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Corporate Governance

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What is corporate governance?

Introduction

Corporate governance is the general reference to all the issues facing directors and boards in directing and governing corporates. It is the systems, processes and rules within and by which a company is directed and controlled.

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.

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.

A person is disqualified from being a director if they are:

- Under 18 years of age.
- An undischarged bankrupt.
- Prohibited from directing, promoting or participating in the management of a company or of an incorporated or unincorporated body under various statutes.
- Prohibited from being a director/partner of an overseas company or overseas limited partnership.
- Subject to property orders under the Protection of Personal and Property Rights Act 1988.

The Companies Act provides that a director includes not only a person formally appointed as a director but also a person in accordance with whose directions an appointed director/a board is accustomed to act, a person who exercises or is entitled to exercise control of powers which a board should exercise, and in certain circumstances, a person to whom powers/duties have been delegated by a board. A person who fills these roles may be liable for a breach of directors' obligations as if they had been duly appointed as a director. Executives, secretaries and advisers who assist boards need to ensure they do not inadvertently find themselves in this position.

A further requirement is that all companies must have at least one director who either:

- Lives in New Zealand; or
- Lives in an enforcement country (as set by regulations) and is a director of a company in that enforcement country.

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 company's 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 company's constitution. The appointment process is governed by that constitution.

The board of directors (the board) consists of the chairperson 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 company's constitution or otherwise is by ordinary resolution of the board.

The chair may be considered to have higher responsibilities than other board members. These 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 company's constitution provides for it. In larger companies and public companies, the chair may be a non-executive or independent director.

The company secretary was a role recognised under the previous Companies Act 1955, but it is not required under the Companies Act 1993. However, secretarial tasks that still need to be undertaken (sometimes by the company's accountant or lawyer) include:

- 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.

An executive director is a director who is also employed by the company.

A resolution is the record of a formal decision of the board.

Performance and compliance

A director must ensure that the company's 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 such as incorporated charitable trusts and incorporated societies are governed by specific legislation.

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 at Work Act 2015 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 incorporating a company is that it limits the liability of the shareholders or owners of the company. Incorporation creates a company which is a separate legal entity, distinct from its 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, then unless expressly required by the terms of the 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 the company's 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:

- Specify the minimum number of directors the company must have.

- Include restrictions on share sales e.g. a pre-emptive rights 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.
- Specify whether directors can appoint alternate directors to act in their absence.

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, a company may also have an agreement with its shareholders. This agreement is a contract between the company and the owners of the company, (i.e. the company's shareholders), containing a full description of the shareholders' rights and obligations. Unlike constitutions, shareholders' agreements are private documents that are not included in the company's public records. 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.
- Dividend policies.

A shareholders' agreement is particularly important in the case of a joint venture (JV) company. The shareholders' rights and obligations in the

JV 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 litigation.

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.

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.

These duties include that directors must:

- Act in good faith and in what the director believes to be the bests interests of the company.
- When exercising powers or performing duties as a director, exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances taking into account factors such as the nature of the company, the decision and the responsibilities undertaken.
- Exercise their powers for a proper purpose (that is, in pursuance of the company's objectives).
- Avoid reckless trading (that is, not to allow the company to carry on business likely to create a substantial risk of serious loss to creditors).
- Avoid incurring obligations unless the director believes the company will be able to perform the obligations.
- Declare all conflicts of interest.

- Not disclose, make use of, or act on company information except as permitted by the Companies Act.
- Comply with any legal obligations imposed on them by legislation, which will include obligations imposed on all company directors (such as those in the Health and Safety at Work Act 2015) and those imposed due to the particular nature of the company's activities (such as obligations imposed on financial institutions by the Anti-Money Laundering and Countering Financing of Terrorism Act 2009).
- Comply with all their obligations under the Companies Act and the company's constitution.

Directors can be liable for conviction and fines for failing to comply with their obligations under the Companies Act (such as a failure to properly use the company name or acting as a director of a 'phoenix company'). Directors can also face significant criminal charges if they exercise powers/perform duties in bad faith, believing the conduct is not in the best interests of the company and knowing the conduct will cause serious loss to the company, or if they act with an intent to defraud creditors.

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 personally 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/de facto partner 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 to the board 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; and
- The nature and extent of that 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 CEO 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 professional 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 works 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 include:

- 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; and
- An amalgamation.

Accountability

Directors who do not fulfil their obligations under the Companies Act of other legislation 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 security interest over a company. A security interest is an interest in property created by agreement such as a general security agreement or terms of trade, or by operation of law. 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, by resolution of the directors on the occurrence of an event specified in the constitution or by resolution of creditors at a watershed meeting (in accordance with the Companies Act).

The liquidator winds up the company and must sell or realise the assets of the company, pay the company's 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's 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;
- Review the company's constitution, if it has one;
- Consider issues likely to arise with the company, such as environmental problems and health and safety risks;
- 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;
    - Legal compliance policies;
    - Indemnities and directors and officers (D&O) insurance cover;
- Consider any conflicts of interest; and
- Consider the level of remuneration in relation to the risks and time involved.

Health and safety obligations

Directors have specific duties under the Health and Safety at Work Act 2015. Directors are personally liable for breach of these duties and can face fines and, in serious cases, imprisonment. Directors must exercise due diligence to ensure their company takes all steps which are reasonably able to be done to ensure the health and safety of the company's workers. The obligation includes taking steps to protect workers' mental health as well as their physical health and safety. In assessing what is reasonably able to be done by the company, relevant factors include the likelihood of a hazard or risk occurring, the degree of harm that might result, what the director knew or reasonably knew about the hazard or risk, ways to eliminate or minimise the risks, and whether the cost of doing so is grossly disproportionate to the risk.

To comply with their health and safety due diligence obligations, directors should:

- Obtain independent expert advice and training as needed.
- Prepare a board charter that outlines the board's commitment to health and safety and update the charter periodically.
- Understand the company's operations, regularly visit the site/s of operation, understand the hazards and risks associated with the operations and ensure there are controls in place to manage those hazards and risks.
- Ensure the company allocates adequate resources and expertise to implement, develop and maintain the health and safety management programme.

- Hold senior management to account for health and safety by developing specific targets, implementing stringent reporting requirements and including health and safety objectives in KPIs.
- Monitor the company's health and safety performance track record and periodically review the company's policies and processes to ensure best practice.

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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Lawlink members

Whangarei
Webb Ross McNab Kilpatrick
Ph: 09 470 2400
Also at Dargaville and Kerikeri
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Warkworth
Webster Malcolm Law
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www.webstermalcolm.co.nz

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www.al.nz

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Also at Paeroa
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www.pittandmoore.co.nz

Richmond
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www.pittandmoore.co.nz

Blenheim
Gascoigne Wicks
Ph: 03 578 4229
Also at Kaikoura (Fridays)
www.gascoignewicks.co.nz

Christchurch
Wynn Williams
Ph: 03 379 7622
www.wynnwilliams.co.nz

Anderson Lloyd
Ph:03 379 0037
www.al.nz

Timaru
Timpany Walton
Ph: 03 687 7126
www.timpanywalton.co.nz

Alexandra
AWS Legal
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www.awslegal.com

Cromwell
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