LEGISLATION DESIGN AND ADVISORY COMMITTEE

21 December 2022

Jamie Strange MP
Economic Development, Science and Innovation Committee
Parliament Buildings
Wellington 6160

Dear Mr Strange,

Companies (Directors Duties) Amendment Bill

Introduction

1. The Legislation Design and Advisory Committee (**LDAC**) is mandated by Cabinet to scrutinise Bills against the *Legislation Guidelines* (2021 Edition) (**Guidelines**). The Guidelines have been created to promote legislation that is well designed and accords with fundamental legal and constitutional principles.

2. The LDAC's focus is not on policy, but rather on legislative design and the consistency of a Bill with the principles contained in the Guidelines.

3. For the reasons set out below, LDAC recommends that the Companies (Directors Duties) Amendment Bill (the **Bill**) does not proceed. We consider that the Bill is unnecessary law, has an unclear purpose, and does not interact with the existing body of law in a coherent way. In this context, there is a significant risk that the Bill will create unintended and unforeseen consequences that outweigh any potential benefits of the change.

The Bill is unnecessary

4. Legislation Guideline 2.3 states that "*Legislation should only be made when it is necessary and is the most appropriate means of achieving the policy objective*." The Cabinet manual also states that Ministers and departments must ensure that unnecessary new legislation is avoided.[1]

5. The rationale against unnecessary legislation is twofold:

   5.1. *Legislating involves significant cost:* Legislation incurs enactment and compliance costs. Enactment costs include both the financial costs to submitters, and the time of the House and select committee. Compliance costs include the cost of affected parties changing processes and obtaining legal advice as to the potential impacts of the change to legislation (both at the time of legislation and on each relevant occasion post-enactment).

   5.2. *Legislation can have unforeseen and unintended consequences:* All new legislation may be interpreted in a manner that was not intended by Parliament or may cause the law to develop in an unforeseen manner. These risks can easily outweigh the benefits, particularly if the intention is to clarify a matter on which there is no real doubt.

[1] Cabinet Manual 2017 at 7.23.

6. The Bill seeks to insert a provision "To avoid doubt". It does not appear to intend to change the law – it only seeks to clarify on the aspects provided for.

7. The matter it seeks to clarify is that a company director may take actions that take into account wider matters than the financial bottom-line. It purports to achieve this by adding a subsection to section 131 of the Companies Act 1993 (the **current Act**) that expressly states that a company director may take into account "*recognised environmental, social and governance factors*" (**ESG factors**) when determining the best interests of the company. The subsection goes on to identify the principles of te Tiriti o Waitangi, environmental impacts, good corporate ethics, being a good employer, and the interests of the wider community as being such factors.

8. LDAC considers that such a "clarification" is unnecessary at best. We have not seen commentary to suggest that a director is unable to consider these matters, and as far as LDAC members are aware directors do so where they consider it fit. Indeed, the Bill's own explanatory note records that the current practice is to take this wider approach. The explanatory note states that:

> *This accords with modern corporate governance theory that recognises that corporations are connected with communities, wider society, and the environment and need to measure their performance not only in financial terms, but also against wider measures including social, and environmental matters.*

9. LDAC is unaware of any provision in the current Act, or of any decision of the courts, that would limit the "best interests of the company" to financial bottom lines. As stated in the textbook *Company & Securities Law in New Zealand*[2] (emphasis added):

> …in the existing law there is no legal obligation on New Zealand boards to prioritise the interests of shareholders. Shareholder primacy is no more than a legal norm. The first objective of the [Companies Act 1993], in its long title, is:
>
> "(a) *to reaffirm the value of the company as a means of achieving economic* ***and social benefits*** *through the aggregation of capital for productive purposes, the spreading of economic risk, and the taking of business risks*."

10. In addition, the Law Commission report[3] that led to the current Companies Act 1993 noted:

> A profit purpose is at least a measure against which the best interests of the company can be weighed. Interestingly enough, however, none of the statutes we have seen impose a profit-maximising purpose on companies and, indeed, very often it would be misleading to assume such a purpose. … The Law Commission has concluded that for New Zealand circumstances a statute covering both business and other companies is appropriate. …

11. The Law Commission report demonstrates that, from its inception, the best interests duty has never been restricted to profit maximisation.

The Bill increases uncertainty

12. As the law currently stands, section 131 requires each individual director to act in what they believe to be the best interests of the company. In other words, whether a director has acted in good faith and in the best interests of the company turns on the director's subjective belief about the specific circumstances facing the company. In practice, the interests of a company,

[2] *Company & Securities Law in New Zealand*, Farrar and Watson (online ed, Thomson Reuters) at 16.18.4.3.
[3] Company Law Reform and Restatement, Law Commission, Report No 9.

its long-term success and the satisfaction of shareholders will often involve directors taking into account wider factors similar to those highlighted by the Bill.

13. The Supreme Court in *Madsen-Ries v Cooper* [2020] NZSC 100 confirmed that the standard to be applied under s 131 is subjective:

> [109] The obligation in s 131(1) to act in the best interests of the company is expressed subjectively: the director must act 'in what the director believes to be the best interests of the company'. If it is a subjective test, as the wording would suggest, this would mirror the position at common law. It does not detract from the subjective nature of the test that directors will probably have a hard task persuading the court that they honestly believed that an act or omission that resulted in substantial and foreseeable detriment to the company was in the company's best interests. Under a subjective test, the fact that an allegedly unreasonable belief was held may, however, provide evidence that the belief was not honestly held.

14. As LDAC understands it, the proposed amendment does not seek to change this approach.

15. However, by including a list of selected ESG factors that a director may take into account, the Bill elevates those select factors. In doing so, the Bill risks undermining the subjective nature of the test and creates uncertainty around how directors ought to assess the best interests of the company. In particular, LDAC notes the potential for uncertainty introduced around:

    - whether and what non-ESG factors can be considered;
    - whether, in some circumstances, a director may be required to take into account one or more of the ESG factors (*see* more on this below)
    - the respective weight factors on the list should be given, especially compared to factors not on the list; and
    - what the factors on the list actually mean in reality for directors.

16. As noted above, the courts may consider that an "unreasonable belief" provides evidence that a belief was not honestly held. While *new section 131(5)* provides that the ESG factors *may* be taken into account, directors may have doubt about whether they *ought* to have regard to these ESG factors in order to forestall an argument that they are not acting in the best interests of the company. That is, the provision creates uncertainty about when (if ever) a director has a duty to take into account one or more of these factors.

17. It is also unclear what is meant by "recognised" ESG factors. Does this limit the ESG factors to those listed? If not, who determines what a recognised factor is and what test do they apply? To what extent does the concept of "recognition" imply an objective test that is inconsistent with the subjective test referred to by the courts?

Defining the policy objective and purpose of proposed legislation

18. Chapter 2 of the LDAC Guidelines notes that the objective of a Bill is its backbone. The policy objective must be clearly defined and discernible, and the provisions of the legislation should be consistent with that objective.

19. The Law Commission has noted that:

> In accepting that internal regulation is the proper focus of a Companies Act, we have also taken the view that a Companies Act is not the appropriate vehicle for imposition of general social

> reforms such as a requirement of worker participation in management or the imposition of environmental goals upon companies. These matters should be pursued through specific legislation imposed upon all employers and business enterprises.[4]

20. LDAC is uncertain about whether the policy objective of the Bill includes promoting the wider social purposes implicit in the list of ESG factors. LDAC agrees with the Law Commission that social objectives or general social reform should be imposed by particular statutes (and only following a careful policy process).

Interactions with existing legislation

21. Chapter 3 of the LDAC Guidelines requires any conflict or interactions between new and existing legislation to be explicitly addressed in the new legislation. Further, new legislation should not restate matters already addressed in existing legislation.

22. The Companies Act 1993 contains numerous tests relating to whether a particular matter is in the best interests of the company.[5] It is unclear how the Bill interacts with these tests. Section 138A contains an offence where a director exercises powers or performs duties in bad faith towards the company and believing that the conduct is not in the best interests of the company. *New section 131(5)* presumably is intended to apply here, but this interaction is unclear.

23. It is also unclear whether the factors listed in the *new section 131(5)* are able to be considered by a director when taking into account the interests of a holding company under section 131(2)-(4).

24. It will be important to consider other impacts that changing the best interests test might have on existing legislation. For example, section 54 of the Incorporated Societies Act 2022 imposes a similar duty on officers of societies, but it is unclear whether the same factors would apply. Another example is the Financial Markets Conduct Act 2013, which relies on the best interests test in section 396(f).

25. In many cases, existing legislation already relates to some of the ESG factors (for example, the Resource Management Act 1991, the Health and Safety at Work Act 2015 and the Employment Relations Act 2000). The interaction with that other legislation is uncertain.

Unforeseen development of the law

26. An additional area of concern is whether the addition of specific ESG factors may result in the development of the law in an unforeseen way. The Companies Act seeks to:

    26.1. make it clear that directors' duties are owed to the company and not to shareholders;

    26.2. provide for limited rights for shareholders to bring derivative actions in the name of the company; and

    26.3. set out specific circumstances where a contravention of a duty gives rise to criminal offences.[6]

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[4] Para 19 of Law Commission Report No 9.

[5] *See* sections 60, 61, 65, 69, 71, 76, 78, and 221 of the Companies Act 1993.

[6] Companies Act 1993, Sections 169, 163 and 138A.

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27. LDAC considers that there is at least a possibility that the addition of specific ESG factors as relevant considerations for directors could encourage the evolution of judicial review into the realm of individual director decision-making (a suggestion the courts have always been clear to avoid) – or at least an attempt to. We note the context of a worldwide trend for citizens to bring actions against companies that are perceived to act contrary to ESG factors. While development is speculative – and even potentially desirable – we simply wish to illustrate the potential for unforeseen development of the law.

Recommendation

28. LDAC recommends that this Bill does not proceed, on the basis that it is unnecessary legislation with an unclear purpose and an uncertain interaction with other legislation. In this context, LDAC considers that the Bill presents a risk of unintended and unforeseen consequences.

29. If the Bill does proceed, LDAC recommends that the Committee pays careful attention to the matters addressed in this letter in order to avoid unintended consequences.

30. Thank you for considering our submission. We would like to be heard in person.

Yours sincerely

Mark Steel
Chair
Legislation Design and Advisory Committee