

**A GUIDE TO
DIRECTORS & OFFICERS
LIABILITIES**

Synopsis of Relevant Issues

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1. LIMITED LIABILITY COMPANIES:

A company is a separate legal entity and can enter into contracts on its own behalf. Owners and shareholders have protection from debts incurred by the company. If a company becomes insolvent it must liquidate all its assets to pay its creditors, but can only demand unpaid share capital from its owners or shareholders. Owners and shareholders are not personally liable to creditors for all the debts incurred by the company. However, the rights of owners and shareholders to have their liability limited are balanced by the responsibilities imposed on directors and officers.

2. RESPONSIBILITIES OF COMPANY DIRECTORS

Under common law, directors have certain responsibilities, and can be liable to creditors if they have acted negligently or recklessly. In addition, the Companies Act 1993 imposes various duties on directors:

- Duty to act in good faith and in the best interests of the company (s131);
- Duty not to agree to the business of the company being carried on "Recklessly" to the likely detriment of the company's creditors (s135);
- Duty not to agree to the company incurring an obligation unless the Director believes on reasonable grounds that the company will perform it (s136);
- Duty to exercise the care, diligence and skill that a reasonable Director would exercise in the same circumstances (s137);
- Duty not to place oneself in a position in which one's duties to the Company conflict with one's personal interests (s140);
- Duty not to use Company Information for personal profit or gain (s145);
- Duty to disclose dealing in shares in the company (s146);

The Act also provides for severe fines and penalties up to \$200,000 and 5 years imprisonment for certain breaches.

The following Acts also impose various duties on Directors:

- The Registrar of Companies and the COMPANIES ACT 1955 and 1993;
- The Securities Commission and the SECURITIES ACT 1978, together with:

- SECURITIES REGULATIONS 1983;
- SECURITIES AMENDMENT ACT 1988;
- SECURITIES (SUBSTANTIAL SECURITY HOLDERS) REGULATIONS 1989;
- SECURITIES TRANSFER ACT 1977;

- The Commerce Commission and the COMMERCE ACT 1986, FAIR TRADING ACT 1986 and CONSUMER GUARANTEES ACT 1993;
- The Overseas Investment Commission and the OVERSEAS INVESTMENT REGULATIONS 1985;
- The Stock Exchange Surveillance Panel and the listing Rules for listed companies;
- The Takeovers Panel and the TAKEOVERS ACT 1993 with any takeovers code approved under the Act;
- The RESOURCE MANAGEMENT ACT 1991;
- The BUILDING ACT 1991;
- The HEALTH AND SAFETY IN EMPLOYMENT ACT 1992;
- The FINANCIAL REPORTING ACT 1993;
- The Privacy Commissioner and the PRIVACY ACT 1993;
- Relevant amendments

3. PERSONAL LIABILITY

The threat of potential lawsuits is a problem that most company directors and board members would most likely prefer to forget about. But regardless of the size or type of business, directors and officers can be faced with many serious risks of exposure in the course of managing a business.

More and more New Zealand executives are realising that they need to increase their insurance cover as their risks grow. It is vital that they have adequate insurance protection to cover the liability arising from board decisions or from their own actions. When lawsuits are filed against directors and officers, they are incurring significant legal expenses and spending time defending themselves, time that could be more profitably spent in the running of their companies.

- Directors and Officers can be indemnified by the company for any costs incurred in defending or settling any claim other than a successful claim for:
 - Criminal liability; and
 - Breach of a Directors duty of good faith; and
 - Breach of a fiduciary duty owed to the company
- The Company can arrange and pay for D&O Insurance covering all liabilities, defence costs and settlement costs except for:
 - Costs incurred in unsuccessfully defended criminal proceedings; and
 - Any criminal liability actually upheld against a director
 - Fines

4. WHY AND TO WHOM ARE DIRECTORS AND OFFICERS LIABLE?

They are liable because they are in positions of responsibility. Director's responsibilities are constantly changing as legislation evolves. Directors are called to be responsible for their actions; they face liability arising from the management of their organisations. This leads to an ever-increasing exposure to potential legal action.

The range of liabilities which can be incurred by a Director encompasses:-

- Liability to the company, its receivers, managers or liquidators;
- Liability to shareholders, e.g. misleading or deceptive conduct in relation to share allotments or dealings with securities;
- Liability to employees, e.g. occupational health and safety, equal opportunity, sexual discrimination, privacy issues;
- Liability to creditors;
- Liability to customers, e.g. misleading and deceptive conduct under the Fair Trading Act or Consumer Guarantees Act;

- Liability to competitors, e.g. price maintenance, breach of copyright etc.;
- Liability to the public at large, e.g. pursuant to occupational health and safety legislation, environmental legislation, in negligence, nuisance etc.;
- Liability to government - NZ Securities Commission, Commerce Commission, Occupational Health and Safety and Environmental Protection Authorities;
- Liability for professional negligence for circumstances in which advice/information is given.

Source: Clayton Utz

5. WHAT DOES DIRECTORS AND OFFICERS INSURANCE COVER?

The cover funds:

- The costs of defending and investigating claims and allegations made against individuals.
- Any damages or settlements that result from such claims or allegations

Most policies also cover:

- Claims made against the directors' estates and legal representatives
- Claims made against a director's spouse
- Directors on the board of an associated company or non-profit entity
- Allegations made against directors arising from an employment dispute
- Claims brought by shareholders
- Official investigations and inquiries
- Daily rates for costs in court attendance

5a Claims Examples

Some of the following examples of claims made against directors and officers are based on real cases. However, they are summarised for illustrative purposes and some of the details may have been changed.

Example 1: Creditors – Reckless Trading

Horticultural Handling was a freight forwarding company that went into liquidation. Nippon Express, an unsecured creditor, brought proceedings against the directors alleging breach of duty under the Companies Act. The directors, who were not involved in the day to day running of the business, argued that they had relied on information supplied by the Managing Director. The court held that they could not rely on that defence as they knew the company had traded at a significant loss, and there was enough information to realise the peril of continuing to trade at all. The directors were held to have breached their duty, and each director was liable for \$250,000 to be paid to the company's creditors by the liquidator.

Example 2: Shareholder Derivative Action

The Court granted leave for an action to be brought by a shareholder, paid for by the company, against the Directors. Barlow Bros. (NZ) Ltd was a highly profitable private company with 77.5% of shares held by father and son D & B Barlow. McFarlane, who held the balance of shares, was B. Barlow's nephew. McFarlane claimed \$650,000, arguing that excessive salaries had been paid to D & B leaving only a modest dividend for the shareholders. Issues of conflict also arose because D & B owned the company that leased premises to Barlow Bros (NZ) Ltd.

Example 3: Employees – Discrimination

A woman was employed as a receptionist. She informed her boss, a director of the company, when she became pregnant. Some weeks later she noticed him interviewing job applicants. After several days' sick leave she returned to work to find one of the job applicants working at her desk. She was dismissed by the director with no warning, no holiday pay, no notice and no severance pay. She did not even receive her wages from the previous week. The Complaints Review Tribunal considered that she had lost her job and had been treated unfairly because she was pregnant. She was awarded approximately \$10,000 in damages, \$5,000 of which was to be paid by the director.

Example 4: Investors – Capital Raising Representations

A company was seeking to raise capital and made an offer to investors. The directors made representations that the capital was needed for a new project.

Not long after the capital was raised, the company announced that for a variety of reasons, the project had been cancelled. The price of the shares then plummeted. Reports came out in the media that the capital was required to pay a damages award that had been made against the company. The media alleged that the directors must have been aware of the possibility of an adverse judgement, but had misrepresented both the size and the likelihood of damages being paid.

The directors denied making any misrepresentations, citing legal advice they had received that they would not be held liable. However, fuelled by continued media speculation, the investors brought proceedings against the directors for making misrepresentations prior to the sales of shares.

Example 5: Competitors – Unintentional Defamation

In a television interview a director was asked to comment on the state of the market, at the time his industry was going through a downturn.

The director, whose company was still trading reasonably well, cited a number of factors that had led to poor results throughout the industry. In addition, he commented that some companies had gone under because of the failure of management to react quickly enough to the downturn, and to make the tough decisions that were necessary.

The director hadn't named anyone in particular, but the directors of a company that had been placed in liquidation alleged that there was enough information that identified them and that they had been defamed by the director's statements.

6. BASIS OF COVER

What is Claims Made Cover?

D & O insurance provides cover on a 'claims made' basis. This means that you are protected against claims that are made against you, and then notified to the insurer, during the period of insurance. This enables companies to select limits of indemnity each year to keep pace with the likely cost of damages.

Is there any Cover for the company?

Except for a special extension in respect of claims brought by security holders, there is no cover for the company itself. The policy is for the benefit of the individual directors and officers who face personal liability exposures. However, the company may be reimbursed under the policy where it has been paid expenses and claims on behalf of directors.

7. RISK MANAGEMENT

Insurance is not a substitute for good management practices and disciplines. Rather, it is a safety net for those occasions when mistakes, oversights and errors of judgement occur in spite of the controls and safeguards that good management has put in place.

The following series of check-lists are designed to assist you in establishing whether you have exposures. They are not intended as a substitute for commercial judgement or professional advice.

DIRECTORS AND OFFICERS – YOUR RISK MANAGEMENT CHECKLIST

| | | NO | YES |
|----|--|--------------------------|--------------------------|
| 1 | Do I understand what my company does? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2 | Have I read all the minutes and do I agree that they are an accurate representation of what was said? | <input type="checkbox"/> | <input type="checkbox"/> |
| 3 | Do all members of the Board have the opportunity to speak their minds? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4 | Am I as aware of the company's current financial position as I could be? | <input type="checkbox"/> | <input type="checkbox"/> |
| 5 | Am I aware of any problems concerning the fundamental viability of any of the companies I am involved with, and if so done my utmost to rectify the situation? | <input type="checkbox"/> | <input type="checkbox"/> |
| 6 | Have the accounts been filed with the Companies Office within the required period of time? | <input type="checkbox"/> | <input type="checkbox"/> |
| 7 | Have I met all the company's professional advisers? | <input type="checkbox"/> | <input type="checkbox"/> |
| 8 | Am I satisfied with my fellow Directors' performance? | <input type="checkbox"/> | <input type="checkbox"/> |
| 9 | Am I satisfied that I do not have any personal conflicts of interest? | <input type="checkbox"/> | <input type="checkbox"/> |
| 10 | Am I happy that I am serving the interests of all out members at all times and not myself? | <input type="checkbox"/> | <input type="checkbox"/> |
| 11 | Have I ensured there is a D & O policy in force plus all other relevant insurances? | <input type="checkbox"/> | <input type="checkbox"/> |
| 12 | Am I sure the company complies with all relevant legislation as far as possible? | <input type="checkbox"/> | <input type="checkbox"/> |
| 13 | Am I aware of any mergers/acquisitions/takeovers or other actual or contemplated restructuring and have I taken all reasonable steps to protect the position of those I owe a duty of care to? | <input type="checkbox"/> | <input type="checkbox"/> |
| 14 | Do I have adequate information to make an informed decision at Board Meetings / Management Meetings? | <input type="checkbox"/> | <input type="checkbox"/> |

This list is of a general nature only. If you have answered No to any of the above questions, a potential exposure exists.

DIRECTORS DUTIES CHECKLIST – REGULAR/MONTHLY MEETING

In the current environment, it is essential that directors fully understand their duties and responsibilities. Failure to perform one's duties can result in fines, personal liability or even imprisonment. This brief checklist is intended to provide assistance in meeting your responsibilities under certain legislation. It is not intended as a substitute for commercial judgement or professional advice.

Building Act

- 1 **Ensure compliance** with any notice to rectify building work
- 2 **Ensure compliance schedule is adhered to** (inspection, maintenance, and reporting systems in respect of building systems)
- 3 **Receive and review report** from building manager(s)
- 4 **Ensure building consent** is applied for and obtained, and advise territorial authority of completion in a code compliance certificate, if any building work is anticipated

Commerce Act

- 5 *If the company is entering into a commercial contract or business acquisition*, the board should check that the provisions of the Commerce Act will not be breached by the transaction, especially where that company is already in a dominant position in the market
- 6 *If this is a problem*, the Board must decide whether to apply for Commerce Commission clearance

Companies Act

7. **Document decision-making in minutes** Incorporate reports from employees and consultants, etc
- 8 **Monitor accounts:** Financial state of company must be able to be determined at any time
- 9 **Monitor delegations** (receive and review reports from administrative officers about delegated duties etc.)
- 10 **Disclose any "interests" directors have** to the board (any entry on interests registry)
- 11 **Regular check of share register**

Fair Trading Act

- 12 **Investigate any complaint** or rectify any breach of Act
- ### Financial Reporting Act

- 13 **Ensure accounting records are maintained** sufficiently to enable the current financial position of the company to be determined at any time, and to enable preparation of financial statements

Health & Safety in Employment Act

- 14 **Monitor hazard identification system** including assessment of any hazard identified
- 15 **Ensure an accident and incident register is kept** properly
- 16 **If an accident has occurred,** ensure it is investigated
- 17 **Receive and review reports** from Health and Safety officer(s)
18. **Eliminate any hazards identified,** and isolate them or minimise any harm, including monitoring of employee's health
- 19 **Regular checks** on emergency readiness
- 20 **Check on compliance** with code of practice

Privacy Act

- 21 **Check compliance** with code of practice if possible, otherwise, general compliance with privacy principles
- 22 **Investigate any complaint,** settlement, or rectification of procedures if in breach of principles

Resource Management Act

- 23 **Review environmental reports** from environmental manager(s) and other delegates, consultant's etc.
- 24 **Update environmental standards,** guidelines and procedure in light of industry standards and practices (if necessary)
- 25 **Conduct routine "environmental audit"**
- 26 **Emergency Response** - Ensure procedures, equipment etc are adequate and ready for any emergency response that is necessary
- 27 **Education and training**

Common Law

- 28 Am I acting in good faith in the best interests of the company?
- 29 Am I exercising my powers for a proper and legal purpose?
- 30 Am I exercising the degree of skill and care of an ordinary prudent director?

- 31 Am I satisfied that I do not have any personal conflicts of interest?
- 32 Am I happy that I am serving the interests of all our shareholders at all times and not myself?
- 33 Am I aware of any problems concerning the fundamental viability of the company, and if so have I done my utmost to rectify the situation?

Disclaimer: This checklist is provided for information only, and is not intended as a substitute for commercial judgement or professional advice, which should be obtained prior to reliance on this checklist. If in doubt, please contact your professional or legal advisers.



Mahony & Co Ltd

DIRECTORS DUTIES CHECKLIST – ANNUAL OR ONE-OFF DUTIES

In the current environment, it is essential that directors fully understand their duties and responsibilities. Failure to perform one's duties can result in fines, personal liability or even imprisonment. This brief checklist is intended to provide assistance in meeting your responsibilities under certain legislation. It is not intended as a substitute for commercial judgment or professional advice.

Building Act

- 1 **Building(s) Warrant of Fitness:** Ensure territorial authority is supplied with warrant(s) and warrant is displayed in the building.
- 2 **Appoint officer responsible for compliance** with Act (building manager)

Commerce Act

- 3 **Compliance** - Institute system and/or procedures to ensure compliance
- 4 **Awareness of Act & Education:** Ensure there is no prohibited conduct
- 5 **Acquisitions:** Consider current practices for business acquisitions

Companies Act

- 6 **Maintain company records:** Ensure records are maintained correctly and ready for inspection, and are not able to be falsified
- 7 **Prepare annual report and financial statements:** In accordance with Financial Reporting Act 1993, and deliver to shareholders
- 8 **Prepare annual return** and deliver to Registrar
- 9 **AGM**
- 10 **Appoint administrative officer(s)** and establish system to monitor delegated duties and powers
- 11 **Accounting Records:** Ensure records are kept correctly and are easily accessible

Fair Trading Act

- 12 **Compliance** - Institute system and/or procedures to ensure compliance
- 13 **Awareness of Act & Education:** Ensure there is no misleading or deceptive conduct in trade (eg advertisements)

Financial Reporting Act

- 14 **Financial statements** - Ensure financial statements (including group financial

statements) are completed and signed within specified time limit

- 15 **Accountancy Practice** - Ensure financial statements are dated, give a fair view of the companies position, and comply with generally accepted accounting practice
- 16 **Audits** - If company is an “issuer”, ensure financial statements are audited, and a copy of the financial statements and the auditor’s report are delivered to the Registrar within the prescribed time

Health & Safety in Employment Act

- 17 **Establish and maintain procedures for** hazard identification, assessment, and control
- 18 **Appoint Health and Safety officer(s)** to ensure compliance with Act
- 19 **Establish emergency procedures**
- 20 **Education:** Set up employee education/information programme
- 21 **Code of Practice:** Decide whether to adopt an approved code
- 22 **Establish and keep a register** of accidents and incidents causing “Serious harm”

Privacy Act

- 23 **Awareness of Privacy Act and Principles:**
- 24 **Education/information programme** for employees to ensure compliance with principles
- 25 **Consider whether a privacy code of practice is needed** (and adoption, if necessary)
- 26 **Compliance** - Consider whether current practices comply with principles, and change of practice in case of non-compliance

Resource Management Act

- 27 **Prepare an environmental policy**, and approve by the board
- 28 **Environmental Compliance Programme**
- (a) Appoint an environmental manager
 - (b) Establish a set of environmental standards, guidelines, and procedures to guide corporate activities
 - (c) Establish a reporting system from all levels up to board level
 - (d) Establish education/training programmes for directors, managers and employees

Common Law

- 29 Are you acting in good faith in the best interests of the company?
- 30 Are you exercising my powers for a proper and legal purpose?
- 31 Are you exercising the degree of skill and care of an ordinary prudent director?
- 32 Are you satisfied that I do not have any personal conflicts of interest?
- 33 Are you serving the interests of all our shareholders at all times and not yourself?
- 34 Are you aware of any problems concerning the fundamental viability of the company, and if so have you done your utmost to rectify the situation?

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