

## CORPORATE

JULY 2011

## FURTHER CLARITY FOR DIRECTORS' DUTIES: *THE MOSES CASE* AND *THE STEIGRAD CASE* (AKA NATHANS AND BRIDGECORP)



**Brynn Gilbertson**  
PARTNER



**Louise Hill**  
SENIOR ASSOCIATE

Historically, there has been little judicial consideration of the liability provisions of the Securities Act 1978. This is likely to change as the courts deal with the series of prosecutions and civil actions that have arisen from the implosion of New Zealand's finance company sector. These cases will require the courts to consider the Securities Act in more detail and, in particular, they will test the extent of directors' liability for untrue statements in prospectuses and advertisements. Last week saw two important decisions in this area:

- the decision of Heath J in *R v Moses & Ors* (CRI 2009-004-1388), which arose from the collapse of Nathans Finance; and
- the decision of the Court of Appeal in *R v Steigrad* [2011] NZCA 304, which arose from the Bridgecorp collapse.

### Principles to be applied in prospectus preparation

These judgments are noteworthy for the contributions they make to the area of Securities Act liability, and the extent of directors' duties and responsibilities in the preparation and issue of offer documents. The key principles arising from these decisions for directors are:

- **Directors are responsible for offer documents:** The statutory duty for ensuring that offer documents are not misleading rests on directors of the issuer. Directors may not delegate to management responsibility for confirming that the offer document is "compliant". Directors must read the contents of an offer document and determine for themselves whether the offer document reflects the position of the company as they know it to be.
- **Directors must form an independent view:** Directors must give sufficient personal attention to the content of an offer document so as to be able to form an independent view about whether there are misleading statements in the offer document. Directors must review the content of the offer document and ask themselves whether the information conveyed presents, to a prudent but non-expert person, an accurate impression of the business and associated risks of the company. That exercise must be undertaken by excluding the director's own insider knowledge.

- **Focus is on overall impression of offer document:** In determining whether offer documents contain an untrue statement, the focus is on the overall impression gained from the offer documents and whether the investment statement and prospectus, read as a whole by a prudent but non-expert person, contain misleading statements. In considering whether those untrue statements are material, the test is whether the misleading statements are relevant to investment risk and would affect a decision to invest.
- **Board should consider offer documents as a group:** Directors should meet and consider, as a group, issues arising in the preparation of offer documents. This allows directors to turn their collective minds to the content of the documents. It is also important for directors to keep clear records of reasons for their decisions on significant issues relating to the preparation of the offer documents.
- **Executive and non-executive directors subject to same duties:** As a matter of law, no distinction is to be drawn between the roles performed in the boardroom by directors, whether executive or non-executive. Every director is required to act in good faith, in what he or she believes to be in the best interests of the company and to exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances. The degree of care, diligence and skill required depends upon the nature of the company, the nature of the decision, the position of the director and the nature of responsibilities undertaken by him or her.
- **Chairman must perform leadership role:** A chairman is not just a figurehead. His or her role involves

leadership. A chairman has the primary obligation of ensuring that the agenda for a meeting is properly formulated, guiding discussion and ensuring that the meeting is conducted efficiently and effectively.

- **Non-executive directors responsible for ensuring they have sufficient information:** A non-executive director must, in carrying out his or her duties as a director, ensure that he or she has enough information on which to make an informed decision. He or she must then apply their independent judgment, outside experience, and objectivity to all issues which come before the board, and not be subordinated to the company's operational considerations.
- **Reliance on external advisers is dependent on relevant information being provided:** In some situations, directors may be entitled to rely on external advice. However, the quality of external advice is only as good as the information provided to the professional, on the basis of which he or she is asked to advise. In addition, directors may only rely on advice to the extent that there is nothing that puts them on notice that further inquiries are required. Courts will examine the information provided to the professional adviser, and the other circumstances of the advice, to determine whether it is appropriate and reasonable for the director to rely on the advice from the external adviser.
- **Directors must monitor changes of circumstances:** Directors need to monitor statements in a prospectus or advertisement (including an investment statement) and ensure that the prospectus or advertisement is not further distributed if any statements in any such document have become

untrue by reason of a change of circumstances.

- **Reasonableness is assessed from the perspective of each director:** The court will assess reasonableness of any belief that statements in a prospectus or advertisement were true from the perspective of each individual director, based on the information available to him or her at the relevant time. The court will take a contemporary, "boardroom" approach to a director's belief and the reasonableness of that belief, rather than a financial autopsy, "courtroom" approach.

### ***R v Moses & Ors:* What is the level of responsibility of directors in preparation of prospectuses and advertisements?**

#### *Issue*

This case involved the prosecution of directors of Nathans Finance NZ Limited (**Nathans**) on several counts associated with the distribution of prospectuses and advertisements containing untrue statements. Nathans raised funds from the public through the issue of secured debenture stock and loaned money to "commercial entities". While Nathans maintained in its prospectus that it had a growing commercial lending book that included diverse sections, in fact most of the funds raised by Nathans from the public was for the purpose of providing working capital to VTL Group Limited (**VTL**). Nathans was placed into receivership on 20 August 2007 owing about \$174 million to investors.

#### *Facts and basis for charges*

The Crown brought charges against the directors of Nathans, alleging that Nathans distributed a prospectus or advertisement that contained an untrue statement. Heath

J neatly summarised the key “untrue statements” alleged to have been included in the documents distributed by Nathans: <sup>1</sup>

- misleading statements that advances to VTL and its subsidiaries had been made on a commercial arm’s length basis, normally for terms no longer than 12 months;
- omitting to disclose an expectation that each of the inter-company advances would be rolled-over on due date, with all interest being capitalised;
- omitting to disclose the true extent of VTL business-related indebtedness;
- a misleading statement that the liquidity of Nathans was supported by VTL;
- omitting to disclose a significant deterioration in the liquidity profile of the company between the financial statements for the year ended 30 June 2006 and the date of distribution of the prospectus, investment statement, extension certificate and advertisements;
- a misleading statement that Nathans had no bad debts;
- misleading statements about the standard of corporate governance, credit assessment and credit management processes that operated within Nathans; and
- misleading statements relating to the growth of a commercial lending book and diversification of lending undertaken by Nathans.

The directors argued that the statements were not misleading and that a reader of the prospectus, investment statement and advertisements would have gained a proper understanding of the position of the company and the relevant investment risks. In addition, if the statements were found to be untrue, the directors argued

that the misleading statements were immaterial, and that they had, at the relevant time, an actual belief based on reasonable grounds that the statements were true.

### *Decision*

In Justice Heath’s opinion the combination of statements and material omissions conveyed a false impression to investors about the true nature of Nathans’ business, the actual state of its financial health and the risks of the investment. The combined effect of the untrue statements in the investment statement and the prospectus conveyed the view that all financial facilities granted by Nathans to VTL had been approved and were managed under the same “robust” credit processes as applied to third parties at arm’s length from Nathans. The absence of any disclosure that loans made to VTL companies were consistently rolled over with interest capitalised was something that would undoubtedly have affected an investment decision.

After comparing what ought to have been disclosed against the impression conveyed to potential investors from the misleading statements, Heath J concluded:

*[I]t is patently unarguable that any of the misleading statements were immaterial to an investment decision and that the relevant omissions were material to what was conveyed by the statements in the offer documents. The information that was not disclosed was clearly relevant to investment risk and could well have affected a decision to invest.<sup>2</sup>*

Heath J was critical of the fact that the directors resisted the recommendation that the prospectus include disclosure of the level of related party lending as at the most recent balance date (30 June 2006), where the related party lending had increased

substantially by the date of the prospectus. Heath J described the responses from the directors to the recommendation of disclosure as reflecting a “very real tension between full disclosure to the public and the commercial imperative of “selling” the offer to the public”<sup>3</sup>. Heath J commented:

*Had a meeting (or even a more informal teleconference) been held the directors would have turned their collective minds to the content of the risk section, on the basis of appropriate information to be obtained through management. An opportunity for the directors to ensure the “Risk” section was compliant was lost. At such a meeting, the directors could have read through the two offer documents and compared the content with the position that they knew existed. Further advice could have been sought on any agreed approach, based on an updated factual position on which the lawyers could advise. The absence of a collective discussion meant that the directors “considered” the documents on an individual basis and, in my view, failed to treat the issue with the solemnity it deserved. The fault for not convening a meeting must rest primarily with the chairman of the board, Mr Moses.<sup>4</sup>*

Having found that the offer documents and advertisements did include untrue statements, Heath J considered whether each director had proved on a balance of probabilities that he had grounds for an honest belief, based on reasonable grounds, that the statements in the prospectus, investment statement and advertisement were not misleading.

Heath J accepted that the directors did honestly believe the statements in the prospectus, investment statement and advertisements to be true. However, this belief was not on reasonable grounds.

On this point, Heath J concluded that:

*Even a cursory analysis of the narrative of the investment statement and prospectus should have led the directors to the view that the impression conveyed by it was at odds with the real position, as they knew it to be. There are no reasonable grounds on which the directors could have believed that the impression conveyed by the narrative of the prospectus was not misleading.<sup>5</sup>*

### **R v Steigrad: What happens if circumstances change after a prospectus is registered?**

#### *Issue*

This Court of Appeal decision arose out of criminal charges against five directors of the Bridgecorp group currently before the High Court. One of the directors, Mr Steigrad, submitted that there was no offence under the Securities Act because a number of counts in the indictment were based on a statement in a prospectus that was correct when the prospectus was first distributed. Mr Steigrad argued that to attract criminal liability, a statement must be untrue at the time of first distribution.

#### *Facts*

Bridgecorp Limited distributed a prospectus between 7 February 2007 and 30 March 2007 which contained an untrue statement, which is that “Bridgecorp [had] never missed an interest payment or, when due, a repayment of principal”. It was accepted that when the prospectus was registered (on or about 21 December 2006), Bridgecorp had not missed an interest payment or repayment of principal. It first defaulted on or about 7 February 2007. Mr Steigrad’s position was that, because this statement was true when the prospectus was first registered, there is no offence under the criminal provisions of the Securities Act. The Crown’s position

was that because the prospectus was available to members of the public in a variety of ways and from a variety of sources between 7 February 2007 and 30 March 2007, it was continually “distributed” during this time, when the statement was untrue. The High Court judge, Venning J, reserved a question of law for determination by the Court of Appeal, relating to the meaning and effect of the requirement that an advertisement and registered prospectus be “distributed” for liability to potentially attach under the criminal provisions of the Securities Act.

#### *Court of Appeal decision*

Glazebrook J, delivering the judgment of the court, stated that whether or not there is an untrue statement in a prospectus must be judged as at the time the registered prospectus is distributed. As distribution includes individual acts of communication, this means that whether or not a statement is untrue is judged at the time of all such communications.

Accurate disclosure throughout the life of a prospectus or duration of an advertising campaign is essential to the integrity of markets for debt securities (in the case of a continuous issuer). In Steigrad, the Court of Appeal had little sympathy for Mr Steigrad’s argument that it is unfair or overly difficult for directors to monitor the continuing truthfulness of all statements made in prospectuses and advertisements. The Court of Appeal stated:

*[W]e accept the Crown’s submission that the promoters and directors of finance companies voluntarily enter the business of offering securities to the public in order to make money. Concerns about compliance costs on promoters and directors cannot be allowed to neuter what this Court has held to be the “broad statutory goal” of the [Securities] Act: facilitating “the raising of capital by securing the timely disclosure of relevant information to prospective subscribers for securities”<sup>6</sup>*

The court did not consider that its interpretation should be altered by the argument raised by Mr Steigrad’s lawyer that this interpretation could result in a director who signed a prospectus, but resigned before a statement became untrue, having committed an offence (the same could also arise in the case of a promoter who ceased to have involvement in a company after a prospectus is first distributed). The court held that either the reasonable belief of the director would be judged at the time of his or her resignation or there was likely to be a common law “no fault” defence available.

### **What next?**

#### *Further judicial guidance*

In the immediate future, we await sentencing for Nathans’ directors, Mr Moses, Mr Doolan and Mr Young, on 2 September. Offences under section 58 of the Securities Act carry a maximum penalty of five years imprisonment or fines of up to \$300,000 plus \$10,000 for every day the offence is continued.

The Financial Markets Authority’s case against the Bridgecorp directors is due to be heard in the High Court in September.

Also expect more judicial action in this area, as there are a number of prosecutions of finance company directors which are currently being pursued by the Financial Markets Authority. While some may argue that these prosecutions are the “ambulance at the bottom of the cliff”, the judgments will give all directors involved in raising money from the public important guidance that must be followed in the preparation and distribution of prospectuses and advertisements, and ultimately may result in more accurate and “timely disclosure of relevant information to prospective subscribers for securities”.

## *New securities law liability regime on the horizon*

A Bill is expected to be introduced later this year which will repeal the Securities Act and the Securities Markets Act and replace them with a new single piece of legislation. As part of this overhaul of New Zealand's securities legislation, the Government is proposing to adopt a comprehensive liability regime that contains an escalating hierarchy of liability which will focus on civil remedies and obtaining compensation for investors. The regime is to be designed so that only egregious violations of securities laws would be the subject of serious criminal offences. This includes specific proposals to make egregious breaches of directors' duties subject to criminal liability and publicly enforceable by the Financial Markets Authority and the Registrar of Companies. Whether these proposed changes will be affected by the finance company cases currently before the courts remains to be seen. However, whatever form the liability regime ends up taking, it is likely that the decisions arising from these cases will have continued relevance for directors and the manner in which they exercise their duties and responsibilities.

To view all our publications or update your details please visit our website:

[www.bellgully.com](http://www.bellgully.com)

For further information, please contact your usual Bell Gully adviser or:

**Brynn Gilbertson**

64 9 916 8948

[brynn.gilbertson@bellgully.com](mailto:brynn.gilbertson@bellgully.com)

**Louise Hill**

64 9 916 8788

[louise.hill@bellgully.com](mailto:louise.hill@bellgully.com)

#### FOOTNOTES

---

1 *R v Moses & Ors* at [24].

2 *R v Moses & Ors* at [226].

3 *R v Moses & Ors* at [174].

4 *R v Moses & Ors* at [185].

5 *R v Moses & Ors* at [429].

6 *R v Steigrad* at [114].

Disclaimer: This publication is necessarily brief and general in nature. You should seek professional advice before taking any further action in relation to the matters dealt with in this publication.

All rights reserved © Bell Gully 2011