Closely held companies under the draft Companies Act

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This paper discusses the treatment of closely held companies under the Law Commission's draft Companies Act. It is the author's address to the 1989 Spring Seminar Series sponsored by the Wellington District Law Society and the Victoria University of Wellington Law Faculty.

I INTRODUCTION

In June 1989 the Law Commission published a draft Companies Act which proposes a fundamental reform of New Zealand company law.[1]

> The draft Act abolishes the distinctions between public, private, unlimited and guarantee limited companies in favour of a uniform regime. The provisions of the draft Act comprise a constitution which can be altered to meet the needs of the incorporators.[2]
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> The draft Act thoroughly revises the law of capital maintenance. It abolishes par value shares, allows companies to purchase own shares and establishes a uniform solvency test for all distributions as well as for financial assistance and cross-holdings.[3]
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> The draft Act codifies the duties of directors.[4] Most duties track those under existing law. However, the draft Act introduces a few new specific obligations, most significantly directors must certify in writing that many transactions comply with the substantive requirements of the Act.[5] The Act substantially increases the financial penalties for director misconduct.[6] The burden of these new rules is mitigated by provision for business judgment and reliance upon the reports of advisers and subordinates.[7]
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> The draft Act considerably strengthens the position of shareholders. It allows for derivative and direct actions by shareholders against directors.[8] In a corollary rule, it specifies which of the directors' obligations run in favour of the shareholders and which

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1 The Law Commission, *Company Law Reform and Restatement-Report No 9* (Wellington, 1989).
2 Clause 22.
3 Clauses 28, 49, 42, 58 and 48.
4 Clauses 101-107.
5 Clauses 39(2), 42(2), 50(3), 51(2), 58(5), 59(2).
6 Clauses 277-281.
7 Clauses 106 and 107.
8 Clauses 127 and 131.

run in favour of the company.[9] Further, the draft Act places control over five decisions in the hands of the shareholders: winding-up, amalgamation (a statutory merger arrangement), major transactions (disposition or acquisition of more property than one half of the existing assets), alteration of the constitution and alteration of class rights.[10] The Act entitles any member who dissents from one of these decisions to have his or her shares purchased by the company.[11]

The draft Act places enforcement primarily with the judiciary through (a) adjudication of civil disputes involving shareholder rights and (b) prosecution of offences committed by directors and companies. The draft Act confines the Registrar to record keeping and disclosure.[12]

The draft Act replaces the present three-track regime for winding up with a uniform system which operates largely under the control of the liquidator.[13] In addition, the draft Act reforms the rules respecting preferential transfers and establishes an assetless company fund.[14]

The draft Act makes no provision for company charges. The law of charges is the subject matter of the draft personal properties securities Act which proposes a uniform regime for all forms of personal property security.[15] That regime is patterned after the Canadian variant of Article 9 of the Uniform Commercial Code, perhaps one of the most successful pieces of commercial legislation in the 20th century.

All of these reforms, although perhaps novel for the New Zealand practitioner, are measures which are well established and commercially tested in other Anglo-American jurisdictions. As for its style and organisation, the draft Act is a model of clarity. It adopts the open-textured plain language approach which has proven so successful in Canada and some of the more progressive jurisdictions of the USA. It avoids the overdrafting so characteristic of Australian legislation and some of the recent local commercial legislation, particularly the Securities Amendment Act 1988 and the Motor Vehicle Securities Act 1988. In terms of policy, the draft Act strikes a happy balance between the regulatory and contract approaches to company law. The draft Act will likely face heavy criticism from the local apostles of the mid-60's Chicago School. However, during the last quarter century, the Chicago School has evolved to the point where most of its North American adherents would feel quite comfortable with the draft Act. Properly explained, the draft Act would, I believe, appeal to the sensibilities of the vast majority of New Zealand investors, businessmen, accountants and solicitors as a socially desirable and commercially feasible reform.

The only reservations that I harbour, as a matter of principle, to the draft Act is its treatment of closely held companies. Most all of the 150,000 limited

9 Clause 131.
10 Clause 78.
11 Clause 81.
12 Clauses 268-276.
13 Clauses 203-216.
14 Clauses 225-228, 244-250.
15 The Law Commission, *Report No 8* (Wellington, 1989).

companies in New Zealand are either incorporated proprietorships or incorporated partnerships having two or three principals. Many jurisdictions have enacted special statutes for such businesses. These include jurisdictions as diverse as West Germany, South Africa and Delaware[16] as well as the many other North American jurisdictions which follow Delaware law. Such a statute has recently been enacted in Australia.[17] Other regimes, such as the New York and California laws and those jurisdictions which follow these two regimes make special provisions or exceptions for closely held companies in their general company law statutes.[18] In either case, the result is that, except for certain reporting and capital maintenance obligations associated with the principle of limited liability, closely held companies can be conducted in much the same manner as partnerships or sole proprietorships.

The draft Act does not follow this common and well-tested approach. Instead, the Law Commission proposes a single statute for all companies. Although it borrows heavily from rules in foreign jurisdictions respecting both closely held companies and publicly listed companies, even a cursory reading leaves little doubt that the regulatory prototype is, if not the publicly listed company, at least a company with a sufficient number of shareholders to justify delegation of management to a separate body. As its sole accommodation to the needs of the closely held companies, the draft Act provides that many of its provisions can be varied by a company's constitution. The Law Commission justifies this approach on a number of grounds including lack of public support for special legislation dealing with closely held companies, the extreme diversity of closely held companies, the availability of standardised constitutions to deal with the needs of closely held companies and the adequacy of the approach proposed by the draft act.[19] The author proposes to test the adequacy of the approach by applying the draft Act to five events (voting, share issues, buyouts, sale, and business failure) common to incorporated proprietorships and partnerships. The discussion focuses upon the operation of the nondisplaceable rules of the draft Act, those not subject to variation by the constitution.

II VOTING

Like the present statute, the draft Act distinguishes between ordinary resolutions and special resolutions. As one of the rules which may not be varied by a company's constitution, the draft Act requires a special resolution (75 percent majority) for approval of five types of transaction: alteration of the constitution, a major transaction, an amalgamation, a liquidation and alteration of the rights of an interest group.[20] As applied to incorporated proprietorships and incorporated

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16 Gesetz betreffend die Gesellschaften mit beschraenker Haftung of 20 May 1898 (West Germany), General Corporation Law of Delaware 1979 ss. 341-356 (Del USA) and Close Corporations Act 1984 (SA).

17 Close Corporations Act 1989 (Australia).

18 California General Corporation Law ss 158, 186, 202, 204, 300, 418, 412, 706, 1111, 1201, 1800, 1904 (Compact Ed, West, 1987).

19 *Report No 9*, above n 1, at 56-57.

20 Clauses 78 and 88.

partnerships having three to five principals, this rule results in a degree of inflexibility which is warranted neither by the expectation of the parties nor the operational needs of the business.

There is no apparent reason why three equal shareholders should not be able to do business under an arrangement whereby the constitution can be altered or the business sold with the approval of two of the three members. Yet, the draft Act requires unanimity. The rule also requires unanimity in the case of two equal shareholders. Although that will often accord with the parties' wishes, it prevents them from resorting to other devices for breaking deadlocks. Although it is designed as a measure for minority protection,[21] as applied to the liquidation of a company, the rule works to the disadvantage of the minority. It runs counter to the expectation of most participants in closely held companies who might well, before the fact, prefer the partnership rule which allows any member to dissolve the business.

A second peculiar feature of the voting system appears in clause 80(1) which provides that a shareholder:

> does not owe any duty to the company or to any other person and does not incur any liability in respect of the exercise of or failure to exercise votes to which that shareholder is entitled.

This rule may not be varied by constitution. Whilst understandable and defensible as applied to widely held companies, this rule reverses the development of the case law which imposes a fiduciary obligation upon the exercise of voting rights by majority shareholders in closely held companies.[22] Although the implementation of such a fiduciary duty in widely held companies poses, as noted in the comments to the proposed Act,[23] insurmountable difficulties, this is not the case in circumstances such as those involved in *Ebrahami*. The existence of the fiduciary obligation accords with the expectations of the parties to such ventures. In the absence of the rule, satisfactory results can be arrived at only by complex organisational arrangements. For example, to avoid the type of freezeout involved in *Ebrahami*, the company can be organised with three classes of shares each having the right to elect one director. The authors of the draft Act might argue that the draft Act's provision in clause 135 for relief of prejudiced shareholders makes such a fiduciary duty unnecessary. As applied to freezeouts and discriminatory bailouts, the argument proves too much. If the voting of shares involved in *Ebrahami* constitutes prejudicial conduct for purposes of clause 135, this effectively establishes a constraint upon the rule in clause 80(1).

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21 *Report No 9*, above n 1 at 46.

22 *Ebrahimi* v *Westbourne Galleries Ltd* [1970] AC 360; *Clemens* v *Clemens Bros Ltd* [1976] 2 A11 ER 268.

23 *Report No 9*, above n 1, at 50-51.

III ISSUANCE OF SHARES

Suppose individuals A, B and C organise a limited company as equal holders of one class of shares. All three persons intend to be working participants in the business. One of the questions which must be anticipated in the organisation of the company concerns the conditions under which equity securities will be issued to another party, eg, in order to acquire additional capital or to retain desirable employees. It is not unlikely that all three investors will insist that any new member be acceptable to all three of the original participants. Partnership law accommodates this expectation by means of a statutory rule that admission of new partners requires the unanimous consent unless the partnership agreement otherwise provides.[24] The veto right ensures that any new member will be admitted on terms acceptable to all of the existing partners.

This straightforward approach cannot be implemented under the proposed Act without serious difficulties. The Act does allow the original incorporators to include in the constitution a provision similar that used in partnership agreements.[25] Suppose, however, that in the time between organisation of the company and the occasion for admission of a new member, one or more of the original shareholders have transferred some shares to family members (for tax purposes) and these members do not actively participate in the business. Under these circumstances, implementation of the proposed clause entails formalities in addition to the resolutions and documentation associated with share transfer. In many cases, a share description must be formulated, adopted by resolution and filed with the Registrar.[26] Shareholder approval of the issue may be required and must also be filed with the Registrar.[27] Additionally, the board must resolve and certify that the terms of the issue are fair and reasonable to the company.[28] Further, the proposed provision cannot be implemented without rendering the inactive members involuntary directors of the business.[29] The inactive members are responsible for certification of the terms of the issue and are responsible for compliance with registration requirements. Having been made involuntary directors by their control over the issue of shares, these inactive members of the company remain directors for purposes of all the other obligations affecting directors, eg, in respect of management and reporting.[30] The provision for involuntary directors obviously anticipates the case of "nominee directors" who act at the behest of a large shareholder. Since control resides with the shareholder, there is reason to make the shareholder an involuntary director. However, in the case of closely held

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24 Partnership Act 1908 s 27(g).

25 Clauses 33, 37(1), 36.

26 If, as will be typically the case, the company's constitution does not provide for issue of the specific shares, the shares can be issued only under clause 33(b) which requires compliance with clauses 34 and 35.

27 If the constitution preserves the shareholders' pre-emptive right, their approval for the new issue is required under clause 37(1)(b).

28 Clause 39.

29 Clauses 96(1)(b)(ii) and 33(b).

30 Clauses 96(1)(b), 101-110.

companies, the rule operates to burden parties who, in most cases, display a singular absence of either expertise or control.

IV PURCHASE OF OWN SHARES

In closely held companies, purchase of own shares serves principally as a vehicle to facilitate the exit of existing shareholders in the event of circumstances as diverse as disagreement, death or retirement from the business. Experience in North America shows that company buyouts are generally preferable to cross-purchase arrangements on grounds of administrative simplicity, taxation and financing costs.[31] This is particularly true where the number of shareholders exceeds three or four. In the most usual configuration, the company constitution provides that, upon occurrence of certain events, the company will purchase the shares of a member. The constitution either sets the value, eg, by means of a formula, or provides for arbitration. The constitution may also specify details of the payout, eg, the use of instalment payments secured by sinking fund arrangements or security over company property. These provisions parallel those found in partnership agreements. Under USA state law applicable to closely held companies, these arrangements can be implemented by resolution of the directors and execution of the buyout agreement, or where the company operates without directors, by execution of the buyout agreement.[32] As the only legal constraint, most jurisdictions require that payments, which generally occur in the form of instalments, comply with the capital maintenance rules.

Under the draft Act, such an arrangement constitutes a special offer to acquire the shares.[33] As such, it must comply with six legal requirements. Firstly, as a distribution, it must comply with the solvency test: after the distribution, the company must be able to pay its debts as they become due and the realisable value of its assets must be greater than the present value of its liabilities.[34] Secondly, the acquisition must be in the best interests of the company, the terms of the acquisition must be fair and reasonable to the company, and the board must not be in possession of information which is not available to shareholders and which is material to an assessment of the value of the shares.[35] Thirdly, the acquisition must be a benefit to the remaining shareholders and the terms of the acquisition be fair and reasonable to these shareholders.[36]

It will be a rare situation when one or more of these tests is satisfied. For instance, a pricing formula which initially appeared fair and reasonable may have become onerous to the company due to changes in shareholder composition or general economic downturn. Buyouts will frequently occur at a time when the

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31 F O'Neal and R Thompson, *O'Neal's Close Corporations* para 7.24 (3rd ed Callaghan, Wilmette, Ill, 1987).

32 California General Corporation Law s 300(a) (Compact Ed, Wes,t 1987); General Corporation Law of Delaware 1979 ss 160(a)(1), 141(a).

33 Clause 50(1)(b).

34 Clauses 49(1), 42(1) and 3(3).

35 Clause 50(2).

36 Clause 51(1).

funds could be put to a more profitable use by the company. In these circumstances, it is doubtful whether such an acquisition would be in the best interests of the company and/or of benefit to remaining shareholders.

Fourthly, the directors must certify that the acquisition complies with these first three legal requirements.[37] The certification requirement may be satisfied by either three separate certificates or combined into a single certificate.[38] Where the requirements are not satisfied, the certification requirement forces the directors to choose between ignoring the law and making a false certification or violating the terms of the constitution. Members who are involuntary directors, eg, by virtue of their control over the issuance of new securities, are not required to join in the certification as they will not generally vote on the matter. However, as involuntary directors, they bear responsibility for the company's compliance with the legal standards applicable to such a special offer to acquire shares.[39]

Fifthly, before the offer is made, the company must send to each shareholder a disclosure document which sets forth the nature and terms of the offer and the text of the resolution together with such further information as may be necessary to enable the shareholder to understand the nature and implications for the company of the proposed acquisition.[40] The disclosure document must be distributed before the offer is communicated to the shareholder who requests buyout. The disclosure requirement reflects actual and proposed regulation abroad of certain types of repurchase activity by listed companies, such as the targeted repurchases involved in greenmail transactions and going private arrangements.[41] These tactics are generally undertaken as defensive measures to takeover bids. Even in that context, these requirements are the subject of ongoing controversy.

There is no precedent for the application of such requirements to buyout arrangements in closely held companies involving no more than a handful of shareholders. Parties to such ventures expect that the buyout provisions contained in the constitution are enforceable in the same manner as other private contracts, subject only to the general constraints upon distributions. It runs wholly contrary to these expectations that one or more shareholders can avoid the operation of such a contract by reference to the best interests of the company in the face of economic downturn. The certification and disclosure requirements involve paperwork which, although it poses few problems to the large company with its corporate secretary and legal advisers and accountants, represents a considerable burden for the two or three member firm. In such firms, particularly those where all shareholders are working members, disclosure adds nothing to the knowledge which the shareholders possess by virtue of their daily connection with the business.

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37 Clauses 50(3), 42(2) and 51(2).

38 Clause 50(3).

39 Clauses 96(2)(b) and 104.

40 Clauses 51(3) and 52.

41 See R Dugan and S Keef, *Company Purchase of Own Shares* (VUP, Wellington, 1989) 54-57, 63-65 (Wellington 1989).

As a sixth obstacle to the use of targeted repurchase in closely held companies, clause 54(3), another provision not subject to variance by the constitution, requires that the unpaid seller rank subordinate to the rights of creditors but in priority to other shareholders. This clause may preclude the company from charging company assets as security for the instalment obligations associated with buyout agreements. Such security arrangements are allowed by law in respect of partnership buyouts. So long as the members are willing to accept the adverse credit consequences which follow from such security arrangements, there is no reason why they should not be given effect in company buyouts. A company should be free to charge its assets for any purposes acceptable to its members and creditors. The arrangements cannot operate to the detriment of creditors. If anticipated by the constitution, any creditor will be on notice of the possibility of security and take that factor into account in its decision whether and on what terms to extend credit. If not anticipated by the constitution and put in place only in connection with the specific buyout, the security arrangement will be subordinate to the prior perfected interests of earlier creditors; the charge must be registered in order to be effective against subsequent creditors.[42]

The burdens imposed by the provisions respecting special offers cannot but encourage incorporators of closely held ventures to resort to other devices to facilitate the exit of retiring members. An initial reading of the draft Act reveals at least two possibilities: cross-purchases with financial assistance and redeemable shares. As used as a substitute for special offers, each of these devices is subject to requirements at variance with those applicable to special offers. Whilst the requirements for financially assisted cross purchases[43] resemble those applicable to special offers, the requirements for redemption[44] are quite dissimilar and, in most cases, provide a more expedient means to retire members from a closely held venture. However, those requirements reflect the needs of shareholders in widely held companies and cannot be varied by agreement.[45]

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42 These priority consequences generally hold true under existing new federal law and will certainly follow under the personal property security legislation proposed in *Report No 8*.

43 Clauses 58 and 59.

44 Clauses 55-57.

45 Under clause 55, redemptions at the option of the company are subject to the same rules as apply to purchase of own shares. In contrast, clause 56 treats redemption at option of the shareholder only as a distribution but not otherwise subject to the rules respecting purchase of own shares. Accordingly, if the incorporators are satisfied by a constitutional provision which provides only them an option for cashing out their investment, they can use the vehicle of redeemable shares under clause 56 and avoid the formalities associated with special offers. However, in most cases, it will be desirable that the company also has an option to reacquire/redeem the shares in certain cases, eg, death of a shareholder, proposed transfer or deadlock. This cannot be accomplished via redemption without compliance with the rules applicable to special offers discussed in the text.

V FINANCIAL ASSISTANCE AND CONFLICTS OF INTEREST IN THE SALE OF A CLOSELY HELD COMPANY

The sale of an incorporated proprietorship or incorporated partnership is sometimes structured as a sale of shares rather than as a sale of assets in order to obtain certain tax advantages. Where the purchaser cannot arrange satisfactory outside finance, all or part of the purchase price will be payable in instalments. Often, the only properties available as security for the unpaid portion of the price are the shares themselves and/or assets of the company. Because of the uncertainties involved in perfecting and realising security in shares of a closely held company, the purchaser will prefer security over the assets of the business. Under present law, an exception to the prohibition against the financial assistance in section 62 allows the parties to use company assets as security.[46] Although there are many types of financial assistance which pose demonstrable threats to creditors and shareholders, the only problem associated with this type of assistance concerns timing the transfer in such a way as to bring it within the exception.[47] The rules governing registration and priority of securities generally ensure that such an arrangement does not rebound to the detriment of creditors.

The draft Act greatly increases the risks of such financial assistance. The proposed rules governing financial assistance generally resemble those governing the purchase of own shares.[48] However, since the relevant shareholders (the purchaser) will be ready to consent to the assistance, the transaction can proceed without regard to the rules which track those, discussed above, applicable to buyouts. When all shareholders consent, the only requirement imposed by the draft Act is that the financial assistance comply with the rule governing distributions;[49] the financial assistance is deemed to be a distribution in respect of the shares purchased.[50] The directors (new shareholders) must be satisfied and certify that after the distribution the company will be able to satisfy the solvency test.[51]

Suppose that the company has tangible assets with a value of 100 and liabilities in an amount of 60. The parties contract for the sale of the shares at a price of 50 which includes 10 in payment for the goodwill of the business. The buyer proposes to pay 10 at the time the contract is executed and pay the outstanding balance (40) in ten equal annual instalments. The buyer undertakes to arrange for the company to grant the seller a charge on the company assets as security for the outstanding obligation. Since this security transaction constitutes financial assistance, it can be implemented only if the solvency test is satisfied.[52] One must assume that the transaction will not contravene the first limb of that test since otherwise it is unlikely that the purchaser would have agreed to pay 60 for the shares. However, the security arrangement threatens to place the company in contravention of the

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46 Companies Act 1955 s 62(1)(c).

47 See *Skelton* v *South Auckland Blue Metals Ltd* [1969] NZLR 955.

48 Compare clauses 58 and 59 with clauses 49-51.

49 Clauses 58(1)(b)(i), 59(1).

50 Clause 58(3).

51 Clauses 42 and 3(3).

52 Clauses 58(3), 42(1) and 3(3).

balance sheet limb of the solvency test. The security qualifies as a contingent liability which, if enforced, is equal to the net worth of the firm's tangible assets. The transaction thus leaves the company with an equity cushion equal to the value assigned to the goodwill (10). Goodwill is an asset whose "realisable value" is extremely difficult to estimate. If the assets are realised other than in connection with the sale of the business as a going concern, it has no value whatsoever. To be sure, the mortgage qualifies as a contingent liability in the sense that it will fall upon the company only if the purchaser fails to meet the instalment obligations. Further, the company has an indemnity claim (either under the common law or by way of express agreement) against the new owner which qualifies as a contingent asset. However, where the new owner has no personal wealth, the value of the contingent liability will generally exceed the value of the contingent asset.

Although the transaction may be put in place without violation of the solvency test, it leaves the company in a very precarious position for future compliance. Where, due to a change in economic climate or mismanagement, the business declines and ends in a winding up soon after the transfer, the transaction will be carefully scrutinised by the liquidator. The liquidator has every incentive to accept a valuation which shows that the assets were overvalued and the transaction violated the solvency test. As a consequence, the new owner will be potentially liable for recovery of the purchase price under clause 46 and the old owner under a theory of constructive trust.[53] This liability is in addition to that which, as under present law, the new owner faces for insolvent trading and the old owner faces for receipt of a preference.[54]

It can of course be argued that such liability is justified where the parties have overvalued the assets. However, the argument misses the thrust of this discussion. Far from accommodating the needs of the principals of incorporated proprietorships and incorporated partnerships, the draft Act imposes a new risk upon those who would do business in this manner. Worse still, from all that appears in the commentary to the draft Act, this impediment was not intentional. Rather, it arises as a result of redesigning the rules governing financial assistance to thwart practices pursued by publicly listed companies and their subsidiaries which rebounded to the detriment of creditors and shareholders.[55]

This transaction also brings into operation the rules governing interested directors. The purchaser of the shares will, in all cases, become a director of the acquired business. As director, he or she will be responsible for putting in place the security over the company's assets. Since the director acquires a material benefit through the transaction, the director qualifies as "interested" under clause 108(1) and satisfies none of the exceptions in clause 108(2) (security for obligations guaranteed by director) or clause 108(3) (remuneration, indemnity and insurance). The draft Act allows the director/owner to vote on the resolution necessary to put

53 See *Belmont Finance Corpn Ltd* v *Williams Furniture Ltd* [1979] Ch 250.

54 Clauses 105, 131(3) and 225; compare Companies Act 1955 ss 309, 320.

55 *Report No 9*, above n 1 paras 428, 413.

the security in place.[56] As an interested director, he/she must enter the nature and extent of the interest in the company's interests register and disclose it to the board of directors.[57] Failure to comply with these formalities subjects the director to a penalty.[58] Moreover, the transaction is subject to avoidance within three months.[59] Although it is unlikely that the avoidance provision will be invoked by the new owner of the business, the possibility of avoidance poses a definite risk where the business is wound up within three months of the transaction and the liquidator wishes to avoid the transaction.

Disclosure and avoidance are the traditional means of constraining a manager's use of corporate assets and opportunities for his/her benefit to the detriment of the owners of the business. However, this abuse is one which arises only where the size of the membership entails a separation of ownership and control. In incorporated proprietorships and incorporated partnerships, disclosure serves no useful purpose whatsoever. It merely involves additional paperwork, non-compliance with which results in potential penal liability. Further, the costs entailed by such paperwork cannot be passed on to customers of the business in the same manner as is possible with widely held companies, many of which enjoy a monopoly position in respect of their goods or services.

The existing rules governing interested directors do not apply to arrangements in which the director is interested only as a holder of shares.[60] This provision excepts all transactions in which the benefit derived by the director is received in his capacity as a shareholder. Such transactions include, for example, subscriptions for shares, payment of dividends and redemptions. Since financial assistance, particularly as it is regulated under the draft Act, amounts to a distribution it would fall within its exception. The exception is warranted in a world where shareholders are treated equally. In such a world, there is no conflict between the interests of the directors and other shareholders in respect of buyouts, dividends, issuance of shares and financial assistance. The omission of this exception in the draft Act reflects the fact that the draft Act does not require equal treatment of shareholders. It anticipates that buyouts, issuance of shares and financial assistance can be limited to particular shareholders.[61] Where the director is the particular shareholder, there is a clear conflict of interests which justifies application of these rules. However, in the present case where directors and shareholders are identical, there arises no conflict of interests which justify operation of the rules.

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56 Clause 111.
57 Clause 109.
58 Clause 277(2).
59 Clause 111.
60 Companies Act 1955, Third Sched, Table A, reg 84(2)(d).
61 Clauses 51, 37(1) and 59.

VI SHAREHOLDER LIABILITY IN THE EVENT OF BUSINESS FAILURE

One reason why proprietors and partners choose to incorporate a business is to obtain the benefits of limited liability. Two out of every three small businesses fail within four years. Although failure is sometimes due to mismanagement, or less frequently fraud, it more often results from changes in market conditions for the firm's output, general economic decline or changes in government regulation. The institution of limited liability companies represents, in some sense, a legislative and societal decision that these exogenous risks should be spread among the wider community of creditors.

New Zealand law, like its counterparts abroad, provides that losses resulting from certain types of mismanagement should however be visited upon managers of the business. In the USA this is accomplished by the common law doctrine which allows the courts to pierce the corporate veil. This doctrine finds application almost exclusively in cases involving incorporated proprietorships and incorporated partnerships.[62] In New Zealand, similar results follow under sections 319, 320 and 321. Although this liability nominally attaches only to directors, in practice the rules are invoked against incorporated proprietorships and incorporated partnerships where the directors also own all the shares in the business.[63]

The authors of the draft Act concluded that section 320 excessively inhibits the use of the company form as a vehicle for the taking of business risk.[64] The draft Act makes several significant changes in the scheme of liability presently anticipated by sections 319 and 320. Firstly, there is no counterpart to section 319. The draft Act imposes upon the board of directors a duty to maintain accurate accounting records.[65] However, the only specific sanction for a failure to comply with this obligation is a penalty.[66] The duty is one that is owed to the shareholders and not to the company.[67] As such, it is subject to enforcement in a direct action under clause 132. However, this is extremely unlikely in the case of sole proprietorships or incorporated partnerships where the shareholders are identical to the directors. In contrast to present law, the draft Act precludes enforcement by the creditors;[68] they are only entitled to enjoin any contravention of the Act,[69] a remedy of little utility in the case where failure to keep records results in business collapse. Nor is there any explicit provision allowing the liquidator to enforce the obligation in the event of winding up. The commentary to the draft Act does not address these changes in the law under section 319.

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62 See cases collected in "Disregarding corporate existence" (1919) 1 ALR 610 and supplements thereto.

63 *Re Bennett, Keane & White Ltd* (1988) 4 NZCLC 64, 317; *Re Day-Nite Carriers Ltd* [1975] 1 NZLR 172; *Re Casual Capers Ltd* (1983) 1 NZCLC 98.

64 *Report No 9*, above n 1 at para 516.

65 Clause 156.

66 Clause 278(2)(i).

67 Clause 131(2).

68 *Report No 9*, above n 1 at 52.

69 Clause 126(1).

However, it would seem that losses resulting from bad record keeping practices are ones fairly allocated to the directors and that any relaxation of the rules is not a proper incentive to risk-taking.

From all that appears in the commentary, the authors of the draft Act were primarily concerned to modify the present law under section 320. Clause 105 imposes a twofold obligation upon a director. Clause 105(1) requires that the director not agree to the company acting in any manner unless the director believes on reasonable grounds that the act does not involve an unreasonable risk of causing the company to fail to satisfy the solvency test. That test is satisfied only if the company is able to pay its debts as they become due and the realisable value of the company's assets is greater than the present value of its liabilities.[70] Under clause 105(2) a director must not agree to the company incurring an obligation unless the director believes on reasonable grounds that the company will be able to perform the obligation when required to do. These duties, unlike those in respect of record keeping, are owed solely to the company.[71] Although it is theoretically possible that shareholders could enforce those obligations by a derivative action,[72] this is extremely unlikely in the case of incorporated proprietorships and incorporated partnerships. Enforcement will occur, if at all, in the context of winding up proceedings. However, it is interesting to note that, unlike the present statute,[73] the draft Act makes no specific provision for enforcement by the liquidator and precludes enforcement by creditors.

The commentary indicates that clause 105 was intended to decrease the threshhold for director liability as compared with that under clause 320.[74] In essence, clause 105 adopts the rule in section 320(1)(a) (incurring a debt without reasonable grounds for repayment) and replaces the other two predicates for liability (fraudulent and reckless trading) with the solvency test which itself contains two alternative liability predicates: failure to pay debts when due and liabilities in excess of assets. The omission of section 320(1)(a) is without significance since conduct in fraud of creditors will violate the director's obligations in respect of the solvency test under clause 105(1) and/or the director's obligations in respect of new debts under clause 105(2). Accordingly, whether clause 105 imposes a lesser obligation upon directors than section 320 depends solely upon a comparison of the solvency test under clause 105(1) with the "reckless trading" limb of section 320(1)(b). As applied to the circumstances involved in the failure of incorporated proprietorships and incorporated partnerships, the new rule may considerably expand the likelihood of liability.

Although clause 105(1) reads easily on first perusal, closer scrutiny reveals that the provision lacks focus and invites a number of widely divergent interpretations. For example, it is unclear whether contravention requires proof of insolvency, an

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70 Clause 3(3).

71 Clause 131(3).

72 Clause 127.

73 Companies Act 1955 s 320(1).

74 *Report No 9*, above 1, at para 516.

act which caused insolvency or an act which posed an unreasonable risk of insolvency and whether the reference to "act" includes continuation of business. Under one plausible interpretation, the clause invites the liquidator to scrutinise every act of the directors including general continuation of business and enquire whether the directors knew that the conduct would cause the company contravene the insolvency test. In the mine-run collapse, the liquidator will not find sufficient evidence of such knowledge.

Clause 105(1) then invites the liquidator to enquire whether the director had reasonable grounds for a belief that that conduct did not pose an unreasonable risk of causing the company to fail the solvency test. In this regard, the liquidator will focus on both specific acts, other than incurrance of debts which is covered by clause 105(2), as well as continued trading in general. In particular, the liquidator will scrutinise all disbursements not accompanied by a concomitant injection of assets to the business. Such disbursements are relevant for the solvency test in as much as they further increase the gap between liabilities and assets under the second limb of the test and make it more difficult to pay future debts for purposes of the first limb. Such disbursements include ones for salary, interest, rentals, etc. In contrast, repayments of loan principal leave unaffected the company's position under the second limb of the test inasmuch as they reduce the company's assets and liabilities to the same extent.

When the company's current expenses exceed its current revenues, payment of a current creditor poses not merely an unreasonable risk but makes it virtually certain that another current creditor cannot be paid. Certainty is qualified only by three possibilities: (1) that current creditors will extend the time for payment, (2) the business can obtain an additional injection of long-term capital to meet current expenses, and/or (3) that turnover will increase. In a world without these possibilities, liability will attach under clause 105(1) during the first month when the business can not meet its current expenses and payment of some creditors is deferred. The possibility of extension and additional injection of capital will be negated no later than the time when the bank refuses to increase further the overdraft limit coupled with the principals' failure to advance additional funds to the business. That leaves, as the only extenuating factor, the possibility of an increase in turnover. This possibility could be negated by a combination of factors including a continual and steady decrease in turnover over four to six months coupled with an increasing discrepancy between current expenses and current revenues.

It can also be argued that nominal capitalisation of an incorporated proprietorship or incorporated partnership contravenes section 105(1). Where a business is capitalised with an equity cushion of $100, as is true of many incorporated proprietorships, there is a high risk that the company will soon after organisation contravene the second limb of the solvency test. Unless operation of the business turns an immediate profit, the company's liabilities will exceed its assets from the outset. Initial under-capitalisation is one of the factors which

courts in the USA accord great significance in their decisions to pierce the corporate veil.[75]

This interpretation of clause 105(1) exposes directors to a considerably greater degree of liability than does section 320(1)(b). It is established that this section concerns primarily the continuation of trading while insolvent. To make allowance for the possibility of business recovery, the courts have consistently held that recklessness is not established by insolvent trading alone. Courts adopt the following test:[76]

> Was there something in the financial position of this company which would have drawn the attention of an ordinary prudent director to the real possibility not so slight so as to be a negligible risk, that his continuing to carry on the business of the company would cause the kind of serious risk to the creditors of the company which the section was designed to prevent.

Under this test, the liquidator must identify a particular feature in the company's financial position. That feature must be such as to reveal a striking risk that continued trading will result in a loss. Courts refuse to accept that a continuing discrepancy between current expenses and current revenues constitutes such a feature. In contrast, the test is met by the director's writing cheques but not mailing them to current creditors.[77] This test is consistent with the general approach to crimes and depicts involving recklessness as an element. Reckless conduct, as contrasted to negligence or wilfulness, involves proceeding in disregard of facts which, if appraised by a reasonable person, would mandate a different course of action.

The proposed interpretation of clause 105(1) poses a lower threshhold for liability than this approach to section 320(1)(b). Firstly, whilst section 320(1)(b) focuses on insolvent trading, clause 105(1) aims at satisfaction of the solvency test. This test encompasses a broader range of conduct which includes not only continued trading but also acts ranging from initial capitalisation to specific disbursements in the ordinary course of business. Secondly, section 320(1)(b) requires a prospect of "serious loss" whereas there is no specific counterpart in clause 105(1); any contravention of the solvency test will suffice. Finally, liability under section 320(1)(b) is activated only by a specific event, one presumably out of the ordinary course which would give the reasonable man second thoughts about continued trading. Under clause 105 there is no reason or need to identify a specific usual event. Indeed, the fact that the firm cannot meet the first limb of the solvency test may suffice to serve as the event which causes conduct to result in a violation of clause 105(1). Under clause 105(1), the seriousness of the loss and the unusual event are, to some extent, reflected in the reference to "unreasonable risk".

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75 See cases collected in "Inadequate capitalisation as factor in disregard of corporate entity" (1959) 63 ALR 2d 1051.

76 *Thompson* v *Innes & Anor* (1985) 2 NZCLC 99, 463 (Bisson J).

77 *Re Petherick Exclusive Fashions Ltd* (1987) 3 NZCLC 99, 946; compare *Re Bennett, Kean & White Ltd* (1988) 4 NZCLC 64, 317 (decision to close business and carry out alterations).

However, in the case of clause 105(1) the element of gravity relates not to the ultimate magnitude of loss suffered by creditors but rather to the contravention of the insolvency test itself. For example, payment of a current expense such as salary at a time when current expenses exceed current revenues poses an almost certain risk that a company will not satisfy the first limb of the solvency test, whereas even a series of such payments under similar circumstances is without significance for section 320(1)(b).

As noted earlier, clause 105(1) is upon to various interpretations. This discussion has focused on one plausible interpretation which, it turns out, exposes the directors of closely held companies to greater liability than section 320. This is not the place to analyse other interpretations some of which will make it more difficult if not impossible for the liquidator to establish liability for insolvent trading under the usual scenario for business collapse. The one plausible counterexample casts doubt upon the proposition in the commentary that clause 105 reformulates the law in such a manner as to reduce the risk of managerial activity.

It is more relevant for the present discussion to enquire whether clause 105(1) adequately reflects the needs of closely held companies. It is not a rule which can be varied by a company's constitution. This is somewhat surprising given the fact that the director's obligations under clause 105 run only to the company and not to the creditors or shareholders.[78] An increasing number of jurisdictions in the USA now allow contractual variation of all directors' obligations owed to the company including even those of negligence and fiduciary duty.[79] This inconsistency probably reflects a certain ambivalence about the decision to exclude creditors from the obligees of directors' obligations.

There is another more fundamental objection to clause 105(1) as it applies to incorporated proprietorships and incorporated partnerships. The very features of this clause which make it a liability trap for directors of closely held companies operate in quite the reverse manner when the clause is applied to listed companies. As a general rule, listed companies are not organised with nominal capital and thus the directors avoid one obvious application of clause 105(1) as it operates in connection with the second limb of the solvency test. Further, and more importantly, the scale of operation of listed companies necessitates and provides the financial foundation for an extensive decentralisation of the decision-making processes. Directors delegate most all decisions to management employees who have access to monthly and even daily reports on the financial state of the business as well as legal opinions of in-house and outside solicitors. So long as the directors have no cause to doubt the competence of these delegates and so long as these delegates do not ignore the flow of information, it will be difficult if not

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78 Clause 131.

79 This legislation is reviewed by Hanks "Evaluating recent state legislation on director and officer liability limitation and indemnification" (1988) 43 Bus Lawyer 1207 and criticised by Hazen "Corporate directors' accountability; the race to the bottom - the second lap" (1987) 66 NCL Rev 171.

impossible to prove that the director lacked reasonable grounds for believing that a particular action did not pose an unreasonable risk.[80]

As demonstrated by case law in the USA, the reasonableness test as applied to large organisations, can serve only to test the manner in which a decision is made and not the rationality of the decision itself.[81] In the context of listed companies, the rule in clause 105 provides, as intended by the commentary, a very high degree of protection for managerial risk-taking. In contrast, the incorporated partnership and incorporated proprietorship, involve little or no delegation of decision-making. The principals in such a business have, at best, a desultory relationship with an accountant. There is no ongoing flow of information which can serve to satisfy the two references in clause 105 to reasonableness. In the absence of such a paperwork shield, there is no way to assess reasonableness except by reference to the underlying facts themselves. The result, as illustrated, is a high degree of liability exposure for directors.

Finally, the solvency test is probably an inappropriate liability predicate for insolvent trading, particularly as applied to closely held companies. Distributions (dividends, repurchase, financial assistance, redemption) are carefully planned events; management has sufficient time to ascertain the company's position under the solvency test. In contrast, managers of small closely held firms have relatively little scope or time to consider the solvency test when making the sort of on-going disbursements which are associated with keeping a business afloat and determinative of liability under clause 105(1).

VI CONCLUSION

There is good reason to doubt that the uniform regime proposed by the draft Act for all companies adequately deals with the needs of incorporated proprietorships and incorporated partnerships which are surely the most common forms of business in New Zealand. As applied to common events in the life of such ventures, the non-displaceable provisions of the Act, ie, ones not subject to variation by the constitution, operate in an inflexible manner to preclude some economic and desirable arrangements, impose formality and paperwork requirements having no relationship to the needs of either the members or creditors, and create liability traps for the unwary and unadvised members of these businesses. These problems are not confined to the situations and clauses which figure in the foregoing discussion. In the **Appendix**, the author identifies other non-displaceable provisions of the draft Act which appear inappropriate for incorporated proprietorships and incorporated partnerships.

As applied to very closely held companies, the approach of the draft Act is fundamentally flawed. The draft Act, including particularly the non-displaceable clauses, comprises a regime predicated upon a separation of ownership and control and, in some cases, upon a further delegation of decision-making to management and

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80 Clause 107.

81 The leading case is *Smith* v *Van Gorkom* 488 A 2d 858 (Del 1985).

its professional advisors. The most obvious manifestations of this approach are the non-displaceable requirements for a board of directors and disclosure of interests.[82] However, the same assumption respecting reality also informs provisions as diverse as the solvency test and lodgement requirements.[83] In very closely held companies where there is no separation of ownership and control, the "agency" abuses which underlie most of the non-displaceable rules are non-existent. The non-variable rules serve only to impose unnecessary transaction costs and frustrate realisation of commonly held investor expectations. This flaw, if it be one, can be easily remedied by means of a provision which exempts closely held companies (eg, those having no more than say six members none of which is a body corporate) from all but certain provisions of the Act.

82 Clauses 98, 109.

83 See particularly clauses 24 (alteration of constitution), 35 (share description) which require lodgement of documents in which there is little or no public interest in the case of closely held business.

APPENDIX

The draft Act proposes numerous rules, in addition to those discussed in this article, which do not accommodate the needs of closely held businesses.

1 Clauses 24(3) and 35(1): Constitution, alteration of the constitution and share descriptions must be filed with the Registrar. There is no public interest in the internal arrangements of very closely held companies.

2 Clause 26(1): The definition of "share" is broad enough to include certain common debt instruments. This confuses the operation of not only control rules (clause 78) but also the solvency test (clauses 3(3), 42, 48, 49(1), 55, 58(3).)

Clause 114: Directors are required. Certain decisions and formalities must be effectuated by the director(s). See clauses: 34, 37 (issuance of shares), clause 42 (distributions), clauses 49-50 (purchase of own shares), clauses 58-60 (financial assistance), clause 100 (others). The draft Act imposes an artificial separation of ownership and control. Also, the numerous certification and disclosure requirements which function as accountability measures in the case of widely held companies serve no such purpose where control and ownership are concentrated in the same persons. See clauses 39, 42, 49-50, 58-59: [certification in connection with issue of shares, distributions, purchase of own shares, and financial assistance respectively] and clauses 51(3) and 52; 59(3); 60; 109, 113: [disclosure in connection with purchase of own shares, financial assistance, conflict of interests, and share dealing respectively].

3 Clauses 167, 176 and 92: [unanimity requirement to dispense with annual report, audit and shareholder meeting] give a single shareholder a degree of control having no necessary connection with the shareholder's interest in the business. The fact that the matters are not mandatory properly acknowledges the absence of any overriding public interest. In a closely held company, their incidence should be controlled by agreement of the members and not dictated by the whim of a single shareholder.

4 Clauses 138, 139, 179 and 184: [shareholder access to information] are clearly designed for widely held companies. The only appropriate mandatory rule for a closely held business is one which entitles the member to unrestricted access to company records.

5 Clause 159: Preparation of a balance sheet, income statement and cash flow statement is completely unnecessary for the orderly management of most small businesses. Given the concentration of ownership and control, it serves no identifiable accountability function. For most such businesses, the record keeping requirement of clause 156 combined with that imposed by tax law suffices to ensure orderly management of financial affairs.

6 Clause 81: mandatory buyout remedy for dissenting shareholders. For a closely held business, the financial ramifications and strategic behaviour associated with the remedy make it an intolerably disruptive measure. The exit of dissenting members can be adequately regulated by the constitution's buyout provisions complemented by the statutory relief against prejudicial conduct.