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UPDATE + NEWS + REVIEW

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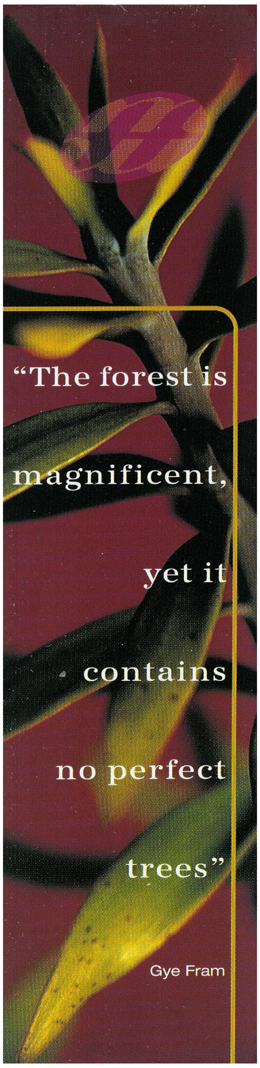

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So you want to be a director? A recent judgement has further highlighted the care and caution a director must exercise and not abrogate to another person. This newsletter addresses this important topic.

Reckless Trading — Passive Directors Will Be Liable

Lloyd Hayward

For many years now, in newsletters and presentations, we have warned of the potential liability of directors for losses incurred as a result of failing to adequately discharge their duties. While we have seen many instances of potential liability we have been unable to obtain the funding necessary to pursue these cases. Finally we have a case where a creditor has agreed to fund the action and the precedent set in this case may encourage creditors to fund similar actions in the future.

Jeff Meltzer and Karen Mason are the Liquidators of Global Print Strategies Limited (In Liquidation). For the past six years they have been pursuing two of the company's directors for reckless trading and failing to keep proper books of account.

In a judgment delivered on 1 October 2008, in the case of *Mason v Lewis*, HC AK CIV 2003-404-0936 these directors were found to have traded recklessly and failed to maintain proper books of account and as a result were found liable to contribute $1.26 million to the liquidation. The orders made under s300 and s301 of the Companies Act 1993 were purely compensatory and did not include any punitive element.

The directors were founding shareholders/directors of a business set up in late 1999 to act as the print broking arm for a major client. This arrangement failed within two months. At that time the company had no other customers; however, it did recover somewhat and traded for a further two years, but the business was never profitable.

The directors took little or no active part in the management of the business and only became directors in order to protect their twenty per cent shareholding in the company. It was managed in all respects by the executive director and manager who turned out to be a particularly slick fraudster. By the time the company was placed into liquidation its debts were in excess of $2 million. The manager was subsequently convicted of fraud and was imprisoned in a separate action brought by the Police.

Throughout the life of the company, no books of account were kept that satisfied the requirements of the Companies Act 1993. At no time could the directors ascertain the financial position of the company with reasonable accuracy.

There were several indicators of insolvency throughout the two year trading period of which the directors failed to take notice, including draft accounts showing very significant losses and negative equity. Notwithstanding these indicators the directors failed to take any action. It was only when the frauds committed by the executive director became known to them that the directors took control of the company. It was placed into liquidation shortly thereafter.

In the first paragraph of the judgment Stevens J stated:

> *"This case is a timely reminder of the fundamental principle of the Companies Act 1993 that company directors must take proper steps to place themselves in a position to guide and monitor the management of the company. The responsibility for governance of the company is theirs. They cannot simply treat the appointment as a sinecure and then leave to management, or other advisers, the duties of running the company and ensuring compliance with legal obligations. Let delinquent directors beware."*

The Court noted that neither director knew:

- what their responsibilities were;
- what information they needed to monitor the company's performance to discharge those responsibilities; or
- what steps they had to take to use that information, together with their powers as directors, to discharge their responsibilities as directors.

The Court found that the inevitable consequence of the directors' lack of assessment and governance was that they failed to take proper steps in respect of the worsening financial position.

In an earlier hearing on the matter, the Court of Appeal stated:

> *"Any suggestion that a director can simply abrogate his or her functions, such has occurred in this case, is quite improper in the face of the legislation."*

Directors' must take proper steps to place themselves in a position to guide and monitor the management of the company. It was the directors' ultimate responsibility to monitor the company's business. It was the directors' underlying failure to see this company properly set up, with adequate books of account, and monitored, which created the very context in which the executive director's unauthorised steps, expenditure and dishonesty could thrive.

What does this mean for your clients?

The days of the "passive" director are over. A passive investment should be just that, a passive investment, but there cannot be a passive directorship. In the liquidations we undertake we often see the husband/wife/partner as a director when it is obvious they have no understanding of a director's responsibilities.

Directors must take an active part in the direction of companies where they are directors. They must act as a reasonable and prudent director would. If they are uncertain as to the course of action they should take then they must obtain advice from a suitably qualified person.

We recommend you suggest to your clients' directors that they review their directorships and consider retaining only those where they take an active part in the business.

Those directors remaining should refresh themselves with respect to the duties of directors of a company. The duties are set out in sections 131 to 138 of the Companies Act 1993. Although the statutory duties are owed to the company by the director for the period of his or her directorship it is invariably only when the company is placed in liquidation that the director's compliance with the duties is scrutinised.

Directors must ensure that adequate books of account are kept

Section 194 of the Companies Act 1993 sets out the obligations of directors with respect to books of account. Failure to comply with the Section is an offence under the Act subject to a $10,000 fine.

Under Section 300, a Court can find directors personally responsible, without limitation of liability, for all or any part of the debts and other liabilities of a company if the failure to comply with Section 194 has contributed to the company's inability to pay all its debts, or has resulted in substantial uncertainty as to the assets and liabilities of the company, or has substantially impeded the orderly liquidation.

In the case of Global Print Strategies Limited (In Liquidation) proper books of account had not been kept since the commencement of trading. This contributed significantly to the Court's views on liability of the directors. This case also serves to highlight the necessity for directors to undertake caution and care and a hands-on role, especially in the current turbulent economic circumstances.

Between the professional staff at Meltzer Mason Heath there is over 100 years insolvency experience. This means that any problems or uncertainties facing your clients are likely to have been seen by us before. Please call us and as always we will offer you and/or your clients a free one hour consultation.

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