IN THE HIGH COURT OF NEW ZEALAND
CHRISTCHURCH REGISTRY

CRI-2015-409-000060
CRI-2015-409-000061
[2016] NZHC 4

BETWEEN		MARK JOSEPH SCHROEDER JUSTIN WILLIAM PRAIN Appellants
AND		FINANCIAL MARKETS AUTHORITY Respondent

Hearing: 29 September 2015

Appearances: P B McMenamin for Appellants
D Robinson for Respondent

Judgment: 11 January 2016

JUDGMENT OF DUNNINGHAM J

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[1] Mr Schroeder and Mr Prain were directors of Apple Fields Limited (AFL). They were charged by the Financial Markets Authority (FMA) with failing to deliver financial statements and an auditor's report to the Registrar of Companies for the financial years ending 2011, 2012 and 2013.[1] Their obligations in that regard are undisputed.

[2] However, they rely on the statutory defence set out at s 40 of the Financial Reporting Act 1993 (the Act). It provides:

> **40 Defences**
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> It is a defence to a director of an entity charged with an offence under any of sections 36 to 39 of this Act if the director proves that—

[1] As required by ss 18 and 38(b) of the Financial Reporting Act 1993.

> (a) the directors of the entity took all reasonable and proper steps to ensure that the applicable requirement of this Act would be complied with; or
>
> ...

[3] In the District Court, Judge Smith did not accept the appellants could avail themselves of the statutory defence.[2] She concluded that they had not established, on the balance of probabilities, that they had taken all reasonable and proper steps to ensure the financial statements and auditor's reports were delivered to the Registrar within the prescribed timeframe for the relevant accounting periods. She sentenced each appellant to a fine of $30,000.

[4] The appellants have abandoned their appeal against sentence, but maintain that, in the circumstances faced by them, they had taken all reasonable and proper steps to comply with the requirements of the Act, and their defence to the charges should succeed.

[5] The sole issue, therefore, is whether the defence set out at s 40(a) has been established. The onus is on the appellants.

The statutory framework

[6] The District Court judgment sets out the relevant provisions of the Act. In summary, the obligations the appellants were under are found in s 13 of the Act.[3] That section provides:

> **13 Obligation to prepare group financial statements**
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> (1) Subject to subsection (2) of this section, the directors of a reporting entity that has, on the balance date of the entity, one or more subsidiaries, must, in addition to complying with section 10 of this Act, ensure that, within 5 months after that balance date or, where the entity is required by any other Act to prepare group financial statements or group accounts within a shorter period after the end of its financial year or balance date, within that period, group financial statements that comply with section 14 of this Act are—

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2 *Financial Markets Authority v Prain* [2015] NZDC 2319.

3 Although s 10 was also referred to, that relates to a single reporting entity. Because AFL had subsidiaries, group financial accounts were required and s 13 applied to it.

(a) completed in relation to that group and that balance date; and

(b) dated and signed on behalf of the directors by 2 directors of the entity, or, if the entity has only 1 director, by that director.

(2) Group financial statements are not required in relation to a reporting entity that is a company [if, on the balance date of the company, the company is not an issuer and the only shareholders of the company] comprise [a reporting entity that is]—

(a) a body corporate that is incorporated in New Zealand or a nominee of such a body corporate; or

(b) a body corporate that is incorporated in New Zealand or a nominee of such a body corporate and a subsidiary of such a body corporate or a nominee of such a subsidiary.

Under s 18, the directors of AFL were then required to deliver the signed financial statements and auditor's report to the Registrar for registration.

[7] It is not disputed that AFL was a reporting entity for the purposes of the Act and, under s 14,[4] the financial statements produced were required to:

(a) comply with generally accepted accounting practice;[5] and

(b) if the statements, by complying with generally accepted accounting practice, did not give a true and fair view of matters to which they relate, the directors had to "add such information and explanations as will give a true and fair view of those matters".

[8] The offences with which the appellants were charged arise under s 38 of the Act. Section 38 provides:

38 Offences by directors of issuers

Where—

(a) the financial statements of an issuer and any group financial statements in relation to a group comprising an issuer and its

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4 Although s 11 of the Act was referred to by the FMA, AFL had subsidiaries so, as the District Court judgment noted, these obligations arose under s 14 of the Act because AFL produced group financial statements.

5 Which in turn was defined in s 3.

subsidiaries are not audited in accordance with section 15 of this Act; or

(b) a copy of the financial statements of an issuer or group financial statements together with the auditor's report on those statements are not delivered to the Registrar in accordance with s 18(1)-

(c) *[Repealed]*.

every director of the issuer commits an offence and is liable on conviction to a fine not exceeding $100,000.

The relevant background

[9] Helpfully, the parties agreed certain background facts which included the following:

(a) Mr Prain and Mr Schroeder were directors of AFL, a limited liability company for the financial years ending 2011, 2012 and 2013, and continue to be directors;

(b) at 6 November 2012 (the date on which the 2012 financial statements were filed) AFL had a total of 1,012 investors with a total share capital of $39,515,000;

(c) AFL is an issuer for the purposes of the Act as it had allotted securities to the public;

(d) AFL was required to deliver financial statements and an auditor's report to the Registrar within 15 months and 20 days of the date of its nominated accounting period, being 1 October to 30 September in each year; and

(e) at the date of prosecution AFL had not delivered financial statements and its auditor's reports to the Registrar for the accounting periods ending 30 September 2011, 30 September 2012 and 30 September 2013.

[10] The evidence about how the appellants' failure to provide the financial accounts came about is relatively uncontentious. However, it is necessary to set out some of the history of AFL to put that evidence in context.

[11] AFL was originally incorporated in 1986 to grow and market apples nationally and internationally. The late Mr George Kain (known as Tom Kain) was the driving force (together with members of his family) behind the company. In these early years it was a substantial company, listed on the New Zealand Stock Exchange.

[12] In the late 1990's, when changes in the regulatory environment made the apple marketing enterprise difficult, the company turned to developing and subdividing the land it had acquired in and around Christchurch.

[13] The first of the appellants, Mr Justin Prain, became a director of AFL in 2002, bringing with him expertise in the management of large scale property development projects. The second of the appellants, Mr Mark Schroeder, became a director in 2003. At that stage, AFL was engaged in two subdivision developments, one of which was at Yaldhurst Road, on the outskirts of Christchurch. It was as a consequence of being involved in the Yaldhurst Road development that issues arose which led to the current charges.

AFL becomes involved with NIL

[14] A separate company, Noble Investments Limited (NIL), owned the land at Yaldhurst Road. NIL's director and shareholder, Mr Gordon Stewart, was also a shareholder and director in AFL at the time. NIL proposed a subdivision with its Yaldhurst Road land holdings. It saw that AFL had obtained some expertise in managing land developments and considered there would be advantages in contracting with AFL to manage its intended Yaldhurst Road subdivision.

[15] AFL entered a contract with NIL, whereby AFL was to manage the development of the Yaldhurst Road subdivision. In return, if it brought the project to fruition, it would earn the right to participate in the profits of the subdivision development, after repayment to NIL of its capital advances and interest. Initially it

was to receive 47.5 per cent of the profits but that was subsequently renegotiated in 2007, as a consequence of changed circumstances, to be 95 per cent. Mr Prain was also directly engaged as a development manager for NIL.

[16] The appellants say that, as a consequence of these arrangements, they were advised that NIL would be considered as a "deemed subsidiary" of AFL and therefore require inclusion of NIL's accounts in AFL's group accounts and audit. It is this advice, and the inability to get NIL to co-operate on providing the accounts, which the appellants say led to the non-compliance with the Act.

AFL's difficulties in appointing and retaining auditors

[17] A further relevant aspect of the background is the difficulty which AFL had, during the relevant period, in appointing and retaining a firm which was prepared to perform the company's audits.

[18] Mr Schroeder explains that when he joined the company, the accounting firm Deloitte was its auditor. In 2006, AFL was notified that Deloitte was no longer prepared to continue in that role so the company had to look elsewhere. AFL then obtained the services of John Purvis, of Goldsmith Fox, who prepared the 2006 accounts and completed that year's audit. However, that firm, too, advised it was no longer intending to provide audit services, and the company was again obliged to look elsewhere.

[19] After a number of enquiries, an officer from the Ministry of Economic Development effected an introduction to BDO Spicers in Auckland and helped secure that firm's agreement to act. The Auckland office of BDO Spicers completed the 2007 and 2008 audit of the accounts. However, in 2009, BDO Spicers gave notice that it was resigning as auditor. The reasons given for resigning resulted from problems AFL had struck with the Yaldhurst Road development. AFL had become embroiled in litigation with owners of adjoining land required for the subdivision. In the course of the litigation, caveats were lodged against titles to land within the subdivision. This, in turn, stymied AFL's ability to obtain finance to advance the subdivision.

[20] As Mr Schroeder explains:

> The creditworthiness and indeed the viability of Apple Fields Limited were brought into doubt. This perception that the company was vulnerable to failure entailed that any audit certifying the accounts may soon be called into question. The company was simply not an attractive proposition to any auditor.

[21] These problems were exacerbated by the onset of the global financial crisis in 2008 which meant a large number of accounting firms withdrew from audit activity and became more selective about who they would accept as clients.

[22] Mr Don Babe, of the firm John Clark, Chartered Accountants, was the company's accountant at this time. He made extensive enquiries in an effort to secure the services of an auditor and, eventually, it seemed he had secured the services of Ashburton-based accountants, to undertake the role of auditor. Unfortunately, that firm, too, reviewed its position and in April 2010 and advised that it was unable to accept appointment as the group's auditors. This, as Mr Schroeder explains, meant AFL was placed in a position where it was unable to deliver the audited accounts on time. Continued enquiries were made to locate an accounting firm which would complete the audit of the 2009 accounts, but it was not until August 2010 that AFL's accountant, Mr Babe, was able to secure the services of Taurus Group of Christchurch to take up the role.

[23] The Taurus Group representative who was appointed to complete the audit, Mr Greg Wright, raised an issue as to the relationship between AFL and NIL. He expressed the view that, because of the profit share arrangement, NIL should be treated as a subsidiary of AFL and its accounts therefore incorporated into the group accounts.

[24] However, Mr Gordon Stewart from NIL took a contrary view, which the auditor was prepared to accept, and the audited 2009 accounts were duly filed on 13 October 2010.

[25] Taurus Group was reappointed to undertake the 2010 audit and the accounts were provided, but that process was interrupted by the February 2011 earthquake. Both AFL's and Taurus' premises were red-stickered and subsequently demolished,

and it took some time before the AFL accounts could be recreated and referred to Mr Wright for audit.

AFL's accountant advises that NIL is a "deemed subsidiary"

[26] In the following year, even though the 2010 accounts had not been prepared, Mr Babe sent the directors a letter of advice on 28 November 2011 regarding the 2011 annual accounts. In it he stated the following:

> You may recall that there have been discussions with auditors over the years regarding the treatment of Noble Investments Limited. Auditors have asked for Noble to be consolidated into the accounts and the directors have resisted because Apple Fields does not control the shareholding or directors of Noble.
>
> Since the 2009 accounts were produced the accounting standards have been revised. The question about whether a company is consolidated now depends on power and returns. Taking the second test first, the question is can the investor receive variable returns from the investee. The first test is, does the investor have the powers to effect the level of returns.
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> My reading is that the answer to both these questions is yes. Therefore Noble will need to be consolidated into the Apple Fields annual accounts.
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> Noble Investments will therefore require auditing. As well as the cost of the audit this step will also require that some of the issues that have been left to finalise will need to be addressed.
>
> Over the years there have been discussions about producing accounts for Noble Investments but I am not aware of any progress. This needs to be given some priority to enable the reporting deadlines to be met.

[27] By July 2012, the 2010 financial statements had still not been audited, and Mr Wright from Taurus Group sought an extension of time from the Companies Office to do so. He also sought information about the agreement between NIL and AFL and details of the debt due by NIL to AFL. The 2010 accounts were finally filed on 6 November 2012.

[28] Taurus received the draft 2011 accounts on 9 November 2012. But, while the directors were hopeful that the 2011 audit could be completed quickly as the 2011 accounts differed in no material particular from the 2010 accounts, a lengthy delay ensued with no progress being made.

[29] Finally, on 26 August 2013, the Taurus Group sent an email to the Companies Office stating that:

> … due to the change in audit regulations, we have made the decision to close our Audit Division and have therefore been unable to complete the outstanding audits.
>
> We are concerned that this places the directors of Apple Fields Limited in a difficult position, being unable to meet the timing requirements of the audits.

Attempts to obtain NIL accounts

[30] Mr Schroeder explains that the information the auditors were seeking relating to NIL was information that AFL "did not have and to this day have been unable to obtain in the face of obdurate refusals by Mr Stewart to provide it". For example, on receipt of Mr Babe's letter in November 2011, Mr Kain emailed Mr Stewart of NIL on 6 December 2011 under the subject line "Re: 2011 Apple Fields Accounts". In it he said:

> Seems the powers that be that we will not be able to exclude NIL this year.
>
> Given we need to advance the AFL accounts and audit how do we make a start on NIL.
>
> Michael Sharp and Don could economically deal with this.

[31] However, the reply received from Mr Stewart on 14 December was to the effect that NIL "has now completely run out of money" and "I think an audit of NIL is a fairly low priority in that environment".

[32] On the withdrawal of Taurus Group as auditor, a new firm, William Buck Christmas Gouwland, accepted engagement as AFL's auditors, saying "we will complete the audits once the financial statements for the year ended September 2012 have been prepared and all supporting information is available".

[33] Mr Schroeder's evidence was that, from the advice he had received, he assumed the new auditors would require provision of the NIL accounts. AFL has been unable to obtain those from Mr Stewart, and it is for that reason that it has failed to file complete and audited accounts as required by the Act.

[34] Mr Prain's evidence reiterates the company's difficulties in retaining auditors, and also that he understood that NIL's accounts had to be incorporated into AFL's accounts prior to auditing based on Mr Babe's 28 November 2011 advice.

[35] He also explained the background to the difficulties experienced with NIL. He said the death of Mr Kain on 29 December 2013 impacted on the directors, and hindered them from making progress on the "necessary negotiation over control of Noble with Mr Stewart", which he considered was required before they could complete the audit.

[36] Furthermore, prior to Mr Kain's death, disagreements had arisen between Mr Stewart and Mr Kain around the conduct of the Yaldhurst development which led to Mr Stewart's resignation as a director from AFL on 2 February 2012. Mr Stewart asserted a breach of the joint venture agreement by AFL because it had failed to procure mainstream development funding. AFL, however, maintained that the failure to produce NIL accounts undermined AFL's ability to procure the required development funding.

[37] Mr Prain explained that the two potentially valuable assets AFL had in this period were the profits which were yet to be realised in the Noble Development, and $50,000,000 of tax losses spread between AFL and its subsidiary companies which could be carried forward in certain circumstances. AFL, itself, had no liquid assets, and cashflow from its potential assets was not expected until at least the medium term future. By implication, it was desirable for AFL to incorporate NIL's accounts into its accounts, because that cast AFL's prospects in a more favourable light. The potential profit from the NIL relationship was also the reason why the directors had chosen not to wind AFL up.

[38] In summary, the evidence was that, despite difficulties in appointing and retaining auditors, AFL did, at all material times, have an auditor appointed who could audit the company's accounts. However, the directors' reliance on AFL's accountant's advice as to the need for NIL's accounts, and the dispute with NIL over alleged breaches of the joint venture agreement, meant the directors were unable to obtain NIL's accounts in order to complete AFL's group accounts in the relevant

period. Because the accounts could not be completed and signed off by the directors, they could not be submitted to auditors and then delivered, with the auditor's report, to the Registrar.

The District Court decision

[39] The District Court issued a comprehensive decision.[6] After traversing the relevant statutory provisions, and the factual background, the District Court found:

(a) at all material times AFL had available to them auditors (Taurus and then William Buck Christmas Gouwland), who were willing and able to complete the audits;

(b) at November 2012, the draft 2011 accounts had been provided to the auditors by the defendants despite receiving the 28 November 2011 advice from Mr Babe, and there was no suggestion that the defendants were concerned that the NIL accounts were not included in these accounts;

(c) there was no evidence as to why the audit of the 2011 accounts was not completed, and the request made in July 2012 for certain information about NIL was not an impediment to the audit, as the information sought was available to AFL;

(d) the advice given by Mr Babe on 28 November 2011 that NIL's accounts needed to be consolidated into the AFL accounts as a deemed subsidiary, was his genuinely held opinion;

(e) the defendants considered the advice from Mr Babe was to be taken seriously and they had an honestly held belief about its veracity and accuracy; and

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6 *Financial Markets Authority v Prain*, above n 1.

(f) the defendants took no meaningful or appreciable steps to obtain any alternative advice from an auditor, accountant or lawyer as to the correctness of Mr Babe's advice.

[40] Given the company's significant share capital and the fact that the auditors of the 2010 accounts expressed the opinion the company was unlikely a going concern, the District Court held that the directors must have known the critical need for shareholders and investors to be provided with audited accounts. That, together with the clear obligations on the directors, should have brought home to them the need to enquire further than Mr Babe's advice, even if they considered Mr Babe's advice correct.

[41] The requirement under s 40 is for the directors to have taken "all reasonable and proper steps" to ensure compliance and the Judge considered that this "precludes passive acceptance of such critical advice without corroboration".[7] In this case the District Court held that it was always open to the directors to submit AFL's accounts to the auditors absent the NIL accounts but, as anticipated by s 14(2) of the Act, to add such information and explanations as were required to give a true and fair view of the company's financial position.

[42] The Judge held that, in the circumstances, it would have been a reasonable and proper step to submit the accounts along with the explanation that the accounts were accurate "in all regards other than in their view the failure to include NIL for the reasons that that information cannot be legally obtained by them".[8] In her view, the directors could not omit to submit their accounts to the auditors in order to avoid having a qualified auditor's report, when they had an obligation to submit the accounts in a timely way.

[43] The Judge observed that the Act is designed to ensure timely and transparent audited accounts, from which investors and shareholders are able to be appraised of the exact circumstances of the company. For that reason, AFL could not continue to

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7 At [91].
8 At [97].

be a "non compliant issuer on an indefinite, ongoing basis".[9] In failing to submit the accounts to the auditors with such qualifications as was required under s 14(2) of the Act, they failed to take a reasonable and proper step.

[44] For those reasons, the District Court found the charges against each of the defendants proven.

The appeal

[45] The appellants argue that the Judge's findings were in error in the following respects:

(a) her conclusion, at [91], that the seriousness of the position "precludes passive acceptance of such critical advice without corroboration" was wrong;

(b) in reliance on *Ministry of Economic Development v Feeney and Ors*, s 138 of the Companies Act 1993 is relevant to the question of whether directors have taken all reasonable and proper steps to ensure compliance with the FRA.[10] As the Judge found that the defendants considered the advice from Mr Babe was to be taken seriously, and had an honestly held belief in its veracity and accuracy, they should be brought within the protection of s 138(1)(b) which entitles directors to rely on "a professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional expert competence"; and

(c) the Judge was wrong to hold that s 14(2) of the Act provided a route by which the accounts could be signed off as true and correct and forwarded to the auditors. The Judge's interpretation overlooked the words "if in complying with generally accepted accounting practice", which were a precondition to the adoption of this course as a solution. This clause requires the directors to correct a false view of a

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9 At [103].

10 *Ministry of Economic Development v Feeney* (2010) 10 NZCLC 264, 715 (DC).

company's affairs if that is created by financial statements which comply with generally accepted accounting practice. It does not provide a method of salvaging accounts which the directors do not consider apply with generally accepted accounting practice, as was the case here.

[46] The grounds of appeal raised the following issues:

(a) Does s 14(2) provide a mechanism by which the directors could have submitted the accounts to the auditors in compliance with the relevant legal requirements?

(b) What relevance does s 138 of the Companies Act 1993 have in determining whether the directors can establish a defence under s 40 in the circumstances that have arisen?

(c) If s 138 is not a defence, or a complete defence, can the directors nevertheless establish, on the facts, they have met the requirements of s 40?

Could s 14(2) have been relied on by the defendants to achieve compliance?

[47] It was common ground at the hearing that s 14(2)[11] would not allow the appellants to submit financial statements, which are not otherwise compliant with generally accepted accounting practice, by simply providing an accompanying explanation or further information.

[48] However, the respondent says it can be inferred from the Judge's decision that, at least for the draft 2011 accounts, but likely also for the 2012 and 2013 accounts, she has found that generally accepted accounting principles did not require consolidation of the NIL accounts, so the accounts were compliant and could have been prepared and submitted for registration with an explanation under s 14(2).

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[11] The equivalent section, s 11(2) which applies to a single company, was also referred to in the decision, but as AFL was required to submit group financial accounts, only s 14(2) is discussed.

[49] This inference is based on updated advice from Mr Babe which was provided by email shortly before the hearing and tendered as evidence in the hearing. It explained that the treatment of associated companies within published accounts used to be determined by NZIAS 27. That standard defined "control" for the purposes of a company being a deemed subsidiary as "the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities". He suggests that, as AFL did not control the financial policies of NIL, it was "probably correct" to say that AFL did not meet that definition of control of NIL under NZIAS 27.

[50] However, he goes on to say that NZIFRS 10 was published in June 2011 and it largely superseded NZIAS 27. It applied to all financial statements prepared for periods that started on or after 1 January 2013. It adopted a different definition of control which included, as Mr Babe's email explained, when an investor company:

> … is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to effect those returns through its power over the investee.

[51] Mr Babe expressed a view in his email advice, which he confirmed in cross-examination, that "I do not think AFL accounts can be complete without the inclusion of Noble, however this decision is ultimately the directors' and auditors".

[52] As a consequence, the respondent argues that it was always open to the appellants to have submitted AFL's accounts to the auditors for the years 2011, 2012 and 2013 absent the NIL accounts, and to qualify them as required by s 14(2) if they thought the accounts did not, by themselves, give a true and fair picture of the company's position.

[53] The appellants, in response, note that the contents of Mr Babe's subsequent emailed advice was not provided until just prior to the District Court hearing and was not known to the appellants up until that time. Instead, they were entirely reliant on the advice in Mr Babe's earlier letter which clearly stated that, by reference to power and returns, the NIL accounts needed to be consolidated with AFL's accounts. The appellants also say that, in any event, the evidence does not go so far as to establish what the correct position was prior to NZIFRS 10 applying. Simply

because the appellants had filed financial statements for 2010, which the auditor signed off, does not reliably confirm the position. It is no more than evidence of their own understanding at the time. In fact, referring to the earlier accounting standards, the appellants submit that it cannot be assumed that they did not require inclusion of NIL's accounts.

[54] Mr Robinson, for the respondent, submitted that, in fact, as NZIFRS 10 was only required to be applied to financial statements prepared for the periods commencing on or after 1 January 2013, AFL's financial statements would have complied with generally accepted accounting principles for the years in question without the inclusion of NIL's accounts. This meant the Judge was correct to say the appellants could have availed themselves of s 14(2) and filed the financial statements with such further explanation as they thought was required to give an accurate picture of the company's position.

[55] However, there is insufficient evidence to draw that conclusion. The only accounting evidence was that given by Mr Babe and, in cross-examination, he maintained that NIL should be treated as a deemed subsidiary of AFL in the relevant period. There was no contrary accounting evidence given. In the circumstances, I do not consider the Judge had evidence on which she could make a finding that the financial statements would have complied in the relevant years without the inclusion of NIL's accounts and, therefore, filed with the Registrar along with such further explanation, under s 14(2), as the directors thought was required.

[56] In any event, whatever the correct position, the real issue is whether the appellants, given their honestly held belief based on Mr Babe's advice that they could not deliver complying financial statements and auditor's reports to the Registrar,[12] took all reasonable and practicable steps to address this non-compliance.

Can the appellants rely on s 138 of the Companies Act 1993 to establish the defence under s 40?

[57] The appellants sought to rely on s 138 of the Companies Act 1993 to establish that all reasonable and practicable steps had been taken to prepare and

[12] As required by ss 18 and 38(b) of the Act.

provide accurate group financial accounts for AFL, which complied with generally accepted accounting standards under s 14 of the Act. Relying on their accountant's advice, they said they could not sign the AFL accounts as complying with generally accepted accounting practice, and as giving a true and fair view of the company's financial position, unless they included NIL's accounts. The directors relied on this combination of the accounting advice received, and the dispute with NIL (which meant NIL's director refused to co-operate to provide the NIL accounts), to avail themselves of the s 40 defence.

[58] It was implicit in the District Court judgment (and the respondent did not challenge) that the Judge proceeded on the basis that the appellants had diligently sought to obtain the accounts from NIL, including offering to pay for the preparation and auditing of those accounts.

[59] The sole issue, therefore, was whether the appellants had acted reasonably in relying on Mr Babe's 28 November 2011 advice, and seeking no other advice, on whether the NIL accounts were required to comply with generally accepted accounting practice. In that regard, they relied on s 138 of the Companies Act 1993 which provides:

> **138 Use of information and advice**
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> (1) Subject to subsection (2) of this section, a director of a company, when exercising powers or performing duties as a director, may rely on reports, statements, and financial data and other information prepared or supplied, and on professional or expert advice given, by any of the following persons:
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> …
>
> (b) a professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional or expert competence:
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> …
>
> (2) Subsection (1) of this section applies to a director only if the director—
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> (a) acts in good faith; and
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> (b) makes proper inquiry where the need for inquiry is indicated by the circumstances; and

(c) has no knowledge that such reliance is unwarranted.

[60] In support of their argument, the appellants referred to the decision of Judge Doogue in the *Feltex* case.[13] In *Feltex*, the directors were charged under s 36A of the Act for issuing a statement containing interim financial information for its half year results which failed to comply with applicable reporting standards. The directors accepted that the statement failed to comply with the applicable reporting standards but, as in the present case, relied on s 40. There the directors' evidence was that they had relied on specialist advice from a reputable accounting firm to review Feltex's compliance with the New Zealand equivalent of International Financial Reporting Standards (NZIFRS), and obtained assurances from those reviewers that the accounts did comply with the applicable standards.

[61] In these circumstances, Judge Doogue accepted the directors could avail themselves of the s 40 defence. She said:

> [39] … if the advice is professional or expert advice and the directors act in good faith, make proper enquiry where the need for the enquiry is indicated by the circumstances, and no knowledge that such reliance is unwarranted, they are entitled to rely on the professional expert advice which they have received. They will then have taken "reasonable and proper steps" to ensure that the applicable requirements of the FRA would be complied with.
>
> [40] Does this mean that they will also have taken "all" reasonable and proper steps? Given the terms of s 138 it is difficult to see how they will not be held to have taken "all" reasonable and proper steps.

[62] However, in the present case, Judge Smith rejected Judge Doogue's approach in *Feltex* saying:[14]

> [73] Neither the defendants or informants referred the Court to any cases with respect to the applicability of s 40 of the FRA. My own considerations of the law found no prior cases of potential material relevance other than perhaps *Ministry of Economic Development v Fenney* [sic] also known as the *"Feltex"* case. While in that matter s 40 was referred to, the case was somewhat different in that the directors of *Feltex* were charged under 36A FRA in relation to the accuracy of *Feltex's* interim financial statement. That section required the statements comply with any applicable financial reporting standard: the *Feltex* statements did not. My own consideration of that case suggests that the learned Judge gave weight to s 138 of the Companies Act 1993 and the defence provided in that legislation and

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13 *Ministry of Economic Development v Feeney*, above n 10.

14 *Financial Market Authority v Prain*, above n 1.

> imported its tenets in the FRA in allowing directors to honestly rely on information and advice received from their professional advisers and employees. I would not follow or adopt that approach. In my view there are specific, acute statutory defences provided in the Financial Reporting Act 1993 (that is s 40) and not only is there no need, it is improper to import the applicability in any way of a separate statute and that is s 138 of the Companies Act 1993 into the FRA.

[63] The approach of Judge Smith finds support in the academic commentary of Susan Watson and Rebecca Hirsch, who say:[15]

> Judge Doogue gave great weight to s 138 of the Companies Act 1993; the provision that allows directors to rely on information and advice received from their professional advisers and employees. Much of the judgment was devoted to showing supposed links between the Companies Act 1993 and the Financial Reporting Act 1993 in an effort to show that s 138, which is a defence for directors who breach their Companies Act duties, applies to breaches of the Financial Reporting Act 1993. With respect, when there is a statutory reasonable steps defence available to directors in s 40 of the Financial Reporting Act 1993, it is difficult to see how s 138 would apply. It is the defence provision for a different piece of legislation – the Companies Act 1993. The Financial Reporting Act 1993 applies not just to companies but to other entities. The argument by counsel and supported by the Judge that the two pieces of legislation came to force at the same time does not strengthen, but in fact weakens, the argument that the defence provision in one Act can apply in the others: if Parliament had intended this, they simply would have included a s 138 equivalent in the Financial Reporting Act 1993.

[64] I accept that s 138 does not constitute an express statutory defence under the Act. However, where a director of the company is charged under the Act, the fact that a director is entitled to rely on reports, statements and financial data, in the circumstances spelt out under s 138, must be relevant to the s 40 enquiry. There will be circumstances where, as Judge Doogue found, reliance on professional advice may be sufficient to establish the defence. However, in every case where s 40 is relied on as a defence, there must be a fact-specific enquiry to see whether the obligation to take all "reasonable and proper steps" to ensure compliance with the Act has been met. Taking professional advice will be part of, but not necessarily a complete answer to, that enquiry.

[65] In the present case, the circumstances differ from those in the *Feltex* case. The reliance on professional advice was not, as in *Feltex*, directly in relation to

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[15] Susan Watson and Rebecca Hirsch "Empty Heads, Pure Hearts: The Unintended Consequences of the Criminalisation of Directors' Duties (2011) 17 New Zealand Business Law Quarterly 302 at 317.

compliance, but rather was advice as to their obligations which led to the directors knowingly not complying with the Act. The question is therefore whether, given their understanding that they had to include NIL's accounts in their group financial statements before they could sign them and submit them to audit, they then took all reasonable steps to comply with their obligations under s 18 of the Act.

[66] In this case the directors did not take legal or accounting advice on the issue of whether there was anything more they could do to achieve compliance with s 18, and so this case is not analogous to that in *Feeney*. The accounting advice the appellants relied on simply gave rise to the circumstances in which there was a failure to comply with the requirement under s 18 to file audited financial statements with the Company Registrar. It did not go so far as to advise the directors that they had taken "all reasonable and proper steps" to ensure the requirement to have financial statements audited and filed with the Registrar had been complied with. The appellants have conflated the advice as to what was required to properly complete the accounts, and the defence under s 40, when in fact these represent two distinct stages in the directors' obligations.

[67] In my view, taking "all reasonable and proper steps" to ensure compliance with s 18 requires the directors to both:

(a) take all practical steps to ensure compliance (such as the efforts to appoint auditors and to obtain the NIL accounts); and

(b) to seek comprehensive legal and/or accounting advice as to the range of options available to them when those practical steps did not bear fruit.

[68] In present circumstances, I consider the appellants were happy to accept Mr Babe's advice without further enquiry, as they did not want to file accounts that excluded the potential profits from NIL. As Mr Schroeder said in evidence:

> Well the fundamental issue for us is always in respect of getting an audit report at all has always been the issue around the inclusion or exclusion of the Noble accounts. The Noble accounts, that being a reflection of the

> principle business activity of this company, were critically important to the overall, to describing the overall health of Applefields.

[69] Similarly, Mr Schroeder explained that, without the future income from the NIL development, the auditors doubted that AFL was a going concern saying:

> It is a serious matter and we never take it lightly, but we had to consider that the ongoing problem with, the development of involvement which still has residual value to the shareholders, and no-one wants a qualified audit. We would far prefer to be able to show that we were actually progressing with it. It hasn't been the case, but it has not finished and it won't finish until it is.

[70] It appears that it suited the directors to rely on Mr Babe's advice and not to investigate what should be done when the NIL information was not forthcoming. It was clear that, without the future income that the NIL development would contribute, AFL's position would look bleak and it would receive a qualified audit.

[71] However, when faced with the consequence of being in breach of the Act for the failure to file audited accounts, I do not consider that the directors can demonstrate they did all that was possible to comply with the Act. It is clear that the directors knew they were in breach of the Act, but they failed to seek any further advice on what they should do when faced with that dilemma. The most obvious step to take would have been to seek legal advice on whether NIL could be compelled to provide the information. That would have been likely to demonstrate whether Mr Babe's advice was correct or not and, if it was, what options the directors had to compel the provision of the accounts from the deemed subsidiary. That was a reasonable step to take which was not taken.

[72] In the circumstances, the issue of reliance on s 138 simply does not arise. The directors took no legal advice on whether they had any alternative ways to obtain the NIL accounts when that was unable to be achieved through request and negotiation. They cannot demonstrate they relied on professional advice to that effect, and so the question of s 138 is irrelevant to whether the s 40(a) defence is satisfied.

Conclusion

[73] For this reason, I am satisfied, albeit through a different route, that the Judge was correct to conclude that the defence in s 40(a) had not been established on the balance of probabilities and the directors were appropriately convicted.

[74] For these reasons, the appeal is dismissed. The directors did not take all reasonable and practical steps to ensure that the Act's requirements were complied with.

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