



# Corporate Governance

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# What is corporate governance?

The obligations and responsibilities of directors have been in the spotlight following the collapses of high profile companies such as Enron in the United States and HIH and OneTel in Australia.

A failure of corporate governance has been blamed for these collapses. Recent public company failures in New Zealand have also been blamed on governance failures. A **failure of corporate governance** refers to a failure of the boards of directors of companies to properly oversee and direct the company's strategy and operations.

**Corporate governance** is the general reference to all the issues facing **directors and boards** in directing and governing corporates. It is sometimes referred to as "the system or process by which a company is directed and controlled in order to protect the shareholder interests".<sup>1</sup>

While this booklet primarily focuses on companies registered under the Companies Act 1993 the principles of corporate governance do not just apply to directors appointed to a commercial company. Good corporate governance is essential for not for profit Boards, such as Incorporated Charitable Trusts, Incorporated Societies and School Boards of Trustees. Not for profit board members have similar corporate governance obligations to those of directors but may also have additional obligations.

The Companies Act does not distinguish between **private** and **public companies**. In practice, there are differences between large companies and **small** or **closely-held** companies. The **small closely-held** company is also known as a private company and relies on a small number of shareholders for capital.

Larger companies will need to raise capital from further afield. It will usually be necessary to meet the requirements of the Securities Act 1978.

A **public company** is listed on the stock exchange and its shares can be bought and sold by the public. Additional and more onerous legal requirements are imposed on public companies, including that of **continuous disclosure** so that the public are made aware of information which may affect the value of shares. These requirements are imposed by the Securities Markets Act 1988 and by the Exchange.

<sup>1</sup> Corporate Governance, A Director's Handbook. CCH NZ Ltd (1999).

## Who can be a director?

Any natural person can be a **director** of a company as long as they are not disqualified and they meet any requirements of the constitution. Those disqualified are:

- Under 18 years of age.
- Undischarged bankrupts.
- Persons prohibited from becoming a director by virtue of previous convictions, by court order or by notice given by the Registrar of Companies.
- Persons the subject of property orders under the Protection of Personal and Property Rights Act 1988.

A prospective director must sign a **Consent to Act** as **Director** and certify that they are not disqualified from being appointed or holding office as a director. The manner of appointment and any restrictions may be set out in the constitution. The default position under the Companies Act is that appointment is by an **ordinary resolution** (majority vote) of the shareholders.

## Definitions

An **Alternate Director** is a person who is appointed to act for a director in the director's absence. Such an appointment must be allowed by the constitution. The appointment process is governed by the constitution.

The **Board of Directors** (the **Board**) is the chair and the directors working together to control the planning and implementation of the corporate obligations of the company.

The **Chairperson** (the **Chair**) is the director appointed to lead the Board. There is no legal requirement for a Board to have a chair, however most do. Usually the chair acts as the public spokesperson for the company and presides at general meetings of the company. The appointment process is either set out in the constitution or otherwise is by ordinary resolution of the Board.

Recent case law has signalled that the chair has higher special responsibilities. These special responsibilities include ensuring that the Board functions properly. The chair must ensure that systems are established and maintained for information to flow to the Board so that the directors are properly informed and can monitor the performance of the company and its compliance with relevant laws.

The chair has no **casting vote**, unless the constitution provides for it.

In larger companies and public companies, the chair is usually a **non-executive or independent director**.

The **Company Secretary** was a role recognised under the previous Companies Act, but not required under the Companies Act 1993. Many companies continue to have a **company secretary**; others rely on their accountant or lawyer to assist in undertaking the company secretarial work. This includes:

- **Board Meeting** administration.
- Preparation of the **board calendar, agendas, minutes, resolutions** and ensuring correct procedures are followed.
- **Compliance**: Ensuring that the company complies with legal requirements.
- **Statutory Registers** and Books: Maintaining documentation such as the **share register, company records, accounting records, register of charges**, and **interests register**.
- Preparing and filing **statutory returns**.

A **Deemed or Shadow Director** is a person not actually appointed as a director but who takes part in decision-making or acts as if they are a director. They may be liable for a breach of directors' obligations as if they had been duly appointed as a director. Executives, secretaries and advisors who assist boards need to ensure they do not inadvertently find themselves in this position.

An **Executive Director** is a director who is also employed by the company.

A **Resolution** is the record of the formal decision of the board.

## Performance and compliance

A director must ensure that the company resources are effectively utilised to create further value for the company. The company's resources must be expended to best attain the company's objectives – these may be profit or not for profit objectives. The board must also take steps to monitor the company's effective compliance with its legal requirements. In the case of companies, a director's obligations and minimum requirements are set out in the Companies Act 1993. Other corporates are governed by specific legislation. An Incorporated Society is incorporated under the Incorporated Societies Act 1908 and a Charitable Trust is under the Charitable Trusts Act 1957.

Other statutes also impose obligations on company directors personally. In certain cases, directors will be personally liable if the company fails to meet the statutory requirements. Statutes providing for such personal liability of directors and substantial fines include the **Resource Management Act 1991**, the **Commerce Act 1986**, the **Fair Trading Act 1986**, the **Health and Safety in Employment Act 1992** and the **Building Act 2004**. Personal liability of directors may also be **attributed** where the director undertakes personal responsibility for a company task.

## Benefits of incorporation

The main benefit of incorporation is that it limits the liability of the shareholders or owners of the company. Incorporation creates a company which is a separate legal entity, apart from the shareholders. A company may act and enter into transactions as if it were a natural person. For instance it can sign a contract and will be bound by that contract. It can sue people and be sued. The company is liable for its own actions and the shareholders will only be liable for any amount left unpaid on their **shares** or **uncalled capital**. The benefit of **limited liability** and the protection it affords to shareholders is referred to as the benefit of the **corporate veil**.

A company lives forever. This is referred to as **perpetual succession**. If a company enters into a contract, it does not need to renew or vary the contract even if there is a change in its directors or shareholders.

Directors act as the controllers, or brain, of the company and so have more onerous legal obligations than do the shareholders. The directors' legal obligations or duties set minimum standards. Directors may be personally liable if those minimum standards are not met.

## The constitution

A company may adopt a constitution if it so chooses. The constitution contains the rules by which a particular company operates. If a company does not adopt a constitution it will be governed by the standard provisions of the Companies Act 1993. A constitution allows a company to modify, restrict or extend various provisions under the Companies Act to the extent allowed by the Act.

A constitution is **registered** with the Companies Office. It is available for public viewing.

A constitution would usually:

- Include the minimum number of directors a company should have.
- Include restrictions on share sales e.g. a **pre-emptive provision** requiring that the shares must be first offered to other shareholders before being sold to a third party.
- Permit **insurance** and **indemnity** for directors.
- Allow company financing of share purchases.

Other corporates also have constitutional documents. In the case of an Incorporated Society these are normally called the **rules** while an Incorporated Charitable Trust has a **trust deed**.

## Shareholders' agreements

In addition to a constitution, often a company may have an agreement between its shareholders. This agreement is a contract between the owners of the company, or shareholders, and usually contains a full description of the rights and obligations of the shareholders. Shareholders' Agreements often contain clauses that deal with:

- The business the company is to carry out.
- Finance required by the company.
- Matters which require unanimous approval.
- Administrative matters e.g. auditors, bankers, choice of accounting period, appropriate company records.
- Restrictions on shareholders e.g. not to compete with the company.
- Dispute resolution e.g. mediation, conciliation, alternative dispute resolution, arbitration or expert determination.
- **Buy-out provisions** which describe the process for shareholders to sell their shares and may include a share valuation process.

A shareholders' agreement is particularly important in the case of a **joint venture** (JV) company. The shareholders' rights and obligations should be clearly stated in the agreement. It should also provide for the mechanism to deal with disputes between the JV shareholders. This is more efficient and cost effective than leaving disputes to be dealt with by default litigation. The shareholders' agreement must be consistent with the constitution. Unlike the constitution, the shareholders' agreement is not registered nor is it public.

## Procedural rules

A company also needs to have rules to govern its meetings. The Companies Act provides for some basic rules about meetings, for instance the requirement that a company keeps minutes and these minutes are prima facie the record of the company's proceedings.

Procedural rules may be adopted in the constitution, set out in a shareholders' agreement or adopted by the company by resolution and form the **Directors' Policies and Protocols**.

## Duties of directors

The Companies Act specifies the duties owed by the directors. In some cases, these duties are owed to the company (and so are only enforceable by the company or a receiver or liquidator of a company) and in some instances, the duties are owed to shareholders.

The Act has two underlying concepts from which all directors' obligations flow. These are that directors must:

- **Act in good faith and in the best interests of the company; and**
- **Meet a reasonable standard of care, diligence and skill when carrying out their duties.**

In addition, some specific duties owed by directors are:

- To exercise their powers for a **proper purpose** (that is, in pursuance of the company's objectives);
- To avoid **reckless trading** (that is, trading while insolvent);
- To avoid incurring certain obligations;
- To declare all **conflicts of interest**;
- To not disclose, make use of, or act on **company information** except as permitted by the Act.

## Conflict of interest

A director is interested in a transaction to which the company is a party if the director:

- Is a party to the transaction.
- May derive a material financial benefit from the transaction.
- Has a material financial interest in any other party to the transaction or has a specified indirect interest.
- Is the parent, child or spouse of another party to, or who may derive a material financial benefit from, the transaction or
- Is otherwise directly or indirectly materially interested in the transaction.

An interested director must disclose the interest and ensure that the interest is recorded in the **interests register** which the company must maintain.

The disclosure must state:

- The monetary value of the director's interest.
- The nature of that interest.
- Information on the extent of the interest.

This disclosure rule is very strict. Failing to disclose an interest can lead to avoidance of the contract by the company, recovery of any profits made by the director and/or a criminal sanction by way of a fine.

## Reliance on managers and professional advisers

The Companies Act states that the directors manage the business of the company. The board is entitled to delegate the management of the company to managers.

One of the most important duties of a board is to employ the Chief Executive Officer (CEO). It is the Chief Executive who usually employs the balance of the management staff of the company.

A director may rely on information by a competent employee, or director, or financial adviser or expert, as long as the reliance is made in good faith and the director makes proper inquiry and has no knowledge that such reliance is unwarranted.

A healthy relationship between the CEO and the Board, particularly the chair, is vital. The CEO reports to the board and with the board on the development of strategy for the company.

## Solvency certificates

In certain circumstances, the directors must each sign a **solvency certificate** certifying that the company meets the **solvency test**.

Solvency is often not easy to determine. It requires the company to demonstrate that it is able to pay its debts as they become due in normal circumstances and to certify that the value of the company's

assets are greater than the value of its liabilities, including contingent liabilities. These are known as **trading** and **balance sheet** solvency, respectively.

Failure to apply the solvency test properly when required may make a director personally liable.

The situations requiring a signed solvency certificate are:

- Distributions by the company for the benefit of a shareholder, including a dividend, and incurring a debt to or for a shareholder's benefit.
- Share repurchases.
- Share redemption options being exercised.
- Financial assistance to acquire shares is offered by the company.
- An amalgamation.

## Accountability

Directors who do not fulfil their obligations under the Companies Act are open to penalties and personal liability. The liability of a director will be determined by his or her involvement in the decision. Failing to vote on a board matter should be carefully considered as the directors are collectively responsible for any decision made by the board.

## Corporate insolvency

A director of a company which is experiencing financial difficulties must be very careful, as a director may become personally liable for the company's debts if the director allows the company to trade recklessly.

**Reckless trading** occurs where a company continues to 'trade' in a manner likely to create substantial risk of serious loss to the company's creditors.

If there is any possibility of this occurring, the board must carefully consider the consequences of continuing to trade and should seek professional advice.

## Receivership and liquidation

A **receiver** is normally appointed by the holder of a charge over a company. A charge over the undertaking of a company is called a **debenture** or **general security agreement** (under the Personal Property Securities Act 1999). A receiver, when appointed, assumes control of the company's business and the board's powers are effectively suspended. A receiver may continue to trade the company.

A **liquidator** is the equivalent of a company undertaker. A liquidator may be appointed by the Court, generally in a situation where a company is unable to pay its debts when they fall due. A company may also be put into liquidation voluntarily by resolution of the shareholders.

The liquidator winds up the company and must sell or release the assets of the company, pay its debts and return any surplus to the shareholders.

## Accepting appointment as a director

If you are asked to accept appointment as a director, you should understand the duties, responsibilities, risks and liabilities involved.

To properly understand these, you must undertake **due diligence** on the company. In some cases, this may just involve a review of the company documentation and records, including previous minutes and agendas, and a discussion with the other directors and/or shareholders.

Before accepting appointment you should:

- Consider the company's business.
- Consider the financial position of the company.
- Review minutes, agendas and board papers.
- Consider issues likely to arise with the company, such as environmental problems.
- Understand the ownership and control of the company.

- Review the board of directors and its procedures including:
  - The number of directors.
  - The regularity of the meetings.
  - The experience and reputation of the other directors.
  - The time commitment which the directorship will require.
  - The time needed to get to know the business of the company.
  - Director development policy.
  - Board evaluation policy.
  - Indemnities and directors and officers (D&O) insurance cover.
  - Other committees and commitments that will require your time.
- Consider any conflicts of interest.
- Consider the level of remuneration in relation to the risks and time involved.

## Where to from here?

This booklet outlines the main functions and responsibilities of directors. Over recent years the law has become more complex and higher standards are required of directors.

If you are a company director, want to appoint directors to your own company or have been invited to become a director, you should contact your Lawlink lawyer who will assist you to get it right.

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