

Corporate Advisory Alert

4 August 2010

Feltex Decision Released

Introduction

As has been widely publicised, earlier this week five former directors of Feltex Carpets Limited ("**Feltex**"), each facing two charges under section 36A of the Financial Reporting Act 1993 ("**Financial Reporting Act**"), were found not guilty of both the charges in the Auckland District Court.

The charges related to Feltex's 31 December 2005 interim accounts, which failed to disclose breaches of certain financial covenants under Feltex's facility with ANZ Bank and also failed to classify the ANZ facility as a current liability.

In a well written and persuasive decision, Judge Jan Doogue found that the directors of Feltex took all reasonable and proper steps to ensure that the requirements of the Financial Reporting Act would be complied with. Central to the decision was Judge Doogue's finding that the directors were entitled to seek and rely on the advice of internal management and of Ernst & Young in relation to the financial statements and the impact of the move to IFRS generally, advice that turned out to be incorrect.

Professional directors generally should take comfort from the result in the Feltex case and also from the overall tenor of the judgment. In the decision, Judge Doogue cites "overwhelming evidence" that the directors were all "honest men" who conducted themselves with "unimpeachable integrity", and notes that there is "not one skerrick of evidence to suggest any intention by them to mislead the regulatory authorities, market, shareholders, creditors, potential investors, or any other person." These are strong comments in a case that vindicates the integrity of the directors concerned, and will be welcomed by the directors involved as well as others concerned about the possible implications of these proceedings which many observers considered were

ill-founded. The decision reinforces for directors and the market generally what have been regarded as longstanding and well established corporate governance principles.

Background

Section 36A of the Financial Reporting Act, under which the directors were charged, requires a statement prepared by a "reporting entity" (as defined in the Act) that contains prospective, summary or interim financial information to comply with the applicable financial reporting standards. However, section 40 of that Act provided a defence for the directors if they could prove that they took all reasonable and proper steps to ensure that the applicable reporting standards would be complied with.

The interim financial statements in question were the first that Feltex had prepared under IFRS, during New Zealand's transition period from GAAP to IFRS. Feltex was also one of the first New Zealand companies to adopt IFRS.

At the time of preparing the financial statements, the directors of Feltex were aware that the company was in breach of certain of its financial covenants with ANZ. However, Feltex had been in discussion with ANZ regarding relaxing these financial covenants, and Judge Doogue accepted that at the time of preparing the financial statements the impression conveyed by ANZ was that the bank would not act on the covenant breaches but instead would take steps to flex the covenants.

Feltex's directors and management, as well as Ernst & Young, failed to pick up that IFRS differed from the previous accounting standards in relation to this point in two material ways, with IFRS containing a more prescriptive test for the classification of debt as "current" or "non-current" and also more prescriptive requirements for disclosure of matters in the explanatory notes to interim financial statements. It was as a result of these differences that the disclosures regarding the ANZ facility were required under IFRS, whereas under GAAP they would not have been.

The decision

Judge Doogue was of the view that section 138 of the Companies Act 1993 ("**Companies Act**"), which allows a director to rely on professional or expert advice in certain circumstances, was relevant to the question of whether the directors took all reasonable and proper steps to ensure the financial statements complied with the Financial Reporting Act, and therefore whether or not the directors were liable under that Act.

Under section 138 of the Companies Act, directors are entitled to rely on professional or expert advice given by certain persons (essentially employees or professional advisers with relevant competence, or a committee of directors of which the director is not a member) provided that the director:

- acted in good faith;
- made proper enquiry where the need for enquiry is indicated by the circumstances; and
- had no knowledge that such reliance was unwarranted.

Judge Doogue found that the Feltex directors had established a comprehensive programme to manage the transition from GAAP to IFRS and the preparation of the 31 December 2005 interim accounts. This included placing reliance on an internal management team that the directors reasonably believed were appropriately qualified, well resourced and competent as well as engaging Ernst & Young, a highly reputable accounting firm, to manage the transition to IFRS and to review the financial statements.

As a result, Judge Doogue found that the directors were entitled under section 138 of the Companies Act to rely on their internal and external advisers, and took all reasonable and proper steps to comply with the company's obligations under the Financial Reporting Act.

Directors' duties

The decision also contains discussion around directors' duties and the ability of directors to rely on advisers that will be of interest to professional directors.

The case against the Feltex directors essentially boiled down to an argument that the directors "should themselves have engaged in a study of the accounting standards, of the way in which they applied to Feltex and the interim financial statement, and of whether in their own individual judgements the statement complied". Judge Doogue dismisses this argument, stating that the "they should have done it themselves" proposition is "utterly unrealistic".

The above statement must be read in the context of the case being considered, and specifically Judge Doogue's comments that the financial standards are "complex", "arcane" and "written for persons with an understanding of accounting principles, an understanding not available to someone lacking appropriate training or experience." However, Judge Doogue goes on to make a more general statement around the ability of directors to rely on others' advice, noting that "reliance on advice, where appropriate conditions are satisfied, does not detract from, but enhances, the quality of directors' duties."

We consider that, in the context of complex modern companies and the professional directors tasked with managing those companies, Judge Doogue's general statement above is welcome, as is the result in this case. In general, directors cannot be expected to personally have a comprehensive understanding of the minutiae of a company's day to day business or of the entire regulatory framework surrounding the company. Therefore, it should not only be permissible but encouraged for a director to employ and rely on appropriate internal and external experts to advise them when carrying out their duties as directors.

Future developments

It should be noted that this week's decision may yet be appealed. In addition, the High Court has allowed a class action by Feltex shareholders relating to the offer of Feltex shares under its 2004 initial public offering.

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