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Commercial Applications of Company Law

BUSINESS PLANNING AND COMPANY FORMATION

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BUSINESS PLANNING AND COMPANY FORMATION

[¶501] Introduction

We saw in Chapter 1 that the limited liability company is a common form of business organisation in New Zealand, with about 533,451 companies in existence in June 2010. In this chapter, we compare the company with other possible forms of business organisation, to determine when a company is the most appropriate form through which to conduct a particular enterprise.

In circumstances where a company is the appropriate form, participants in the enterprise will need to be aware of management and accountability issues. These issues differ depending on how a company is classified.

The third part of this chapter deals with the requirements for registration, and the process by which companies are formed. The fourth part looks at listing, and the fifth part examines the use of corporate groups in business planning.

CHOICE OF FORM OF BUSINESS ORGANISATION

[¶502] What are the different forms of business organisation?

Companies are one possible form of business organisation. Others include sole proprietorships, general and limited partnerships, unincorporated joint ventures, and trading trusts. This section summarises some of the key features of those other forms of business association, and suggests some criteria according to which a person or persons proposing to carry on a particular enterprise might decide which form to use.

It is important to note that, although our focus in this section is on different types of business organisations, it is possible to have organisations which are used for purposes other than conducting a business. Unincorporated and incorporated societies are examples. We therefore commence this section by briefly describing the key features of unincorporated and incorporated societies so that these can be compared to the types of business organisation we describe later in the section.

[¶503] Unincorporated and incorporated societies are not business organisations

Unincorporated societies

Unincorporated societies are clubs and societies which are formed to carry on various activities, but whose members do not aim to make a profit and distribute it to themselves. If they did, the members would be partners in a partnership. A partnership is a form of unincorporated society. However, we see below that a key definition of a partnership is that the partners are carrying on business in common with a view to profit. Of course, an unincorporated society may make a surplus as an incidental result of some of its activities. This surplus must be used for the purposes of the society, however, and cannot be distributed to the individual members of the society.

An unincorporated society is not a separate legal entity. This means that it cannot hold property in its own name (property must be held in the names of the individual members of the society) and the society is unable to enter into contracts in its own name. Nor can the society sue or be sued in its own name. The members of an unincorporated society do not have the benefit of limited liability. However, where the members have elected a committee to conduct the management of the society, as a general rule it will be the members of the committee rather than all of the members who are required to defend any legal proceeding brought against the unincorporated society by someone who has been injured by the activities of the society.

1 AS Sievers, *Associations and Club Laws in Australia and New Zealand* (2nd ed, 1996), p 38.

Incorporated societies

An unincorporated society may incorporate under the *Incorporated Societies Act 1908*. The benefits of incorporation, which are described later in this chapter, are then available to the society. These include limited liability for the members of the society. In addition, the society will be able to hold property in its own name. However, a very important restriction is that societies which are formed primarily for trading or other business purposes, or which make profits that are distributed to members, cannot incorporate under this Act.

2 Ibid, pp 88–89.

Therefore, unincorporated and incorporated societies are not business organisations in the way that the organisations we now describe are.

[¶504] What are the key differences between companies and other forms of business organisation?

In Chapter 3, we analysed some of the particular legal and functional characteristics of companies that differentiate them from other forms of business organisation.

Many businesses are not conducted by a company. Other forms of business organisation are available. The advantages and disadvantages of using a company over one of these other forms are discussed below, along with the key characteristics of these other main forms of business organisation.

Sole proprietorship

The expressions **sole proprietorship** and **sole trader** are used to describe the situation where an individual person carries on a business in his or her own name. Where a sole proprietorship exists, there is no separation between the business and personal assets or obligations of the person conducting the business. The sole proprietor signs all the contracts relating to the business, owns its assets and is personally liable for all its debts.

Because the income generated by the business is the income of the proprietor, the proprietor is the taxpayer and the business losses or profits can be offset against the proprietor's other income.

General partnership

As discussed in Chapter 4, a **partnership** is a relationship between people carrying on business in common with a view to profit.

3 Section 4, *Partnership Act 1908*.

There is no need to take any formal legal steps to create a partnership — it simply arises as a matter of law where two or more people are in this relationship. Usually, however, the terms of the agreement between partners are recorded in a formal legal document referred to as a "partnership agreement".

A partnership is not a separate legal entity.

4 Court rules allow a partnership to sue and be sued in the firm's name. This is done only to simplify procedures by making it unnecessary to name each partner separately. It does not affect the legal nature of the partnership.

Like sole proprietors, the individual partners in a partnership must own the assets of and incur the obligations relating to the partnership's business personally and in their own names. This means, for example, that if partners in a firm want to borrow money to expand the firm's business, they would each have to sign the loan contract and each would be personally liable to the lender for the full amount of the debt.

5 The liability of partners is "joint and several". "Several liability" is liability which can be divided among those who have caused some harm or wrongdoing so that each wrongdoer is responsible for only his or her part of the harm caused. "Joint liability" arises when two or more persons are jointly liable for some harm or wrongdoing, which means that if one of these persons is unable to pay his or her share of the liability (for example, because of bankruptcy), the other persons who are jointly liable must pay the entire amount. Where liability is "joint and several", the liability can be enforced individually against one or more of the persons responsible or against all of the persons jointly.

Unlike shareholders in a company, partners do not have limited liability unless they are "sleeping

partners" of a limited partnership (see below).

Partners are agents

6 An agent is a person who, as a matter of law, can act for another person. Provided the agent acts within the scope of his or her authority, the principal (that is, the person on whose behalf the agent acts) is bound by the acts of the agent. Agency in the context of company law is discussed in Chapter 21.

for each other with respect to the conduct of the business. This means that an individual partner can incur an obligation for which all the other partners are also responsible. Unless they have agreed otherwise, partners have a right to participate in the management of the business and share in its proceeds equally.

If the identity of the partners changes — for example, because a partner resigns or a new partner joins — the original partnership is dissolved and a new one is formed. This may require the transfer of assets and obligations from the retiring partner or to the new partner. The process of transferring assets and obligations can be quite complex. Any single partner can cause the partnership to be dissolved. Further, the right to be a partner cannot be assigned or transferred to another person without the unanimous consent of the other partners (although it is possible to assign the income attributable to a partnership share).

The profits and losses generated by the partnership business are taxable in the hands of the individual partners, and can be offset against their other income. Unlike a company, a partnership is not taxed as a separate entity.

Since 1994, under New Zealand law, partnerships can potentially be of any size. However, the sheer logistics of managing a large partnership make the company form a more attractive option in many cases.

Limited partnership

Limited partnership is a form of business association permitted under the *Limited Partnerships Act 2008*. It allows investors who want to contribute capital to a business, and to have no say in the business's day-to-day management, to join with others to invest in a partnership structure but with the benefit of limited liability. Formal requirements must be complied with in order to form a limited partnership. These partnerships can last indefinitely until deregistered.

7 Section 7, *Limited Partnerships Act 2008*.

A limited partnership must have at least one general partner. The general partner may itself be a corporation. The general partner is generally the person who carries on the business and who does not have limited liability, and at least one limited partner, who is the person contributing capital to the venture. So long as the limited partner does not involve itself in the management of the business, its liability will be limited to the amount contributed to the partnership. However, the benefit of limited liability may be lost if the limited partner participates in management.

8 Section 30. See the Schedule of the Limited Partnerships Act for a list of those activities which are deemed not to constitute management.

Limited partnerships replace special partnerships. Special partnerships were rarely used in New Zealand for a number of reasons, including doubt over what constituted management of the business. It appears as though limited partnerships will be more popular than special partnerships because it is now clear what role limited partners can take in a limited partnership without incurring liability, and losses and gains can be attributed to the partners directly.

Unincorporated joint venture

An **unincorporated joint venture** is simply a contractual arrangement between two or more people that they will join together to conduct a particular venture. The joint venture is not a separate legal entity and the assets and obligations of the venture are those of the venturers personally.

Sometimes it can be difficult to distinguish between a partnership and a joint venture. Generally, in a joint venture, the participants' respective contributions and entitlements will be agreed in advance, and will be quite specific. This can be important in demonstrating that the parties are not conducting a business "in common", which would make the arrangement a partnership.

Unlike partners, joint venturers are not agents for each other, and their liability with respect to debts incurred in the course of the venture, while personal and unlimited, is several and not joint.

9 See footnote 5 for definitions of "joint liability" and "several liability".

Trusts

Many businesses are conducted through **trusts** . In particular, this mechanism is commonly used by Maori in the case of communally held property and commercial ventures. A trust arises where one person is required to hold or invest property for the benefit of another person. The person who holds the property is the **trustee** , and the people who are entitled to enjoy the property and receive the income or other proceeds from it are the **beneficiaries** .

A trust is not itself a legal entity. The person who contracts or holds property for a trust is the trustee. Trustees are personally liable for debts incurred on behalf of the trust, although usually the trustee will have a right to be indemnified (or reimbursed) out of trust assets for the amount of the claim.

10 A trustee may lose its right of indemnity where it has acted in breach of trust, however.

The beneficiaries generally are not liable for the debts incurred by the trustee, unless they have given specific directions to the trustee and the debt arises as a result of the trustee acting in accordance with those directions.

Trusts are often used in family businesses to enable the distribution of income derived from the business to a number of beneficiaries. Often, a company is incorporated to act as trustee of the trust and conduct the business for the benefit of the beneficiaries. This is sometimes referred to as "income splitting". Provided the trust income is fully distributed, it is not taxable in the hands of the trustee.

The advantages and disadvantages of using a company to conduct a business, rather than these alternate structures, are discussed below.

[¶505] How do we choose between the different forms of business organisation?

In Chapter 1, we noted that any person who wishes to do so can incorporate a company to carry on a lawful business enterprise. Business people and their advisers often assume that a company is the most appropriate form of business organisation. The reasons advanced for that choice are that using a limited liability company "ensures" that the personal assets of the investors and managers of the business are protected from claims by the company's creditors, and there is a tax advantage in using a company because the rate of income tax payable by companies is lower than the highest individual tax rate. We will see that the reality is more complicated. A range of factors must be considered before making the decision, in a particular case, to use a company to carry on a business.

In summary, some of the perceived advantages of the corporate form include limited liability, perpetual succession, free transferability of interests, and the ability to raise debt capital from outside the organisation. Perceived disadvantages include the costs involved, the requirements for public reporting, and the duties imposed by company law on the participants in a company.

[¶506] What are some of the advantages of the company form?

In this section, we identify some of the possible advantages of using a company to carry on a business.

Limited liability

The key difference between corporations and other forms of business association is that the corporation is a separate legal entity. As such, its debts are its own and not those of its participants. In limited liability companies, the liability of the company's shareholders to contribute to meet the company's debts is limited to a previously agreed amount. In the case of companies limited by shares, the shareholders' liability is limited to the amount (if any)

remaining unpaid on the shareholders' shares. This is referred to as **limited liability** , which we discussed at length in Chapter 3.

By electing to use a limited liability company to carry on a business, a person investing in that business can decide how much "capital" (that is, money or assets) he or she wishes to invest in the company. That person makes that investment and is issued with shares in the company in return. The company then begins to trade, incurring obligations to creditors such as lenders, suppliers and employees.

If the company is unsuccessful, it may reach a position where its liabilities exceed its assets and it is unable to pay its debts as and when they fall due. In such circumstances, the company is insolvent. Assuming the company's controllers have not acted unlawfully, on insolvency the company's shareholders would lose their initial investment but would not be required to contribute any more money (other than any amount unpaid on partly paid shares) to meet the company's debts. Once the company's assets are exhausted, creditors are unable to recover any further amounts.

So limited liability is a means for entrepreneurs and other investors to decide how much of their own personal wealth to risk in a particular business venture, and to quarantine the remainder of their personal wealth from that risk. Similarly, a larger company may decide to quarantine the risk of, say, a new project by incorporating a separate subsidiary to carry on that project. If the project fails, the parent company stands to lose only the amount it invested in the subsidiary.

Perpetual succession

A second significant advantage of using the corporate form to carry on business is that a company has **perpetual succession** . This means that a company's existence continues indefinitely until it is brought to an end through liquidation and deregistration,

11 See Chapter 24.

despite any changes in the identity of its participants.

In other forms of business association that are not separate legal entities (such as sole proprietorship or partnership), the business assets and obligations are held by the individual participants. This means that if the identity of the participants changes (for example, because a sole proprietor dies or partners resign from or join a partnership), it may be necessary to transfer those assets and obligations.

So a company's perpetual succession can be an advantage where it is intended that the business will be ongoing. It allows for assets and obligations to be held in the company indefinitely, reducing the cost and complexity involved in transferring those assets and obligations if the identity of the participants in the enterprise changes.

Free transferability of interests

A corollary of limited liability and perpetual succession is that the corporate form is uniquely well suited to the free **transferability of investors' interests** . Section 39 of the *Companies Act 1993* provides for free transferability as the "default rule" (that is, the rule that applies unless the participants in a company elect to displace it). In contrast, the default rule in partnership is that partnership interests cannot be assigned.

Companies, by effectively "unitising" investors' interests in the business in the form of shares, create fungible securities that are capable of being traded through organised markets such as stock exchanges. The fact that shareholders in companies have limited liability means that potential purchasers are not required to go to the expense of discovering all the potential claims against them, or the creditworthiness of the other investors in the company. This reduces the transaction costs of investing in companies as against investment in other forms of business association, and facilitates the operation of stock exchanges (the liquidity of which is an important contributor to companies' ability to raise finance from the investing public).

Companies as large commercial enterprises

Given the advantages of companies as described above, the corporate form is likely to be the

most suitable for operating a large-scale commercial operation.

Company law as a standard form contract between participants

In all but sole proprietorships and single director/shareholder companies, business associations involve relationships between participants. The respective rights and responsibilities of investors, managers and creditors must be agreed between those participants. In many respects, the law can be seen to provide "standard form" terms governing aspects of those relationships. The law as it applies to different forms of business association provides **mandatory rules** (that is, by electing that form of business association, the participants agree to be bound by these rules) and **default rules** (that is, rules that apply in that form of business association unless the participants agree that the rules should be altered or excluded).

Where the law itself provides rules governing the relationship of participants that are appropriate for the enterprise to be carried on, this can reduce **transaction costs** for the participants. This is because there is less need to obtain legal and other advice to customise the rules for the particular circumstances, or to have lengthy agreements governing all possible situations prepared and executed by all the participants (including new participants as they join). The rules of general application found in the law are often settled and may have been the subject of judicial interpretation or academic commentary, so that participants can be confident of the likely application of the rules in any given situation.

This can be illustrated by comparing the default rules under the law of partnership and company law regarding the right of investors to participate in management and to share in profits.

Under the *Partnership Act 1908*, the default rules

12 Section 27.

assume that all the partners will be active participants in the management of the enterprise. They will all have an equal say on important decisions affecting the business. In addition, unless the default rule is modified in a partnership agreement, they will all participate in the profits of the business equally. Further, each partner is an agent for the others, giving one partner the ability to bind all the others personally.

The default rules for company law assume that management powers will be exercised by a governing body, the board of directors. Individual shareholders may have only limited rights to participate in decision-making. Because of this division between ownership and control, company law contains rules designed to protect shareholders and prevent directors using their control of the company to their own advantage. Participants in companies are not agents for each other, although we will see in Chapter 21 that certain company officers can bind the company itself in certain circumstances. In company law, the default rule is that shareholders are entitled to participate in the profits of the business pro rata by reference to the amount of capital contributed by them, rather than equally regardless of their contribution.

So particularly for business enterprises that involve a separation of ownership and control, company law can provide a useful set of rules to govern the relationship between participants. Even for other companies that do not have this separation, company law has developed a set of rules that are appropriate, or that can be customised at a lower cost than would otherwise be possible. In addition, one of the comparative "strengths" of company law is its flexibility. As we will see in Chapter 18, companies may issue shares of different classes, with different rights (particularly control rights and distribution rights) attaching to those classes of shares. This means that the differing interests of different classes of investors can be easily accommodated. Similarly, arrangements for management (such as special restrictions on officers' powers) can be incorporated into the existing framework of company law through the company's constitution.

Company charges

We noted in Chapter 3 that businesses, including companies, have the ability to give a charge over their assets. This means that they can create a security interest over assets that are acquired, transformed and disposed of in the ordinary course of business. Such a charge is a significant form of security in a commercial context, where often a business's main asset is its inventory.

13 A company's "inventory" is its goods, other property and services (a) held for sale in the ordinary course of business, or (b) in the process of production for such sale, or (c) to be used up in the production of goods, other property or services for sale (that is, consumable supplies).

The ability to give a lender security over that inventory, but to continue to transform or transfer that inventory in the ordinary course of business, means that financing may be more readily available, or available at a lower cost, than to a business enterprise that does not use this form of funding.

Charges are discussed in detail in Chapter 20.

Taxation consideration

Companies are "taxpayers" for the purposes of New Zealand income tax legislation. They pay income tax at a lower rate than individuals who are taxed at the top personal tax rate. However, because companies pay a flat rate of 28% from the first dollar of earnings from 1 April 2011, compared with the graduated scales applicable to individuals, for the first (approximately $50,000 $ of income the taxation rates for companies exceed that of individuals. This is because the individual tax rates from 1 April 2011 to 31 March 2012 state that the second highest individual tax rate of 30 cents applies to taxable income over $48, 001.

The entity level taxation imposed on companies results, to a degree, in "double taxation" of company profits. This is because the company pays tax on its taxable income at its marginal rate, and then when its after-tax profits are distributed to shareholders as dividends the shareholders pay tax at their marginal rate on the amount of the dividend. However, this is offset to a certain degree by "dividend imputation", a process by which the shareholder receives a credit for a pro rata share of the tax paid by the company, to be offset against the shareholder's own liability to pay tax on the amount of the distribution.

Dividend imputation does not fully offset the effect of double taxation. In particular, if a shareholder's marginal tax rate is lower than the company's (because the shareholder's income is under the relevant threshold, or the shareholder does not pay tax) the benefit may not be fully realised.

The individual tax position of an investor in an enterprise will determine whether a form of business association that attracts entity level taxation (such as a company) or one that does not (such as a trust or a partnership) is the most appropriate for that investor.

[¶507] What are some of the disadvantages of the company form?

The foregoing discussion has canvassed some of the possible advantages of using a company to carry on a business. It is clear from that discussion that the question of whether the particular characteristic is an advantage or not depends on the individual circumstances of the participants in the enterprise. Here, we look at what are perceived to be the main disadvantages of the company form — the costs in establishing and administering a company, and the extent to which the *Companies Act 1993* requires participants in companies to disclose information about the company's financial affairs. Also, because the Companies Act includes a number of public law obligations, breach of which may attract criminal sanctions, this additional layer of accountability should be taken into account.

Establishment and administration costs

The costs of forming a company are described below. In each individual case, they must be compared with the costs involved in other forms of business association. For example, although there are no formalities such as registration associated with forming a partnership, most partnerships would require a customised partnership agreement, which may be expensive to draft.

Companies and their participants have ongoing administrative obligations throughout the company's life. These obligations are described in Chapter 17, and their extent depends on the nature of the company. We will see that, for smaller companies, these obligations are considerably less onerous than those for large listed companies. Maintaining records, making the public filings, and disclosing information to shareholders all have a cost, both in professional fees

(such as accounting and audit costs, legal fees, and the costs of registry services) and in management time diverted from managing the company's business to complying with legal and regulatory requirements. These costs are sometimes called **compliance costs** .

Publicity

All companies are required to disclose certain information to the New Zealand Registrar of Companies (and therefore the public generally) and their shareholders. These disclosure obligations are discussed in Chapter 17.

We will also see in Chapter 17 that all companies that are "issuers" are required to disclose to the Registrar (and hence to make public) their key financial information on a periodic basis. This process is usually called **mandatory periodic disclosure** . This information is readily available to anyone who seeks it, including Government departments and regulatory agencies, the company's competitors, and creditors of the company and its individual participants.

In addition to this periodic reporting, companies that are listed on the NZSX are required to disclose material information about themselves publicly as it becomes available. This process is usually called **mandatory continuing disclosure** .

These two types of disclosure obligation may make it difficult to keep private the information about businesses conducted through a company. This can operate to the competitive detriment of the company.

Public law obligations

Companies are legal entities created by Government exercising political power on behalf of the people. They and their participants have special powers and privileges as a result of the process of incorporation. In return, companies and their participants are required to submit themselves to regulation under public law. Many of the obligations imposed on companies and their participants under companies and related legislation are public law obligations, in the sense that they can be enforced by the State through sanctions.

In this respect, company law differs from the law regulating other forms of business association. For example, the breach by a partner of his or her duty to avoid conflicts of interest would not attract public law sanctions, but the breach by a director of the duty to avoid conflicts may result in a substantial fine.

14 Section 373(2), *Companies Act 1993*.

It is also possible that a director may face a period of imprisonment depending on the statutory provision which has been breached.

15 Criminal sanctions may apply where the director has acted dishonestly. See Chapter 16 for discussion of the consequences of breach of duty.

[¶508] Deciding on the most appropriate form of business association

The decision as to the most appropriate form of business association for a particular enterprise requires careful consideration of all these factors. For most larger enterprises, particularly those that propose to raise capital from the public, a company will be the most appropriate form of business association. In smaller businesses, the choice may be less clear-cut. However, many small businesses do elect to use the corporate form, largely because of the perceived advantages in obtaining limited liability. This is true even where agreements with the company's main finance creditors have the practical effect of restricting the benefits of limited liability to the day-to-day debts of the business and involuntary liabilities such as legal claims.

TYPES OF COMPANIES

[¶509] Overview of the different types of companies

Under New Zealand law there is no distinction between different types of companies in terms of registration process or legal status. The same registration and management rules apply.

However, reporting requirements differ depending on size and fund-raising activities. A **reporting entity** is any company which is not exempt, and includes listed companies, issuers, and all members of any group of companies. Overseas companies are treated as though they are reporting entities. An **exempt company** is any company whose assets and turnover do not exceed a specified figure (currently $1m and $2m, respectively) and which is not an overseas company, a member of a group or an issuer. Figure 5.1 provides an overview of how companies are classified. More detailed information is provided in Chapter 17.

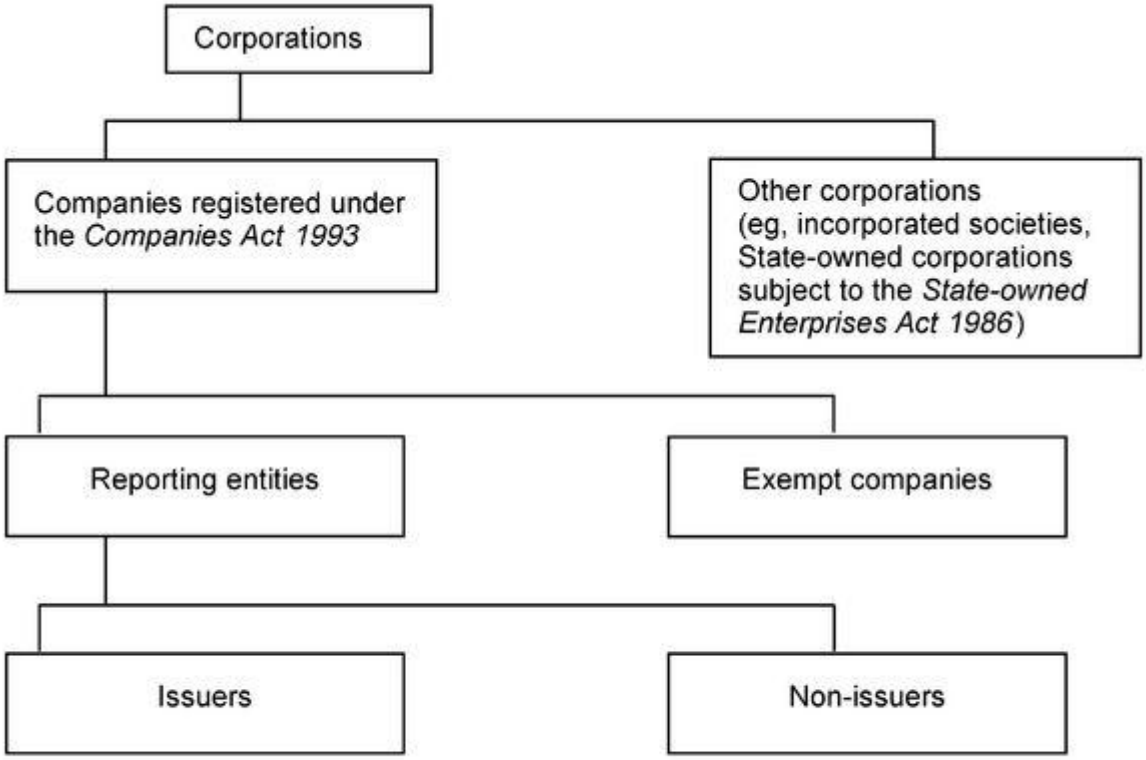

Figure 5.1: Classification of companies

[¶510] How can companies provide for the shareholders' liability?

Companies limited by shares are the most common form of limited liability company in New Zealand. In this situation, the liability of the shareholders is limited to the amount unpaid on their shares.

16 Section 97(2)(a), *Companies Act 1993*.

However, through a customised constitution the shareholders of a company can adopt alternative means of determining liability or elect not to have any limitation on their liability at all. The *Companies Act 1993* makes no legal distinction between these companies and those where liability is limited by shares.

[¶511] How are companies classified as issuers or not?

The distinction between an issuer and a non-issuer under New Zealand company law is purely functional. A company may be described as being one or the other depending on whether it raises money from the public or not. Issuers, however, may or may not be listed companies.

In brief, a person (whether natural or juridical) proposing to raise money from the public is defined as an **issuer** and must comply with the legal requirements of the *Securities Act 1978*. These requirements relate to the **activity** of fund raising rather than to the nature of the enterprises wishing to raise the funds. Thus, although companies raising money from the public are by definition issuers, issuers will not necessarily be companies. Issuing companies must

comply with the disclosure requirements prescribed by the *Companies Act 1993*, which are more rigorous than those required of companies that are not issuers.

As we noted in Chapter 2, the *Financial Reporting Act 1993* and the Securities Act impose more onerous obligations on issuers and certain other companies than on non-issuing companies. Examples of these obligations include:

- issuers are required to lodge financial statements with the Registrar of Companies regardless of the size of the company's operations,

17 Section 18, *Financial Reporting Act 1993*.

and

- the annual report of an issuer which is also a "public issuer" (*Securities Markets Act 1988*)

18 A "public issuer" is a party to a listing agreement with a stock exchange.

must contain information on relevant interests held by substantial security holders.

19 Section 26, *Securities Markets Act 1988*.

[¶512] Can companies change type?

As there is no legal distinction between different types of company, there is also no legal impediment to a company changing from being an issuer to being a non-issuer, from a listed to a non-listed company, or from an exempt company to a reporting entity.

20 This is dependent on size and is described further in Chapter 17.

REGISTRATION OF COMPANIES

[¶513] How are companies created?

Companies are created (or "incorporated") through being registered by the Registrar of Companies. A person wishing to create a company lodges an application for registration with the Registrar and pays the prescribed fee. The application form must contain certain information about the new company. This section explains the requirements for registration.

A person proposing to use a company to carry on a business has a choice of either registering a new company themselves, or acquiring an already registered company from another person. Companies that have been registered for the purpose of being onsold, and that have not traded prior to sale, are often referred to as **shelf companies** .

21 This is a commercial term, not a legal one.

A number of these companies may be formed by law firms or accountancy firms and made available for purchase as a service to their clients. Before amendments to the *Companies Act 1955* were made, starting in 1983, incorporating a company could be quite complex, and acquiring a shelf company reduced the administrative burden for business people. Shelf companies are particularly useful where a new company is required urgently for a particular project.

[¶514] What is the required procedure?

The first step in registering a company is to reserve a name for the company. Once that has been done, the applicant needs to lodge an application form with the Registrar of Companies. A copy of the form is included at ¶2901. In order to complete this form, the person proposing to register the company will need to do the following:

- Decide who will be the shareholder or shareholders of the company. All companies must have at least one shareholder.

22 Section 10(c), *Companies Act 1993*.

The planners will also need to decide the number of shares to be taken up by each shareholder, and the characteristics of those shares. If the shares are to be divided into different classes with different rights, the rights attaching to each class must be decided.

23 Shares are discussed in Chapter 18. If certain classes of share have limited rights, these must be provided for in the constitution.

The proposed shareholders must consent in writing to becoming shareholders of the company.

24 Section 12(1)(d).

• Decide who will be the director or directors of the company. The directors must give their consent in writing to being appointed as directors.

25 Section 12(1)(c).

The *Companies Act 1993* does not require that a director must ordinarily reside in New Zealand. 26 In Australia, s 201A(1) of the *Corporations Act 2001* states that a proprietary company must have at least one director and that director must ordinarily reside in Australia. Section 201A(2) states that an Australian public company must have at least three directors, two of whom must ordinarily reside in Australia. There have been proposals for New Zealand to follow the Australian position and require one resident director: see Bell Gully, *Corporate Reporter,* 5 October 2011 at p.7.

• Choose an address to be the company's registered office.

27 Section 12(2(d), Companies Act.

• Decide whether the company's internal arrangements will be governed by the replaceable rules in the Companies Act, or whether a constitution replacing some or all of those rules is to be adopted. A company may but is not required to have a constitution.

28 Part V. See Chapter 6 for discussion of the internal governance rules of companies.

• Choose a name for the company.

29 Part IV.

The procedure for registering a company is set out in s 12 of the Companies Act. The person proposing to register the company must complete and lodge with the Registrar a form detailing the arrangements set out above, and pay a registration fee. A copy of the form is available on the Companies Office website (www.companies.govt.nz). If the company is to have its own constitution, a copy of the constitution must be lodged with the application. Standard-form constitutions are available for purchase from the websites of the Companies Office and CCH New Zealand Limited (www.cch.co.nz).

If the application is complete and the fee has been paid, the Registrar will register the company and issue a registration certificate containing details of the registration.

30 Section 13.

The new company comes into existence on the day on which the certificate of registration is issued.

31 Section 14.

Since mid-2002 it has been possible for companies (other than issuers or overseas companies) to be registered online (www.companies.govt.nz). In summary, the process involves the following steps:

• Application for the reservation of a name. This can be completed online. Once approval is granted, both a name reservation reference and a company number will be provided to the applicant in the letter confirming the reservation of the name. Both of these numbers need to be included when applying for registration.

• Application for incorporation. This must be completed within 20 days of the reservation of the name, otherwise the reservation will expire. An applicant can withdraw on the 18th working day and receive a further 20 days to complete the registration process. The form can be completed and submitted online and requires such information as name and number,

shareholders, directors, registered office and constitution (if any).

• Payment of the application fee. This can also be completed online by credit card.

• Notification of successful registration (or if there are problems that need to be resolved) will be carried out by email.

• Finally, the successful applicant faxes copies of the necessary consent forms, completed and signed (by directors and shareholders). These are available for downloading from the Companies Office website. The registration process is then complete.

On 28 June 2010, the Companies Office introduced a new IT platform called "Enterprise." The purpose of Enterprise was to enhance user experience, but also integrate new registries such as the *Financial Service Providers Register.*

[¶515] Company names

All companies must have a name.

32 Section 10(a).

This name must be reserved by the applicant prior to applying for registration.

33 Section 20.

Rules apply to selecting and using a company name, and these are set out in s 22 of the *Companies Act 1993*. Certain names are prohibited. A name that is identical or almost identical to another company's name or a registered business name is not acceptable, nor are names that are offensive or contravene an enactment.

If the liability of shareholders in the company is limited, the company must include the word "Limited" or the words "Tāpui (Limited)" in its name.

34 Section 21.

As stated earlier in this chapter, shareholders' liability is limited unless the company's constitution provides otherwise.

Companies can change their names after registration, in accordance with the procedure laid down in s 23. Any application must be in the prescribed form and be made by a director with the approval of the board. If the company has a constitution, any procedure prescribed in that constitution must also be observed.

[¶516] Pre-registration conduct

Although registration of a company can now be achieved relatively quickly, it may be that the particular circumstances of a transaction require that certain agreements or arrangements be entered into on behalf of the company prior to the time at which it comes into existence.

Under s 182 of the *Companies Act 1993*, where a person enters into, or attempts to enter into, a contract on behalf of, or for the benefit of, a company before it is registered, the company can, by ratifying (or approving) that contract, become bound by it and entitled to the benefit of it after registration. If the company is not registered, the person who made the contract may be liable to pay damages to the other party or parties to the contract, under s 183. If the company fails to ratify the contract, the other party may apply to the court for relief, return of property, or validation.

35 Section 184.

Persons who take steps related to establishing a new company have traditionally been referred to as the company's **promoters** .

36 The *Companies Act 1993* makes no reference to this term, however.

Where promotion of the company involves the promoter selling assets to the business, and it is planned to invite outside investors to participate in the company, the promoters can be made

subject to special duties to the company. These include duties of disclosure to the company about profits they are making, and duties of disclosure to potential investors.

LISTING ON MARKETS OPERATED BY THE NEW ZEALAND EXCHANGE

[¶517] What is listing?

In Chapter 1, we noted that some companies elect, by entering into a contract with the New Zealand Exchange (the NZX),

37 Information on rules, criteria for listing and performance can be obtained from the NZX website — www.nzx.com.

to list on, for example, the New Zealand Stock Market (the NZSX) and have one or more classes of their securities quoted for trading on the NZSX. Such companies are usually referred to as "listed companies". Once the company is listed and its securities quoted, those securities can be bought and sold by investors through the electronic marketplace conducted by the NZX.

Although there are about 533,451 companies registered as New Zealand companies, only about 176 are listed on the NZSX.

38 Overseas companies and non-company entities also list securities on the NZSX.

All listed companies are issuers, but not all issuers are listed.

In this section, we look briefly at the reasons why a company might choose to apply for listing, the eligibility criteria adopted by the NZSX, and the process of listing.

[¶518] Why do companies list?

Listing on the New Zealand Stock Market (NZSX) provides access to capital at a lower cost, enabling a business to realise its potential for growth, while gaining greater flexibility in financing methods.

39 A case study of an initial public offering (an IPO) can be found in G Walker, "Case study of an IPO in New Zealand", in G Walker (gen ed), *Securities Regulation in Australia and New Zealand* (2nd ed, 1998). For current details, see the NZX website at www.nzx.com.

Securities for which there is a ready market are more attractive to investors than those for which no market exists. This helps the company to raise additional capital from the investing public when it needs to do so.

The reasons why **liquid investments** (those easily converted to cash) are more attractive to investors than **illiquid investments** (those not easily, or only slowly, converted to cash) belong more to the realm of finance theory than company law. It is sufficient for our purposes to note that the fact that liquid securities are more attractive to investors has important implications for companies trying to raise new capital. In particular, investors will generally be prepared to pay a higher price for a liquid security than an illiquid one offering the same potential returns, and a larger number of investors will be interested in acquiring liquid rather than illiquid investments.

So listing, by creating a liquid market for a company's securities, can lower the company's cost of capital. In addition, there may be other benefits, such as increased prestige or better relationships with lenders and suppliers. Offset against these benefits are the costs of complying with the additional disclosure and other obligations contained in the NZX Listing Rules.

40 The costs for a given float will be between 3% and 7% of the sum raised. This is made up of fees and compliance costs.

[¶519] How do companies list?

Companies proposing to list must make an application to the New Zealand Exchange (the NZX), which has a discretion (so long as it is acting properly) to accept or reject any application. The NZX sets out the criteria for listing in its Listing Rules.

There are three possible markets on which an issuer might list. The different objectives of each of these markets are reflected in the criteria for listing:

• **The NZSX** : The New Zealand Stock Market (the NZSX) is the NZX's premier equities market. It features the securities of most of New Zealand's listed companies and a number of overseas companies. Companies on the NZSX have one of three listing types. The first type is **primary listing** , where NZX is the home exchange and the company abides by the NZX Listing Rules. The second type is **dual primary listing** , where the company abides by all of the NZX Listing Rules as well as its home exchange listing rules. The third type is **overseas dual listing** , where the company abides by a limited number of the NZX Listing Rules as well as those of its home exchange. Companies generally quote ordinary shares on the NZSX. They can also quote options, partly paid shares, warrants units, and notes and preference shares with equity-like characteristics. For a company to list on the NZSX, the securities being quoted must have a minimum anticipated market value on initial listing and a specific spread of shareholders. As of September 2011, there were 176 companies listed on the NZSX.

• **The NZDX** : The New Zealand Debt Market (the NZDX) offers a range of investment securities including corporate and Government bonds and fixed-income securities. As of August 2011, there were 109 securities listed on the NZDX.

• **The NZAX** : The New Zealand Alternative Market (the NZAX) was developed by the NZX to provide a market for the raising of capital and the trading of securities issued by companies that, because of their size or structure, may not be suited to the NZSX. As of August 2011, there were 24 securities listed on the NZAX.

The process that should be followed for any company wishing to list securities is as follows:

• professional advisers are appointed to advise on appropriate procedures and documentation

• due diligence is carried out to ensure that the legal requirements for disclosure have been complied with

• offering documents and profile are prepared

• a pre-listing agreement is made with the NZX which allows the exchange to provide information to the FMA should it consider it necessary

• discussions are held with the NZX

• an application to list is filed with the NZX Legal and Surveillance Department (this is then reviewed within 10 business days), and

• listing is approved or declined (in which latter case an unsuccessful applicant may be asked to pay the expenses and overheads incurred by the NZX).

Once listed, a company pays the NZX an initial fee, and thereafter an annual fee which is calculated by reference to the company's market capitalisation.

CORPORATE GROUPS IN BUSINESS PLANNING

[¶520] What are "corporate groups"?

Throughout this discussion we have treated individual companies as being discrete in a commercial sense as well as in a legal sense. However, the reality is that, for all but the very smallest commercial enterprises, most businesses operating in the corporate form are conducted through groups of companies rather than individual companies.

The expression **corporate group** is used loosely to describe the situation where control of one or more companies is in the hands of another company. In this book we use the term "corporate group", whereas some other texts use the term "group of companies". The terms have the same meaning. The degree of control that the latter company is required to exercise over the former

before they are treated as being a group tends to depend on the context in which the expression is used. Some of the definitions that the *Companies Act 1993* uses to determine whether companies are in a group relationship for different purposes are discussed below.

[¶521] Why use a corporate group, rather than an individual company?

The participants in a business enterprise may choose to conduct that enterprise through a number of separate companies, rather than a single company, for a number of reasons. In particular, these may include:

- perceived organisational benefits in separating out the management of different aspects of the enterprise, and
- a wish to rely on the doctrine of limited liability to quarantine the risk of one part of the enterprise from the assets of the remainder.

Are corporate groups common?

Most listed companies use a group structure. Most of the top companies listed on the New Zealand Stock Market (the NZSX) are part of a corporate group.

Does the law treat corporate groups differently?

For the most part, company law treats each company in a corporate group as a separate entity, and there are few special rules that apply particularly to group companies. The limited circumstances in which the law does recognise, and address directly, corporate groups are outlined below.

[¶522] Group relationships — the definitions

Where company law does recognise and regulate group relationships, it does so only where the relationship between the companies in question falls within the relevant definitions. In some cases, the law applies to related bodies corporate. In others, the wider concept of control is used to define the existence of a group.

Holding companies, subsidiaries and related bodies corporate

Some parts of the *Companies Act 1993* impose special obligations on companies and their participants where a relationship of **holding company** and **subsidiary company** exists.

Section 5 of the Companies Act provides that a company is a subsidiary of another company (called its "holding company") if, and only if:

- the holding company controls the composition of the subsidiary's board — a company is taken to control the composition of another's board if it has the power to unilaterally make changes to the membership of the board, or
- the holding company is in a position to cast or control the casting of more than one-half of the votes at a general meeting of the subsidiary, or
- the holding company holds more than one-half of the issued share capital (excluding non-voting shares) of the subsidiary, or
- the subsidiary is a subsidiary of another subsidiary of the holding company.

41 Sections 5 and 7, *Companies Act 1993*.

Companies will be treated as holding company and subsidiary where they satisfy any one of these tests. However, the categories clearly overlap. For example, where one company ("H Co Ltd") holds over 50% of the issued shares in another ("S Co Ltd") in which directors are elected by a resolution of shareholders in a general meeting and all the issued shares are ordinary shares of the same class, H Co Ltd will usually satisfy each of the first three limbs of the definition.

A simple company group structure is illustrated in Figure 5.2.

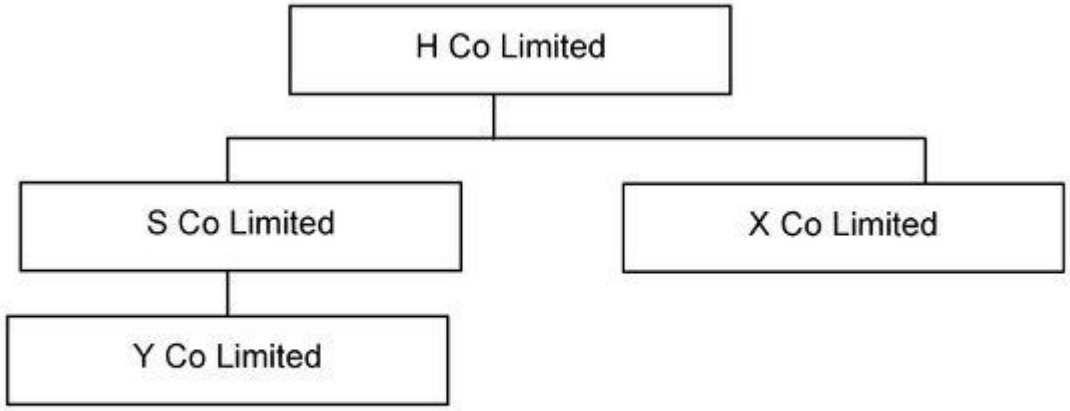

Figure 5.2: Simple corporate group structure

In Figure 5.2, S Co, X Co and Y Co are all subsidiaries of H Co. H Co is the holding company of S Co, X Co and Y Co. Y Co is also a subsidiary of S Co, and S Co is the holding company of Y Co.

Section 8 also contains provisions that refine the definition. In addition, s 2(3) defines companies as related where their businesses are carried on in such a way that their separate businesses are not readily identifiable.

Companies that are in the relationship of holding company and subsidiary are referred to in the Companies Act as "related". A subsidiary is also a **related company** of all other subsidiaries of its holding company. Therefore all the companies illustrated in Figure 5.2 are related companies.

Companies in which all the issued shares are held by a holding company or its nominee are referred to as **wholly-owned subsidiaries** .

Controlled entities

In certain cases, the Companies Act imposes special rules on companies and the entities they control. Some examples are given at ¶523.

The concept of "control" in relation to the composition and membership of the board is defined in s 7. Financial Reporting Standard, FRS-37, identifies the circumstances where consolidated financial statements should be made for subsidiaries.

[¶523] In what circumstances does the law recognise and regulate corporate groups?

The most important of the special rules that apply to corporate groups are as follows:

- **Insolvent trading** : A related company (as defined in s 2(3) of the *Companies Act 1993*) may, in certain circumstances identified in s 271, be liable for debts incurred. This means that the court has the discretion to order either that a holding or other related company contribute to claims made against a company in liquidation, or that the liquidation of related companies be conducted together.

- **Limit on shareholdings** : Under s 82 a subsidiary company (as defined in s 5) is prohibited from holding shares in its holding company.

- **Financial statements** : The accounting rules for company financial statements and reporting contained in the *Financial Reporting Act 1993* require the preparation of a consolidated or group financial statement "where required by the appropriate Financial Reporting Standard or Statement of Standard Accounting Practice" (currently FRS-37), and for group reporting and disclosure. As such, they arguably represent a significant acknowledgment of the commercial significance of corporate groups. The accounting rules use a somewhat broader definition of "control" than do the Companies Act and the Financial

Reporting Act.

• **Reporting entities and exempt companies** : The assets and operations of companies are taken into account in determining whether they are reporting entities or exempt. Any member of a "group" (which is defined in s 2 of the Financial Reporting Act as a "reporting entity and its subsidiaries") cannot be treated as exempt.