

## LITIGATION

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## NEW ENFORCEMENT POWERS FOR FMA AND CRIMINAL LIABILITY FOR BREACHES OF DIRECTORS' DUTIES ON THE HORIZON



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The Government is currently implementing the most significant reforms to New Zealand's securities laws in two decades. Two recent developments are of particular importance:

- A suite of reforms has just been passed into law, including the Financial Markets Authority Act 2011, which established the Financial Markets Authority (FMA), and cloaked it with a broader range of investigative and enforcement powers than its predecessors; and
- The Cabinet has approved a set of proposals for a fundamental review of New Zealand's company and securities laws.

In our [previous litigation update](#) we reported on the Government's proposals to empower the FMA to initiate or take over civil actions on behalf of investors and issuers against directors of companies which issue securities to the public (as well as certain other financial markets participants). This update reports on:

- The FMA's new public enforcement powers; and
- The Cabinet proposal to create criminal liability for intentional and egregious breaches of directors' duties, which the Ministry of Economic Development (MED) is now developing in the context of its review of securities laws.

### Public enforcement powers

The Financial Markets Authority Act empowers the FMA to initiate or take over civil actions on behalf of investors and issuers against directors, auditors, and

trustees. This is a significant new power:

- The FMA can use its new powers to initiate or take over civil actions on behalf of investors and issuers for causes of action which arose before the commencement of the new legislation.
- The potential targets of this new enforcement power are "financial markets participants", which the legislation defines to include the directors, auditors, and trustees of companies and unit trusts which issue securities to the public.
- The types of civil actions which the FMA can now exercise on behalf of investors and issuers are extremely broad. They encompass:
  - any causes of action arising under the Companies Act, Financial Reporting Act 1993, Securities Act 1978, Securities Markets Act 1988 (and several other statutes); and
  - any proceedings seeking damages or other relief for fraud, negligence, default, breach of duty, or other misconduct, committed in connection with a breach of the financial markets legislation.
- Individual claimants can opt out of the FMA's action as of right. However, the ability of corporate claimants to opt out is subject to the Court's discretion.
- Once commenced, the FMA will control the proceedings, subject to the Court's oversight and directions. Any amount recovered by the action will be first applied to pay the FMA's costs of bringing the proceedings.

This is a very significant change and the full implications remain to be seen.

## Proposed criminal liability for breach of directors' duties

The Cabinet has [approved](#) proposals to introduce criminal liability for intentional and egregious breaches of the following directors' duties under the Companies Act 1993:

- The duty to act in good faith and in what the director believes to be the best interests of the company (section 131);
- The duty not to carry on the business of the company in a manner likely to create a substantial risk of serious loss to the company's creditors (section 135); and
- The duty not to incur an obligation unless the director believes at the time on reasonable grounds that the company will be able to perform the obligation when it is required to do so (section 136).

These proposals reflect concerns that the range of existing criminal sanctions in respect of conduct after the allotment of securities is too limited. The cabinet paper concludes that the criminalisation of intentional breaches of directors' duties is necessary to provide an increased deterrent against directorial misconduct. The cabinet proposals are intended to address serious offending.

However, while we support Government's policy that the law should respond forcefully to dishonest business practices, we have reservations about the broad scope of the proposed reforms. As we explain below, these reforms are fraught with difficulty and it is important that the Government proceed carefully to avoid the risk of exposing honest directors to legal risk and uncertainty.

### Problem definition

Before creating new criminal prohibitions, it is important to determine whether the targeted conduct is already caught by existing provisions under the Companies Act, the Financial Reporting Act 1993, the Securities Act 1978, the Securities Markets Act 1988, the Fair Trading Act 1986, or the Crimes Act 1961. If the targeted conduct is already covered by existing criminal prohibitions, then we consider that the real

issue is the effective enforcement of those provisions. This latter approach accords with the [recommendations of the Capital Market Development Taskforce](#), which called for visible and credible enforcement of existing regulatory rules.

There may be potential gaps in the criminal law regime in respect of conduct by directors subsequent to the allotment of securities which is dishonest and intended to cause loss to creditors or investors (or carried out with the knowledge that such loss will occur). Though harmful to the New Zealand economy, much of this conduct is already caught by existing prohibitions. We consider that any new offence should be narrowly tailored to target gaps in existing sanctions against dishonest and illegitimate business practices. In our view, this concern is not fundamentally a company law issue – i.e., the practices are no less harmful when committed in the context of trading trusts or limited partnerships.

We also note that the criminal law is one of a number of options available for cracking down on dishonest misconduct intended to prejudice creditors. We support, for example, the enhancement of creditors' rights against culpable bankrupts and strengthening creditors' ability to recover assets diverted to sham trusts or "phoenix" entities.

Evidence from the World Bank indicates that "in banking and securities markets, characteristics related to private monitoring and enforcement drive development more than public enforcement measures". The World Bank's conclusions accord with our own experience – creditors (and receivers and liquidators) are usually the "front line" parties dealing with corporate malfeasance. It is timely to reassess the adequacy of the legal mechanisms for recovering assets diverted into sham trusts by culpable bankrupts.

These reforms need not be mutually exclusive with criminal law reform, but they may be a higher priority for creditors and the investing public, without the complexities associated with formulating a new criminal prohibition.

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## Potential unintended consequences

While we agree with the Government's objectives in criminalising dishonest misconduct, any reforms must deal with two serious unintended consequences.

First, criminal liability may deter honest and competent directors who concerned about the risk of misguided allegations of wrongdoing. Criminal proceedings entail a much greater emotional and reputational toll on defendants than civil proceedings. In our view, these potential consequences cannot be underestimated. Concern that the civil duties imposed on directors may be too onerous was [recently expressed](#) by the chairman of the Australian Securities and Investments Commission, Tony D'Aloisio, who commented, "there are concerns out there as to whether or not it is going to discourage good people from becoming directors, particularly for the medium- to small-size enterprises". These concerns are echoed by the results of a survey published late last year by the [Australian Institute of Company Directors](#), which indicated widespread concerns among directors about their exposure to civil and criminal liability.

Careful drafting will be the key to ensuring that any criminal prohibition does not inadvertently deter competent and honest candidates for corporate boards.

Second, directors and officers insurance (D&O) policies commonly contain exclusion clauses for criminal conduct. Accordingly, a criminal conviction for breaching directors' duties may void the D&O cover which is available to fund compensation to the victims who have suffered financial losses. Since criminal proceedings against a director will usually precede civil proceedings by or on behalf of investors and creditors, the criminalisation of directors' duties may therefore have the unintended consequence of prejudicing investors and creditors.

## Getting the details right

The Government has not yet formulated detailed legislative proposals. We draw significant comfort from the MED's engagement with the legal community and financial markets participants to develop principled and workable draft legislation.

Bell Gully's preliminary view is that any criminal liability provision should be based on the following elements: (1) dishonesty and (2) knowledge that creditors or investors may be prejudiced by the dishonest misconduct.

We consider that dishonesty and knowledge are the appropriate benchmark for criminal liability. In our view, a requirement of simple intentionality adds little to statutory standards which already incorporate an element of intentionality (such as the statutory requirement to act in good faith and in what the director believes to be the best interests of the company). Moreover, the real dividing line between directorial conduct which is civilly and criminally wrongful has less to do with the intentionality of the conduct (such as continuing to operate the business) and more with dishonesty and the knowledge that the conduct will prejudice investors and creditors.

We believe that the elements of dishonesty and knowledge are consistent with the principles and policy objectives contained in the cabinet proposals. We also consider that an offence formulated on these elements would be less problematic than using civil law directors' duties as the foundation for the new offence provisions.

## Going forward

The Government has indicated that it will publish an exposure draft of new legislation in August and will introduce a bill to Parliament by the end of the year. The proposed criminalisation of certain breaches of directors' duties is a debate in which all New Zealand businesses are stakeholders. Bell Gully will provide updates on developments arising from the cabinet paper. In the meantime, if you would like to discuss any aspect of the cabinet paper or the recently passed financial markets legislation, please contact your usual Bell Gully adviser.

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