens in countries with tough laws as well as lax ones.<sup>77</sup> Australia's strict corporate regime has failed to prevent collapses on a much larger scale than seen in New Zealand.<sup>78</sup> Other factors such as human nature all influence the extent of corporate mismanagement and collapse present in a society.<sup>79</sup> Honest and prudent directors will respect their duties, even when the sanction is civil (though in the face of criminal liability, they may well take a particularly cautious approach to their duties). Rogues, on the other hand, will be rogues, regardless of the sanctions.

The fact that the contours of the criminal law are politically driven does not necessarily mean that *should* be the case.<sup>80</sup> In other words, one cannot assume that the outcomes of the legislative process will be justifiable.<sup>81</sup> This paper will examine whether there is a principled basis to justify the proposed expansion of the criminal law.

### ***B A principled approach regained***

There are a number of different views on when it is appropriate to use the criminal law.<sup>82</sup> There are those who take a moral approach to the criminal law,<sup>83</sup> who focus on culpability and the role of the criminal law in punishing behaviour. According to this view, the state should criminalise and punish whenever there is a culpable wrong, and not otherwise.<sup>84</sup> In Andrew Ashworth's words, the "centrality of the culpability requirement surely is part of the essence of the criminal law."<sup>85</sup> Culpability is certainly an important aspect of the law in New Zealand. The chapter on when to create a new criminal offence in the New Zealand Legislation Advisory Committee (LAC) Guidelines expresses this view,<sup>86</sup> and MED highlighted the importance of

Wellington and Auckland, 1994) at 2; Goddard, above n 49 at 194, 195. The Law Commission, above n 8 at [43]-[46] also expresses cynicism about that view.

<sup>77</sup> Sealy, above n 76 at 434. Sealy doubted whether a significant tightening of the law on directors' duties would have much to prevent the 1987 stock market crash from happening.

<sup>78</sup> Blackmore, above n 54 at 45-47, giving the examples of the collapses of HIH and One.Tel. Len Sealy considers Australia's provisions to have "more bark than bite" (Sealy, above n at 97).

<sup>79</sup> Sealy, above n at 97; Goddard, above n at 194, 195.

<sup>80</sup> Ashworth, above n 64 at 229.

<sup>81</sup> Steven Penney "Crime, Copyright, and the Digital Age" in Law Commission of Canada (ed) *What Is a Crime? Defining Criminal Conduct in Contemporary Society* (UBC Press, Vancouver, 2004) at 68.

<sup>82</sup> Simester and von Hirsch, above n at 4; Penney, above n 81 at 69.

<sup>83</sup> Also known as a "retributivist" approach (see Simester and von Hirsch, above n 4 at 4; Gerard E Lynch "The Role of Criminal Law in Policing Corporate Misconduct" (1997) 60(3) LCP 23 at 44, 45).

<sup>84</sup> Penney, above n 81 at 69; Simester and von Hirsch, above n 4 at 4.

<sup>85</sup> Ashworth, above n 64 at 240.

<sup>86</sup> The Guidelines state "[t]he criminal law is intended to punish only that conduct which is in some way blameworthy." (See Legislation Advisory Committee, above n 64 at [12.1.2]).

culpability when it sought to justify the creation of the present offence.<sup>87</sup> The problem with this view of the criminal law is that it shifts the discussion of criminality to the question of what behaviour is culpable (a question with no easy answer). In a liberal society such as New Zealand, the starting point in answering this question is whether or not the behaviour causes significant harm to individual or public interests.<sup>88</sup>

At the other end of the spectrum is the utilitarian view of the criminal law.<sup>89</sup> This view focuses on deterrence, and looks upon the criminal law as another tool (albeit a particularly powerful one) in the state's regulatory arsenal. According to this view, the state should use the criminal law when it is efficient to do so, and not otherwise. In other words, "[t]he objective of a legal rule is to deter certain undesirable behaviour without simultaneously deterring (too much) desirable behaviour. Rules should minimise the sum of losses from: (a) undesirable behaviour that the rules permit, (b) desirable behaviour that the laws deter, and (c) the costs of enforcement. The legal system balances these competing objectives through the choice of sanctions as well as though the choice of substantive doctrines."<sup>90</sup> On this view, criminal liability would be the appropriate sanction for breaches of directors' duties if it would deter mismanagement without deterring too much desirable behaviour and would not cost too much to enforce.

Another approach is the "minimalist" view of the criminal law. Many commentators, concerned with overcriminalisation, argue that the state should only use the criminal law when it is truly necessary.<sup>91</sup> Underpinning the minimalist position is the view that the criminal law is a "bluntly coercive, morally loaded sledgehammer".<sup>92</sup> It deprives citizens of their liberty and autonomy, and as a result, it should be kept to a minimum.<sup>93</sup> John Coffee turns this theory into the maxim that the civil law "prices" whereas the criminal law "prohibits".<sup>94</sup> According to Coffee, a price will be

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<sup>87</sup> The MED Discussion Paper stated that the "main issue" confronting the proposal to criminalise breaches of directors' duties is whether New Zealand society regards the finance company behaviour as "sufficiently immoral to justify creating a new offence." Ministry of Economic Development, above n 14 at [135] (also see [128]).

<sup>88</sup> Legislation Advisory Committee, above n 64 at 253; also see Simester and von Hirsch, above n 4 at 35.

<sup>89</sup> Also described by phrases such as "economic", "instrumentalist", or "consequentialist".

<sup>90</sup> Frank H Easterbrook and Daniel R Fischel *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, Massachusetts, 1996) at 316; Treasury (Australia) *Review of Sanctions in Corporate Law* (March 2007) at [1.37].

<sup>91</sup> Simester and Brookbanks, above n 4 at 720; Ashworth, above n 64 at 31, 53.

<sup>92</sup> Simester and von Hirsch, above n 4 at 10; Simester and Brookbanks, above n 4 at 719.

<sup>93</sup> Ashworth, above n 64 at 31, 53; Simester and Brookbanks, above n 4 at 720; Husak, above n 70 at 207; Coffee, above n 65 at 1875.

<sup>94</sup> Coffee, above n 65.

appropriate when a legal standard seeks to deter misbehaviour in the course of a socially beneficial activity. A prohibition would be appropriate when behaviour is entirely undesirable and ought to be deemed morally wrongful.

It is useful, at this point, to consider what is unique about the criminal law. While it is not possible to define a crime by its content, the criminal law does have some distinguishing features. It does three things – it punishes, it deters, and most significantly, it censures.<sup>95</sup> Whereas deterrence is a common feature of civil law, and the civil law punishes on occasion,<sup>96</sup> censure is unique to the criminal law.<sup>97</sup> The ability to censure, both prospectively and retrospectively, is a central feature of the criminal law.<sup>98</sup> Prospectively, criminal law communicates that behaviour is morally wrong and should not be done. To this extent, the criminal law plays a role in shaping social norms and morals.<sup>99</sup>

A conviction, by contrast, represents society's retrospective condemnation of the behaviour of a convicted person – that person is labelled as a criminal, and this is significant in itself.<sup>100</sup> This is particularly the case with white-collar crime. A director's reputation will be one of his or her greatest assets, and in many cases, prosecution would do it irreparable damage. The significant media coverage afforded to prosecutions of high profile directors, such as those resulting from the recent finance company collapses, highlights this.<sup>101</sup>

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<sup>95</sup> Simester and von Hirsch, above n 4 at 4; Simester and Brookbanks, above n 4 at 4; Lynch, above n 83 at 44-46.

<sup>96</sup> For instance, exemplary damages seek to punish (see Legislation Advisory Committee, above n 64 at 252), as do civil pecuniary penalties such as those provided in the Securities Act 1978 and Securities Markets Act 1988 (see Ministry of Economic Development, above n 14 at [125]). In addition, compensation awards will often far outweigh pecuniary penalties, so in that sense compensation can also punish (see [126]).

<sup>97</sup> Simester and von Hirsch, above n 4 at 3-5; Simester and Brookbanks, above n 4 at 2-5; LAC Guidelines, above n 64 at 252 [12.1.2].

<sup>98</sup> Treasury (Australia), above n 90 at [2.4]; Ashworth, above n 64 at 236, 237, 238; Simester and von Hirsch, above n 4 at 4.

<sup>99</sup> Simester and von Hirsch, above n 4 at 4; Penney, above n 81 at 72; Coffee, above n 65 at 1876.

<sup>100</sup> Simester and von Hirsch, above n 4 at 5. This is why there is a difference between a conviction with discharge and a discharge without conviction (see s 108 Sentencing Act 2002). Simester and von Hirsch note that calling someone a 'tortfeasor' (!) has no such stigma.

<sup>101</sup> Institute of Directors "Submission to the Ministry of Economic Development on the Review of Securities Law Discussion Paper - June 2010" at 3, 4; Harnos Horton Lusk "Submission to the Ministry of Economic Development on the Review of Securities Law Discussion Paper - June 2010" at [48]; Listed Companies Association "Submission to the Ministry of Economic Development on the Review of Securities Law Discussion Paper - June 2010" at [39]; Chapman Tripp, above n 71 at [13].

Simester and von Hirsch (as well as Sullivan and Brookbanks)<sup>102</sup> merge all three of these views of the criminal law into what they call the principles of criminalisation.<sup>103</sup> They argue that criminal law is a regulatory tool for influencing behaviour, but a special kind of regulatory tool, given the social significance of criminal laws and criminal convictions.<sup>104</sup> In their view, the criminal law should be used only if there is a prima facie positive case for criminalisation, and that negative constraints are satisfied. A prima facie positive case for criminalisation would be established essentially on moral grounds – namely, does the behaviour cause culpable harm.<sup>105</sup> If a prima facie case for criminalisation is established, then other, utilitarian considerations should be considered such as whether there are other more appropriate or less intrusive methods of regulation.<sup>106</sup>

This paper will not seek to resolve this debate. Rather, it will consider reasons for and against the proposed expansion of the criminal law from each of these perspectives. Indeed, any principles of criminalisation will not provide an “objective benchmark of criminality”. Instead, they may be persuasive one way or another.<sup>107</sup> They will help determine whether reasons for introducing a new criminal offence are good or bad.<sup>108</sup> They provide a basis to evaluate the proposal to create a new offence, rather than just accepting the pattern of knee-jerk legislating driving the proposed amendment.

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<sup>102</sup> Simester and von Hirsch, above n 4; Simester and Brookbanks, above n 4 at chapter 21; A P Simester and others *Simester and Sullivan's Criminal Law: Theory and Doctrine* (4th ed, Hart Publishing, Oxford, UK, 2010) at chapter 16; A P Simester and G R Sullivan "On the Nature and Rationale of Property Offences" in R A Duff and Stuart Green (eds) *Defining Crimes* (Oxford University Press, Oxford, 2005).

<sup>103</sup> See generally Simester and von Hirsch, above n 4.

<sup>104</sup> At 4.

<sup>105</sup> Simester and Brookbanks, above n 4 at 720.

<sup>106</sup> At 720; The Capital Markets Development Taskforce take a similarly balanced approach in the corporate context, stating that “[g]ood rules and regulations are those that *facilitate a desired activity* or outcome, are *enforceable* and *fair to all participants*, and impose minimal costs or unintended consequences.” (Emphasis added) (Capital Markets Development Taskforce *Capital Markets Matter: Report of the Capital Markets Development Taskforce* (December, 2009) at 80).

<sup>107</sup> Ashworth, above n 64 at 22.

<sup>108</sup> At 22.

## Chapter three

This chapter applies the three different approaches to the criminal law to the proposal to criminalise breaches of directors' duties. The ultimate aim of the chapter is to answer the question – do principles of the criminal law justify the extension of the criminal law proposed in the Bill.

### *A A moral approach to the criminal law?*

According to the moral view of the criminal law, the criminal law should punish all culpable wrongs and not otherwise.<sup>109</sup> This raises the question, when is behaviour culpable? Reasonable people will disagree on the answer to this question, but broadly speaking, the elements of culpability are harmfulness and wrongfulness.<sup>110</sup> Wrongfulness tends to morph into a lack of morality, which is a fairly elusive and subjective concept. The focus with wrongfulness tends to be on the state of mind of the defendant. For instance, a defendant who causes reckless harm to others is more culpable and blameworthy than one who causes harm negligently.<sup>111</sup>

In practice the two concepts conflate – if one's behaviour causes harm to others, that one is aware of, this is a good indicator of its wrongfulness.<sup>112</sup> Harmfulness is the natural starting point for a discussion on criminalisation in a “liberal and pluralistic society”.<sup>113</sup> This section will focus on harm. Chapter six will examine wrongfulness in the context of the wording of the Bill – and question whether the Bill provides an appropriate fault element to distinguish between behaviour that is culpable, and behaviour that is not.

The gist of the harm principle is that if conduct causes harm to others, this is a good reason to impose criminal liability.<sup>114</sup> We are harmed when our interests are set

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<sup>109</sup> According to the Legislation Advisory Committee, above n 64, “[t]he criminal law is intended to punish only that conduct which is in some way blameworthy” at 252.

<sup>110</sup> See for example, Simester and von Hirsch, above n 4 at 20.

<sup>111</sup> See for example Lynch, above n 83 at 41.

<sup>112</sup> Simester and von Hirsch, above n 4 at 20, 21. Though Simester and von Hirsch discuss how that is not necessarily the case.

<sup>113</sup> Legislation Advisory Committee, above n 64 at 253. Also see for example Ashworth, above n 64 at 30; Simester and von Hirsch, above n 4 at 35; Joel Feinberg *The Moral Limits of the Criminal Law, vol 1: Harm to Others* (Oxford University Press, New York, Oxford, 1984); Dennis J Baker *The Right Not to be Criminalized: Demarcating Criminal Law's Authority* (Ashgate, Farnham, England, 2011); Penney, above n 81 at 72.

<sup>114</sup> Feinberg, above n 113 at 26; the corollary is that preventing offence to others or harm to self are not good reasons to impose the criminal law.

back,<sup>115</sup> our prospects changed for the worse.<sup>116</sup> Do breaches of directors' duties cause harm to others? MED addressed this question when proposing criminalisation of breaches of directors' duties. According to MED, a number of large entities (primarily finance companies) have failed in recent years.<sup>117</sup> This has resulted in investors losing billions of dollars. In particular, many investors on fixed incomes have lost substantial portions and sometimes all of their savings. Some suffered a significant drop in their quality of life.<sup>118</sup> This language comes squarely within the harm principle, both in terms of the type of harm – financial losses – and the extent of the set back – being significant.

It is certainly true that the actions of directors can have a profound effect on the lives of shareholders, creditors employees, or the public generally.<sup>119</sup> A share's value depends on the value of the company, so if a company is worse off, its share value will be too. As well, if a company is approaching insolvency, breaches of directors' duties have the potential to cause significant losses to creditors.<sup>120</sup> Similarly, if a company is insolvent, employees may lose their jobs.<sup>121</sup>

However, one category of interests that creates problems for the harm principle are property rights, particularly intangible property rights such as shares and patents.<sup>122</sup> A company is purely a creation of statute. Identifying rights and duties relating to companies requires knowledge of the concepts of company law, and may be subject to disputes in the courts. Therefore, to claim that interference with one's (intangible) property rights in shares constitutes harm is contingent upon the state determining who has an interest in the harmed property.<sup>123</sup> In this view, the state's claim to deploy the criminal law is self-justifying and circular.<sup>124</sup> In this context, the harm principle can be applied in a different way. Simester et al argue that the law of property facilitates the creation of forms of welfare and human flourishing that would not be

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<sup>115</sup> At 33.

<sup>116</sup> Simester and von Hirsch, above n 4 at 36.

<sup>117</sup> Ministry of Economic Development, above n 14 at [133].

<sup>118</sup> At [133], [134].

<sup>119</sup> Senate Standing Committee on Legal and Constitutional Affairs *Company Directors' Duties* (Australian Government Publishing Series, Canberra, 1989) (the Coney Committee) at [2.4].

<sup>120</sup> This is the basis for the rule that when a company is insolvent or near insolvency, directors owe a duty to creditors (see *Nicholson v Permakraft (New Zealand) Ltd (in liq)* [1985] 1 NZLR 242 (CA) at 250; *Sojourner v Robb* [2008] 1 NZLR 751 (CA) at [25]), and the basis for the directors' duties in ss 135 and 136 aimed at protecting creditors.

<sup>121</sup> This is reflected in s 132 of the Companies Act 1993. Section 132 allows directors to make provision for the benefit of employees when a company is ceasing to trade.

<sup>122</sup> Simester and von Hirsch, above n 4 at 40-43; Simester and Sullivan, above n 102 at 168-172

<sup>123</sup> Simester and Sullivan, above n 102 at 170; Simester and von Hirsch, above n 4 at 41.

<sup>124</sup> Simester and Sullivan, above n 102 at 170, 171; Simester and von Hirsch, above n 4 at 41.

possible if property law was lost.<sup>125</sup> They also argue that widespread perpetration of conduct that breaches property rights could damage the operation of the property regime itself. This harm justifies the state imposing the criminal law to protect against harm to that regime.

This logic applies to company law. There is a broad consensus that company law benefits to society.<sup>126</sup> By allowing the aggregation of capital and the spreading of economic risks,<sup>127</sup> the company form enables entrepreneurs to enter new markets, develop new products, innovate, and take other business risks.<sup>128</sup> In New Zealand, it is the “major legal mechanism for economic development.”<sup>129</sup> MED was very aware of this type of harm, stating that as well as causing loss to individual investors, the recent corporate collapses have had a “contagion effect”, causing a “general loss in confidence in the finance company sector”.<sup>130</sup> The idea that corporate mismanagement can have a “contagion” or “ripple” effect is widely held.<sup>131</sup> The concern is that individual cases of mismanagement will create a perception among the public that mismanagement is widespread, regardless of whether this is the case.<sup>132</sup>

Certainly in relation to issuers, and companies that participate in capital markets, this concern is well founded.<sup>133</sup> Share value in companies whose shares are traded on

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<sup>125</sup> Simester and Sullivan, above n 102 at 171-173; Simester and von Hirsch, above n 4 at 41, 42.

<sup>126</sup> This paper presumes this to be the case; otherwise there would be little point in discussing the enforcement of directors’ duties. Wider reform would be needed.

<sup>127</sup> Companies Act 1993 Long Title (a).

<sup>128</sup> Roswell B Perkins "Corporate Governance and the Companies Act of 1993" (Paper presented at the The Company Law Conference, Wellington and Auckland, 1997) at 84; Goddard, above n 49 at 193; Oesterle, above n 72 at 21-23.

<sup>129</sup> Law Commission, above n 8 at [11], also see viii, [4], [11], [22], [323]; Walls, above n 76 at 1; Oesterle, above n 72 at 21-23; Michael Bos and Martin Wiseman "Directors' liabilities to creditors" [2003] NZLJ 262 at 268.

<sup>130</sup> Ministry of Economic Development, above n 14 at [133], [134]; the Explanatory Note to the Bill echoes this sentiment, stating that the “[t]hese policies aim to increase confidence in New Zealand’s financial markets and in New Zealand’s regulation of corporate forms”.

<sup>131</sup> See for example Treasury (Australia), above n 90 at vii, [2.18], [2.19]; *Lim Weng Kee v PP* [2002] 4 SLR 327 at 336; cited in Pey-Woan Lee "Regulating Directors' Duties with Civil Penalties: Taking a Leaf from Australia's Book" (2006) 35(1) Common Law World Review 1 at 12.

<sup>132</sup> Finance companies are unlikely to attract the same levels of investment that they did before the failures, even after the significant regulatory reforms. That is to say, mismanagement in some finance companies has harmed the finance company sector in general (see Ministry of Economic Development, above n 14 at [133], [134]).

<sup>133</sup> Take for example the collapse of the Australian insurer HIH. HIH collapsed in 2001 leaving shortfalls of estimated as being between A\$3.6 to \$5.3 billion. “The collapse caused considerable harm to employees, policyholders, the Australian business community and the Australian public at large” (See Blackmore, above n at 45). It even led to a Royal Commission (Neville Owen *The HIH Royal Commission* (April 2003) ). See also Watson and Hirsch, above n 20 at 105, 106.

public markets is as much determined by investor perceptions and matters of confidence, as it is determined by book value of the company. If investors perceive there to be significant risks of corporate mismanagement, they will be less willing to invest their money, or would pay less for the same product due to the greater perceived risk of the investment.<sup>134</sup> Alternatively, investors may invest elsewhere, for instance in property or overseas. This explains why securities law focuses on the confidence and integrity of markets.<sup>135</sup>

However, there is no obvious reason why company law should address this harm. The examples of corporate collapses that caused large-scale losses in confidence involved listed companies in 1987, and finance companies more recently, both of which issue securities to the public.<sup>136</sup> There is nothing to suggest that mismanagement in small companies has such a ripple effect, nor is there anything to suggest that company performance is contingent on confidence in the company form.

Therefore, securities law would seem to be the appropriate vehicle to address these concerns. This would be consistent with the current division between company and securities law in New Zealand. Company law is concerned with the “constitutional rights and duties of shareholders and directors under a significantly consensual regime”, and focuses on the small company as the paradigm. Securities law on the other hand is concerned with the “public interest in the integrity of the securities market.”<sup>137</sup>

In conclusion then, breaches of directors’ duties appear to satisfy the harm principle. On a moral view, this would justify the state using the criminal law to punish those who culpably cause such harm. That said, the focus of this harm is on companies that issue securities to the public. To that extent, it is not clear why such an offence should apply to all companies, rather than just issuers.

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<sup>134</sup> Coffee, above n 65 at 1884.

<sup>135</sup> See for example Law Commission, above n 8 at [132]; s 8 Financial Markets Authority Act 2011 states the FMA’s objective is to “promote and facilitate the development of fair, efficient, and transparent financial markets”; also see clause 3 Financial Markets Conduct Bill. The corollary is that regulation that promotes the confidence of investors will “lower the cost of capital for businesses.” (See Capital Markets Development Taskforce, above n 106 at 80).

<sup>136</sup> The “ripple effect” described in *Lim Weng Kee v PP* at 336 was in the context the “large listed company”, and the collapses that caused so much anguish in Australia of HIH and One.Tel both involved listed companies.

<sup>137</sup> Law Commission, above n 8 at [131], [132]; Farrar, above n 13 at 384; clause 3 Financial Markets Conduct Bill; s 8 Financial Markets Authority Act 2011.

## ***B A utilitarian approach to the criminal law?***

Deterrence is the key for those who take utilitarian approach to the criminal law. Will the new criminal offence effectively deter mismanagement without deterring desirable behaviour (and be cost-effective to enforce)? There is considerable debate about the extent to which increasing corporate sanctions effectively prevent corporate mismanagement and collapse.<sup>138</sup> Furthermore, for the proposed offences to be effective, the FMA will need a considerable increase in enforcement resources, of which there is no sign.<sup>139</sup> However, the biggest concern, from the utilitarian point of view, is whether the proposal will deter appropriate people from becoming directors and deter directors from taking legitimate risks. Virtually all the submitters that commented on the proposal (both in response to the MED Discussion Paper and to the Select Committee in response to the Bill) expressed this concern.<sup>140</sup>

Underpinning this concern is the fact that the enforcement of directors' duties involves balancing two competing goals – on the one hand, encouraging the efficient management of businesses, and on the other hand, deterring mismanagement.<sup>141</sup> The basis of the concern is that criminalising breaches of directors' duties will tilt the balance too far in favour of deterring mismanagement. The key question is whether criminalisation of directors' duties will actually deter appropriate people from becoming directors, and deter directors from taking legitimate business risks or whether this concern is just a self-serving argument wheeled out by directors and those representing them to avoid increasing their own personal liability?<sup>142</sup>

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<sup>138</sup> See discussion at Chapter two A.

<sup>139</sup> Watts, above n 61 at 52; Bell Gully "Submission by Bell Gully on the Review of Securities Law Discussion Paper Issued by the Ministry of Economic Development in June 2010" at [29(c)]; Peter Watts "Submission to Commerce Select Committee on the Companies and Limited Partnerships Amendment Bill 2011" at [3].

<sup>140</sup> This was the overwhelming view in response to the MED Discussion Paper. Examples include Bell Gully, above n 139 at 66; NZX "Submission to the Ministry of Economic Development on the Review of Securities Law Discussion Paper - June 2010" at 40; Simpson Grierson "Submission to the Investment Law Team of the Ministry of Economic Development: Review of Securities Law" at 49. Similarly, the submissions on the Bill that are publicly available reflect a similar concern. Examples include New Zealand Law Society "Submission to the Commerce Select Committee on the Companies and Limited Partnerships Amendment Bill 2011" at [5], [10]; Institute of Directors "Submission to the Commerce Select Committee on the Companies and Limited Partnerships Amendment Bill 2011" at 1, 2; Chapman Tripp, above n 71 at [4.1], [12.1].

<sup>141</sup> See Companies Act 1993 Long Title (d).

<sup>142</sup> Similar claims were made in response to the enacting of directors' duties in the Companies Act 1993 (see for example Goddard, above n 49 at 216; Oesterle, above n 72 at 34. Also see Law Commission, above n 8 at 14). However, Jack Hodder observed in 1997 that there were "no conspicuous signs of directors being hard to find, or of mass resignations by experienced commercial

It is hard to test this view empirically.<sup>143</sup> One could argue that directors already face a smorgasbord of criminal liability.<sup>144</sup> Anyone overly concerned about criminal liability would be unlikely to be a director, in any case. Furthermore, the Bill does not change directors' substantive duties. In that sense it should not affect the way honest and prudent directors behave.<sup>145</sup>

However, both choices of substantive doctrine, and sanction, determine the law's effect on people's behaviour.<sup>146</sup> Furthermore, there is some evidence of this over-deterrence argument. Two recent studies in Australia (one by Chartered Secretaries Australia,<sup>147</sup> the other by the Australian Institute of Company Directors<sup>148</sup>) provide evidence, albeit inconclusive, that directors' personal liability in Australia was inhibiting risk taking, and deterring people from taking up directorships.<sup>149</sup> The evidence is not conclusive, given both bodies represent directors, and even if clause 4 of the Bill became law, directors would still face much more criminal liability in Australia than New Zealand. That said, the message of the surveys is not surprising. Notably, Tony D'Aloisio (former head of the Australian Securities and Investments Commission (ASIC)) expressed similar concerns about the extent to which criminal

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players." (Jack Hodder "Wither the Companies Act 1993?" [1997] NZLJ 97 at 99; David Tompkins speaking extrajudicially was of a similar view: David Tompkins "Directing the Directors: The Duties of Directors Under the Companies Act 1993" (1994) 2 Wai L Rev 13 at 38, 39).

<sup>143</sup> Treasury (Australia), above n 90 at [1.39].

<sup>144</sup> Examples include the Securities Act 1978, the Crimes Act 1961, the Financial Reporting Act 1993, the Fair Trading Act 1986, the Securities Markets Act 1988, and the list goes on. See David Friar "Criminal sanctions - doing business under threat of prison" (December 2011) <<http://www.bellgully.com/resources/resource.03015.asp>>; Bell Gully, above n 139 at 66.

<sup>145</sup> New Zealanders Shareholders Association Inc "Submissions to the Securities Act Review 2010" at [5.1.137].

<sup>146</sup> Easterbrook and Fischel, above n 90 at 316. Also see Coffee, above n 65 at 1879 who argues that not every desirable legal standard should be enforced by the strongest available sanction.

<sup>147</sup> Chartered Secretaries Australia "Submission to Treasury on the Review of Sanctions for Breaches of Corporate Law" (June 2007).

<sup>148</sup> Australian Institute of Company Directors *Impact of Legislation on Directors* (2010).

<sup>149</sup> 59% of directors surveyed by Chartered Secretaries Australia considered a reduction in personal liability for directors would increase risk taking (though acknowledging this is not necessarily desirable), and 56% of directors surveyed believed excessive penalties were discouraging suitably qualified people from accepting directorships, though only 13% actually knew of a situation where this happened (Chartered Secretaries Australia, above n 147 at 2). 65% of those surveyed by the Australian Institute of Company Directors felt that personal liability had caused them or a board on which they sat to take an overly cautious approach to business decision making, and 57% knew of other directors who had declined the offer of a directorship primarily due to the risk of personal liability (Australian Institute of Company Directors, above n 148 at 4).

liability for directors in Australia was discouraging good people from becoming directors, “particularly for the medium-to small-size enterprises.”<sup>150</sup>

In addition, even the MED Discussion Paper and the Cabinet Paper proposing the amendment recognised the potential for over-deterrence.<sup>151</sup> Indeed, MED rejected implementing the civil pecuniary penalty<sup>152</sup> in parallel to criminal sanctions (an option used in Australia) on the basis that the looser rules of evidence and procedure would deter good people from becoming directors, and deter directors from taking legitimate business risks.<sup>153</sup> The conclusion that civil pecuniary penalties would deter more than criminal penalties is suspect at best.

Granted the likelihood of liability is higher with civil pecuniary penalties, but the consequences of liability is much more significant in the case of criminal penalties. The stigma associated with a conviction is such a serious concern (particularly for directors whose reputation is so important) that it could radically alter the decision-making “calculus” of potential directors.<sup>154</sup> The costs of becoming a director and taking business risks would greatly increase.<sup>155</sup> Responsible people have a “very low tolerance for *any* level of risk” of criminal liability.<sup>156</sup>

In addition, even if the threshold for conviction is high, the threshold for *prosecution* is not. It is relatively easy for the enforcement agencies to initiate proceedings.<sup>157</sup> Yet the financial, emotional and reputational turmoil associated with prosecution remains even if the accused director is acquitted.<sup>158</sup> While the high threshold for liability

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<sup>150</sup> Damon Kitney "Go easy on directors, says retiring corporate regulator" *The Australian* (online ed, Australia, March 30, 2011). ASIC is the Australian equivalent of the FMA.

<sup>151</sup> Ministry of Economic Development, above n 14 at [124], [137]; Office of the Minister of Commerce, above n 14 at [204].

<sup>152</sup> The civil pecuniary penalty is a kind of proceeding brought by the state in the civil courts, thus using the civil law’s looser rules of evidence and procedure (including the lower threshold for liability – balance of probabilities rather than beyond reasonable doubt). The aim of the pecuniary penalty as its name suggests is punishment. The Commerce Act 1986, Securities Act 1987, and Securities Markets Act 1988 all provide pecuniary penalties, as does the Australian Corporations Act 2001 (Cth) for breaches of directors’ duties.

<sup>153</sup> Ministry of Economic Development, above n 14 at [138]. Similarly, Sealy, above n 55 at 98 describes Australia’s civil penalty regime for the enforcement of directors’ duties as an “even more formidable deterrent” than criminal penalties. Coffee, above n 65 considers civil pecuniary penalties generally undesirable.

<sup>154</sup> Chapmann Tripp, above n 71 at [12.1].

<sup>155</sup> At [12.1].

<sup>156</sup> At [12.1] (emphasis original).

<sup>157</sup> Listed Companies Association, above n 101 at [39]; Harnos Horton Lusk, above n 101 at [48].

<sup>158</sup> Institute of Directors, above n 101 at 3, 4; Harnos Horton Lusk, above n 101 at [48]; Listed Companies Association, above n 101 at [39]; Chapmann Tripp, above n 71 at [13].

safeguards honest directors against conviction, it does not protect them from potential prosecution.<sup>159</sup> It would be surprising therefore, if this increased risk of prosecution did not deter good people from becoming directors. Indeed, the increased risk of prosecution could mean that the only people unconcerned about prosecution would want to become directors.<sup>160</sup> That is surely undesirable.

Finally, to reiterate Tony D'Aloisio's argument, increased liability for directors might make director recruitment particularly hard for SMEs.<sup>161</sup> Of the array of criminal liability directors face discussed above, much of that liability focuses on directors of companies that issue securities to the public.<sup>162</sup> This has two implications. First, directors of such companies tend to be very well advised (given the extent of their potential liability), and so they will have a better appreciation of exactly what they need to do to avoid criminal liability in these different contexts. Second, criminal liability will be more novel for directors of SMEs. Relatively speaking, it will have a greater deterrent effect, than compared with directors of issuers.

On balance, there is reason to believe that criminalising breaches of directors' duties will deter appropriate people from becoming directors, and deter directors from taking legitimate business risks, though the host of submitters expressing this concern may be overstating the risk. Combine that with the earlier view on the ineffectiveness of heavy sanctions in preventing corporate mismanagement, and there is strong reason not to criminalise breaches of directors' duties, if one takes an utilitarian view of the criminal law.

### *C To price or prohibit?*

A third approach is to accept John Coffee's proposition that criminal law should be used when we want to "prohibit" conduct, and the civil law used when we want to "price" it.<sup>163</sup> Coffee's approach is a response to overcriminalisation; his concern is with limiting the scope of the criminal law. Applying Coffee's approach, if it is accepted that directing a company is a socially beneficial activity, and that some level

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<sup>159</sup> Harnos Horton Lusk, above n 101 at [48]; Listed Companies Association, above n 101 at [39].

<sup>160</sup> Simpson Grierson "Submission to Commerce Select Committee on the Companies and Limited Partnerships Amendment Bill 2011" at 3 states "we see the criminalisation of directors' duties as more likely to change the behaviour of those who are **not** criminally inclined, as opposed to those who are" (emphasis original).

<sup>161</sup> Kitney, above n 150; also see New Zealand Law Society, above n 140 at [10.2], [13].

<sup>162</sup> This is the case with the Securities Act 1978 and Securities Markets Act 1988, and the Financial Reporting Act 1993 is more onerous in relation to issuers and large companies (see definition of "reporting entity" in s 2).

<sup>163</sup> Coffee, above n 65.

of mismanagement is an inevitable consequence of allowing that activity, then the civil law is the appropriate mechanism to deter that mismanagement. In such a situation, plaintiffs have no moral right to be free from mismanagement.<sup>164</sup>

The first question is whether managing companies is a socially beneficial activity. This paper presumes this to be the case.<sup>165</sup> Secondly, an inevitable consequence of the company structure is some level of mismanagement.<sup>166</sup> The separation of ownership and control means that on occasion those with control (directors) will take advantage of their position of control for their own benefit at the expense of shareholders.<sup>167</sup> This is what some refer to as “agency costs”.<sup>168</sup> In addition, “business always involves risk”.<sup>169</sup> Given this, and given that sometimes risks will eventuate, an inevitable consequence of limited liability is that sometimes creditors will lose money.<sup>170</sup> Limited liability represents a policy decision that when a company goes insolvent, at the end of the day, people will lose money (particularly creditors). Underpinning this is a view that the benefits that accrue from allowing entrepreneurial behaviour outweigh the detriments that follow company failures.<sup>171</sup>

Company law in its present form addresses this balance by imposing civil duties on directors to act in the best interests of the company,<sup>172</sup> and to consider the interests of

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<sup>164</sup> At 1884. Also see Lynch, above n 83 at 41-43.

<sup>165</sup> See discussion above, at Chapter three A.

<sup>166</sup> Law Commission, above n 8 at [23].

<sup>167</sup> This is the genesis of the fiduciary duty in s 131: Chapman Tripp, above n 71 at [8], [21]; Law Commission, above n 8 at [23]; Walls, above n 76 at 4.

<sup>168</sup> Chapman Tripp, above n 71 at [8], [21]; Stephen Bainbridge "Really criminalizing agency costs" (10/19/2011) <<http://www.professorbainbridge.com/professorbainbridge.com/2011/10/really-criminalizing-agency-costs.html>>; The expression “agency costs” stems from the writing on corporate governance, originated in Adolf Berle and Gardiner Means *The Modern Corporation and Private Property* (Commerce Clearing House, New York, 1932) and Michael C Jensen and William H Meckling "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305. For a summary of the writing on corporate governance and agency costs see Rebecca Hirsch "Decoding Family Businesses: Are Corporate Governance Guidelines Necessary for Family Businesses?" (2011) 17 *NZBLQ* 126 at 136, 137; Susan Watson and Rebecca Hirsch "The Link Between Corporate Governance and Corruption in New Zealand" (2010) 24 *NZULR* 42 at 47.

<sup>169</sup> *Petros Developments Limited (in Liquidation); Re Advanced Plastics Limited v Harnett & Anor* HC Auckland CIV-2003-404-000633, 15 December 2004 at [14]; *Re South Pacific Shipping Ltd (in liq)* at [128].

<sup>170</sup> Sealy, above n 76 at 435; Goddard, above n 49 at 194, 211.

<sup>171</sup> Goddard, above n 49 at 193 makes a similar point. Also see Oesterle, above n at 21-23.

<sup>172</sup> Section 131 Companies Act 1993.

creditors when the company is approaching insolvency.<sup>173</sup> Directors' duties reflect a balance between incentivising enterprising behaviour, and deterring mismanagement.<sup>174</sup> The goal of directors' duties then (both their content, and the way they are enforced<sup>175</sup>) is not to stop all mismanagement and company failures— to do so would stifle the usefulness of the company form.<sup>176</sup> The goal is to achieve the optimum balance between encouraging enterprising behaviour and deterring mismanagement. The criminal law does not balance competing interests well, it is a “blunt and archaic tool of regulation”,<sup>177</sup> and as a result, it is not the appropriate mechanism to enforce breaches of directors' duties. Given that some breaches of directors' duties are inevitable, yet the company still plays a beneficial role in society, then one cannot say that a plaintiff (or victim) has a “moral right to be free of the defendant's conduct.”<sup>178</sup>

Therefore, on Coffee's approach, directors' duties should be enforced by a “price” rather than a “prohibition”. That is, by the civil law not the criminal law. Save the criminal law for behaviour that is traditionally criminal such as theft and fraud. This sentiment informs Douglas Meagher's argument for “divorcing” the criminal from company law. Leave the criminal laws for the criminal legislation, he argues, and do not use criminal sanctions to enforce general corporate laws.<sup>179</sup>

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<sup>173</sup> Sections 135 and 136 reflect this; also, when a company is insolvent or nearing insolvency, the best interests of the company include the interests of the company's creditors (see *Nicholson v Permakraft (New Zealand) Ltd (in liq)* at 250; *Sojourner v Robb* (CA) at [25]).

<sup>174</sup> Companies Act 1993 Long Title (d). Also see *Nicholson v Permakraft (New Zealand) Ltd (in liq)* at 250; Ministry of Economic Development, above n 14 at [107]; Law Commission, above n 8 at [21], [46], [68], [324]; Matthew Berkahn *Regulatory and Enabling Approaches to Corporate Law Enforcement* (The Centre for Commercial & Corporate Law, Christchurch, 2006) at 16; Senate Standing Committee on Legal and Constitutional Affairs, above n 119 at [2.22], [2.39]; Treasury (Australia), above n 90 at vii, 1; Orojo, above n 32 at 436; Sealy, above n 55 at 93; Tompkins, above n 142 at 38; Peter McKenzie "Corporate Law Reform: The New Zealand Experience" (1994) 4 *Australian Journal of Corporate Law* 1 at 5; Sealy, above n 55 at 94; Bos and Wiseman, above n 129 at 262.

<sup>175</sup> Recall that both substantive doctrine, and choice of sanction influence people's behaviour (see Easterbrook and Fischel, above n 90 at 316; Coffee, above n 65 at 1879).

<sup>176</sup> In Jack Hodder's words, “there is an economic cost to excessive caution” (Hodder, above n 142 at 99). Chapman Tripp's submission on the Bill echoes a similar sentiment “[t]he basic flaw in the rationale behind the Bill is the notion that it is possible to eliminate “egregious” misconduct without adversely impacting on the incentives or decision-making of honest and diligent directors” (Chapman Tripp, above n 71 at [12]).

<sup>177</sup> Lynch, above n 83 at 63.

<sup>178</sup> Coffee, above n 65 at 1884; Lynch, above n 83 at 41-43. As is discussed later, there is significant potential for directors' duties (in their current form) to push directors in a direction that is undesirable, particularly in relation to the decision of when to put a company into insolvency. See below at Chapter six A(2).

<sup>179</sup> Douglas Meagher "Company Law: Directors and the Company they keep" [1990] NZLJ 442 at 442.

The question this chapter sought to answer was whether criminal concepts justify the proposed extension of the criminal law. The answer is ambivalent. The case for criminalising breaches of directors' duties varies in strength depending on one's view on the proper role of the criminal law, and on one's view of the paradigm company. On a utilitarian view, the criminal law is not the appropriate sanction for breaches of directors' duties. This is particularly so if the focus is on the SME. Applying Coffee's analysis, directors' duties are better enforced by a price than a prohibition. On a moral view of the criminal law, breaches of directors' duties have significant potential to cause harm to individual and public interests. Therefore, if culpable, the criminal law should punish such breaches. However, the case for criminalisation is much stronger if the focus is on companies that issue securities to the public. To that extent, limiting criminal liability to directors of issuers would strengthen the case for criminalising such breaches of directors' duties.

## Chapter four: the Companies Act 1993

The chosen vehicle for this proposal is the Companies Act 1993; it is not the Securities Act 1978 (or the Financial Markets Conduct Bill that is set to replace it), nor the Crimes Act 1961. It will not apply to sole traders, partners, joint venturers, and trustees.<sup>180</sup> Therefore, it is necessary to consider the impact of the proposed amendment on the overall scheme of the Companies Act 1993. The framers of the Law Commission Report that led to the Companies Act 1993 sought to create a coherent policy by which future amendments could be tested. Therefore, an obvious question is how does the proposed amendment shape up against the policy created by the Law Commission. This will be the focus of the first part of the chapter. The second part of the chapter will look at the enforcement of directors' duties in the current regime, and consider whether the current regime leaves a gap that needs filling, and whether the criminal law is necessary to fill such a gap.

### *A Coherence with the Companies Act 1993*

A major problem with the Companies Act 1955 was its lack of internal consistency.<sup>181</sup> The large number of piecemeal and unrelated amendments was one of the factors that created the need for its reform.<sup>182</sup> The Law Commission, referring to the state of the law before the 1993 Act, noted that “[a]t present, many of the policies of law in the area of company regulation are difficult to articulate. In those circumstances, tack-on amendment has often served to confuse that position and make the legislation impenetrable.”<sup>183</sup> To try to bring about greater consistency in New Zealand company law, the Law Commission sought to “set up a structure in the legislation which is referable to clear policy objectives,”<sup>184</sup> and reflected a “rational and consistent legal structure.”<sup>185</sup> It hoped that “future amendment will be able to be tested against and made consistent with” this policy.<sup>186</sup> Clause 4 of the bill proposes to amend the

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<sup>180</sup> Friar, above n 142; Bell Gully, above n 15 at 4.

<sup>181</sup> Walls, above n 76 at 1; Alan Galbraith "Balancing the Rights of Shareholders, Directors and Executive Officers and Creditors" (Paper presented at the New Zealand Society of Accountants and New Zealand Law Society: The Company Law Conference, Wellington and Auckland, 1994) at 126; Law Commission, above n 8 at [49].

<sup>182</sup> Galbraith, above n 181 at 126; Walls, above n 76 at 1 compared the 1955 Act to a building, pointing out that “by the 1980s at least, it had become a much added-to building. Some of the additions were not in the best of architectural taste, and some of them leaked.”

<sup>183</sup> Law Commission, above n 8 at [49].

<sup>184</sup> At [49], also see viii and [4] for a similar sentiment, and see Law Commission, above n 12 at 8.

<sup>185</sup> Galbraith, above n 181 at 126; also see Sian Elias "Company Law After Ten Years of Reform" (Paper presented at the The Company Law Conference Wellington and Auckland, 1997) at 4.

<sup>186</sup> Law Commission, above n 8 at [49].

Companies Act 1993. The question then arises, how does the proposed amendment fit with the policy underpinning the Act?

### *1 The policy debate in company law*

There is an on-going debate as to whether companies statutes should be “mandatory” or “enabling”.<sup>187</sup> Proponents of the enabling approach argue that company statutes should focus on “oiling the wheels of commerce”<sup>188</sup> by providing a set of default rules that enable the use of the corporate form, leaving parties free to tailor their arrangements to suit their own needs.<sup>189</sup> Underpinning this view is a belief that companies will perform best when left to themselves, as individual parties are best placed understand their own needs.<sup>190</sup> The state should not be involved in company business unless it is genuinely necessary.<sup>191</sup> If company law seeks to balance encouraging enterprising behaviour and deterring mismanagement, then proponents of the enabling approach would place more weight on the former.

At the other end of the spectrum is the mandatory approach. The mandatory approach contemplates more heavy-handed regulation, leaving parties with less freedom to make and vary the internal rules governing their companies.<sup>192</sup> Underpinning the mandatory approach is a view that, in many instances, individuals will not be in a position to protect their own interests,<sup>193</sup> and that the market is an ineffective regulator of corporate activity.<sup>194</sup> In seeking to find a balance between encouraging efficient and innovative management, and deterring mismanagement, the mandatory approach would prioritise the latter.

In the context of enforcement, the mandatory-enabling debate manifests itself as debate between public and private enforcement. According to the enabling approach, the enforcing of private rights should be left to the parties involved in the company, and the state should not generally speaking be involved in the workings of private

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<sup>187</sup> There are many synonyms by which this debate is framed include “regulatory” and “facilitative”. I shall stick to mandatory-enabling.

<sup>188</sup> Sealy, above n 76 at 434.

<sup>189</sup> Ian M Ramsay "Models of Corporate Regulation: The Mandatory/Enabling Debate" in Charles E. F. Rickett and Ross B. Grantham (eds) *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, UK, 1998) at 221.

<sup>190</sup> At 216.

<sup>191</sup> Goddard, above n 49 at 206.

<sup>192</sup> Ramsay, above n 189 at 221.

<sup>193</sup> At 227.

<sup>194</sup> At 229, 230.

companies.<sup>195</sup> A mandatory proscription, on the other hand, would have the state playing a prominent role in enforcing company law obligations, and parties could not agree to remove the state's ability to enforce those obligations.<sup>196</sup> In practice, companies statutes inevitably involve a mix of mandatory and enabling rules, and will engage a mix of public and private enforcement.<sup>197</sup>

## 2 *The policy debate applied: NZLC R9 and the Companies Act 1993*

The framers of NZLC R9 were very aware of this debate and the desirability of ensuring consistency in a companies statute.<sup>198</sup> An enabling philosophy underpinned the draft Act produced by the Law Commission.<sup>199</sup> This approach extended to enforcement, where it stated “in the normal course the enforcement of private interests will be a matter for the shareholders affected.”<sup>200</sup> Corporate collapses often drive company law reform,<sup>201</sup> therefore one may have expected the 1987 stock market crash to have had a significant impact on the Report and the Companies Act 1993. However, the crash had little legacy on company law reform at the time. Concerns raised by the 1987 crash were left to securities law reform.<sup>202</sup>

After some changes, the Law Commission's draft Act found its way into law as the Companies Act 1993. Though the Law Commission's draft Act underwent a number

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<sup>195</sup> Matthew Berkahn and Lindsay Trotman "Public and Private Enforcement of Company Law in New Zealand 1986-1998" [2000] 7 *Canta LR* 516 at 517; Berkahn, above n at 10, 11; Ramsay, above n 189 at 218; Anthony I Ogus *Regulation: Legal Form and Economic Theory* (Clarendon Press, Oxford, 1994) at 2.

<sup>196</sup> Ramsay, above n 189 at 218; Ogus, above n 195 at 2; Berkahn and Trotman, above n 195 at 517; Berkahn, above n 74 at 10, 11.

<sup>197</sup> Ramsay, above n 189 at 221. Australia's Corporations Act 2001 (Cth) has a distinctly mandatory core, but even that statute has enabling rules, whereas even the most enabling of companies statutes still provide a directors' duty of loyalty (Delaware being the archetype enabling statute) (see Ramsay at 221-228; also see Goddard, above n 49 at 212-216). Also see Law Commission, above n 8 at [185]. Even Peter Shirlcliffe, arguing ardently against mandatory rules concedes that a “certain quorum of rules” may be necessary (Peter Shirlcliffe "Good Governance: A Case for Paternalism or Personal Responsibility?" [1998] *CSLB* 66 at 66).

<sup>198</sup> Law Commission, above n 8 at [21], [24], [49]; Law Commission, above n 12 at 8.

<sup>199</sup> See for example Law Commission, above n 8 at [12], [21], [76], [83], [131].

<sup>200</sup> At [318]; also see Berkahn and Trotman, above n 195 at 526.

<sup>201</sup> See discussion above at Chapter two (B).

<sup>202</sup> The Law Commission questioned whether ineffective legislation was a factor in the 1987 crash, and considered that if ineffective legislation was responsible, the Securities Act 1978 and Sharebrokers Act 1908 were more to blame than the Companies Act 1955. It considered that the 1987 crash to be more a consequence of “euphoria and panic of public markets” susceptible to losses in confidence, than a result of corporate mismanagement and fraud (Law Commission, above n 8 at [43]-[46]; also see Walls, above n 76 at 2).

of changes throughout the legislative process that shifted the Act in a mandatory direction, the “central planks” of the Law Commission’s proposal remained intact, and the Companies Act 1993 is largely an enabling statute.<sup>203</sup> This is particularly so regarding enforcement. This part of the Act almost entirely gave effect to the Law Commission’s recommendations.<sup>204</sup> The Act assumes private enforcement, leaving enforcement of general company law obligations such as directors’ duties up to shareholders (in relation to solvent companies, and liquidators upon insolvency).<sup>205</sup>

### 3 *A shift in approach?*

Now we know the policy underpinning the Companies Act 1993, the next step is to follow the Law Commission’s advice and test the proposed amendment against that policy. Introducing public enforcement backed by criminal sanctions would be a significant shift in approach for the Companies Act 1993. Instead of leaving the enforcement of directors’ duties to private parties such as shareholders and liquidators, the state would play a significant enforcement role. The Law Commission’s view that “in the normal course the enforcement of private interests will be a matter for the shareholders affected”<sup>206</sup> would cease to be true. To this extent, the proposed amendment is exactly the kind of which the Law Commission warned.<sup>207</sup>

The proposal would change the dynamics of company supervision in New Zealand. At present, no regulatory agency plays a general enforcement role in relation to companies that do not issue securities to the public<sup>208</sup> (the overwhelming majority of New Zealand’s companies). Funding issues aside,<sup>209</sup> the Companies Act 1993 balances the rights of shareholders, directors, and creditors. Giving the state the ability to enforce directors’ duties in relation to non-issuers could upset this balance,

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<sup>203</sup> Fitzsimons, above n 74 at 283; Elias, above n 185 at 2; Berkahn, above n 174 at 43; indeed the Explanatory Note to the Companies Bill 1990 (50-1) stated that the Bill “gives effect, in substance, to what the Law Commission has proposed”. Also see Long Title (a) and (d) of the Companies Act 1993.

<sup>204</sup> Farrar, above n 13 at 384; Berkahn, above n 174 at 47.

<sup>205</sup> Farrar, above n 13 at 384; Fitzsimons, above n 74 at 286; Elias, above n 185 at 10; Berkahn, above n 174; Farrar, above n 51 at 261.

<sup>206</sup> Law Commission, above n 8 at [318].

<sup>207</sup> At 8 at [4], [49]; commentators such as Walls, above n 76 at 1; and Galbraith, above n 181 at 126 also stated this concern.

<sup>208</sup> The FMA plays such a role but only in relation to financial markets participants. The Registrar of Companies does not play a general enforcement role; its primary role is maintenance of the company register. Though it does play some role through the administration of management bans and it does have powers to inspect documents for the purposes of detecting offences (see Farrar, above n 13 at 386; Berkahn, above n 174 at 58).

<sup>209</sup> See Watts, above n 61 at 52; Bell Gully, above n 139 at [29(c)]; also see above at Chapter three B.

causing the directors to focus on their own potential liability rather than the interests of the company. The two do not always overlap. For example, it is “always safer” for a director not to make a speculative investment than it is to make it, yet in many instances not making a speculative investment could cost shareholders dearly.<sup>210</sup> Similarly, when a company is in financial trouble, the safest thing for a director to do is enter the company into an insolvency procedure. Yet, in some cases, putting a company into an insolvency procedure unnecessarily is contrary to the interests of creditors, shareholders, employees, and other stakeholders.<sup>211</sup> Introducing the state into this relationship could distort the focus of directors, and cause them to consider how their behaviour would appear in the eyes of a prosecutor, rather than focusing on getting the best result for the company’s stakeholders. In addition, parties could use the threat of reporting behaviour to the authorities to obtain a “tactical advantage” during an internal company dispute.<sup>212</sup>

Another problem that the proposed amendment could create is what some call “reverse engineering”. The duties in ss 131 and 135 would form the basis of both civil and criminal liability. The courts, being wary not to overextend the reach of the criminal law, may take a stricter approach in relation to the duties in a criminal context, and this jurisprudence could distort the interpretation of duties in a civil context.<sup>213</sup>

Perhaps more concerning however is the bigger picture. The Government has ignored the Law Commission’s advice; at no stage in the history of this amendment has it considered the implications of the amendment on the policy underpinning the Companies Act 1993. This is a concerning precedent, suggesting that the Companies Act 1993 could face a similar history to the Companies Act 1955.

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<sup>210</sup> Goddard, above n 49 at 216. Also see Oesterle, above n 72 at 26, 27.

<sup>211</sup> See Chapmann Tripp, above n 71 at [31]; Thomas G W Telfer "Risk and Insolvent Trading" in Charles E. F. Rickett and Ross B. Grantham (eds) *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, UK, 1998 ) at 128, 129; Oesterle, above n 72 at 27-29. Six B(2) explores this situation in detail.

<sup>212</sup> Bell Gully, above n 15 at 4; also see Simpson Grierson, above n 140 at [29].

<sup>213</sup> Dan Prentice "Corporate Personality, Limited Liability and the Protection of Creditors" in Ross B. Grantham and Charles E. F. Rickett (eds) *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, UK, 1998) at 111. Prentice discusses how the overlap of civil and criminal liability in the fraudulent trading provision (s 332) of the Companies Act 1948 (UK) rendered the provision essentially useless, as the courts required subjective rather than objective recklessness even in a civil context. The provision was an early form of creditor protection that evolved into the types of duties in ss 135 and 136 of the Companies Act 1993. Also see Oesterle, above n 72 at 24.

One may respond by arguing that inconsistency with an enabling approach to company law is only undesirable if one believes in the enabling approach.<sup>214</sup> However, the proposed amendment will not transform the Companies Act 1993 into a statute reflecting a mandatory approach to company law. More extensive reform would be needed to achieve that objective. At this stage, a revision of the policy underpinning the Act is not on the cards.<sup>215</sup> Furthermore, the finance company collapses do not create good reason to question the status quo. Finance companies represent a small segment of issuers, and an even smaller segment of companies in general. Concerns relating to finance companies have been addressed. In addition, as discussed earlier, it is questionable whether increasing corporate sanctions is an effective method of addressing mismanagement.<sup>216</sup>

To conclude, no stage in the law making process has the government considered the amendment's effect on the Companies Act 1993 as the Law Commission had hoped would happen. Considered in isolation the amendment may not be drastic, but if this precedent of ill-considered law making continues then we will end up where we started, with an incoherent and inconsistent piece of legislation.

## ***B The current enforcement regime***

As discussed above, the Companies Act 1993 relies on private enforcement (of directors' duties as well as other rights and obligations). One factor driving the proposal is MED's and the Minister of Commerce's view that the Act's reliance on private enforcement was leading to under-enforcement of directors' duties. This section will consider whether there is a gap in the enforcement of directors' duties, and whether criminal liability is needed to plug that gap.

### *1 Concerns with private enforcement*

In relation to solvent companies that are not financial market participants, the derivative action is virtually the only mechanism to enforce breaches of directors' duties.<sup>217</sup> In this sense, the derivative action plays a pivotal role. If it is not working

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<sup>214</sup> For example, Galbraith, above n 181 at 126 discusses how the loss of consistency during the legislative process of the Act could be good or bad depending on one's view of the proper philosophy of company law.

<sup>215</sup> At 126. Galbraith considers it unproductive to revisit the policy debate that went into the Companies Act 1993 when wider reform is not on the cards.

<sup>216</sup> See above at chapter two A.

<sup>217</sup> See chapter two and see Taylor, above n 39 at 361, 362. Liquidators can enforce breaches of directors' duties against directors of insolvent companies via the power in s 301 Companies Act 1993;

well, then there may well be a “gap” in the law.<sup>218</sup> In practice, many breaches of directors’ duties only come to light after a company becomes insolvent, and liquidators enforce breaches in those circumstances.<sup>219</sup> However, given liquidators only play a role on insolvency, their role is limited to after the damage has been done.

The most obvious response to MED and the Minister of Commerce’s concern about under-enforcement is that the FMA has a new power to enforce breaches of directors’ duties against financial markets participants. This power has only existed since 1 May 2011<sup>220</sup> (indeed the FMA only came into existence then). This is after MED released the Discussion Paper and the Minister of Commerce released the Cabinet Paper,<sup>221</sup> so one can forgive their lack of consideration of this power.<sup>222</sup> The point is, in relation to financial markets participants, Parliament has already addressed concerns about under-enforcement. This is particularly relevant given under-enforcement is more concerning in relation to issuers, given their public dimension, and given the importance of confidence in financial markets discussed earlier. The means concerns about under-enforcement resulting from breaches of directors’ duties should focus on companies that are not financial markets participants (generally speaking small companies or SMEs).

There is a general concern about the reliance on private enforcement that extends to the derivative action (as well as action taken by liquidators) – namely, that private parties can lack an incentive to take enforcement action in some cases of serious offending.<sup>223</sup> Private enforcement is only likely when “the expected compensation awarded to the company multiplied by the probability of the case being successful exceeds the expected cost of the legal action.”<sup>224</sup> In other words, the criteria a private party will use to decide whether to take action may not include factors such as the seriousness or egregiousness of the conduct, and the need to deter such behaviour. A regulator, on the other hand, would have an incentive to take action against all serious

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the FMA can enforce breaches of directors’ duties against directors of companies that are financial markets participants thanks to its power in s 34 FMA Act 2011.

<sup>218</sup> Soon after it came into force the derivative action had many critics (see Taylor, above n 39 at 333; Susan Watson "A matter of balance: the statutory derivative action in New Zealand" (1998) 19(8) *The Company Lawyer* 236 at 244).

<sup>219</sup> Ministry of Economic Development, above n 14 at [110]; Office of the Minister of Commerce, above n 14 at [202]; Taylor, above n 39 at 361.

<sup>220</sup> Section 2 Financial Markets Authority Act 2011.

<sup>221</sup> MED released the Discussion Paper in June 2010; the Minister of Commerce released the Cabinet Paper in Feb 2011.

<sup>222</sup> Though presumably both would have been aware of the impending law change.

<sup>223</sup> Ministry of Economic Development, above n 14 at [122]; Office of the Minister of Commerce, above n 14 at [203]; Farrar, above n 13 at 386.

<sup>224</sup> Ministry of Economic Development, above n 14 at [122].

offending.<sup>225</sup> The propensity for under-enforcement of directors' duties was a significant factor in MED's proposal.

## 2 *Concerns specific to the derivative action*

In the context of the derivative action, this cost benefit analysis has legal significance. When deciding whether to grant leave to bring a derivative action under s 165 of the Companies Act 1993, the Court must have regard to the factors listed in s 165(2). These factors include the likelihood of proceedings succeeding, and costs of the proceedings in relation to the relief likely to be obtained. Courts determine these factors by asking whether a prudent businessperson in the conduct of his or her own affairs would have decided to bring a claim.<sup>226</sup> This involves considering factors such as the amount at stake, the strength of the claim, likely costs, and the prospect of executing any judgment.<sup>227</sup>

Broadly speaking, the derivative action has two purposes: compensation and deterrence.<sup>228</sup> The retrospective purpose – compensation – is achieved to the extent that it provides shareholders with a mechanism to enforce breaches of directors' duties and get compensation for losses caused by those breaches. By creating a mechanism for enforcing breaches, the derivative action plays a deterrent role. The threat of enforcement litigation and a potentially large compensation award will deter directors' from breaching their duties. The main criticism of the derivative action is that the criteria for granting leave are heavily geared towards compensation rather than deterrence. Underpinning decisions to grant leave is a pragmatic cost benefit analysis, not a need to deter serious misconduct.<sup>229</sup>

Section 165(2)(b) requires the courts to consider the costs of proceedings.<sup>230</sup> Civil litigation in New Zealand is costly (often prohibitively costly) and time consuming,<sup>231</sup>

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<sup>225</sup> At [122].

<sup>226</sup> *Vrij v Boyle* [1995] 3 NZLR 763 (HC) at 130; this test has been applied numerous cases such as *Peters v Birnie* [2010] NZAR 494 (HC) at [27]-[29]; *Needham v EBT Worldwide Ltd* (2006) 3 NZCCLR 57 (HC) at [21]-[23]; *Greymouth Holdings Ltd v Jet Trustees Ltd* HC Auckland CIV-2011-404-5309, 19 December 2011 at [25]-[27].

<sup>227</sup> *Vrij v Boyle* at 130; *Peters v Birnie* at [28]

<sup>228</sup> *Frykberg v Heaven* at [52]; John C Coffee and Donald E Schwartz "The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform" (1981) 81 Colum L Rev 261 at 302; Watson, above n at 236, 237; Taylor, above n 39 at 335.

<sup>229</sup> Taylor, above n 39 at 343.

<sup>230</sup> Companies Act 1993 s 165(2)(b); *Vrij v Boyle* at 130; *Needham v EBT Worldwide Ltd* at [23].

<sup>231</sup> See generally John Smillie "Who Wants Jurisdocracy?" (2006) 11(2) Otago LR 183.

and Companies Act litigation is no exception.<sup>232</sup> This high cost could put off some shareholders from taking enforcement action, regardless of the likelihood of success or the egregiousness of the misconduct.<sup>233</sup> Section 166 attempts to mitigate this problem by creating a presumption that the company pay costs for derivative proceedings, unless it “unjust or inequitable” for the company to do so.<sup>234</sup> However, in practice it is not common for a Court to order a company to fund proceedings at the time leave is granted.<sup>235</sup> Lynne Taylor’s empirical study found that the courts ordered the company to pay costs in only 37.5% of cases.<sup>236</sup> If this is the case, then one could assume that many cases of director misconduct go unenforced simply because potential plaintiffs cannot afford the cost of the litigation.

As well as a lack of incentives, a common concern is that shareholders lack the information to discover and prove breaches of directors’ duties.<sup>237</sup> Mandatory disclosure obligations may address some problems regarding access to information,<sup>238</sup> but the underlying concern is that shareholders lack the ability and experience to evaluate the information.<sup>239</sup>

John Farrar captures this sentiment, stating that “[a]lthough shareholder remedies were simplified and restated [in the 1993 Act], no particular incentives were provided for minority shareholders to resort to them.”<sup>240</sup> In Farrar’s opinion, the lack of incentives for shareholders to pursue civil remedies creates a “gap”,<sup>241</sup> leaving many breaches unenforced in the case of companies that are not governed by securities law.<sup>242</sup> The conclusion from this analysis is that the derivative action is an insufficient deterrent for corporate mismanagement. The under-enforcement of directors’ duties

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<sup>232</sup> Galbraith, above n 181 at 136 describes how “well heeled litigant[s]” have the ability to impose huge and obstructive costs onto other parties to litigation; Berkahn, above n 174 at 13 also discusses the high cost of the derivative action.

<sup>233</sup> See Berkahn and Trotman, above n 195 at 518, 519.

<sup>234</sup> *Frykberg v Heaven* at [45].

<sup>235</sup> Taylor, above n 39 at 355, 362.

<sup>236</sup> At 355. Part of the reason for this seems to be the fact that derivative proceedings tend to involve closely-held companies where there is a significant overlap between ownership and control. For example, in *Frykberg v Heaven* the Court declined to order costs on the basis that the defendant had a potentially larger share of the equity of the company, and so would essentially be funding litigation against himself (at [52]).

<sup>237</sup> Berkahn and Trotman, above n 195 at 518.

<sup>238</sup> Law Commission, above n 8 at [144].

<sup>239</sup> Berkahn, above n 174 at 13; Berkahn and Trotman, above n 195 at 518.

<sup>240</sup> Farrar, above n 13 at 384.

<sup>241</sup> At 386.

<sup>242</sup> At 386, 389.

could mean that the substantive duties in the Act lack bite. These duties will not sufficiently deter mismanagement.

However, there is more to this story. First, in relation issuers, shareholders may well lack an incentive to bring enforcement proceedings, given shareholders interests are likely to be spread throughout the stock market.<sup>243</sup> However, the FMA has the power to enforce breaches of directors' duties against these companies. In the context of privately owned companies, shareholders interests tend to be much more intertwined with the interests of the company, and in that context, shareholders very much will have the incentive to enforce breaches of directors' duties.<sup>244</sup>

Furthermore, in practice, the derivative action is a very effective remedy. Lynne Taylor was initially sceptical about how useful the statutory derivative action would be,<sup>245</sup> but after conducting an empirical study in 2006, she concluded that it had become a popular and effective remedy for disgruntled shareholders.<sup>246</sup> Applications for leave have been frequent and the prudent businessperson test has not been a hard one.<sup>247</sup> Despite the high incidence of successful leave applications, very few substantive claims have gone to hearing. Taylor's conclusion is that disgruntled shareholders use the low threshold for leave as a "bargaining chip" to give them leverage in settlement negotiations.<sup>248</sup>

An obvious benefit of this approach is that it keeps disputes out of our already clogged court system.<sup>249</sup> One concern regarding the Companies Act 1993's reliance on private enforcement was that it made the courts pivotal in the enforcement and regulation of the Companies Act 1993.<sup>250</sup> Lacking a regulatory body analogous to ASIC, disgruntled shareholders have no choice but to litigate.<sup>251</sup> This situation could have created two undesirable outcomes – either the courts could have taken an overly restrictive approach to the derivative action (and other shareholder remedies),

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<sup>243</sup> Berkahn and Trotman, above n 195 at 519-521.

<sup>244</sup> At 521, 522; also see Berkahn, above n 174 at 16-18.

<sup>245</sup> Taylor, above n 39 at 333.

<sup>246</sup> At 333, 334, 363, 364. One point to note is that over 90% of applications have been in relation to closely-held companies (at 351).

<sup>247</sup> At 363. Taylor's study found that applications for leave succeeded 70% of the time (at 354).

<sup>248</sup> At 362, 363.

<sup>249</sup> Smillie, above n 231 at 188 discusses how the New Zealand courts system is increasingly costly and decreasingly efficient.

<sup>250</sup> Fitzsimons, above n 74 at 267; Simester and Brookbanks discuss how this is a general concern with reliance on the civil law instead of the criminal law (Simester and Brookbanks, above n 4 at 734).

<sup>251</sup> Fitzsimons, above n 74 288-292; Taylor, above n 39 at 361. The FMA now plays a similar role to ASIC, but only in relation to issuers.

effectively disenfranchising shareholders of smaller companies.<sup>252</sup> Alternatively, the courts could have taken a wide approach, opening the floodgates to more litigation.<sup>253</sup> Taylor's study suggests the operation of the derivative action has avoided both of these concerns; shareholders are not disenfranchised, and the courts are not burdened with full-blown trials.

Taylor's conclusion is that the use as a bargaining chip "still reflects the rationale for the derivative action".<sup>254</sup> The low threshold means the action is effective in obtaining a settlement that will punish and compensate for wrongs done in the past. The extent to which it provides a useful mechanism for enforcing breaches of directors' duties and holding errant directors to account means it works in deterring future wrongdoing.<sup>255</sup>

Another point is that although the seriousness of the misconduct is not directly relevant to the prudent businessperson test, the more serious the misconduct, the greater the likelihood that there is evidence of misconduct. As well, losses from serious misconduct are likely to be greater, so potential recovery from an action is likely to be higher. In addition, courts may consider the extent of a defendant director's culpability in assessing quantum of damages for breach of duty.<sup>256</sup> This means the more serious the misconduct, the more likely a shareholder is to bring a derivative action, and the more likely the court is to grant leave.

Therefore, the current enforcement regime is working well. This suggests there is no need to create a new criminal offence. If legislators still believe there is a gap in relation to the enforcement of directors' duties, another solution would be to extend the FMA's power to enforce breaches of directors' duties to all companies. The FMA would have an incentive to take action against all serious misconduct and the cost benefit analysis undertaken by private litigants would not be such a factor.<sup>257</sup> This approach would be consistent with a minimalist view of the criminal law, avoiding the concerns associated with creating a new criminal offence. Indeed, a question

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<sup>252</sup> Fitzsimons, above n 74 at 290-292.

<sup>253</sup> Galbraith, above n 181 at 139; This is undesirable in its own right on the basis that we do not want the courts clogged up, and undesirable to the extent that it could tip the company law balance too far in favour of deterring corporate mismanagement at the expense of incentivising enterprising behaviour.

<sup>254</sup> Taylor, above n 39 at 363.

<sup>255</sup> At 363, 364.

<sup>256</sup> The Court of Appeal in *Mason v Lewis* considered the defendant's culpability relevant in determining the quantum of damages for breach of s 135 (at [112]).

<sup>257</sup> The key question for exercises of the FMA's s 34 powers is whether taking action is in the public interest (s 34(1)). Though when considering if action is in the public interest, the FMA must consider "whether exercising the powers is an effective and efficient use of the FMA's resources" (s 34(5)(c)).

posed in the LAC Guidelines is whether the conduct is best regulated by the civil law.<sup>258</sup> The answer in this situation seems to be yes. It would also avoid some of the concerns about the over deterring effect of the criminal law discussed in chapter three. Even John Farrar, who believes the current regime does leave a ‘gap’ in the law, advocates for the use of a civil penalty to plug that gap, rather than adopting the “draconian” Australian approach.<sup>259</sup>

To conclude this chapter, the extent to which the amendment is contrary to policy is undesirable, and the lack of consideration of the amendment’s effect on the Act’s policy is equally undesirable. Furthermore, in relation to companies that are issuers, we already have public enforcement through the FMA’s new s 34 power. In relation to companies that are not issuers, the derivative action is working effectively. To this extent, there does not seem to be a gap in the law. Furthermore, even if there were a gap, criminal liability would not be needed to plug it; an extension of the FMA’s s 34 powers to bring civil proceedings to enforce breaches of directors’ duties would suffice.

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<sup>258</sup> Legislation Advisory Committee, above n 64 at 254.

<sup>259</sup> Farrar, above n 13 at 386 (while a civil penalty regime is different to the FMA’s power to take over an individual’s right of action, the effect would be similar: the FMA could enforce breaches of directors’ duties, but the consequences of breaches would be civil rather than criminal).

## Chapter five

The theme of this chapter is that one's view on matters of company law generally, and on criminalising breaches of directors' duties in particular, is influenced by how one views the paradigm company. If the paradigm company is considered to be a SME, then the case for criminalising breaches of directors' duties is weak. If on the other hand one considers the paradigm company to be the large corporation that issues securities to the public, then the case for criminalisation is much stronger. The reason for this is that the harm that results from mismanagement in companies that issue securities to the public is much more widespread, affecting other corporations, the integrity of markets, and society in general. Whereas, in relation to SMEs, harm resulting from breaches of directors' duties is self-contained.

This chapter will demonstrate this reasoning in practice, consider the appropriate paradigm for the Companies Act 1993, and reconsider arguments for and against criminalisation having regard to that paradigm.

### *A Paradigms in practice*

There are many examples of paradigm companies affecting debates in company law, both in the courts, as well as in academic and policy circles. Courts frequently turn to different paradigms in their company law reasoning, and these paradigms have developed over time. Early views of the company as a partnership<sup>260</sup> justified harsh views of majority rule,<sup>261</sup> and helped foster the view of the company as a private enterprise rather than a creation of the state.<sup>262</sup> Increasing separation of ownership and control led to the view of the company as a trust and this view helped develop

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<sup>260</sup> In *Foss v Harbottle* the judge stated that “[c]orporations like this, of a private nature, are in truth little more than private partnerships” (at 202). Also see Stephen Bottomley "Shareholder Derivative Actions and Public Interest Suits: Two Versions of the Same Story?" (1992) 15(1) UNSWLJ 127 at 141; Jennifer Hill "Changes in the Role of the Shareholder" in Charles E. F. Rickett and Ross B. Grantham (eds) *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, UK, 1998) at 177, 178.

<sup>261</sup> Bottomley, above n 260 at 141. Categorisation of a company as a “quasi-partnership” with implications of “mutual trust and confidence” between directors and shareholders, is still relevant to the unfair prejudice jurisprudence under s 174 Companies Act 1993 (see *Holden v Architectural Finishes Ltd* (1996) 7 NZCLC 260,976 (HC); Susan Watson and Chris Noonan "Distilling Their Frenzy: The Conceptual Basis of the Oppression Remedy in New Zealand Company Law" (2005) 11 NZBLQ 288.

<sup>262</sup> Hill, above n 260 at 177, 178.

directors' fiduciary duties.<sup>263</sup> More recently, the paradigm developed into vast corporate group as the “quintessential” model of business.<sup>264</sup>

Similarly, in policy debates, Berkahn applies this perspective to explain the different approaches to enforcement. In Berkahn's view, proponents of public enforcement normally use the large, widely-held public company as the paradigm.<sup>265</sup> The paradigm shareholder is seen as little more than a passive investor; someone that lacks information, influence and interest in the internal workings of the companies in which they invest.<sup>266</sup> In contrast, proponents of private enforcement presume the closely-held smaller company as the paradigm, where there is much less separation of ownership and control,<sup>267</sup> and the typical shareholder is more a participant than merely a passive investor.<sup>268</sup> This approach presumes that shareholders have enough motivation and understanding to make private enforcement rights useful, and that corporate actions result from informed and consensual decisions.<sup>269</sup>

### ***B Paradigms applied***

This analysis applies equally to the proposal to criminalise directors' duties. The MED Discussion Paper, the Cabinet Paper, and the MPs debating the bill at its first reading, all assumed that the paradigm company was a large public company or even the finance company. MED, in its paper, focused on the finance company collapses and how these have caused “loss in confidence in the finance company sector”.<sup>270</sup> The Cabinet Paper, identifying the gap in the current law, states that there is no offence provision to deal with conduct covered by directors' duties “after the allotment of securities.”<sup>271</sup> This is referring to companies that issue securities to the public – by definition large public companies. Similarly, during the first reading of the Bill, Hon

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<sup>263</sup> See *Arataki Properties Ltd v Craig* [1986] 2 NZLR 294 (CA) at 298; Hill, above n 260 at 179, 180.

<sup>264</sup> Bottomley, above n 260 at 141; Hill, above n 260 at 182, 190. An example of this reasoning in case law is the US case *Brown v Tenney* 508 NE 2d 347 (Illinois App 1 Dist 1987) at 350, where the judge extended the rules on derivative action to allow a shareholder in a parent company to take a derivative action against a subsidiary, justified by the need for the law to keep up with the reality that the corporate group was the typical way of doing business.

<sup>265</sup> Berkahn and Trotman, above n 195 at 521; Berkahn, above n 174 at 17.

<sup>266</sup> Berkahn, above n 174 at 17; Berkahn and Trotman, above n 195 at 520.

<sup>267</sup> Berkahn and Trotman, above n 195 at 521; Berkahn, above n 174 at 17, 18.

<sup>268</sup> Berkahn, above n 174 at 17; Charles E F Rickett and Ross B Grantham *Company and Securities Law: Commentary and Materials* (Brookers, Wellington, 2002) at 898.

<sup>269</sup> Berkahn and Trotman, above n 195 at 521; Berkahn, above n 174 at 17, 18.

<sup>270</sup> Ministry of Economic Development, above n 14 at [133], [134].

<sup>271</sup> Office of the Minister of Commerce, above n 14 at [209]. This is a reference to the fact that the Securities Act 1978 provides significant regulation at the initial stage when securities are offered to the public, but less oversight after that.

Craig Foss MP and David Parker MP both focused exclusively on how the harm caused by directors of finance companies justified the current proposal.<sup>272</sup>

Is the public issuer the appropriate paradigm company when considering an amendment to the Companies Act 1993? The answer must be no. The paradigm company for the Companies Act 1993 is the small company or the SME. Both the structure of New Zealand's corporate regime, and the nature of company dynamics in New Zealand, confirm that this paradigm is appropriate.

The division of New Zealand's corporate law regime into companies and securities law, allows the Companies Act 1993 to focus on the small company.<sup>273</sup> It recognises that companies are incredibly diverse, and that large companies that issue securities to the public require closer scrutiny than a typical SME. According to the Law Commission, company law is concerned with "the constitutional rights and duties of shareholders and directors under a significantly consensual regime."<sup>274</sup> Securities law, on the other hand, "is concerned with the public interest in the integrity of the securities market."<sup>275</sup> In the Law Commission's view, the public interest in the integrity of the securities market justified stricter regulation, more onerous standards, and more extensive public enforcement.<sup>276</sup> This distinction is very much alive today.<sup>277</sup>

Furthermore, the nature of company ownership and structure in New Zealand means that the 1993 Act's focus on the small company is entirely appropriate. Both in relative and absolute terms, New Zealand has a very high proportion of small companies.<sup>278</sup> A recent MED survey found that 97% of enterprises in New Zealand have less than 20 employees.<sup>279</sup> Even if companies with no employees are excluded,

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<sup>272</sup> (24 July 2012) 682 NZPD 3852; Mr Parker even makes special mention of Rod Petricevic.

<sup>273</sup> Farrar, above n 13 384; Law Commission, above n 8 at [17], [18], [34], [67], [68].

<sup>274</sup> Law Commission, above n 8 at [131].

<sup>275</sup> At [132].

<sup>276</sup> At [18], [34], [35], [67], [68], [132]-[134], [148]; also see Elias, above n 185 at 2, 3.

<sup>277</sup> For example, clause 3 of the Financial Markets Conduct Bill 2011 (342-2) states that its purpose is to promote confidence and participation in financial markets (the Financial Markets Conduct Bill is to replace the Securities Act 1978).

<sup>278</sup> Duncan Mills and Jason Timmins *Firm Dynamics in New Zealand: A Comparative Analysis with OECD Countries* (New Zealand Treasury, Working Paper 04/11, September 2004) at [5.1]; similarly, Ministry of Economic Development, above n 6 at 5 state that "enterprises in New Zealand are mainly small and medium sized."

<sup>279</sup> Ministry of Economic Development, above n 6 at 5 (the overwhelming proportion of enterprises are companies: see Companies Office, above n 6); Mills and Timmins, above n 278 at [5.1.1] produces similar results.

this figure is still more than 90%.<sup>280</sup> In contrast, New Zealand's capital markets form a relatively small portion of our economy compared to other countries such as Australia.<sup>281</sup> These figures demonstrate that the Companies Act 1993's focus on the small company is appropriate.

### ***C The case for criminalising breaches of directors' duties reconsidered***

If one accepts the SME as the paradigm, then the case for criminalising breaches of directors' duties is weak. The harm that results from breaches of directors' duties is self-contained to parties that have a direct interest in the mismanaged company. Those parties harmed by mismanagement have effective mechanisms to protect themselves before harm happens, and they are more likely to be able to address mismanagement while it is happening, or obtain redress after the event. Chapter three discussed how in the context of issuers, harm from corporate mismanagement could have widespread effects. However, in the context of the SME, this is not the case. Share value is dependent on the value of a company's assets and liabilities, rather than on perceptions of investors who trade on liquid and volatile markets. The ability to raise capital from the public does not determine SME performance.

Furthermore, mismanagement has less potential to cause harm to "wider stakeholders" such as employees, customers, suppliers, and the communities in which the corporations exist.<sup>282</sup> For example, given that 97% of New Zealand's enterprises have less than 20 employees (and 90% have five or fewer<sup>283</sup>), individual cases of mismanagement and company failure cannot cause large scale job losses in the overwhelming majority of instances. Similarly, by their very nature, SME's are

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<sup>280</sup> Mills and Timmins, above n 278 at [5.1.1].

<sup>281</sup> Both in terms of the number of companies listed per head of population, and in terms of value of markets as a percentage of GDP. Lewis Evans *Capital Market Integration: The Structure of the New Zealand Economy and its Capital Markets - A Report Prepared for the Ministry of Economic Development and the Capital Market Development Taskforce* (New Zealand Institute for the Study of Competition and Regulation Inc, 2009) at 4, 10, 11; also see the Capital Markets Development Taskforce, above n 106 at 84.

<sup>282</sup> There is an on-going debate in company law about the question of to whom directors' duties should be owed (that is, should they be owed only to the company, or should they include these "wider stakeholders" – sometimes known as the corporate social responsibility debate). Underpinning that debate is an acceptance that the actions of directors can have an impact on those wider stakeholders. However, the current proposal to criminalise breaches of directors' duties will not change the question of to whom directors' duties are owed. For more on that debate see Len Sealy "Directors' "Wider" Responsibilities - Problems Conceptual, Practical and Procedural" (1987) 13 Mon LR 164; Colin Bamford "Directors' duties: the public dimension" (2000) 21(2) *The Company Lawyer* 38; s 172 Companies Act 2006 (UK).

<sup>283</sup> Ministry of Economic Development, above n 6 at 5.

unlikely to have such significant market power that their behaviour will significantly affect customers and suppliers

Mismanagement in SMEs primarily affects shareholders and creditors. Starting with shareholders, the “general setting” in small companies is that “owners are involved in the management of the company.”<sup>284</sup> There is a reduced separation of ownership and control. Some claim that this leads to a reduction in agency costs.<sup>285</sup> More importantly, the overlap in ownership and control means that shareholder control mechanisms provided by the Companies Act 1993 are genuinely useful. Either shareholders will be directors, or if they are not, the Act gives them significant capacity to control director behaviour. The Act gives shareholders the power to appoint and remove directors,<sup>286</sup> and requires shareholder approval for major transactions.<sup>287</sup> Practical difficulties and shareholder apathy may render these powers largely ineffective in relation to large companies,<sup>288</sup> but in relation to SMEs they give shareholders genuine influence over the direction of the company.

In the context of SMEs, relationships between shareholders and directors are voluntary and consensual, and shareholders have significant capacity to influence the direction of the companies in which they are shareholders. If a shareholder is unhappy with a director’s performance, it is typically the shareholder’s fault for appointing them, and the shareholder has the power to remove them.<sup>289</sup> Additionally, if a shareholder is unhappy that a risky venture did not pay off, the shareholder has less to complain about: shareholders reap the benefits if a risky venture succeeds, and so they have fewer grounds to complain should the venture fail.<sup>290</sup> Furthermore, shareholders

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<sup>284</sup> Hirsch, above n 168 at 137; also Ministry of Economic Development, above n 6 at 5 which states that SMEs “are generally managed and operated by the owner.” Similarly, Rebecca Hirsch and Susan Watson “The Link Between Corporate Governance and Corruption in New Zealand” (2010) 24 NZULR 42 at 47 state “[i]n closely-held companies, it is common for shareholders to also act as directors.” Watson and Noonan, above n 261 at 289 express a similar view.

<sup>285</sup> See Hirsch, above n 168 at 137. Reduced separation of ownership and control can mitigate many of the problems that create agency costs in bigger companies, but some argue this lack of separation can create other problems.

<sup>286</sup> Companies Act 1993 ss 153(2), 155, 156

<sup>287</sup> Companies Act 1993 s 129. A major transaction is a transaction involving at least half the value of the company. Major transactions require shareholder approval by a 75% majority.

<sup>288</sup> Hill, above n 260 at 182, 183, 191.

<sup>289</sup> The words of Lindley LJ in *Lagunas Nitrate* [1899] 2 Ch 392 are pertinent: “No one need join a company unless he likes, and if a person knows that if he becomes a member he will find as directors persons who, in his opinion, ought not to be directors, he should not join the company.” (Quoted in Hugh Rennie and Peter Watts “Directors’ Duties and Shareholders’ Rights” (Paper presented at the New Zealand Law Society, 1996) at 36).

<sup>290</sup> For example, see Sealy, above n 76 at 435; Goddard, above n 49 at 194; Bos and Wiseman, above n 129 at 262.

of SME's have a number of effective remedies to address corporate mismanagement.<sup>291</sup>

Like shareholders, the harm caused to creditors by mismanagement in SMEs is not normally a pressing concern and does not justify increased state intervention. To quote Dan Prentice, “[m]ost creditors of most companies are eventually paid.”<sup>292</sup> As well, it is an inevitable consequence of limited liability that creditors will lose money on some occasions.<sup>293</sup> Therefore, harm to creditors should not be a cause of undue concern. A number of factors support this conclusion. Generally speaking, creditors only become creditors voluntarily,<sup>294</sup> and creditors will be aware of, and compensated for, the different levels of risks that different companies operate,<sup>295</sup> and creditors can diversify to mitigate the risk of individual failures.<sup>296</sup> On many occasions when creditors lose money, they will have only themselves to blame.<sup>297</sup>

There are other mechanisms for creditors to protect themselves in advance. Lenders can secure loans or obtain personal guarantees (common practice in relation to small companies).<sup>298</sup> Trade creditors can include reservation of title clauses in their contracts, or threaten to cut off supply if concerned about solvency.<sup>299</sup> As well, when companies do become insolvent, there is a whole body of law to deal with such losses fairly. Indeed, many argue that company law already provides too much protection for

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<sup>291</sup> Such as the derivative action discussed above, and the much litigated unfair prejudice remedy (see Watson and Noonan, above n 261).

<sup>292</sup> Prentice, above n 213 at 100.

<sup>293</sup> Telfer, above n 211 at 128, 129; Goddard, above n 49 at 193, 194.

<sup>294</sup> Telfer, above n 211 at 130-134; Goddard, above n 49 at 193, 194. There are exceptions such as tort creditors, but most creditors such as lenders and trade creditors only become creditors voluntarily, particularly if the company is an SME, not having significant market power.

<sup>295</sup> Telfer, above n 211 at 128; If a creditors does not understand the extent of the risk it is dealing with, this will be an indicator that the risk is illegitimate: *Re South Pacific Shipping Ltd (in liq)* at [125]. Also see Goddard, above n 49 at 193.

<sup>296</sup> Goddard, above n 49 at 193; Telfer, above n 211 at 130, 131; Bos and Wiseman, above n 129 at 268.

<sup>297</sup> Individual creditors' contributory negligence is not formally relevant in assessing breaches of s 135, because recoveries from breaches of s 135 go into the general pool of assets available for distribution, and the duty in s 135 is owed to the company (see *Re South Pacific Shipping Ltd (in liq)* at [171]; Watts, above n 25 at 601, 602). However, on occasions Courts have recognised that losses to creditors will be a result of their own contributory negligence (*Re Cellar House Ltd; Walker v Allen* HC Nelson CP13/00, 18 March 2004; *FXHT Fund Managers (in Liq) v Oberholster* [2010] NZCA 197; Watts, above n 25 at 601-603). This recognises that creditors have scope to protect themselves. Bos and Wiseman, above n 129 at 265 describes some creditors as “authors of their own misfortune.”

<sup>298</sup> Telfer, above n 211 at 130; Oesterle, above n 72 at 33, 34.

<sup>299</sup> Telfer, above n 211 at 131; Oesterle, above n 72 at 33, 34; Bos and Wiseman, above n 129 at 268.

creditors.<sup>300</sup> Furthermore, trade creditors and lenders are very often large corporations, needing much less protection than the proprietors of the typical SME or family business.<sup>301</sup> Harm to creditors does not create cause for concern.

To conclude this section, the position taken in the MED Discussion Paper and the Cabinet paper makes sense if the finance company is considered to be the paradigm. However, if the small company or SME is the paradigm, then the case for criminalising breaches of directors' duties is weak. The harm that results from breaches is self-contained; it only extends to parties that have alternative mechanisms for protecting themselves in advance and recovering losses after the event. In the context of the Companies Act 1993, the paradigm is, and should remain, the small company.

#### ***D Should there be criminal liability for breaches of directors' duties?***

Having considered concepts of company and criminal law, the proposal to criminalise breaches of directors' duties is lacking justification. The proposal is unnecessary; the supposed gaps in the law identified by MED and the Minister of Commerce are overstated. Reserve Bank regulation addresses concerns specific to finance companies. The FMA has a new power to enforce breaches of directors' duties against companies that issue securities to the public. This addresses the concern that regulators lacked powers to enforce directors' duties after the allotment of securities. This power also addresses concerns about under-enforcement of directors' duties in relation to companies that issue securities to the public. In relation to companies that are not issuers, the private enforcement regime provided by the Companies Act 1993 is working effectively, and under-enforcement is less of a concern. In addition, the range of criminal offences in the Companies Act 1993 and Crimes Act 1961 provide prosecutors with sufficient scope to prosecute errant directors who are morally culpable. Parliament should only create a new criminal offence when necessary. There is no need to criminalise breaches of directors' duties.

Furthermore, criminalising breaches of directors' duties would have undesirable consequences. It would likely deter appropriate people from becoming directors, and deter directors from taking legitimate business risks, and it would distort the policy underpinning the Companies Act 1993. More generally, the overextension of the criminal law is an undesirable trend that ought not to continue.

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<sup>300</sup> Oesterle, above n 72; Bos and Wiseman, above n 129.

<sup>301</sup> See Oesterle, above n 72 at 42; Telfer, above n 211 at 131; Bos and Wiseman, above n 129 at 264.

If legislators are still convinced that directors of companies that issue securities to the public ought to be punished when they breach their duties, then such a criminal offence should be limited accordingly. If legislators are still concerned about under-enforcement of directors' duties in relation to non-issuers, then an extension of the FMA's s 34 power would sufficiently address such a concern.

## Chapter six: the wording of the Bill

Though the conclusion of this paper is that Parliament should not criminalise breaches of directors' duties, the chapter will consider the wording of the Bill on the basis that Parliament is still intent on criminalising breaches of directors' duties.

Recall that the inspiration for the current proposal comes from the Australian approach to directors' duties. However, the wording of the proposed offence departs significantly from the Australian model. Instead of creating a stand-alone criminal offence similar to s 184 of the Australian Corporations Act 2001 (Cth), it tacks criminal liability onto the back of two civil duties that do not form an appropriate basis for criminal liability. Furthermore, knowledge (of serious detriment to the interests of the company for s 138A(1) and of serious loss to creditors for s 138A(2)) is an inappropriate mental element for criminal liability in this context. The fault element in the Australian equivalent of recklessness or intentional dishonesty would be more appropriate.

### *A Using a civil standard to form the basis of criminal liability*

One of the problems with using civil law directors' duties as a basis for criminal liability is that directors' duties are very uncertain. This is not such a problem in a civil context – indeed some consider the flexibility of directors' duties one of their assets.<sup>302</sup> However, in a criminal context, certainty is very important.<sup>303</sup> It is a principle of the rule of law that people should be able to know the law in advance with certainty so they can carry out their lives without fear of entanglement in the criminal law.<sup>304</sup> The other problem with the uncertainty in the proposed provision is that the more uncertain a provision, the more it is likely to deter positive behaviour.<sup>305</sup> Honest and prudent directors concerned to avoid criminal prosecution would act based on a wide reading of the provision, whereas dishonest or imprudent directors who were less concerned about criminal liability may view the uncertainty as a way

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<sup>302</sup> Chapmann Tripp, above n 71 at [21], [22].

<sup>303</sup> To quote Lord Bingham “no one should be punished under a law unless it is sufficiently clear and certain to enable him to know what conduct is forbidden before he does it.” (*R v Rimmington and Goldstein* [2005] UKHL 63, [2006] 1 AC 459 at [33]). Peter Watts also discusses how the uncertainty of ss 131 and 135 make them inapt provisions to form the basis of a criminal offence, see Watts, above n 139 at [11].

<sup>304</sup> Legislation Advisory Committee, above n 64 at 253; also see Simester and von Hirsch, above n 4 at 198, 199. In their words, criminal convictions should not be “like birthday presents. (Surprise!)” (Also see Simester and Brookbanks, above n 4 at 735).

<sup>305</sup> Chapmann Tripp, above n 71 at [30].

of reducing their chances of getting caught by such a provision – reducing its ability to deter bad behaviour.

The starting point of this uncertainty is that the list of statutory duties in the Companies Act 1993 is only a “text of first resort”. The balance of opinion is that the statutory duties must be read in parallel with the common law.<sup>306</sup> The exact scope of directors’ duties is far from accessible.

### 1 Section 131

Section 131 is essentially a fiduciary standard<sup>307</sup> requires directors to act in good faith and in what the director believes to be the best interests of the company.<sup>308</sup> Fiduciary duties, and in particular the duty in s 131 are “vague”,<sup>309</sup> “malleable”<sup>310</sup> and “imprecise”.<sup>311</sup>

The uncertainty with this duty relates to determining the best interests of the company.<sup>312</sup> Does the director act in the best interests of the company, as distinct from the interests of any stakeholders in the company, or does the director consider the interests of stakeholders (and which stakeholders)?<sup>313</sup> While a company has separate legal personality, in reality it has no real existence apart from the natural persons who have a stake in it.<sup>314</sup> To quote Palmer, “ascertaining the interests of the company necessarily becomes little more than defining the interests of the appropriate stakeholders”.<sup>315</sup> People’s views on the interests of the appropriate stakeholders will depend to some extent on their political views regarding the role of the corporation in society.<sup>316</sup> Without getting into this debate, the point is that there is considerable uncertainty over the effect of s 131.

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<sup>306</sup> *Benton v Priore* [2003] 1 NZLR 564 (HC) at [46]; *Sojourner v Robb* [2006] 3 NZLR 808 (HC) at [100]; Watts, above n at 425, 426.

<sup>307</sup> Jessica Palmer "Understanding the Directors' Fiduciary Obligations" (2006) 12 NZBLQ 315 at 315.

<sup>308</sup> Section 131 Companies Act 1993.

<sup>309</sup> John C Coffee "From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics" (1981-1982) 19 Am Crim L Rev 117 at 150 speaking of fiduciary duties generally.

<sup>310</sup> Chapmann Tripp, above n 71 at [21].

<sup>311</sup> At [21].

<sup>312</sup> Palmer, above n 307 at 315, 334; *Sojourner v Robb* at [18].

<sup>313</sup> Palmer, above n 307 at 319.

<sup>314</sup> At 320.

<sup>315</sup> At 322.

<sup>316</sup> See n 316.

Take for example *Sojourner v Robb*.<sup>317</sup> A classic s 131 case involving the disposal of an undervalued asset to a company in which the directors (Mr and Mrs Robb) had a significant interest, when the disposing company was in financial trouble. The directors of the disposing company were also its shareholders. If one equates the interests of the company to its shareholders (as is often the case, and was the belief of the Robbs), then the transaction was not contrary to the shareholders, and thus the company's interests.<sup>318</sup> However, given the company was approaching insolvency, the best interests of the company included the interests of creditors.<sup>319</sup> The undervalued transaction was contrary to creditors' interests, so therefore, it was also contrary to the company's interests.<sup>320</sup> Therefore, the Robbs had made a mistake of law and had not acted in the best interests of the company. Therefore, they breached s 131. Though s 131 is framed in terms of the director's belief of the company's best interests, the director's belief must be reasonable.<sup>321</sup>

However, under the proposal in the Bill the Robbs would have escaped liability, given that the requirement for knowledge in the criminal law is a subjective one. From a subjective point of view, the Robbs did not know that his action was contrary to the interests of the company. But the basis for his belief was a mistake of law. This runs into s 25 of the Crimes Act 1961, which states that ignorance of the law is no excuse.<sup>322</sup> The problem is that section 131 requires knowledge of a very complicated legal concept. It also highlights the problem, outlined in chapter two, with criminalising property rights –namely that one needs to be an expert in company law to know their rights and obligations under the law. This uncertainty makes these directors' duties less amenable to criminalisation.

## 2 Section 135

The uncertainty is even worse with s 135, a section that has been widely criticised.<sup>323</sup> The first problem relates to the name of the section ("reckless trading"), which is inconsistent with the section's words (agreeing to, causing or allowing the business of

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<sup>317</sup> *Sojourner v Robb* (HC); *Sojourner v Robb* (CA).

<sup>318</sup> *Sojourner v Robb* (HC) at [103]-[106].

<sup>319</sup> *Nicholson v Permakraft (New Zealand) Ltd (in liq)* at 250; *Sojourner v Robb* (CA) at [25].

<sup>320</sup> *Sojourner v Robb* (HC) at [103]-[105].

<sup>321</sup> At [102], [105].

<sup>322</sup> Peter Watts in his submission to the Commerce Select Committee makes a similar point, discussing the example of a director of an electricity lines company who improves services to rural customers, motivated by a desire to perform a "social service" at the expense of shareholders profit. See Watts, above n 139 at [6], citing *Hutton v West Cork Railway Co* (1883) 23 ChD 654.

<sup>323</sup> *Re South Pacific Shipping Ltd (in liq)* at [127]; *Mason v Lewis* [2006] 3 NZLR 225 (CA) at [45]-[48].

a company to be carried out in a manner that creates substantial risk of serious loss to creditors”).<sup>324</sup> Recklessness usually requires a conscious running of an unjustified risk.<sup>325</sup> This requires a subjective awareness of a risk,<sup>326</sup> but the running of that risk must be unjustified or unreasonable on objective grounds.<sup>327</sup> Section 135 is a purely objective standard,<sup>328</sup> more akin to negligence than recklessness.<sup>329</sup>

It gets even worse. “The taking of substantial business risk is a necessary part of business” and there will be occasions when taking substantial risks will be legitimate.<sup>330</sup> Indeed, facilitating the taking of business risks is a key purpose of the Companies Act 1993.<sup>331</sup> Yet, the section seems to prohibit substantial risk taking, regardless of how legitimate and desirable it is.<sup>332</sup> If the section is read literally, it is “impossible to apply the section in a sensible way.”<sup>333</sup> William Young J read the section down to impose a distinction between legitimate and illegitimate risks, recognising that substantial risk taking may be justified in many circumstances.<sup>334</sup> Even taking a benign view, many consider that s 135 fails to strike the appropriate balance between incentivising risk taking and deterring mismanagement.<sup>335</sup> An uncertain section requiring a non-literal reading should not form the basis of a criminal prohibition, given the need for certainty in the criminal law.<sup>336</sup>

Another criticism of s 135 is that it gives little guidance to directors on when to stop trading.<sup>337</sup> If a company is in financial difficulties, the safest thing for a director to do personally is to “hand the keys over to the bank,”<sup>338</sup> and enter the company into an

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<sup>324</sup> Section 135 Companies Act 1993; Watson and Hirsch, above n 20 at 108; Watts, above n 61 at 52.

<sup>325</sup> *R v Tipple* 22/12/05, CA217/05 at [27], [35], [36]; Simester and Brookbanks, above n 4 at 106, 107.

<sup>326</sup> *R v Tipple* at [27]; Simester and Brookbanks, above n 4 at 111.

<sup>327</sup> *R v Tipple* at [27]; Simester and Brookbanks, above n 4 at 107.

<sup>328</sup> *Mason v Lewis* at [50], [51].

<sup>329</sup> See *Mason v Lewis* at [46]; Oesterle, above n 72 at 26.

<sup>330</sup> *Re South Pacific Shipping Ltd (in liq)* at [128].

<sup>331</sup> Companies Act 1993 Long Title (a).

<sup>332</sup> *Re South Pacific Shipping Ltd (in liq)* at [128]; *Fatupaito v Bates* [2001] 3 NZLR 386 (HC) at [67]; Watts, above n 139 at [8].

<sup>333</sup> *Re South Pacific Shipping Ltd (in liq)* at [129], [130]; *Lower v Traveller* [2005] 3 NZLR 479; *Mason v Lewis* (CA) at [49]; Watts, above n 61 at 52; Watson and Hirsch, above n 20 at 108; Oesterle, above n 72 at 37.

<sup>334</sup> *Re South Pacific Shipping Ltd (in liq)* at [129], [130]; Watts, above n 139 at [8].

<sup>335</sup> Oesterle, above n 72; Bos and Wiseman, above n 129.

<sup>336</sup> Watts, above n 139 at [9].

<sup>337</sup> *Re South Pacific Shipping Ltd (in liq)* at [128]; Chapman Tripp, above n 71 at [25].

<sup>338</sup> Ross Pennington “‘Literally insane’? Maybe not. Ill-advised? Definitely” (03 September 2012) <<http://www.chapmantripp.com/publications/Pages/Criminalise%20breaches%20of%20directors%20duties.pdf.aspx>> (first published in Boardroom Magazine). Similarly, Bell Gully in its submission to the

insolvency procedure.<sup>339</sup> Yet, when a company is in financial difficulties, if the company has positive cashflow, or if the company is worth more as a “going concern,” then an insolvency procedure will crystallise creditors losses.<sup>340</sup> Worse still, insolvency could result in “destruction of legitimate business, unnecessary job losses and disruptions to all customers and suppliers”.<sup>341</sup> Adding criminal liability to the back of s 135 would compound the disconnect between the directors’ personal interest and the interests of other stakeholders.<sup>342</sup>

### ***B The fault requirement in the Bill***

Section 184 of the Corporations Act 2001 (Cth) provides recklessness or intentional dishonesty as the mental element for liability. Liability in the proposed offence in s 138A hinges on knowledge (of serious detriment to the interests of the company or of serious loss to creditors).

Knowledge at criminal law is a high standard. It is a subjective concept that requires a positive and correct belief that the appropriate circumstances exist.<sup>343</sup> In relation to s 138A(2), this provision requires knowledge that the risk taking will result in serious loss to creditors. At the time a director decides to take a risk, that decision will not yet have caused serious loss to creditors. It will only cause loss to creditors when those risks are realised.<sup>344</sup> This implies that a director must know of a future event. The Court of Appeal recently considered the meaning of knowledge in relation to a future event in *Kerr v R*.<sup>345</sup> The Court observed that it is “not possible to ‘know’ of a future event dependent on human activity”,<sup>346</sup> and when that is the case it will be appropriate to equate knowledge with belief.<sup>347</sup> In that context, they concluded that merely being suspicious or reckless as to the consequences did not equate to a belief.<sup>348</sup> Therefore, a breach of s 138A(2) will likely require proof that the director subjectively believed the taking of a risk would cause serious loss to creditors.

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Commerce Select Committee describe how s 135 encourages directors to “abandon ship” when their company most needs them (Bell Gully, above n 15 at 3). Also see Oesterle, above n 72 at 30.

<sup>339</sup> Chapmann Tripp, above n 71 at [25].

<sup>340</sup> At [25]; also see Oesterle, above n 72 at 28-31.

<sup>341</sup> Chapmann Tripp, above n 71 at [25]; also see Oesterle, above n 72 at 28, 29.

<sup>342</sup> Chapmann Tripp, above n 71 at [27].

<sup>343</sup> Simester and Brookbanks, above n 4 at 116.

<sup>344</sup> Chapmann Tripp, above n 71 at [23]. Peter Watts describes how such loss “can only be judged in retrospect” (see Watts, above n 139 at [11]).

<sup>345</sup> *Kerr v R* [2012] NZCA 121.

<sup>346</sup> At [18].

<sup>347</sup> At [17].

<sup>348</sup> At [20].

Many of the submitters on the Bill were unhappy with knowledge as the mental element for the offence.<sup>349</sup> Whilst knowledge relates to the circumstances in a directors' mind when making a decision, a Court would likely be addressing the question after the company has failed, and with the benefit of hindsight, there is a high chance that losses will seem obvious.<sup>350</sup> This could mean that the threshold for liability is too low.

While that is true, in the context of business decisions, Courts have demonstrated a reluctance to impose criminal liability on directors in the absence of traditional culpability such as fraud or dishonesty, particularly in relation to companies are not issuers.<sup>351</sup> The courts are reluctant to review commercial decisions made on a commercial basis; they are less reluctant to second-guess decisions where the motive is suspect.<sup>352</sup> Therefore, when determining whether a director knew of serious loss to creditors, it is likely that a Court will require some sort of dishonesty.

This highlights another problem. Breaches of s 131 tend to involve misdirection, and such breaches tend to be more clear-cut. Courts will have no difficulty applying the knowledge requirement to related party transactions or to transactions not at market value. Breaches in these circumstances are culpable to a more obvious extent, and are tantamount to theft. Whereas, breaches of s 135 more often than not result from incompetence or a blind faith in a director's ability to resurrect the company's prospects.<sup>353</sup> A "paradigm case of reckless trading" according to the Court of Appeal in *Mason v Lewis*, involved defendant directors that were not honest, but they "paid no or no proper attention to the financial affairs of the company."<sup>354</sup> Conduct of this sort, is not so obviously culpable. As a result, breaches of s 135 are less deserving of criminal liability, and Courts will less readily find directors in breach of the knowledge requirement, in the absence of dishonesty, when behaviour is analogous to fraud.

The problem then is that other provisions of the Companies Act 1993 would catch behaviour that goes beyond a lack of competence or responsibility – particularly

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<sup>349</sup> For example, Chapman Tripp, above n 71 at [19], [20]; New Zealand Law Society, above n 140 at [7], [8].

<sup>350</sup> Chapman Tripp, above n 71, describe this as "hindsight bias" at [12.2].

<sup>351</sup> See for example the Feltex case (*Ministry of Economic Development v Feeney* (2010) 10 NZCLC 264,715 (DC)), where the Court stretched the bounds of statutory interpretation, applying a defence in the Companies Act 1993 to a prosecution under the Financial Reporting Act 1993 (see Watson and Hirsch, above n 20 at 111, 112, 115).

<sup>352</sup> Galbraith, above n 181 at 139.

<sup>353</sup> Watson and Hirsch, above n 20 at 109.

<sup>354</sup> *Mason v Lewis* at [69].

fraudulent trading in s 380. The mens rea for s 380 is an intent to defraud creditors. The actus reus can include transferring property<sup>355</sup> or causing material loss to creditors.<sup>356</sup> The essence of fraudulent trading is keeping a business going with the dishonest intention of prejudicing the rights of creditors.<sup>357</sup> Keeping a business going in a way that prejudices creditors is the essence of s 135. Add the dishonest intention, and this would then require the defendant to have acted deliberately with knowledge that he or she was acting in breach of a legal obligation,<sup>358</sup> which in general requires an intention to prejudice another's legal right.<sup>359</sup> Intention in criminal law includes direct intention (essentially motive) and indirect intention (doing something knowing that a consequence was a virtual certainty, regardless of whether or not one wanted that consequence to come about).<sup>360</sup> The Crown need not prove any motive, and there need not be any material personal gain to the defendant.<sup>361</sup>

This is a very similar offence to the one proposed in s 138A(2). Both require a director to cause or allow a business to keep going in a way that prejudices creditors. Both would likely require some sort of dishonesty. Indeed, the Judge states (citing the Court of Appeal in *Firth*) that deliberate and intentional breaches of s 135 may provide evidence of the breach of legal obligation giving rise to an inference of dishonest dealing!<sup>362</sup> Somers J in *Re Nimbus Trawling Co Ltd* when discussing a similar provision of the Companies Act 1955 stated that “intent to defraud” is not aimed at those that are blameworthy, irresponsible or even hopelessly optimistic.”<sup>363</sup>

Combine with this the fact that criminal liability under s 138A(2) will require proof that the director (1) *agreed, caused, or allowed* (2) the company's business to be carried out in a manner *likely* (3) to create a *substantial* risk (4) of *serious* loss to the company's creditors, (5) and that the director *knew* (6) the act or omission would be *seriously detrimental* to the company's creditors. It is unlikely prosecutors would frequently enforce such a complicated provision. According to the LAC, if a “new

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<sup>355</sup> Section 380(2)(b)(ii).

<sup>356</sup> Section 380(3).

<sup>357</sup> *R v Holland-Kearins* [1999] DCR 535 at 539.

<sup>358</sup> At 539. Judge Cadenhead cites *R v Firth* [1998] 1 NZLR 513 (CA) at 519 and *R v Williams* [1985] 1 NZLR 294 (CA) at 308 for this proposition (both *Williams* and *Firth* concerned the meaning of “intent to defraud” in relation to offences to the Crimes Act 1961).

<sup>359</sup> *R v Holland-Kearins* at 539.

<sup>360</sup> The Court of Appeal recently considered the position of indirect (or oblique) intention in *Police v K* [2011] NZCA 533 at [28]-[33]. An example of indirect intention is a man who boards a plane in London knowing the plane is heading to Manchester intends to go to Manchester regardless of whether Manchester is the last place in the world he wants to be.

<sup>361</sup> *R v Holland-Kearins* at 539.

<sup>362</sup> At 553, 554.

<sup>363</sup> *Re Nimbus Trawling Co Ltd* [1986] 2 NZLR 308 (CA) at 320.

offence is unlikely to be enforced, or enforced only rarely,” the proposal should be “examined carefully”.<sup>364</sup> Unenforced laws can bring the law into disrepute if the public considers that offenders can get away with crimes that are left unpunished.<sup>365</sup> In addition, unenforced laws add compliance costs to those who are law abiding, giving an advantage to those that do not apply.<sup>366</sup> This is a genuine concern with s 138A(2). It may deter honest and prudent directors who are concerned about criminal liability from taking legitimate risks, but it may not deter the minority of directors who take excessive risks with other people’s money, who the bill seek to target.

### *C Alternative proscriptions*

A simple requirement of recklessness would make more sense in the context of deterring excessive risk taking. Recklessness incorporates a subjective element (conscious running of a risk), and an objective element (that the risk was unjustified).<sup>367</sup> The requirement of consciousness would ensure the section only caught directors who were culpable. The requirement for the risk to be unjustified would incorporate the fact that companies are inherently concerned with risk, and that often the taking of significant risks will be justified. The approach of the courts in distinguishing between legitimate and illegitimate risk taking seems to incorporate this aspect of recklessness into the current approach to the s 135.

This suggestion is premised on the conclusion that there should be criminal liability for breaches of directors’ duties (contrary to the conclusion in Chapter five). The conclusion that criminal liability should not extend beyond directors of companies that issue securities to the public still applies. It would still raise concerns about deterring directors from taking desirable risks and distorting the policy underpinning the Act. But rather than being an example of hollow law making that is intended to create the impression that Parliament is taking public concern about corporate mismanagement seriously, it would be a provision that would actually be effective in deterring directors from taking unjustified risks. It would also provide a mechanism to make those that do take such risks accountable. To that extent, the proposed s 138A should be amended to read:

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<sup>364</sup> Legislation Advisory Committee, above n 64 at 254; the Capital Markets Development Taskforce, above n 106 is of a very similar view at 82.

<sup>365</sup> Legislation Advisory Committee, above n 64 at 254.

<sup>366</sup> Capital Markets Development Taskforce, above n 106 at 85.

<sup>367</sup> *R v Tipple* at [27], [35], [36]; Simester and Brookbanks, above n 4 at 106, 107.

“A director of a company that is a financial markets participant (within the meaning of that term in s 4 of the Financial Markets Authority Act 2011) commits an offence if he or she is:

- (a) reckless; or
- (b) intentionally dishonest;

and fails to act in good faith in the best interests of the company.”

#### ***D Conclusions on the wording of the Bill***

The proposal to criminalise breaches of s 135 should be scrapped. As it stands, a court would likely require dishonesty before finding a director in breach of the proposed s 138A(2). If that is so, then the offence is very similar to the fraudulent trading offence in s 380. If the courts take a more liberal approach to the knowledge requirement, then the Bill risks prohibiting hopeless optimism and excessive risk taking. Such behaviour is not “egregious”, and to that extent not in line with the intention of the drivers of the Bill.

Furthermore, instead of tacking criminal liability on to the back of civil duties, Parliament should create a stand-alone offence, along the lines of the Australian equivalent, proposed above, providing recklessness or intentional dishonesty as the mental element, but limited to directors of companies that are financial markets participants (and therefore issue securities to the public).

## Conclusion

In conclusion, the proposal to criminalise breaches of directors' duties in clause 4 of the Companies and Limited Partnerships Bill should not proceed, and it should certainly not proceed in its present form. The proposal in the Bill is ill considered, flawed in principle, and poorly worded.

Criminalising breaches of directors' duties is inconsistent with the policy underpinning the Companies Act 1993. It will deter appropriate people from taking up directorships and deter directors from taking legitimate business risks. Furthermore, there are no significant gaps in the current law that need filling. The FMA's new s 34 powers should address concerns about under-enforcement of directors' duties; and there are plenty of existing provisions to punish errant directors who are morally culpable. The proposal is primarily a knee-jerk reaction to recent finance company collapses, and an attempt by the Government to create the impression that it is taking this misbehaviour seriously. For these reasons, this paper opposes the introduction of criminal liability for breaches of directors' duties.

If legislators consider that the current regime makes for under-enforcement of directors' duties in relation to companies that do not issue securities to the public, then extending the FMA's s 34 powers is the solution. If legislators believe that criminal liability is appropriate for breaches of directors' duties by directors of companies that issue securities to the public, then they should limit the offence accordingly. Furthermore, legislators should not criminalise breaches of s 135, and should not provide knowledge as the fault element of such an offence. A more appropriate response would be a stand-alone offence along the lines of the one proposed above, similar to s 184 Corporations Act 2001 (Cth), that provides criminal liability for directors that are reckless or intentionally dishonest, and fail to act in good faith in the best interests of the company. A provision along those lines would better reflect the intentions of the drivers behind the proposal, and would have fewer undesirable consequences.

If the proposal in clause 4 becomes law, it will not stop corporate mismanagement and corporate collapses, but it will have a number of undesirable consequences.

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## **Appendix 1: Relevant provisions**

### **Companies and Limited Partnerships Amendment Bill 2011**

#### **“138A Offence for serious breaches of certain duties**

“(1) Every director of a company who does an act, or omits to do an act, in breach of the duty in section 131 (duty of directors to act in good faith and in best interests of company) commits an offence if he or she knows that the act or omission is seriously detrimental to the interests of the company.

“(2) Every director of a company who does an act, or omits to do an act, in breach of the duty in section 135 (reckless trading) commits an offence if he or she knows that the act or omission will result in serious loss to the company's creditors.

“(3) A person who commits an offence under this section is liable on conviction to the penalties set out in section 373(4).”

### **Companies Act 1993**

#### **Long Title**

An Act to reform the law relating to companies, and, in particular,

(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

(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; and

#### **Section 131 Duty of directors to act in good faith and in best interests of company**

(1) Subject to this section, 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.

#### **Section 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.

### **Section 165 Derivative actions**

- (1) Subject to subsection (3) of this section, the Court may, on the application of a shareholder or director of a company, grant leave to that shareholder or director to—
  - (a) Bring proceedings in the name and on behalf of the company or any related company; or
  - (b) Intervene in proceedings to which the company or any related company is a party for the purpose of continuing, defending, or discontinuing the proceedings on behalf of the company or related company, as the case may be.
- (2) Without limiting subsection (1) of this section, in determining whether to grant leave under that subsection, the Court shall have regard to—
  - (a) The likelihood of the proceedings succeeding;
  - (b) The costs of the proceedings in relation to the relief likely to be obtained;
  - (c) Any action already taken by the company or related company to obtain relief;
  - (d) The interests of the company or related company in the proceedings being commenced, continued, defended, or discontinued, as the case may be.
- (3) Leave to bring proceedings or intervene in proceedings may be granted under subsection (1) of this section, only if the Court is satisfied that either—
  - (a) The company or related company does not intend to bring, diligently continue or defend, or discontinue the proceedings, as the case may be; or
  - (b) It is in the interests of the company or related company that the conduct of the proceedings should not be left to the directors or to the determination of the shareholders as a whole.
- (4) Notice of the application must be served on the company or related company.
- (5) The company or related company—
  - (a) May appear and be heard; and
  - (b) Must inform the Court, whether or not it intends to bring, continue, defend, or discontinue the proceedings, as the case may be.
- (6) Except as provided in this section, a shareholder is not entitled to bring or intervene in any proceedings in the name of, or on behalf of, a company or a related company.

### **Section 380 Carrying on business fraudulently**

- (2) Every director of a company who,—

- (a) by false pretences or other fraud induces a person to give credit to the company; or
- (b) with intent to defraud creditors of the company,—
  - (i) gives, transfers, or causes a charge to be given on, property of the company to any person; or
  - (ii) causes property to be given or transferred to any person; or
  - (iii) caused or was a party to execution being levied against property of the company—
 commits an offence and is liable on conviction to the penalties set out in section 373(4).

(3) Every director of a company commits an offence and is liable on conviction to the penalties set out in section 373(4), who, with intent to defraud a creditor or creditors of the company, does any thing that causes material loss to any creditor.

## **Financial Markets Authority Act 2011**

### **Section 34 FMA may exercise person's right of action**

(1) If, as a result of an inquiry or investigation carried out by the FMA, the FMA considers that it is in the public interest for it to do so, the FMA may, in accordance with this subpart,

- (a) exercise the right of action that a person (**person A**) has against a person who is or has been a financial markets participant by commencing and controlling specified proceedings against the person who is or has been a financial markets participant; or
- (b) take over specified proceedings that have been commenced by a person (**person A**) against a person who is or has been a financial markets participant for the purpose of continuing the proceedings

...

(5) The FMA must, when considering whether exercising a power under this section is in the public interest, have regard to—

- (a) its main objective under section 8; and
- (b) the likely effect of the proceedings on the future conduct of financial markets participants in connection with the financial markets; and
- (c) whether exercising the powers is an efficient and effective use of the FMA's resources; and
- (d) the extent to which the proceedings involve matters of general commercial significance or importance to the financial markets; and

- (e) the likelihood of person A commencing the proceedings (if those proceedings have not yet been commenced) and diligently continuing the proceedings; and
- (f) any other matters it considers relevant.

## **Corporations Act 2001 (Cth)**

### **Section 184 Good faith, use of position and use of information – criminal offences**

(1) A director or other officer of a corporation commits an offence if they:

- (a) are reckless; or
- (b) are intentionally dishonest;

and fail to exercise their powers and discharge their duties:

- (c) in good faith in the best interests of the corporation; or
- (d) for a proper purpose.