BELL GULLY

SUBMISSION

to the

Economic Development, Science and Innovation Select Committee

on the

Companies (Directors Duties) Amendment Bill

JANUARY 2023

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BELL GULLY

Introduction

Bell Gully welcomes the opportunity to make a submission on the Companies (Directors Duties) Amendment Bill (the **Bill**). Bell Gully is a leading New Zealand law firm. We regularly advise New Zealand's largest listed and unlisted companies on matters of corporate governance.

The views expressed in this submission are those of a number of our partners with relevant experience. They do not necessarily represent the views of our clients.

Summary of our submission

- **Inadequate problem identification:** We question whether there is an identified problem that the proposed change would solve. We understand the purpose of the Bill is to make clear that a director "can take actions which take into account wider matters other than the financial bottom-line".[1] In our opinion, there is no current issue with directors doing so, including by having regard to environmental, social, and governance (**ESG**) considerations when acting in what they believe to be the best interests of the company. This is also consistent with our experience in practice.

- **Risk of unintended consequences:** Although well-meaning, there is a risk of unintended consequences associated with the Bill. These include an increased litigation risk for corporate directors by creating a potential foothold for legal challenges to directors' business judgment; the possible emergence of a "check-box" mentality in board decision making; and increased compliance costs.

- **Suggested amendments:** If the Bill is to proceed, it would be desirable to make certain drafting changes, including:

    - aligning the wording of the draft subsection with subsection 131(1) of the Companies Act 1993;

    - removing the word "recognised", which may inadvertently undermine the good faith, subjective business judgment inherent in section 131; and

    - clarifying that the listed considerations are not exhaustive and that there is no particular hierarchy among those listed considerations.

Contact details

If the Select Committee, or officials, have any questions concerning this submission or would like us to elaborate on any aspect of it, please contact:

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[1] Companies (Directors Duties) Amendment Bill 2021 (75-1), explanatory note.

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1. Inadequate problem identification

1.1 The stated purpose of the Bill is to make "clear that a director, in acting as the mind and will of the company, can take actions which take into account wider matters other than the financial bottom-line".

1.2 If enacted in its current form, the revised duty would specifically identify a range of stakeholder interests – described as "recognised environmental, social and governance factors" – that directors may take into account when determining the best interests of the company. These include: the principles of Te Tiriti o Waitangi, environmental impacts, standards of ethical behaviour, fair and equitable employment practices, and the interests of the wider community.

1.3 However, as a matter of law, we do not consider that there is any current issue with directors taking into account such matters when acting in what they believe to be the best interests of the company.

1.4 Section 131 of the Companies Act 1993 requires company directors, "when exercising powers or performing duties", to "act in good faith and in what the director believes to be the best interests of the company". The section was enacted as part of the original version of the Companies Act and came into force on 1 July 1994.

1.5 The reference to "the best interests of the company" generally requires the directors to assess and act in the best interests of the shareholders as a whole (i.e., shareholder primacy).[2] In interpreting that duty, the courts generally recognise a broad discretion for directors to exercise their business judgment as to what constitutes the best interests of the company.

1.6 We understand from the legislative materials that the proposed Bill is not intended to change the overall paradigm from the current focus on the best interests of the company. Rather, the legislative materials suggest that the purpose is merely clarificatory in relation to the factors that a director may consider. Any broader revision of the company governance model would require much more comprehensive discussion and debate than is possible in the context of the Bill.

1.7 In its 1987 preliminary paper that ultimately led to the Companies Act, the Law Commission recognised that the courts had imposed fiduciary duties upon directors, including to "act honestly and in good faith for proper purpose and in the best interests of the company".[3] The Law Commission stated that the definition of the "best interests of the company" was especially "critical" where it came to decisions "made in the long term interest of the entity (for example, decisions to benefit employees or to benefit the communities in which the company operates)".[4] The question was also said to be context-specific with the Law Commission stating that the "range of interests which affect the benefit to the commercial entity will of course have to be determined in the context of the particular commercial enterprise".[5] Therefore, from the early days of the Companies Act reform, the Law Commission envisaged that the section 131 duty involved more than just profit maximisation and in some cases the interests of the company could equate with "benefit [to] the communities in which the company operates".

1.8 This analysis was carried through in its subsequent reports. In 1989, the Law Commission's primary report, *Company Law Reform and Restatement*, downplayed the distinction between the interests of the commercial entity and the interests of the company's shareholders in stating:[6]

> *Since it has been held that the collective shareholders include future shareholders, identification of the company with the enterprise may have been largely achieved in law. The uncertainty does, however, mean that there is considerable scope for directors to rationalise decisions which are against the interests of existing shareholders.*

1.9 The Law Commission stated that it did not wish to be "dogmatic about these questions of theory" and instead relied upon the distinction between who could enforce the rights – with shareholders only able to enforce rights

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2 *Madsen-Reis (as liquidators of Debut Homes Limited (in liquidation)) v Cooper* [2021] 1 NZLR 43, [2020] NZSC 100 (***Debut Homes***) at [28].

3 Law Commission *Company Law* (NZLC PP5, 1987).

4 Law Commission *Company Law* (NZLC PP5, 1987) at [206].

5 Law Commission *Company Law* (NZLC PP5, 1987) at [206].

6 Law Commission *Company Law Reform and Restatement* (NZLC R9, 1990) at [189].

directly against directors on certain matters where "shareholder interest is particularly at risk".[7] Ordinarily, only the company itself can bring a claim against a director for breach of section 131.

1.10 The long title of the Companies Act, as enacted, also records "the value of the company as a means of achieving economic and social benefits" and allows directors "a wide discretion in matters of business judgment".

1.11 The Supreme Court in the *Debut Homes* case has recently confirmed that the test of the best interests of the company is a subjective one, and one which acknowledges the business judgment of directors. The Court noted that the courts are "not well equipped… to second-guess the business decisions made by directors in what they honestly believed to be in the best interests of the company".[8] However, the Court also said that a director cannot subjectively believe they are acting in the best interests of the company "if they have failed to consider the interests of the company".[9]

1.12 In our opinion, there is no New Zealand authority that holds that directors cannot consider wider stakeholder interests as part of their consideration of the best interests of the company. In our view, directors can – and, in our experience, already do – take into account the interests of employees, customers and suppliers, and the community through the lens of the company's best interests. That is because directors are given the latitude, through a subjective test and acknowledgement of business judgment, to consider what they believe to be the company's best interests, including by taking a long-run view of the company's interests.

2. Risk of unintended consequences

2.1 As noted above, we understand that the Bill is not intended to shift the paradigm from the best interests of the company towards a stakeholder model. Nevertheless, in its current form, there is a risk that the proposed amendments may give rise to unnecessary compliance costs and unintended, adverse consequences for New Zealand directors and the companies they govern.

2.2 First, the Bill is likely to increase litigation risk for company directors by creating a potential foothold for challenges to the exercise of business judgment. Although the Bill is expressed as being merely for the avoidance of doubt, in our view, consistent with traditional rules of interpretation that Parliament acts deliberately and does not legislate for no purpose, the courts may give the Bill some more substantive effect. We see a risk that a court might interpret the express permission for directors to consider the "recognised" factors as suggesting an implicit hierarchy of considerations relevant to the best interests of the company or as suggesting that, in some circumstances, a director must take into account such factors as relevant considerations. This may give rise to the risk of liability for boards of directors that cannot evidence that they sufficiently considered such factors in the context of otherwise good faith decision-making.

2.3 Second, as a matter of practice, some boards may guard against litigation risk by adopting a "check-box" mentality to their consideration of the listed factors in sub-clause (5)(a)-(e) of the Bill. This may have the effect of undermining the quality of decision-making by boards, introducing unnecessary prescription to business judgment and creating a rigid, unhelpful hierarchy of corporate priorities by reference to the statutory factors.

2.4 Third, we foresee that companies will incur costs to ensure their compliance with the Bill, including director training on the content of the amendments; preparing agendas of board meetings that consider each of the listed factors; drafting board resolutions and minutes of board meetings to record consideration, as applicable, of the listed factors; and potentially, drafting lengthier annual reports to address these factors explicitly. In our view, these costs may be disproportionate for smaller companies.

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7 Law Commission *Company Law Reform and Restatement* (NZLC R9, 1990) at [190]-[191].

8 *Debut Homes* at [112].

9 *Debut Homes* at [114].

3. Position in other jurisdictions

3.1 A number of other jurisdictions have considered or adopted amendments to directors' duties provisions. A proper review of directors' duties in New Zealand would allow for different models in comparable jurisdictions to be explored.

3.2 For example, in the United Kingdom, section 172(1) of the Companies Act 2006 (UK) both explicitly adopts a shareholder primacy model and then goes on to impose an obligation on directors to have regard to certain stakeholder interests. That section states:

> *A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—*
>
> *(a) the likely consequences of any decision in the long term,*
>
> *(b) the interests of the company's employees,*
>
> *(c) the need to foster the company's business relationships with suppliers, customers and others,*
>
> *(d) the impact of the company's operations on the community and the environment,*
>
> *(e) the desirability of the company maintaining a reputation for high standards of business conduct, and*
>
> *(f) the need to act fairly as between members of the company.*

3.3 Since 2018, certain UK companies have also been obliged to issue an annual "section 172(1) statement" to describe "how the directors have had regard to the matters set out in section 172(1)(a) to (f)" when performing their best interests duty.

3.4 On the other hand, Canada has adopted a similar permissive approach to the proposed amendment in the Bill (i.e. purporting to list factors that directors ***may*** consider). In 2019, section 122 of the *Canada Business Corporations Act* was amended by adding the following after subsection (1):

> *When acting with a view to the best interests of the corporation under paragraph (1)(a), the directors and officers of the corporation may consider, but are not limited to, the following factors:*
> *(a) the interests of*
>
> *(i) shareholders,*
>
> *(ii) employees,*
>
> *(iii) retirees and pensioners,*
>
> *(iv) creditors,*
>
> *(v) consumers, and*
>
> *(vi) governments;*
>
> *(b) the environment; and*
>
> *(c) the long-term interests of the corporation.*

3.5 Notably, similar reforms have been considered, but not advanced, in Australia. For example, both the Parliamentary Joint Committee on Corporations and Financial Services and the Corporations and Markets Advisory Committee concluded that there was no compelling case to amend directors' duties to include either a permissive clause (permitting directors to take account of the interests of stakeholders other than shareholders), or a positive clause (requiring directors to take account of the interests of stakeholders other than shareholders).[10]

3.6 Recent analysis in Australia has also concluded that the "best interests" duty already creates sufficient discretion for directors to consider relevant facts and circumstances. In July 2022, the Australian Institute of Company Directors (**AICD**) issued guidance (by way of a practice statement) on how directors can discharge

[10] Australian Parliamentary Joint Committee on Corporations and Financial Services *Corporate responsibility: Managing risk and creating value* (21 June 2006); Corporations and Markets Advisory Committee *The Social Responsibility of Corporations* (December 2006).

their "best interests" duty with respect to stakeholders.[11] That practice statement was supported by a legal opinion prepared by Sydney barristers Bret Walker AO SC and Gerald Ng.[12] That opinion concluded that the best interests duty "permits directors considerable latitude" and there is no reason directors "could not have regard to the interests of customers, employees and the community more generally, provided that there is a rational justification for doing so by reference to the long-term interests of the company, including its interest in avoiding reputational harm".

3.7 A leading Australian law firm, Allens Linklaters, also reviewed the formulation and operation of the best interests duty in Australia, and compared that duty with the equivalent duty in the key comparator jurisdictions of Canada, Delaware, New Zealand and the United Kingdom.[13] Allens Linklaters ultimately concluded that an express requirement to consider additional stakeholders has little practical influence on directorial decision-making.

3.8 We consider that the adoption of varying approaches by other common law jurisdictions supports a more detailed consideration of the best approach to be adopted in New Zealand. That would require broader consultation and engagement from law reform bodies, industry bodies, the legal profession, and officials, among others.

3.9 For the reasons set out above, we submit that the Select Committee should recommend that the Bill be rejected.

4. Suggested amendments

4.1 If the Select Committee is minded to recommend that the Bill proceed, we submit that several amendments should be made to the Bill.

4.2 We suggest the following amendments, as shown in marked-up form in the appendix to our submission:

(a) We suggest aligning the wording of the draft subsection with subsection 131(1). As currently drafted, the expression "when determining the best interests of the company" suggests that there may be only one correct view as to what the best interests of the company are. This is inconsistent with the current wording of section 131 and the courts' interpretation of the duty.

(b) We suggest removing the reference to "*recognised*" standards. It is unclear what this means and it is inconsistent with the subjective nature of the duty under section 131 of the Companies Act. It would be inconsistent with the history and past judicial interpretations of section 131 to import objective standards for what directors may take into account. We think that the word "recognised" is likely to create uncertainty and conceptual confusion.

(c) We suggest adding language which makes it clear that the listed considerations are not exhaustive and that there is no particular hierarchy among the matters listed. We consider that our proposed wording better captures what we understand to be the purpose of the Bill.

Once again, we thank the Committee for the opportunity to submit on this Bill.

Bell Gully

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11 Australian Institute of Company Directors *Directors' "best interests" duty in practice* (July 2022) available at: https://www.aicd.com.au/content/dam/aicd/pdf/tools-resources/director-tools/board/directors-best-interests-duty-in-practice-web2.pdf

12 Brett Walker and Gerald Ng *The Content of Directors' "Best Interest" Duty* (24 February 2022) available at: https://www.aicd.com.au/content/dam/aicd/pdf/news-media/research/2022/AICD-walker-opinion-feb-2022.pdf

13 Allens Linklaters *Directors' and Officers' Duties: Evaluation of the 'best interests' duty* (26 May 2022) available at: https://www.aicd.com.au/content/dam/aicd/pdf/news-media/research/2022/Allens-research-the-best-interests-duty-26-05-2022.pdf

APPENDIX: Marked-up proposed amendments to the Bill

Section 131 amended (Duty of directors to act in good faith and in best interests of company)

After section 131(4), insert:

(5) To avoid doubt, a director of a company may, when ~~determining~~ acting in what the director believes to be the best interests of the company, take into account ~~recognised~~ environmental, social and governance factors, including, but not limited to and in no particular order of priority, the following ~~such as~~:

(a) recognising the principles of the Treaty of Waitangi (Te Tiriti o Waitangi);

(b) reducing adverse environmental impacts;

(c) upholding high standards of ethical behaviour;

(d) following fair and equitable employment practices;

(e) recognising the interests of the wider community.

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