¶101 Introduction

This chapter introduces some of the basic features of companies. The first part looks at companies as a form of business association and at the structure or architecture of companies. It describes in very general terms some of the key features of companies. The second part looks at the historical development of companies. The final part defines some of the important concepts discussed in this book.

¶102 A definition of "company"

A **company** is an artificial person created by the law.

The function of a company in a legal sense is to hold assets (property) and to carry on a business or other activity as an entity separate from the participants (investors, managers) in that business or activity.

Companies come into existence through a **process of registration**. A person or group who wishes to use a company to carry on a particular activity makes an application to the New Zealand Government (in the form of the governmental agency responsible for the formation of companies – the New Zealand Companies Office) for the registration of a new company. Provided all the conditions for registration are met, the New Zealand Government will exercise its power to create a new company by registering it. The process of registration is discussed in detail in Chapter 5. A company's existence comes to an end when it is deregistered. Deregistration is discussed in Chapter 24.

http://www.pbookshop.com

Companies as a form of business organisation

¶103 Introduction

A company is a type of corporation. "Corporation" and "body corporate" are terms used to describe all artificial legal entities that have the attribute of separate legal personality.

What do we mean by **separate legal personality**? This phrase is defined at ¶302. In brief, it means that a company is treated as a separate person from those who participate in the company. Because it is a separate person, it has its own legal identity or personality, which means that it can, for example, hold property in its own name and enter into contracts in its own name. It can commence or defend legal proceedings in its own name.

Most corporations that are used to carry on business in New Zealand are "companies", that is, corporations formed or treated as being formed under the Companies Act 1993, which is the statute that governs the formation, conduct and termination of companies in New Zealand. The Companies Act is discussed in Chapter 2.

Companies are the focus of this book, because they are the most common and economically significant form of corporation. The differences between companies and other types of corporations are discussed in Chapter 5.

Commercial companies developed as a means of allowing a large number of people to pool their resources (in the form of capital or management skills) to undertake an enterprise too large for a single individual. Creating a separate legal person to hold and incur the rights and obligations of the enterprise simplified dealings between the enterprise and those with whom it conducted business.

With the introduction of limited liability in the middle of the nineteenth century, certain types of companies also provided a way for participants in an enterprise to limit the extent to which their own personal wealth was put at risk if the enterprise failed (in particular, companies limited by shares).

Limited liability is discussed at ¶313. In brief, **limited liability** means that if a company is unable to pay all of its debts, those participants who have invested money in the company are not liable to contribute any more than what they have agreed to invest. Because liabilities incurred in running the enterprise are the company's own, and not the participants', the participants generally will not be required to provide any more than their initial or agreed contribution to the company to meet those liabilities.

Company law developed alongside the company to regulate the relationship between:

- participants in the company
- the company and the State, and
- the company and those with whom the company had dealings.

The development and structure of company law is discussed in detail in Chapter 2.

Although one of the key drivers in the development of companies was to simplify the participation of large numbers of people in a collective enterprise, the special characteristics of companies (in particular, the limited liability conferred on its participants) also made the corporate form attractive to those engaged in small business. Traditionally, the law required that companies have more than one shareholder, but it is now possible to incorporate a company with only one shareholder. This means that it is possible for an individual to form a company and conduct his or her business through that company, obtaining the benefits that flow from using that form of organisation. The advantages and disadvantages of using a company to carry on a business are discussed in Chapter 5.

¶104 What are companies used for?

Some important statistics on New Zealand companies are as follows:

- There were a total of 592,350 New Zealand-registered companies on the Companies Office database as of 30 June 2013. These companies are entered on the New Zealand Companies Register. There were also 2,126 overseas-registered companies on the same database. Some of the overseas companies will be entered on the overseas register.
- The majority of registered companies in New Zealand are limited liability companies.
- There were 145 companies listed on the NZX Main Board, which is operated by the New Zealand Exchange Limited (NZX) as of February 2014. These are the companies in which public investors can buy and sell shares on the NZX Main Board.

Over 99% of the 592,350 New Zealand-registered companies are limited by shares. These companies range in size from single director/shareholder companies in which there is only one participant and negligible assets, to companies with billions of dollars in assets, a vast number of shareholders, and thousands of employees. Most enterprises in New Zealand, however, are small- and medium-sized enterprises. Since 2012, 97.2% of enterprises employed 20 or fewer people. (See the Ministry of Business, Innovation and Employment website (www.mbie.govt.nz) for data.)

As of 28 November 2013, companies appearing on the New Zealand Companies Register are assigned a New Zealand Business Number (NZBN).

A flat tax rate of 28% applies to companies in New Zealand from 1 April 2011. The total tax take from all taxpayers in New Zealand in the income year 2012/13 was approximately $53.8 billion. This figure includes direct and indirect tax. Company tax amounted to $10.447 billion of all tax revenues. Company tax, therefore, comprises a substantial portion of all taxation revenues collected. For more information, see Inland Revenue *Annual Report 2013* at 17.

New Zealand's largest company in terms of market capitalisation in February 2014 was Fletcher Building Limited. The term "market capitalisation" means the amount of money that would have to be paid to acquire all of the company's issued shares at their current market price. Market capitalisation is determined by multiplying the number of issued shares by the market value of each share. In February 2014, Fletcher Building was capitalised at $10,482,765 billion.

Over 85% of the companies registered under the Companies Act are, however, small or "closely held" companies with one or two shareholders.

http://www.pbookshop.com

¶105 Are all companies listed on the NZX Main Board?

Some companies have their shares listed for quotation on the NZX Main Board. If a company is listed on the NZX Main Board, members of the public can buy and sell those shares through the securities market conducted by the NZX. In February 2014, there were 145 companies listed on the NZX Main Board. Since there were about 592,350 New Zealand-registered companies on 30 June 2013, the 145 companies listed on the NZX Main Board represent a very small percentage of companies overall. However, listed companies are very significant to the New Zealand economy. The total market capitalisation of the NZX Main Board in November 2013 was $83.02 billion.

Many New Zealanders own shares in companies listed on the NZX Main Board. In New Zealand, direct share ownership stood at 23% in 2012. As of 2012, direct share ownership in Australia stood at 34%. Another 4% of Australians owned shares either directly or through a fund. See ASX *Australian Share Ownership Study* (2012) at 29 (http://www.asx.com.au/documents/resources/asx-sos-2012.pdf).

Listed companies will generally have at least several thousand shareholders. Most shares in New Zealand listed companies are owned by the big investment houses (such as life insurance companies and superannuation and investment trusts) and financial institutions. Overseas investors owned 42.3% of New Zealand listed shares in 2001.[1]

The architecture of companies

¶106 Introduction

As the above discussion indicates, companies come in a great variety of shapes and sizes. However, companies formed and operating under New Zealand law have, for the most part, a common architecture or structure. All companies must have at least one shareholder. All companies must also have at least one director, who is responsible for managing the company's business. Larger companies may also have other officers involved in management.

The next section summarises these key features in order to introduce you to the architecture of companies.

1. M Fox and G Walker "Corporate Control of NZX Companies" (2003) 21 *Company and Securities Law Journal* 538. See also M Fox, G Walker and A Pekmezovic "Corporate Control of NZSX Companies: The 2009 Data" (2010) 28 C&SLJ 494–95. For a general review, see M Fox and G Walker "New Zealand Sharemarket Ownership" in G Walker (gen ed) *Securities Regulation in Australia and New Zealand* (2nd ed, 1998) at 261 and M Fox, G Walker and A Pekmezovic "Corporate Governance Research on New Zealand Listed Companies" (2012) 29(1) Ariz J of Int & Comp Law 1–47. The process of listing and its effects are discussed in greater detail in Chapter 5.

¶107 The capital structure of companies

In most cases, the commercial activities of companies require the use of a fund of property that belongs to the company. The sources of that fund (referred to in general terms as the company's **capital**) are:

- contributions of capital made by the persons who form the company and persons who become shareholders after the company is formed
- amounts of credit advanced to the company by creditors, including those who lend money to the company and those who supply goods and services on credit, and
- profits (if any) not distributed to shareholders.

These sources of capital are discussed in greater detail in Chapters 18, 19 and 20.

http://www.pbookshop.com

What is equity capital?

The capital contributed by the shareholders of the company is referred to as **equity capital**. In the case of a company limited by shares, the shareholders provide money or property to the company, and receive a share or shares in return.

What is a share?

A share represents a number of rights that may or may not (depending on the terms of issue of the share) include **control rights** (such as voting rights and rights to receive information) and **distribution rights** (such as a right to receive dividends or to share in the assets of the company on the liquidation of the company).

Once a person has paid money or transferred property to the company and a share is issued in return, the money or property becomes the property of the company not the shareholder.

A company can issue different **classes of shares**, with different rights attached to each class. Examples of classes of shares include preference shares and ordinary shares. Classes of shares are discussed in Chapter 18.

What does it mean to be a shareholder of a company?

A person who holds shares in a company is a **shareholder** of the company. Shareholders of companies have particular rights in relation to the administration of the company's affairs that depend on the law and the terms of issue of the share.

The company's shareholders are, generally speaking, its owners or proprietors. In economic terms, shareholders are **principals** as opposed to the managers of the company who are the **agents** of the principals.

The shareholders are the people who have invested money with the company in the expectation that they will receive a return on their money if the company is successful, either in the form of distributions (dividends) paid out of the company's profits during its trading life, or in the form of growth in the value of their investment in the company over time. In the case of a limited liability company, the shareholders are the company's shareholders – the people who have purchased shares in the company.

Any legal person can be a shareholder of a company. This means that the shareholder does not have to be a natural person (ie a human being) but may itself be a company. This is particularly the case in business enterprises structured as corporate groups. Corporate groups are discussed in Chapter 5.

It is possible to form and operate a company with only minimal capital. Sometimes the total amount subscribed for shares may be as little as $1.00.

What is debt capital?

Another important source of capital for companies is **debt capital**. Like any other legal person, companies are able to borrow money and, typically, a company may borrow money from a bank or other credit provider to fund its operations. The loan may be secured (by a charge over some or all of the company's assets or business) or unsecured. Suppliers may also supply goods and services to companies on credit.

Persons who lend or advance credit to companies are not shareholders of the company – they are in a contractual relationship with the company. However, company law does contain particular provisions that affect the relationship between debtor and creditor where the debtor is a company. These include rules designed to protect the interests of creditors when the company becomes insolvent (ie when the company is unable to meet its debts when they become due for payment).

¶108 The management structure of companies

Managing companies involves decision-making. That decision-making includes:

- deciding on the appropriate capital structure for the company (whether to borrow money, to pay dividends, or to increase or reduce the number of shares on issue), and
- deciding on the nature and form of the company's activities (what enterprise to carry on, and how to use the company's capital).

The distinguishing feature of the management structure of many large companies is that it involves the separation of responsibility for these decisions between shareholders and officers. This feature of large companies is usually described as

the "separation of management and control", whereby officers take management decisions but control resides with shareholders. Obviously there is no separation of management and control in a one-person company because the same person is the director and the shareholder.

Who are the company's officers, and what is their role?

We saw in ¶107 that the shareholders of the company are, in a general sense, its owners or proprietors. The **officers** of the company are those persons responsible for its management. In small companies, the shareholders and officers may be the same people (and indeed, in single director/shareholder companies are always the same person). So in small companies there is often no separation of management and control. By contrast, in large companies with many shareholders, it is not possible for all the shareholders to take an active part in the management of the company. In these cases, the separate roles of officers and shareholders in corporate decision-making are more pronounced.

Only a natural person (ie a human being) can be appointed as an officer of a company.

The officers of the company include its **directors**. All companies are required to have at least one director. Where a company has more than one director, the directors collectively are referred to as the **board of directors**. The directors are selected in the manner agreed between the shareholders and reflected in the company's internal governance rules,[2] and are usually responsible for managing the business of the company. The precise scope of the directors' powers, and the division of decision-making power between shareholders and directors, depends on the law and the company's internal governance rules. The division of power between directors and shareholders is discussed in Chapter 7.

Usually, the directors will be responsible for making most of the decisions affecting the company, without requiring the approval of shareholders and without being required to comply with instructions from the shareholders. However, certain fundamental decisions, such as changes to the company's internal governance rules and changes that affect the rights of shareholders, will require the approval of shareholders. Those decisions requiring shareholder approval are discussed in Chapter 8.

In small companies, the directors themselves will generally make most of the ongoing decisions relating to the company. However, in large, complex business enterprises, the directors may delegate management functions to the company's executives, and retain responsibility for selecting and supervising those executives and setting the broad strategic direction for the company.

2. See ¶115 for a definition of "internal governance rules". Internal governance rules are discussed in Chapter 6.

http://www.pbookshop.com

Directors may be executive or non-executive directors. **Executive directors** are those who are employed by the company and devote all or substantially all of their working time to managing the company's affairs. **Non-executive directors** are not employed in the company's business and provide an "outsider's" contribution and oversight to the board of directors.

The Companies Act does not require companies to have a secretary. However, some large listed companies do have a secretary for management purposes.

In addition to its directors, a company may have other officers. Company law imposes certain duties and restrictions on directors and other company officers. Directors and other officers must act in good faith and in the interests of their company, and also act with the care, diligence and skill that a reasonable director would exercise. These duties are discussed in Chapters 12–15.

The historical development of companies

¶109 How did companies develop?

It is important, in studying company law, to understand the history of companies and the development of company law in the social and economic context in which they occurred. As a generalisation, we can say that the corporate form has evolved and continues to evolve to meet the needs of the economy at the particular time: see M Roe "Chaos and Evolution in Law and Economics" (1996) 109 Harv L Rev 641.

Some **key milestones** in the historical development of the modern company were:

- the emergence of the "corporation aggregate" and the concept of "joint stock" during the fifteenth to nineteenth centuries
- the introduction of legislation in 1844 to make incorporation available as a general right
- the introduction of limited liability under statute in 1856
- confirmation that the privileges of incorporation extend to small, closely held companies, in *Salomon*'s case in 1897 (see ¶113 and Chapter 3)
- the recognition of the proprietary company in Australia as a distinct form of company in 1896
- the introduction of the private company in New Zealand in 1903, and
- the statutory facilitation of true "one-person" companies in 1993.

These key milestones are described below.

http://www.pbookshop.com

¶110 What are "corporations aggregate" and "joint stock", and when did these concepts develop?

The development of the modern New Zealand commercial company can be traced back to the earliest "corporations aggregate", which emerged in England during the Middle Ages as a means of conferring on a group of people the capacity to hold and deal with property and interests to advance their collective aims. Bodies such as municipal boroughs, trade guilds and colleges facilitated joint activity by conferring legal existence on a group that was independent of the (perhaps fluctuating) identity of the members from time to time.

Frequently, as was the case with the trade guilds and merchants' associations, the corporation existed as the beneficiary of some special right or entitlement conferred by the Crown, such as a monopoly or the right to control the operation of a particular trade.

The creation of a corporation aggregate — its "incorporation" — required the consent of the Crown, through a Royal Charter.

During the seventeenth century, incorporation was granted by Royal Charter to various "merchant venturers", conferring on them rights to conduct trade in a particular region.[3] Well-known examples of such corporations include the East India Company, the Hudson's Bay Company and the Massachusetts Bay Company, which had clear links to England's developing colonial activities. These corporations shared with the modern company the attributes of separate legal personality that are discussed in Chapter 3.

What is "joint stock", and why is it important?

The seventeenth century also marked the development of what is known as "joint stock". The more ambitious commercial activities of the period required, in many cases, greater amounts of capital than a single individual could provide. To meet this need, commercial practice developed a mechanism whereby a person could invest a sum of money in a venture (or an ongoing series of ventures), receiving in return an entitlement to share in the profits of the venture. The investors' entitlement was represented by a share. Such shares were transferable, and could be sold by the investor without the consent of other investors.

In some cases (such as the East India Company), the venture was carried on by a corporation, and the share represented a claim against the corporation. However, as incorporation could be achieved only by Royal Charter and was relatively rare, many such ventures were carried on through a form of unincorporated association that became known as a "joint stock company".

3. See J D Cox and T L Hazen *Cox & Hazen on Corporations* (2nd ed, Aspen, 2003) Vol 1 at 82.

What was the "South Sea Bubble"?

By the beginning of the eighteenth century, there was a well-developed secondary market for shares in these ventures, and speculation was rife. Shares in one company formed in 1711, the South Sea Company, rose in price from £100 to £1,000 in a matter of days. It has been estimated that, immediately prior to the collapse of the boom, the amounts invested in such ventures amounted to £500m, twice the value of all the land in England at the time.[4] This period is referred to by legal historians as the "South Sea Bubble".

The bubble finally burst in 1720, resulting in large losses and considerable hardship for many members of England's growing middle class. In response, Parliament passed legislation, called the Bubble Act 1720, to prohibit such associations from acting as bodies corporate and from issuing transferable shares without the legal authority of a Royal Charter or an Act of Parliament.

Although the joint stock company became illegal in 1720, the commercial factors that gave rise to it did not go away, and indeed those factors continued to grow in importance throughout the eighteenth century. Incorporation by Royal Charter or Act of Parliament remained difficult to obtain. Large-scale ventures, such as the development of railways, demanded a means of raising capital from investors to be utilised by managers in these projects. Lawyers developed the "deed of settlement" company as a means of achieving these commercial aims while circumventing the prohibition contained in the Bubble Act although it is not clear that deed of settlement companies were outside the Bubble Act.[5]

What were "deed of settlement" companies?

Deed of settlement companies were, essentially, a combination of association and trust. The assets of the venture were held on trust by trustees, and the venture managed by the managers or directors. The venture did not have separate legal personality and its property, rights and obligations were held by the trustees. Investors received a share that represented an interest in the trust property. Such shares were often expressed to be transferable under the terms of the trust, which were contained in the deed of settlement. Attempts were made in drafting the deed of settlement to limit the liability of the investors to the amount invested by them in the enterprise.

By the beginning of the nineteenth century, deed of settlement companies were becoming more common in England. However, they were complex to establish and administer, were ineffectively regulated by the State, and did not confer upon participants many of the benefits of separate legal personality that a corporation possessed. Following the repeal of the Bubble Act in 1825, various means of better facilitating and regulating these commercial arrangements were explored. New

4. At 18.
5. At 19.

legislation for the registration and regulation of deed of settlement companies was enacted in England in 1844, following the report by a Parliamentary Select Committee chaired by William Gladstone. The Joint Stock Companies Act 1844 has been described as "the legislative ancestor of modern company law": see RP Austin and IM Ramsay *Ford's Principles of Corporations Law* (15th ed, LexisNexis, Australia, 2013) at [2.130].

¶111 When did the right to incorporate companies become generally available?

The Joint Stock Companies Act allowed business associations to become companies by a process of registration. Before that time, incorporation had been a privilege conferred by Royal Charter or by Act of Parliament. Now any group wishing to form a company for a lawful purpose could apply for registration and, by lodging the required information and paying the prescribed fees, could obtain it. Registration was granted in two stages, provisional and final, with final registration being available only after the company had secured investments from a quarter of the proposed final number of investors.

The fact that companies registered under the 1844 Act were corporations, and therefore had the key attributes of separate legal personality, did not of itself confer limited liability on the participants in the company. If the debts of a company incorporated under the 1844 Act exceeded its assets, creditors of the company could pursue individual investors once their claims against the company had been exhausted. Attempts to limit investors' liability depended on specific agreement with creditors or on complex drafting in the deed of settlement itself. However, unlimited liability was seen as a disincentive to investment, requiring investors to monitor closely the financial position (and therefore ability to meet their share of any claim by a creditor) of other investors and the activities of managers.

¶112 When was limited liability first introduced?

In 1855, the United Kingdom Parliament passed the Limited Liability Act 1855 (UK), which allowed those forming a company to elect to do so on the basis that the liability of its investors would be limited to the amount they agreed to invest in the company. These companies were required to include the word "limited" in their name, to alert those dealing with the company to the fact that the liability of the shareholders was limited.

Various reform proposals over the following six years resulted ultimately in the enactment of the Companies Act 1862 (UK), which consolidated the procedures for the incorporation and winding up of companies, and put in place many of the key features of modern company law.

http://www.pbookshop.com

In the period from 1860 to 1993, New Zealand followed United Kingdom company legislation. Thus, for example, the Companies Act 1882 (NZ) copied the Companies Act 1867 (UK). Companies formed under the 1882 New Zealand Act had many of the attributes of the modern commercial company.

¶113 When were companies first used for small business?

Up to this point we have been considering the historical development of the company as a means of bringing together providers of capital (investors) with specialist business managers or entrepreneurs in larger-scale, collective enterprises. Typically, such ventures involved asking members of the public for investment, and required a separation of ownership of the enterprise (which was in the hands of a large, fluctuating membership) and its management. Company law developed in part for the protection of public investors, and adopted the large-scale collective enterprise as its model.

However, the attributes of companies, in particular the limited liability conferred on their shareholders, also made them an attractive form through which to carry on small business. Typically, a company formed to carry on a small business would not have public investors, and would be controlled and managed by its main investor, often a person who had perhaps conducted the business as a sole trader prior to its incorporation.

The fact that the "corporation aggregate" model was adopted for company law was reflected in the fact that the companies legislation required that companies have a certain minimum number of shareholders. Historically, incorporation required the coming together or association of more than one person to form a company. This position has now been reversed by statute (see below).

What was the significance of Salomon's case?

It was not clear until the landmark English case of *Salomon v Salomon & Co Ltd* [1897] AC 22 in 1897 that the benefits of incorporation would extend to incorporated small businesses that were effectively under the control of a single entrepreneur. *Salomon*'s case is discussed in Chapter 3.

A business formed and operated by Mr Salomon as a sole trader had been transferred by him to a company that he had formed under the Companies Act 1862 (UK) and in which he was the major shareholder and controller. To meet the then statutory requirement that a company have at least seven shareholders, shares were issued to other members of his family, but those family members did not have any real interest in the business.

Mr Salomon transferred his business to the company in order, among other things, to obtain limited liability. He intended that – if the business failed – his personal wealth would not be put at risk since he would not be personally liable to satisfy the outstanding claims of the business' creditors.

The English Court of Appeal initially took the view that such an arrangement should not attract all the benefits of incorporation (including limited liability for Mr Salomon and the other family members). In *Broderip v Salomon* [1895] 2 Ch. 323 at 340–341, Lopes LJ said:

> "It would be lamentable if a scheme like this could not be defeated. If we were to permit it to succeed, we should be authorising a perversion of the Joint Stock Companies Acts . . . The transaction is a device to apply the machinery of the [Act] to a state of things never contemplated by that Act – an ingenious device to obtain the protection of that Act in a way and for objects not authorised by that Act, and in my judgment in a way inconsistent with and opposed to its policy and provisions".

Lindley LJ took the view that:

> "If the legislature thinks it right to extend the principle of limited liability to sole traders it will no doubt do so, with such safeguards, if any, as it may think necessary. But until the law is changed such attempts as these ought to be defeated wherever they are brought to light. They do infinite mischief; they bring into disrepute one of the most useful statutes of modern times, by perverting its legitimate use, and by making it an instrument for cheating honest creditors".

http://www.pbookshop.com

Hence, the Court of Appeal held that Mr Salomon and his company should not be accorded the privileges of incorporation. Mr Salomon appealed and the Court's decision was reversed by the English House of Lords. The House of Lords in *Salomon v Salomon & Co Ltd* [1897] AC 22 at 53 said, in relation to small business:

> "It has become the fashion to call companies of this class 'one man companies'. That is a taking nickname, but it does not help one much in the way of argument. If it is intended to convey the meaning that a company which is under the absolute control of one person is not a company legally incorporated, although the requirements of the Act of 1862 may have been complied with, it is inaccurate and misleading: if it merely means that there is a predominant partner possessing an overwhelming influence and entitled practically to the whole of the profits, there is nothing in that that I can see contrary to the true intention of the Act of 1862, or against public policy, or detrimental to the interests of creditors".

The final decision was that the benefits of incorporation were capable of extending to small, private companies, even though such companies arguably were not the type of business which the companies legislation was intended to facilitate. The decision in *Salomon*'s case confirmed the availability of the limited company as a vehicle for both large and small business, whether or not it involved public investors.

When was the concept of a proprietary company introduced in Australia?

Around the same time that the decision in *Salomon*'s case confirmed that the benefits of incorporation were available to small, privately owned businesses, the Victorian State Parliament in Australia passed the first legislation in the common law world providing for different, less onerous regulation of these types of companies. New disclosure requirements designed to protect public investors, introduced into Victorian law in 1896, were expressed not to apply to "proprietary companies". Proprietary companies are companies that have a limited number of shareholders and that are not permitted to ask the public for investment. The proprietary company is by far the most common type of company in Australia. The Australian proprietary company resembles the former "private" company in New Zealand under the Companies Act 1955.

When was the concept of a private company introduced in New Zealand?

The Companies Act 1903 (NZ) introduced a distinction between private and public companies in New Zealand. Part IV of the 1903 Act introduced a special regime for private companies not exceeding 25 persons whereby certain provisions of the Act were inapplicable. Private companies were prohibited from issuing a prospectus. It has been estimated that over 90% of the companies registered under the Companies Act 1955 were private companies. Thus, from 1903 until 30 June 1997 when the Companies Act 1993 came into full effect after a three-year transition period, there were effectively three types of company in New Zealand – private companies, public companies and public listed companies. Since 30 June 1997, when the distinction between private companies and public companies was finally abolished, there are two main types of company in New Zealand – companies and listed companies (ie companies listed on markets operated by the NZX).

When did it become possible to have a one-person company?

In 1993, the Companies Act enabled the use of companies for small, one-person businesses. Since 1 July 1994, it has been possible to form a company that has only one participant. These are referred to in this book as "single director/shareholder companies". These companies are discussed further in Chapter 6. The introduction of the single director/shareholder company represents the final departure from the concept, reflected in the views of the Court of Appeal in *Salomon*'s case, that an association of at least two shareholders is necessary to create a company.

http://www.pbookshop.com

¶114 The diffusion of New Zealand company law

As we have seen, New Zealand followed United Kingdom company law in the period 18601993. New Zealand was not alone in this practice. In the Southern Hemisphere, a number of jurisdictions adopted United Kingdom company law, including Australia, Hong Kong, Singapore and Malaysia. So, for example, all of these countries adopted a version of the Companies Act 1948 (UK). Later, there was a degree of interaction between these former British enclaves as regards company legislation such that, at one point, Singapore and Malaysia modelled their company legislation on Australia's. More recently, a number of South Pacific nations have reformed their company legislation using the New Zealand Companies Act 1993 as a model. To this extent, contemporary New Zealand company law has been diffused or exported to South Pacific nations such as Samoa, the Kingdom of Tonga, the Solomon Islands and Vanuatu.

Some key terms and concepts

¶115 Summary of some important terms used in this chapter

A summary of some of the terms and concepts that we have introduced in this chapter is set out below. At this stage you need only understand what they mean in broad terms. Your detailed understanding of each concept will develop as you work through this book.

Companies Act 1993 is the statute governing the creation, operation and termination of companies in New Zealand.

Company is a particular type of corporation that is formed by being registered under the Companies Act. The company is the most common form of corporation used in New Zealand business.

Company limited by shares is a particular type of company. In a company limited by shares, shareholders have purchased shares by making a contribution to the company. If the company becomes insolvent, the shareholders generally are not required to make any further contribution to meet the company's debts.

Companies Office is the New Zealand government agency that has primary responsibility for the provision of services relating to the registration of companies and other corporate entities as well as public access to corporate and securities information. The Companies Office also has compliance and enforcement functions. It falls under the purview of the Ministry of Business, Innovation and Employment (MBIE). The MBIE was formed on 1 July 2012 and subsumed the former Ministry of Economic Development (MED), which until then had responsibility for the Companies Office.

contains the "spread" requirements. Generally, the spread requirements are met if the issuer's securities are held by at least 500 members of the public holding at least 25% of the securities of the class issued. Listing is a privilege not a right and, pursuant to Listing Rule 5.3.1, the NZX is not obliged to grant listing notwithstanding that all applicable provisions of the rules have been satisfied by the applicant for listing. At any time, the NZX may impose conditions to any listing. For example, the NZX may impose restrictions (sometimes called "escrow provisions") for a specific period on the sale or disposal of vendor securities: see Listing Rule 5.3.2. Similarly, the NZX has an absolute discretion to suspend the quotation of any securities: see Listing Rule 5.4.2.

- **Section 6 – Requirements for Documents.** This section sets out documentation standards. For example, the constitution of any issuer must be approved by the NZX.
- **Section 7 – Issues and Buy Back of Securities.** This section deals with the Offering Document requirements (Prospectus, Investment Statement or Profile) of the NZX. The NZX must approve every such offering document. The section also contains rules regarding share buy-backs, notification of the level of subscription and the role of the Organising Participant.
- **Section 8 – Voting Rights and Rights of Equity Securities.** This section deals with the voting rights attached to shares and modification of the rights of security holders.
- **Section 9 – Transactions with Related Parties and Major Transactions.** This section begins by dealing with transactions involving the disposal or acquisition of assets. For example, Listing Rule 9.1.1 prohibits the disposal of over 50% of the assets of an issuer without the prior approval of an ordinary or special resolution (where s 129 of the Companies Act applies). Listing Rule 9.2 deals with related-party transactions. Listing Rule 9.3 contains voting restrictions in respect of certain transactions.
- **Section 10 – Disclosure and Information.** Listing Rule 10.1.1 requires that every issuer shall, once it becomes aware of any "Material Information" (as defined in section 1 of the NZSX/NZDX Listing Rules), immediately release that material information to the NZX except in certain defined circumstances. Some examples of information that is likely to be regarded as material information are provided in this section. In addition, the form of disclosure is mandated (for example, via the NZX's Market Announcement Platform). Other provisions in this section deal with the release of information upon major change of control or direction and annual and half-yearly reports.
- **Section 11 – Transfers and Statements.** This section deals with transfers of securities and the issue of statements relating to securities to shareholders.

Regulations of companies

¶218 Overview

Companies are a special type of legal person, created by the Government following an application for registration. The special status of companies as legal persons, and the special rights and protections (such as limited liability) conferred on participants in companies, mean that companies are treated as requiring special regulation. In addition, the provisions of the Companies Act require administration and enforcement. This section summarises the respective roles of the Companies Office, the FMA and the courts in regulating companies. By contrast, in Australia, one regulator performs the work done by the Companies Office and the FMA. In Australia, the Australian Securities and Investments Commission (ASIC) registers companies and administers Australia's securities regulation regime.

http://www.pbookshop.com

¶219 The Companies Office and the Registrar of Companies

In New Zealand, the **Ministry of Business, Innovation and Employment (MBIE)** has overall responsibility for companies. The **Registrar of Companies** heads the Companies Office. The Registrar of Companies is a position created by statute. The Registrar is the principal regulator of companies in New Zealand. The role and powers of the Registrar are contained in Pt 20 of the Companies Act. Enhanced powers were granted to the Registrar by Pt 4 of the Companies Amendment Act 2014; however, these powers do not come into force until July 2015.

What is the structure of the Companies Office?

As stated, the Registrar of Companies heads the Companies Office. Immediately beneath the Registrar is the Group Manager of Business Registries. There are five main operational units beneath the National Manager of Business Registries:

- **The National Enforcement Unit:** The manager of this unit has responsibility for prosecutions and director prohibitions. This unit is based in Auckland.
- **Central Region:** The manager of this unit has responsibility for client services and insurance and superannuation unit.
- **Internet Support:** The manager of this unit has responsibility for internet support and online promotions.
- **Contact Centre and Southern Region:** The manager of this unit has responsibility for the contact centre, client services and quality control.
- **Northern Region:** The manager of this unit has responsibility for legal services, client services, compliance, other registers, document processing and document imaging.

What are the main functions of the Companies Office?

Details of the organisational structure, functions and legislation administered by the Companies Office can be found at the website of the Companies Office (see www.business.govt.nz/companies/).

As further discussed in Chapter 17, one of the principal functions of the Companies Office is to maintain registers containing information about companies that can be accessed by members of the public.

Some of the following information about the function of the Companies Office is extracted from the Companies Office publication, *Online with NZ Business: Strategic Business Plan 2005-06*. This booklet has not been updated.

The Companies Office is responsible for the provision of services relating to the registration of companies and other corporate entities and public access to corporate and securities information. The Companies Office has compliance and enforcement functions under the Companies Act, the Securities Act 1978, the Corporations (Investigation and Management) Act 1989, the Financial Reporting Act 1993 and the Friendly Societies and Credit Unions Act 1982.

Corporate body registers maintained by the Companies Office: The Companies Office maintains and manages a number of registers including the following:

- New Zealand and overseas companies
- financial service providers
- co-operative companies
- incorporated societies
- industrial and provident societies
- limited partnerships and overseas limited partnerships
- charitable trusts
- unit trusts
- friendly societies
- superannuation schemes
- contributory mortgage brokers
- credit unions, and
- building societies.

Administration of the registries falls into four areas:

- new registrations
- maintenance of registered information
- removal of defunct entities, and
- ensuring compliance with statutory disclosure obligations.

The Companies Office monitors compliance and timeframes for filing changes to registered information, as prescribed by the associated legislation.

The information held on the registers is available for public search. Searches can be conducted online via the Companies Office website or at the regional office where the company is registered.

Since May 2002, the Companies Office has maintained the **Personal Property Securities Register**. This register is a centralised, fully electronic register that creates a single procedure for the creation and registration of security interests in personal property. This register was provided for in the Personal Property Securities Act 1999 and is discussed further in Chapter 20.

In August 2010, the Companies Office introduced the **Financial Services Providers Register**. The register was established in accordance with the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSP Act). The FSP Act came into effect on 1 July 2011 and established a *compulsory registration* system for financial service providers. Thus, all financial service providers must be formally registered under the FSP Act and are also expected to comply with the care, diligence and skill provisions of the Financial Advisers Act 2008.

In order to qualify for registration, financial service providers are generally required to be members of an industry-run dispute resolution scheme or an alternative reserve scheme established by the Ministry of Consumer Affairs.

The purposes of the register as set out in s 26 of the FSP Act are as follows:

- to enable the public and any person to identify registered financial service providers and access information about them
- to assist any person in the exercise of the person's powers or the performance of the person's functions under the Act
- to prohibit certain people from being involved in the management or direction of registered financial service providers, and
- to conform to New Zealand's obligations under the Financial Action Task Force Recommendations on Money Laundering.

http://www.pbookshop.com

The register includes information about financial service providers, the type or types of financial service for which the financial service provider is registered and the name and business address of the approved dispute resolution scheme or the reserve scheme of which the financial service provider is a member.

Securities and corporate compliance: A number of statutory responsibilities in relation to the supervision of corporate bodies and issuers of securities have been transferred from the Companies Office to the FMA. The Securities and Corporate Compliance Unit of the Companies Office ceased to exist on 1 May 2011 when the FMA came into being. Previous functions carried out by the unit included: market supervision, investigation of non-compliance with various statutory regimes and enforcement of legislation.

¶220 The Financial Markets Authority

The FMA is the chief governmental agency with responsibility for regulating the financial sector.[2] It took over the functions of the former Securities Commission (NZSC) and the office of the Government Actuary in 2011. The FMA derives its functions and powers from the FMA Act. This Act came into force on 1 May 2011 and had the effect of establishing the FMA as of this date. As a result, any powers of the Securities Commission as of 1 May 2011 have been transferred to the FMA. The FMA also has new and enhanced powers.[3]

The FMA has functions in relation to those companies to which the provisions of the Securities Act 1978, the Securities Markets Act 1988 and the FMC Act apply: see s 9 (1)(c)(i) of the FMA Act. It also has functions where the FMA Act relates to "financial markets participants" as defined. The latter term includes issuers and "a director or senior manager" of a public issuer.

What is the principal legislation?

The **Financial Markets Authority Act 2011** sets out the main objectives and functions of the FMA. The Act comprises four parts.

- Part 1 – **Preliminary provisions.** This Part specifies the purposes of the Act and deals with matters of interpretation. Here s 4 (interpretation) and s 9 (FMA's functions) are the key provisions.
- Part 2 – **Financial Markets Authority.** This Part establishes the FMA and describes its functions and objectives. It also contains provisions dealing with the membership of the board of the FMA, divisions of the FMA and FMA meetings.

2. See P Maume "The Financial Markets Authority: A Model Example for Regulatory Consolidation?" (2013) 25(3) NZULR 616.
3. See P Maume and G Walker "Enforcing Financial Markets Law in New Zealand" [2013] NZ L Rev 263.

- Part 3 – **General information-gathering and enforcement powers.** This Part is divided into five subparts. Subpart 1 defines the information-gathering powers of the FMA. It provides that the FMA has power to obtain information, documents and evidence. Subpart 2 deals with the sharing of information and documents between the FMA and other law enforcement or regulatory agencies and overseas regulators. Subpart 3 is concerned with representative actions and empowers the FMA to exercise a person's right to bring a civil action against a financial market participant where it considers this to be in the public interest. Subpart 4 is entitled "Other powers". The FMA may in accordance with this subpart make confidentiality orders, accept undertakings and state a case for opinion before the High Court. Subpart 5 contains miscellaneous provisions relating to the FMA's powers.
- Part 4 – **Miscellaneous provisions.** This Part deals with regulations relating to fees, charges and costs. It also provided for the disestablishment of the NZSC and the Government Actuary and covers the consequences of such disestablishment. For example, s 72 states that the functions, duties and powers of the NZSC vest in the FMA to the extent that those functions, duties and powers are consistent with those of the FMA under the FMA Act and other legislation.
- **Schedule** 1 to the Act refers to **financial markets legislation**, including the:
  - ☐ Auditor Regulation Act 2011
  - ☐ Financial Advisers Act 2008
  - ☐ Financial Service Providers (Registration and Dispute Resolution) Act 2008
  - ☐ Parts 4 and 5 and schs 1 and 2 of the KiwiSaver Act 2006
  - ☐ Securities Act 1978
  - ☐ Securities Markets Act 1988
  - ☐ Securities Transfer Act 1991
  - ☐ Securities Trustees and Statutory Supervisors Act 2011
  - ☐ Superannuation Schemes Act 1989, and
  - ☐ Unit Trusts Act 1960.
- **Schedule** 2, which covered the FMA's search powers, was repealed, on 1 October 2012, by s 245(8) of the Search and Surveillance Act 2012 (2012 No 24).

What is the FMA's structure?

The FMA is an independent Crown entity for the purposes of s 7 of the Crown Entities Act 2004. Its main objective is to promote and facilitate the development of fair, efficient, and transparent financial markets. Like the former Securities Commission, the FMA comprises between five and nine members. It is able to act in divisions of three members. In addition, the Minister of Commerce will be able to

http://www.pbookshop.com

appoint up to five associate members for specified matters. This enables the FMA to deal with special requirements arising from its functions or build up expertise in particular areas.

What are the FMA's main functions?

While the FMA has assumed any powers possessed by its predecessor (the Securities Commission), it also has new and expanded powers by virtue of the FMA itself. Among these powers are the general information-gathering (search and seizure) and enforcement powers contained in Pt 3 and the levy-raising power contained in Pt 4 of the FMA Act.

Section 9 of the Act sets out the functions of the FMA. These can be summarised as:

- to promote the participation of businesses, investors, and consumers in the financial markets
- to perform and exercise the functions, powers, and duties conferred or imposed on it by or under the financial markets legislation and any other enactments
- to monitor compliance with, investigate conduct that constitutes or may constitute a contravention of and enforce specified legislation including the Auditor Regulation Act 2011, Financial Advisers Act 2008, Financial Service Providers (Registration and Dispute Resolution) Act 2008, Securities Act 1978, Securities Markets Act 1988 and the Securities Trustees and Statutory Supervisors Act 2011. It has the same powers in relation to legislation such as the Companies Act 1993, the Corporations (Investigation and Management) Act 1989, the Co-operative Companies Act 1996, the Financial Reporting Act 2013, Limited Partnerships Act 2008, Pt 5C of the Reserve Bank of New Zealand Act 1989 and the Trustee Companies Act 1967, to the extent that these Acts apply to "financial markets participants". The latter term is defined in s 4 of the Financial Markets Authority Act 2011 and encompasses financial advisers and brokers as well as issuers and directors or senior managers of public issuers.
- to monitor, and conduct inquiries and investigations into any matter relating to, financial markets or the activities of financial markets participants or of other persons engaged in conduct relating to those markets.

What are the FMA's statutory powers?

The FMA takes over all powers of the Securities Commission, except where the FMA Act otherwise provides: see s 72(1)(a).

- **General grant of power:** The FMA can do anything that a natural person of full age and capacity can do, provided it is for the purpose of performing its functions and subject to any Act or rule of law.

- **FMA's consideration of prospectuses, amendments, trust deeds and deeds of participation:** The Securities Amendment Act 2011 made changes to the way prospectuses were registered. Prospectuses are lodged with the Registrar of Companies as before but the Registrar of Companies' role is confined to formal compliance: see ss 42 and 43A of the Securities Act 1978. Once a prospectus is registered, the Registrar of Companies must notify the FMA under s 43C so that the FMA may consider whether the prospectus complies with the Act and Regulations. The FMA has power to prohibit the distribution of investment statements, prohibit allotments or cancel registration of prospectuses: see ss 43F and 43G of the Securities Act.
- **General information-gathering and enforcement powers** appear in Pt 3 of the FMA Act. Part 3, subpart 1 of the FMA Act makes provision for the FMA's power to require a person to supply evidence or produce documents (s 25); the FMA's power to receive evidence (s 26); how evidence may be given (s 27) and witnesses' expenses (s 28).

The following make up the most important of the FMA's specific statutory powers under the FMA Act.

- **General information-gathering powers:**
  - ☐ **Information-gathering:** Like the former Securities Commission, the FMA is able to require a person to supply information, produce documents or give evidence if the FMA considers this to be desirable for the purposes of performing its functions. Section 25 of the FMA Act confers a broad range of powers on the FMA to obtain information.
  - ☐ **Protection against liability:** The FMA is protected from liability in exercising its powers, unless acting in bad faith. See s 55 of the FMA.
  - ☐ **Power to enter and search place, vehicle, or other thing:** The FMA may authorise a specified person to enter and search premises, subject to a search warrant. The new power extends to "vehicles" and "other things", meaning intangible things like email addresses and Internet data storage facilities. This provision was made because financial information is usually stored in computer files and aligns the FMA's power to the changes envisaged by the Search and Surveillance Act 2012. The term "vehicle" is defined in s 3 of the Search and Surveillance Act as "any conveyance that is capable of being moved under a person's control, whether or not the conveyance is used for the carriage of persons or goods, and includes a motor vehicle, aircraft, train, ship, or bicycle".
  - ☐ **Search Warrants:** The FMA must apply for a search warrant to an "issuing officer" (that is, a Judge of the High Court or District Court). The issuing officer can grant a search warrant where he/she is satisfied that there are reasonable grounds to suspect that a person has engaged or is engaging in

http://www.pbookshop.com

- **Enforcement powers under the FMC Act:**

  The FMC Act sets out the enforcement powers of the FMA in relation to matters covered by that Act (eg insider conduct, market manipulation, general dealing misconduct, continuous disclosure, substantial holding disclosure and directors' and officers' disclosure obligations). The Securities Commission had the power to make a variety of orders under the Act, including prohibition and corrective orders, disclosure orders and temporary banning orders for investment adviser and broker activities where a provision in the Securities Markets Act has been contravened. These powers now reside with the FMA.

  The FMA has the power to make some enforcement orders itself and can also apply to the court for other enforcement orders. It can also make pecuniary penalty orders and declarations of contravention and can apply to the court for compensatory orders and other civil remedy orders on behalf of those who have suffered loss.

  In addition to enforcing the FMC Act, the FMA now has an enforcement role in respect of "financial markets legislation" as defined in the FMA Act. This includes the regime for financial advisers and brokers which was in full force as of 1 July 2011. The FMA's enforcement powers in relation to financial advisers and brokers are detailed in Chapter 26.

¶221 The New Zealand Exchange Limited

We saw in Chapter 1 that some companies elect to have their securities listed for quotation on the main securities market conducted by the New Zealand Exchange Limited (NZX). When they do so, they contract with the NZX that they will comply with the Main Board/Debt Market Listing Rules. The NZX acts as co-regulator with the FMA in the sense that it has a primary policing function for listed companies' compliance with those rules. However, it is important to remember that the NZX is not a governmental or regulatory agency like the FMA.

http://www.pbookshop.com

Historically, it was the Sharebrokers Amendment Act 1981 that enabled the Stock Exchange Association of New Zealand and each of the then four trading exchanges to form together as a statutory membership-based entity.

In late 2002, however, members of the New Zealand Stock Exchange (NZSE) voted in favour of the demutualisation of the NZSE.[4] Technological change and competitive pressures drove the change.[5] Enabled by the New Zealand Stock Exchange Restructuring Act 2002, the NZSE became a limited liability company – NZSE Limited – with its own constitution on 1 January 2003. As a result, new Conduct Rules for the NZSE were introduced. The Conduct Rules comprised the Business Rules and the Listing Rules. The Business Rules comprised the NZSE Business Rules 2002, the NZSE Regulations and the NZSE Code of Practice.

On 30 May 2003, NZSE Limited announced a further change of name to New Zealand Exchange Limited, trading as NZX, as part of a re-branding exercise. (Thus, the website of the NZX has been www.nzx.com since the rebranding – and the website is continuously updated.) The NZX listed on its own stock market – the NZX Main Board – on 4 June 2003.[6]

As of January 2014, the key rules of the NZX are as follows:

- NZX Main Board/Debt Market Listing Rules (1 January 2014)
- NZX Alternative Market Listing Rules (August 2010), and
- NZX Participants Rules (August 2012).

The main markets now operated by the NZX are as follows:

- **The NZX Main Board**: The NZX Main Board is 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 NZX Main Board have one of three listing types. The first type is primary listing where NZX is the home exchange and the company abides by Main Board/Debt Market Listing Rules. The second type is dual primary listing where the company abides by all Main Board/Debt Market 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 Main Board/Debt Market Listing Rules as well as those of its home exchange. Companies generally quote ordinary shares on the NZX Main Board. 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 NZX Main Board, the securities being quoted must have a minimum anticipated market value on initial listing and a specific spread of shareholders. There were 145 companies listed on the NZX Main Board in February 2014.

4. For a general discussion of the demutualisation process, see E McKnight, R Fraser and H Gething *Demutualisation* (FT Law and Tax, London, 1996). For a discussion of demutualisation of the Australian Stock Exchange in October 1998, see F Donnan "Self-Regulation and the Demutualisation of the Australian Stock Exchange" (1999) 10 *Australian Journal of Corporate Law* 1. See also, IOSCO "Issues Paper on Exchange Demutualisation" (June 2001).

5. See NZSE *Annual and Special Meeting Documentation* (16 October 2002). Thanks to Elaine Campbell, General Counsel of the NZX, for relevant documentation.

6. J Whyte "NZ exchange sizes up the task ahead" *The Australian Financial Review* (31 January 2003) at 73 (discussing listing of NZSE Limited in 2003); J Whyte "Full steam ahead for NZSE listing" *The Australian Financial Review* (29 May 2003) at 19 (NZSE to list on its own market on 4 June 2003); "NZSE to change name" *The Weekend Australian Financial Review* (31 May–1 June 2003) at 11 (name change from NZSE to NZX ahead of NZX listing); J Whyte "NZX shares list at top of price range" *The Australian Financial Review* (5 June 2003) at 21 (NZX listed on its own market on 4 June 2003); R Callick "Exchange makes an impressive Mark" *The Australian Financial Review* (8 July 2003) at 53 (longer review article describing the work of Mark Weldon as change agent and CEO of the NZX).

- **The NZX Debt Market:** The NZX Debt Market offers a range of investment securities, including corporate and government bonds and fixed-income securities. There were 13 companies listed on the NZX Debt Market in February 2014.
- **The NZAX:** The NZX Alternative Market provides 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 NZX Main Board. There were 18 companies listed on the NZX Alternative Market in February 2014.

What is the legal status of the Main Board/Debt Market Listing Rules?

The Main Board/Debt Market Listing Rules form part of the listing agreement between the NZX and the listed company. The listing agreement is a private contract. In effect, it provides that the NZX may vary its Listing Rules as it sees fit (subject always to the approval process contained in s 360 of the Securities Markets Act 1988) and may act unilaterally in relation to exercising its powers to suspend or delist a company.

The NZX or a security holder – via the Contracts (Privity) Act 1982 – has the ability to enforce the Listing Rules. The FMA plays an important role in enforcing the Listing Rules relating to continuous disclosure: see ss 270 and 362 of the FMC Act. See ss 19B, 19G of the Securities Markets Act.

In Australia, the Listing Rules of the Australian Stock Exchange (ASX) primarily operate as private law that is binding only as a matter of contract between the ASX and the listed company: see CCH *Australia, Annotated Listing Rules*.

However, they do have general statutory force. This is because s 793C of the Corporations Act 2001 gives the courts the power, on the application of ASIC, the ASX or a "person aggrieved", to order any person obliged to comply with the Listing Rules to do so.

The securities markets operated by the NZX are markets where buyers and sellers exchange listed securities, and where a company requiring additional capital may issue newly listed securities to prospective buyers. The NZX states that its purpose is to provide and operate an efficient market for the raising of capital for listed companies and the trading of securities, including shares and fixed-interest securities such as bonds and government stock. These functions and objectives are aspects of the economic role of financial markets. Most micro-economists define an efficient market as one in which the costs of transactions are minimised. The function of the market is also to transfer financial resources from those with surplus funds to those who can use those assets more productively. This function also enhances the risk-bearing capacity of the economy.

¶222 Jurisdiction of courts

Companies are legal persons capable of suing and being sued in their own name – that is, they can be the plaintiff or defendant in a civil proceeding, or a defendant in a criminal proceeding. This section reviews the jurisdiction of courts over companies, explaining which courts are allowed to hear matters in which companies are involved.

What courts have jurisdiction over companies generally?

In matters other than those arising under the Companies Act 1993, companies are subject to the ordinary jurisdictional rules. For example, an action to recover a debt would be brought in the court system, in either the District Court or the High Court, depending on the amount of money involved. The current rules setting out the monetary limits for jurisdiction for courts can be found in the District Courts Act 1947. The same would be true for tort claims, such as claims by or against the company for negligence.

What courts have jurisdiction over matters arising under the Companies Act?

Matters arising under the Companies Act fall into two categories:

- actions for breach of a provision of the Companies Act (criminal), and
- proceedings in accordance with the Companies Act (such as an application for an order for the appointment of a liquidator under s 241).

Which court has jurisdiction to hear or decide a matter under the Companies Act depends on the particular matter. Matters can be decided in the general court system (in the District Court or the High Court), subject to relevant jurisdictional limits.

http://www.pbookshop.com

Corporate governance theory suggests that, where companies have a large number of shareholders each of whom holds a relatively small percentage of the company's issued shares, there may be practical barriers to shareholders exercising control through their voting rights.

¶803 How much control do shareholders have in large listed companies?

In Chapter 1, we saw that there are around 592,350 limited liability companies in New Zealand. The vast majority of these companies are small businesses that have only a few shareholders, all or most of whom participate, directly or indirectly, in the management of the company. In such companies, the effectiveness of shareholder control is rarely in issue – where the shareholders are themselves also the directors of the company, there is no possibility for divergence between the interests of shareholders and managers. In larger unlisted companies, while not all shareholders will have a direct involvement in management, shareholders may still be in a position to monitor and influence management in a fairly direct way because, for example, all of the shareholders are personally related to each other in some way, or live in the same region or work in the same industry.

However, in large listed companies with many shareholders, there are greater practical barriers to shareholders joining together to mount an effective challenge to management. For example, AMP Limited has over one million shareholders, most of whom own only a small percentage of shares (and, therefore, votes) in the company. Many commentators have observed that, in such widely held companies, shareholder control may be illusory.[1]

Where ownership of a company's shares is widely dispersed, a person who controls less than 50% of the votes that can be exercised in a general meeting may nevertheless have effective control of the company. This reality of control is reflected in the takeover laws discussed in Chapter 27, which place restrictions on persons acquiring more than 20% of the shares in a widely held company.

¶804 What impact do institutional investors have on control?

In recent years the effect of substantial institutional share ownership has been the subject of considerable interest for its impact on shareholders' control of widely held companies. For example, in 1996, 42% of the top 40 listed equities in New Zealand were owned by institutional investors, including life insurance companies,

1. The observation that such companies are, effectively, controlled by management and not by their shareholders is generally traced back to A Berle and G Means *The Modern Corporation and Private Property* (Transaction Publishers, New York, 1932). See, also, G Stapledon *Institutional Shareholders and Corporate Governance* (Clarendon Press, Oxford, 1996) at ch 1.

superannuation funds, unit trusts and banks. Traditionally, institutional investors were viewed as passive and aloof, and unlikely to intervene actively in the corporate governance of companies in which they invest. However, more recent experience in New Zealand suggests that institutional investors may be expanding their influence in corporate governance.[2]

The scope of shareholder voting rights

¶805 Understanding shareholder voting rights

In the following discussion we collect together the most important voting rights granted to shareholders under the common law, the Companies Act and typical constitutional provisions. Many of the voting rights discussed in this section are mentioned elsewhere in this book in the chapters that deal with the particular subject-matter of the resolution. The procedures in accordance with which the voting rights described in this part must be exercised are discussed in Chapter 9.

When analysing the voting rights granted to shareholders of a company, you should ask yourself in each case:

- whether the power to vote is conferred by law or is something that can be removed or excluded by agreement between the participants in the company
- whether shareholders have a power to compel the company to take some action against the wishes of directors, or whether the power is simply one to approve or veto some action proposed by the directors
- what percentage of shareholders must agree with the resolution for it to be passed (generally, either an ordinary or a special resolution will be required), and
- whether those who dissent from the proposal are bound by the majority's decision, or have a right to ask a court to review the merits of the decision to ensure that it is fair.

2. For a discussion, see M Fox, G Walker and A Pekmezovic "Corporate Governance Research on New Zealand Listed Companies" (2012) 29(1) *Arizona Journal of International and Comparative Law* 1. See also M Fox and G Walker "New Zealand Sharemarket Ownership" in G Walker (gen ed) *Securities Regulation in Australia and New Zealand* (2nd ed, Lawbook Company, Sydney, 1998) at 261; M Fox, G Walker and A Pekmezovic "Corporate Control of New Zealand Stock Market (NZSX) Companies: The 2009 Data" (2010) 28 C&SLJ 494; M Fox and G Walker "Foreign Control of NZSE Companies: New Zealand Evidence" (2000) 18 C&SLJ 283. See further F Navissi and V Naiker "Institutional ownership and corporate value" (2006) 32(3) Managerial Finance 247–256. Aik Win Tan and T Keeper "Institutional Investors and Corporate Governance: A New Zealand Perspective" (Centre for Accounting, Governance and Taxation Research, School of Accounting and Commercial Law, Victoria University of Wellington, Working Paper No. 65, October 2008) – www.victoria.ac.nz/sacl/cagtr/working-papers/WP65.pdf.

http://www.pbookshop.com

We will see in the following discussion that the scope of shareholder voting rights depends on the type of company in question. Generally speaking, shareholders of listed companies have more extensive voting rights than shareholders of unlisted companies.

¶806 On what issues do shareholders have a vote?

Shareholders' voting rights are limited to the matters expressly provided for in the Companies Act, the company's constitution (if any) and the common law. The NZX Main Board/Debt Market Listing Rules confer more extensive voting rights on shareholders of listed companies.

Subject to some exceptions, shareholders may have a right to vote on certain decisions, including:

- appointing or removing a director or auditor
- adopting a constitution
- altering the company's constitution (if it has one)
- approving a major transaction (as defined)
- approving an amalgamation, and
- putting the company into liquidation.

Shareholders may also have a say in the following:

- authorising matters otherwise than in accordance with the Act's procedures by unanimous consent, in those cases covered by s 107
- management review by shareholders at a meeting of shareholders (s 109), and
- alterations of shareholders' rights (s 117).

The shareholders' voting rights related to each of these matters are discussed below.

Structural or constitutional decisions

¶807 Appointment or removal of director or auditor

The minimum number of directors of a company is one (ss 10(d), 150).

Shareholders have the right to appoint and remove directors, unless that right has been excluded by the company's constitution.

Directors may be appointed in three ways, described below. In all cases the person must consent in writing (s 152).

A director must be a natural person who is not disqualified from office by the requirements of s 151 of the Companies Act. Disqualification applies if the person is aged under 18 years, or is an undischarged bankrupt, a person prohibited by various enactments from being a director, or someone who does not comply with qualifications contained in the company's constitution.

First, a person named as a director in an application for registration or amalgamation holds office from the date the application is effective (s 153(1)).

Secondly, directors may be appointed after the registration or amalgamation by ordinary resolution of the shareholders (s 153(2)).

Subject to the constitution, the resolution must comply with s 155(1). This requires a separate unopposed resolution, if more than one director is being appointed by the same resolution.

Thirdly, the court may appoint a director on application from a shareholder or creditor of the company where the number of directors falls below the required quorum or to nil and it is not possible or practicable to appoint them (s 154).

A person might also be liable as a director even though not appointed as such, by virtue of the broad definition of "director" in s 126. This applies essentially to a person in accordance with whose directions or instructions the board or a director may be required or is accustomed to act.

Unless the company's constitution provides otherwise, shareholders may remove a director by ordinary resolution (s 156).

The resolution must be passed at a meeting called for that purpose, and the notice of meeting must state the purpose. If a director is not removed by ordinary resolution, he or she continues in office until vacation occurs by resignation, disqualification, death or otherwise in accordance with the constitution (s 157).

The rules surrounding the appointment of auditors changed on 1 April 2014 when a new Part 11 was inserted into the Companies Act by the Financial Reporting (Amendments to Other Enactments) Act 2013.

Under s 207P of the Companies Act an auditor must be appointed if financial statements are required to be audited under the Companies Act or the Financial Markets Conduct Act 2013.

The first auditor of a company may be appointed by the directors before the first annual meeting: s 207P(4). Thereafter, the company must appoint an auditor at the annual meeting: s 207P(2). Provision for automatic reappointment appears in s 207T.

There is an extended discussion as regards auditors in Chapter 17.

http://www.pbookshop.com

¶808 Adopting and amending the constitution

If a company chooses to adopt a constitution on registration, no shareholder resolutions are involved. After registration, a special resolution of the shareholders is required to adopt a constitution (ss 32, 106(1)(a)).

A company may alter or revoke its constitution, or a provision of its constitution, by special resolution (s 106(1)(a)).

The company's constitution itself may include further restrictions on or requirements for amendment or revocation (such as a requirement that a particular shareholder agree to the amendment or revocation) and any such additional requirements must be met (s 30(b)).

A proposal to adopt, alter or revoke a constitution may be initiated by the shareholders themselves under cl 9(1) of sch 1 of the Companies Act, unless that clause has been altered pursuant to s 124. Directors also may initiate such proposals (s 128(2)).

Changes to a company's constitution that are passed by a special resolution of shareholders are binding on the company and its board, even if the directors disagree with the changes (s 31(2)).

¶809 Approving a major transaction

Section 129

Approval of a major transaction is another procedure that requires a special resolution (ss 106(1)(b), 129(1)).[3] The transaction must be either approved by a special resolution or contingent on approval by a special resolution. A "special resolution" is "a resolution approved by a majority of 75% or, if a higher majority is required by the constitution, that higher majority, of the votes of those shareholders entitled to vote and voting on the question" (s 2).

Major transaction is defined in s 129(2) of the Companies Act. It involves the acquisition or disposition of assets or liabilities the value of which is more than half the value of the company's assets before the acquisition or disposition. This applies to an actual acquisition or disposition, or an agreement to acquire or dispose, whether contingent or not. It applies also to a transaction having the effect or likely effect of the company acquiring rights or interests or incurring obligations or liabilities, including contingent liabilities, the value of which exceeds half the value of the company's assets before the transaction.

3. See also the discussion in S Watson "Allocation of Power within the Company" in J Farrar and S Watson (gen eds) *Company and Securities Law in New Zealand* (2nd ed, Thomson Brookers, Wellington, 2013) at [12.4].

http://www.pbookshop.com

The major transaction provision increases shareholder control over these transactions. It overrides to some extent the common law rule that the power to manage is vested in the directors. See *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34.

The statutory version of the management rule, contained in s 128, recognises explicitly that it may be overridden by other provisions of the Act (such as s 129) (s 128(3)).

NZX Main Board/Debt Market Listing Rule 9.1 — disposals and acquisitions

The stock exchange rule for listed companies disposing or acquiring assets is slightly different. Such transactions are required by Listing Rule 9.1.1 to be approved by ordinary resolution or a special resolution if s 129 applies, where:

- the transaction would change the essential nature of the business of the issuer, or
- in respect of which the gross value of the transaction is in excess of 50% of the average market capitalisation of the issuer.

The term "average market capitalisation" is defined.

The rule does not apply to a takeover offer by an issuer in respect of a code company, or to any transaction with a bank at arm's length and in the ordinary course of business, as a result of which the issuer has recourse to the "credit risk of a bank". In addition, the rule does not apply to an issue by an issuer of securities for cash which does not change the essential nature of the business of the issuer. The stock exchange may waive application of the rule.

NZX Main Board/Debt Market Listing Rule 9.2 — material transactions with related parties

Approval by ordinary resolution is required by NZX Main Board/Debt Market Listing Rule 9.2 for an issuer to enter into a material transaction with a related party. "Material transaction" and "related party" are defined terms. A summary of the definition of **material transaction** is that it applies to transactions involving a value of more than 10% of the average market capitalisation of the issuer, or to any amalgamation not being one between wholly owned subsidiaries. Some exceptions are listed in Listing Rule 9.2.4. Under NZX Main Board/Debt Market Listing Rule 9.2.5, notice of the relevant meeting must be approved by the stock exchange and be accompanied by an appraisal report and other material enabling holders of securities to decide whether the transaction price and terms are fair.

¶810 Approving an amalgamation

An amalgamation proposal must be approved by special resolution of shareholders (ss 106(1)(c), 221(5)(a)). An amalgamation takes place when two or more companies merge and continue as one company (s 219).[4] The shareholders are entitled to receive certain information outlined in s 221 of the Companies Act, not less than 20 working days before the proposal is to take effect. Any provision that would require the approval of an interest group must be approved by special resolution of that interest group. Interest groups are discussed at ¶814. Note, however, that the Companies Amendment Act 2014 introduced new provisions as regards arrangements and amalgamations of code companies.

¶811 Initiating liquidation

Shareholders may put the company into liquidation by special resolution (ss 106(1)(d), 241(2)(a)). In some circumstances, the board or the court may commence liquidation also. From the commencement of liquidation, a shareholder must not transfer shares or exercise constitutional powers except for the purposes of the liquidation (s 248).

¶812 Unanimous consent procedures

Because they require unanimous consent, the procedures permitted by s 107 of the Companies Act will, in practical terms, be available only to closely held companies. The Act makes no other concession for closely held companies, unlike company law statutes in countries such as the United States and Germany.

The s 107 procedures permit the company to enter into a stated range of transactions without complying with some of the procedural rules (eg the disclosure requirements of s 140 when a director is interested in a transaction with the company).

The transactions to which s 107(1) applies are as follows:

- authorising a dividend otherwise than in accordance with s 53
- approving a discount scheme otherwise than in accordance with s 55
- acquiring shares otherwise than in accordance with ss 59–65
- redeeming shares otherwise than in accordance with ss 69–72
- giving financial assistance for the purpose of, or in connection with, the purchase of shares otherwise than in accordance with ss 76–80, and
- authorising matters referred to in s 161(1) (directors' remuneration and benefits) otherwise than in accordance with s 161.

4. See generally, D Cooper "Amalgamations" in J Farrar and S Watson (gen eds) *Company and Securities Law in New Zealand* (2nd ed, Thomson Brookers, Wellington, 2013) at ch 38.

In addition, the company may:

- issue shares otherwise than in accordance with ss 42, 44 and 45 (s 107(2)), and
- enter into a transaction in which a director has an interest so that ss 140 and 141 do not apply (s 107(3)).

The s 107 procedures cannot apply unless there is agreement or concurrence from **all entitled persons**. Entitled persons are the shareholders plus any person upon whom the constitution confers any of the rights and powers of a shareholder (s 2).

This might include people who are debenture holders and the like; for example, where the constitution provides a debenture holder with the power to remove the board in the event of default.

The agreement or concurrence must be in writing (s 107(4)). It may be either specific to the particular exercise of the power referred to, or it may be general (s 107(5)).

If it is a general one:

- an entitled person has power to withdraw his or her agreement or consent by written notice (s 107(6)), and
- the board must send written notice of the exercise of the power to every entitled person within 10 working days (s 107(7)).

The power to withdraw from an agreement considerably weakens the effectiveness of the unanimous consent procedure.

Where the transaction is one of those in the initial list above, the power must not be exercised unless the board is satisfied on reasonable grounds that the company will, immediately after the exercise of the power, satisfy the solvency test (s 108).[5] Certification requirements apply (s 108(2)). Thus, the directors who vote in favour of the exercise of the power must sign a certificate stating that, in their opinion, the company will, after the exercise of the power, satisfy the solvency test.

An analysis of s 107 was undertaken by Robert Dugan in 1997.[6] He concluded that a s 107 agreement cannot serve as a vehicle for shareholder management of the business, because a board remains necessary to implement the transactions.[7] Also, the directors cannot escape their duties under ss 131–137.

5. The solvency test is discussed in Chapter 19.
6. R Dugan *Companies Act 1993: Governance Issues for Closely Held Companies* (Victoria University Press, 1997).
7. Ibid, at 87.

http://www.pbookshop.com

A further problem identified by Dugan is that, in some cases, s 107 may require more documentation than the statutory provisions that are overridden by the assent.[8] He provides the example of a remuneration scheme for a sole shareholder and director. Under s 161, the director must ensure that particulars of the arrangement are entered in the interests register and must resolve and certify that the arrangement is fair to the company.

By way of contrast, if the transaction is done under s 107, the director must sign a written assent, any other entitled person must also sign an assent, and the notice requirements in s 107(6) would apply every time the director took drawings against his or her current account. In addition, at each drawing the director must resolve and certify compliance with the solvency test under s 108.

It is possible for shareholders to enter into a shareholders' agreement outside the Act. This might provide for such things as an agreement not to exercise the shareholder's withdrawal right under s 107(6). It might also regulate voting rights and share transfers.

¶813 Shareholder review of management

Unless the constitution provides otherwise, management of the company is entrusted to the board of directors (s 128). However, under s 109 of the Companies Act, at a meeting of shareholders the chairperson must give shareholders reasonable opportunity to question, discuss or comment on management (s 109(1)). The meeting may pass a resolution relating to the management of the company (s 109(2)). Any such resolution is not binding on the board unless the constitution provides otherwise (s 109(3)).

¶814 Altering class and interest group rights

Under the Companies Act, the alteration of rights attaching to shares is subject to the approval of shareholder interest groups. Thus, a company cannot take such action against an interest group unless that action has been approved by a special resolution of those shareholders affected. This fundamental rule is set out in s 117(1).

What are class and interest group rights?

Subject to the constitution, a company may issue different classes of shares with different rights attaching to them (s 37). Typically, different rights may be in relation to voting, dividend entitlement, in repayment of capital, and entitlement to share in surplus assets on liquidation.

Class means a class of shares having attached to them identical rights, privileges, limitations and conditions (s 116(1)).

8. Ibid, at 40.

Shares may be treated as being divided into classes even though they are not described in the constitution or the terms of issue of the shares as being of different classes. The existence of a class depends on the identity of interest between different shareholders. Thus, if shareholders have different rights, privileges, limitations or conditions attaching to their shares, these shares may be treated as being in different classes.

An **interest group** is not a formal class of shareholders but is a temporary grouping that may emerge in response to a particular company action or proposal. Suppose, for example, that a company has a class of preference shares and it is proposed that some of the preference shareholders will have their dividend entitlement increased. Without the concept of interest groups within a class, then, should a block of the preference shareholders happen to control enough votes to satisfy a special resolution procedure, the remaining preference shareholders would be unfairly discriminated against under such a proposal.

Thus, the Act – after defining "interest group" in s 116 as being a group of shareholders whose rights are identical and affected in the same way – adds that if a proposal distinguishes between some holders of shares in a class and other holders of shares of that class, holders of shares in the same class may fall into two or more interest groups (s 116(2)(b)). It follows that a special resolution would be required from the interest group adversely affected.

What amounts to an alteration of "rights attached to shares"?

Under s 117(2), rights attached to shares will include voting rights, rights to distributions, pre-emptive rights and also the right to have the procedures set out in the Act or the constitution observed.

In addition, the issue of further shares is generally deemed to be an action affecting rights attached to existing shares (s 117(3)). However, this will not always be the case. In *White v Bristol Aeroplane Co* [1953] Ch 65, a bonus issue of shares (both preference and ordinary) to ordinary shareholders greatly diluted the voting rights of preference shareholders. Nonetheless, the issue was held not to amount to a variation of the class rights attaching to shares, because the company's constitution gave power to vary rights attached to any class of shares. Section 117(3)(a) of the Act permits the same result to be achieved.

Rights of dissenting shareholders

Where an interest group has, under s 117(1), approved an alteration of rights attaching to shares, minority shareholders who were not in agreement and who cast all their votes against approving the proposal are entitled to require the company to purchase their shares in accordance with s 111 (s 118).

http://www.pbookshop.com

theory suggests that companies whose operations are funded by a higher level of debt can offer a relatively higher level of returns to shareholders than more conservatively geared companies, provided that the company's income is more than adequate to cover the cost of carrying the debt (ie interest and principal repayments). However, if the company's income falls, shareholders in a more highly geared company face a greater risk that the carrying costs of the debt will swallow all of the company's profits (leaving none available for dividends) or exceed the company's ability to pay, resulting in insolvency.

In practice, the optimum level of gearing for most companies would appear to be one involving the maximum amount of debt that can be serviced, without affecting the company's ability to pay dividends, on conservative projections of the company's future profitability. However, company managers may in practice be limited in making the funding decision by conditions imposed by financiers or by conditions in the financial markets. For example, a bank may require as a condition of lending to a company that the company's total indebtedness not exceed 60% of the company's total assets.

It is important to understand the legal rules relating to company finance against this background of capital decision-making.

What are the sources of company finance?

The principal sources of finance for limited liability companies include:

- share capital
- debt finance
- off-balance sheet funding such as equipment leasing and project finance
- trade finance, and
- retained earnings.

Share capital: A company's share capital is made up of the money or assets contributed to the company by people proposing to become shareholders of the company. The amount contributed becomes the property of the company and the contributor is issued with shares in the company, which may be "ordinary shares" or shares with particular rights attached. The nature of share capital is discussed in greater detail below.

Debt finance: Debt finance is money lent to the company, in the expectation that the company will pay interest throughout the term of the loan, and will repay the principal (the original amount loaned) by the end of the term. The lender may be an outsider, such as a bank, or an insider, such as a shareholder of the company.[2] Term

2. For example, as in *Salomon's* case, discussed in Chapter 3.

loans (such as those often made by banks) and overdraft facilities are examples of debt finance. Others include promissory notes, bills of exchange and letters of credit. Debt finance is discussed in detail in Chapter 20.

Trade finance: Trade finance is a term used to describe the situation in which a company has received goods or services in advance of paying for them, or has received payment in advance of delivering goods or services.

Retained earnings: Retained earnings are earnings from previous periods that have not been distributed to the company's shareholders.

Both trade finance and retained earnings are important sources of working capital for many companies.

¶1803 Differences between share capital and debt finance

Introduction

We saw above that understanding the main differences between equity and debt is important in addressing the funding decision in companies. This section summarises those main differences. However, in considering the following, it is important to understand that they are general statements about the typical terms of the two types of claims only. The particular terms of a particular debt or equity security may be different. In addition, it is possible to structure particular claims of one type so that they have some of the characteristics of the other type. An example of this is preference shares, which are discussed at ¶1805. Even though preference shares are equity, they have many of the usual characteristics of debt.

What are the characteristics of debt?

Generally, **debt** has the following characteristics:

- the company is required to pay interest at an agreed rate (whether or not its operations are profitable)
- the company is required to repay the principal at the end of an agreed term (the company may sometimes repay the principal earlier)
- the lender has priority over shareholders for repayment of the principal on a company's liquidation
- the lender is not a shareholder of the company and has no shareholder rights (such as voting rights)
- the lender has no right to share in any surplus assets on liquidation (ie no right to a share of any assets left in a solvent company on its liquidation after all the legitimate claims have been satisfied), and
- the capital provided is for a short or finite term, and there is an expectation that it will be repaid in the normal course of business.

http://www.pbookshop.com

What are the characteristics of equity?

Equity securities (shares) will usually have the following characteristics:

- the company is able to pay dividends only if the company satisfies the solvency test
- there is no expectation that the principal will be repaid to shareholders during the company's life
- the shareholders will be entitled to repayment of their principal on the company's liquidation only after all other legitimate claims have been satisfied
- the shareholders have the rights (such as voting rights) conferred on them by the Companies Act 1993 (the Act) and the company's constitution
- the shareholders are entitled to share in any surplus assets on the company's liquidation, and
- the capital provided is long-term, and there is no general expectation that it will be repaid before the company is put into liquidation.

What are the key differences?

These differences are illustrated in Table 18.1.

Table 18.1: Difference between debt and equity

	Debt	Equity
Payments to investors	Interest at an agreed rate that the company is contractually bound to pay	Dividends payable is declared by the directors, subject to the company satisfying the solvency test
Repayment of principal	Parties usually expect repayment of the principal at the end of the term	Usually, no expectation that equity capital will be repaid to shareholders while the company is a going concern
Priority	Lender has priority over shareholders for payment of interest and repayment of principal	
Ownership	Lender is not a shareholder	Equity holder is a shareholder, with shareholder rights (such as voting rights)
Right to share in surplus assets on company's liquidation	After repayment of principal, no right to participate	May participate in surplus assets, depending on the terms of the issue of the shares

However, the typical terms outlined in Table 18.1 may be varied by the company and the investor, by agreement.

Shareholders as residual claimants: In ordinary circumstances, shareholders are the company's residual claimants. Debt holders or fixed claimants are entitled to receive distributions and repayment of principal in priority to equity holders. Equity holders carry the risk of insolvency but enjoy all of the potential gains if the company's profitability exceeds its debt-carrying costs. Generally, equity represents long-term finance for the company, while debt is considered short-term (or at least of a finite term).[3]

Tax deductibility: Another important difference between equity and debt finance is that the distributions paid on debt finance (ie interest payments) are generally tax deductible for the company, whereas the distributions paid on equity (ie dividends) are not.

http://www.pbookshop.com

The nature of share capital

¶1804 What is "share capital"?

A company's **share capital** is the amount of money or assets contributed to the company by its shareholders when they subscribe for shares in the company. In subscribing for a share, a person who wishes to become a shareholder takes some of his or her own money or assets and contributes that amount to the company. The money or assets contributed then belong to the company. In return, the shareholder is issued with shares in the company. A company's power to issue shares is contained in s 42 of the Act.

The concept of "share capital" is much less significant under the Companies Act 1993 than it was under the Companies Act 1955. Indeed, there is only one reference to "capital" in the 1993 Act. The expression "share capital" is now a misnomer if it implies the existence of an identifiable capital fund maintained for the benefit of creditors and shareholders. Today, the share structure of a New Zealand company has no significance for the rights of creditors. Protection of creditors is provided by the solvency test. The solvency test requirements are discussed at ¶1912.

What is a "share"?

A **share** in a limited liability company is a claim against the company to which the rights set out in the Companies Act and the company's constitution (if it has one) attach. Generally, those rights will be:

3. See, further, W Klein, J Coffee, and F Partnoy *Business Organization and Finance, Legal and Economic Principles* (11th edition, Foundation Press, 2010).

- distribution rights (ie rights to receive dividends during the company's life and, depending on the terms of issue of the particular share, rights to repayment of the principal and to share in any surplus assets of the company on the company's liquidation), and
- control rights (ie rights to exercise some control over the management of the company's affairs, generally taking the form of a right to vote on particular decisions affecting the company).

The legal nature of a share is set out in s 35 of the Act.

A share is a piece of personal property that belongs to the shareholder. Unlike real property (such as land), a share is an example of intangible property referred to by lawyers as a "chose in action". Because it is the property of the shareholder, it can be dealt with by the shareholder in the same way as other property – for example, it can be sold, mortgaged or devised by will.

¶1805 What are "classes of shares"?

We noted in Chapter 2 that companies can issue shares of different types, with different rights attaching to each type of shares. The power to issue shares of different types, or "classes", is given by s 37 of the Act, which states that a company may determine the terms on which its shares are issued, and the rights and restrictions attaching to those shares.

Why do companies issue different classes of shares?

Companies issue shares of different classes to accommodate the different needs and preferences of different types of investors. Subject to certain restrictions discussed below, the directors of a company can decide the terms of issue for new shares. Although not restricted to these matters, different **classes of shares** will generally be created where the company wishes to issue shares with different rights in relation to:

- entitlement to dividends
- priority in relation to the payment of dividends
- voting rights
- priority in repayment of capital if the company is put into liquidation, or
- right to share in surplus assets if the company is put into liquidation.

Where a company proposes to issue shares of different classes, it is good practice to set out the rights attaching to each class in the company's constitution, although this is not strictly required. If a company that does not have a constitution is proposing to issue a new class of shares, a constitution should be adopted.

The reasons why a company may wish to issue shares of different classes, and the kinds of rights that can attach to the different classes, depend on the individual circumstances of each company. In particular, a company may wish to:

- entrench control in the hands of a particular shareholder or group of shareholders – this could be done by creating two classes of shares, one of which has greater voting rights in a general meeting, or has other control rights such as the right to nominate one or more directors to the company's board
- issue shares that have many of the characteristics of debt (such as the right to a fixed distribution payable in priority to distributions to other shareholders, and the right to a repayment of principal at the end of an agreed term) but that are treated as equity for the purposes of calculating the company's gearing ratio – in these circumstances, the company would issue preference shares, which are described below
- establish separate classes of shares, to be issued to the participants in an incorporated joint venture, or
- issue shares that participate differently in the company's profits (eg in some family companies, different parts of the company's profits can be streamed to particular family shareholders for tax or commercial reasons).

Are there any restrictions on the rights that can be attached to shares?

For unlisted companies, there are few restrictions on the rights that can be attached to particular classes of shares. The replaceable rule in s 36 of the Companies Act provides for one vote per share, but it is possible to vary this by issuing shares of different classes with different voting rights attached. However, for listed companies, certain requirements of the Main Board/Debt Market Listing Rules may affect the company's ability to issue shares, say, that have enhanced voting rights. This is because Main Board/Debt Market Listing Rule 8.1.4 requires NZX approval for the amending of voting rights.

Can the rights attaching to shares be changed?

Changing the rights attaching to shares in a particular class is discussed at ¶1814 and ¶1816.

http://www.pbookshop.com

What are "ordinary shares"?

Many companies elect to issue shares of two classes – ordinary shares and preference shares.[4]

Typically, where this distinction exists, the **ordinary shares** will have:

- the right to share equally in any dividends (if they are declared) with all other ordinary shareholders, after all other claimants have been paid
- the right to vote at a general meeting of the company
- the right to be repaid their capital (or a pro rata[5] share of it) on the company being put into liquidation after all other claimants have been repaid, and
- the right to share pro rata in any surplus assets after the company is put into liquidation.

What are "preference shares"?

Preference shares typically have:

- the right to receive a fixed dividend (say 10 cents per share per year), provided there are profits available for distribution and a dividend is declared by the company
- the right to be repaid the principal if the company is put into liquidation, in priority to ordinary shareholders
- no voting rights unless dividends are in arrears, except on resolutions to reduce the company's capital or put the company into liquidation, or at class meetings on matters affecting their class rights, and
- no right to share in surplus assets once the company has been liquidated.

Cumulative preference shares: Preference shares may be *cumulative* or *non-cumulative*. The holder of a cumulative preference share carries forward his or her entitlement to a distribution from one year to the next if no dividend is declared in a particular year. For example, if a person holds a cumulative preference share offering a dividend of 10 cents and in Year 1 no dividend is declared (eg because there are no profits available from which a dividend can be paid), that person will be entitled to receive a dividend of 20 cents in Year 2 before any dividend is paid to

4. See E Ip "The Share Capital Puzzle: The Corporate Decision to Issue Ordinary or Preference Shares" (2002) 20 *Company and Securities Law Journal* 289.
5. "Pro rata" means in proportion. Assume a company has issued ordinary share capital of $100, made up of 10 shares issued at $10 each. A owns seven of these shares and B owns three. If there is only $10 left for the ordinary shareholders when the company's liquidation is completed, A would receive $7 and B would receive $3.

ordinary shareholders. The holder of a non-cumulative preference share loses his or her entitlement to any dividend that is not declared or paid in the relevant year.

Redeemable preference shares: The Act also allows companies to issue redeemable preference shares. Redeemable preference shares allow for the repayment of the principal at a particular time or on the occurrence of a particular event prior to the company being put into liquidation. Such shares can be redeemed at the option of the company at a specific date. Section 75(2) exempts such a redemption from the usual procedures required for redemption, particularly the application of the solvency test.

Converting preference shares: Another type of preference share sometimes issued is a converting preference share. These shares usually carry a right to a preferred, fixed dividend for a particular term, and then allow for or require conversion to ordinary shares at the end of the term. Usually, the conversion ratio will reflect in some way the value of ordinary shares at the time of the conversion.

http://www.pbookshop.com

¶1806 What are "partly paid shares"?

Sometimes, a company will choose to issue shares that are partly paid. This means that the person subscribing for the share pays only part of the subscription price to the company at the time the share is issued, with the balance to be paid at a later date.

What is a "call"?

Where a company has issued partly paid shares, the company is entitled to make a call at a later time for some or all of the balance owing on the share. Section 100 of the Act states that, if shares in a company are partly paid, the shareholder is liable to pay calls on the shares in accordance with the terms on which the shares are on issue.

What if a call is not paid?

Generally, where a company has issued partly paid shares, it will adopt a constitution containing provisions dealing with what is to occur if the shareholder does not meet the call. Under s 100, the company can recover the amount owing on the call from the shareholder. Often the company's constitution will say that the share is forfeited, and the company can arrange to auction the share to another person, keep the amount of the call, and pay the balance of the proceeds of sale to the defaulting shareholder.

Why do companies issue partly paid shares?

A company may issue partly paid shares for any of a number of reasons. The company may forecast significant funding requirements in the future and wish to "lock in" a commitment for equity funding in the early stages of the project. For example, a company engaged in the research and development stages of a project may wish to issue partly paid shares, so that it is assured of being able to call for the balance of the subscription price on those shares when it requires further funds for commercialisation of the project. Using partly paid shares may be preferable to issuing more shares at the commercialisation phase, especially if issuing more shares would require the (costly) preparation of a prospectus. The prospectus requirements of the Securities Act 1978 are discussed at ¶1909.

Alternatively, a company may wish to give particular people the rights of shareholders (including voting rights and rights to receive dividends) without requiring them to put up the full amount of the subscription price at the outset. In the 1980s, this was a popular means of providing rewards and incentives to company officers. However, this type of issue is now less popular.

¶1807 What are "options"?

Broadly speaking, an **option** is a right to buy or sell something at a price that has been previously agreed, at (or by) some agreed time in the future.

Options over unissued shares: Companies sometimes issue options over their unissued shares that entitle or require the option holder to subscribe for shares at an agreed price (or at a price to be calculated by reference to an agreed formula) at or by a specified time in the future.

Options over issued shares: Options can also be granted by persons who own issued shares in a company, giving the taker of the option the right or obligation to acquire the option-writer's shares in the future. Sometimes, options over issued shares are referred to as "warrants".

Who are the parties to an option contract?

There are two parties to an option contract – a purchaser (or taker) and a seller (or writer). The purchaser pays the seller an amount (referred to as the option premium) to acquire the right conferred by the option.

What are some important types and features of options?

Some common terminology used in connection with options is set out in Table 18.2.

Table 18.2: Option terminology

Term	Definition
Put option	An option that carries the right to sell a share. The person who holds the option has the right to require the other party to buy the share at the agreed exercise price.
Call option	An option that carries the right to buy a share. The person who holds the option has the right to require the other party to issue or sell them the share at the agreed exercise price.
Option premium	The price paid by the purchaser to acquire the option.
Exercise price or strike price	The price payable to exercise the option and buy the underlying security.
American-style options	Options that are exercisable at any time up to an agreed expiry date.
European-style options	Options that are exercisable only on the agreed expiry date.

http://www.pbookshop.com

The price provided for in the option is referred to as the "exercise price". If the exercise price of a call option is below the market value of the underlying security, the option is said to be "in the money". If the exercise price of a call option is above the market value of the underlying security, the option is said to be "out of the money". The reverse is true of a put option.

If an option is in the money, the option itself has a value. In the case of options issued by listed companies, these are sometimes traded on the stock exchange separately from the shares that underlie them.

Ownership

¶1808 Who are the owners of New Zealand companies?

Shares in large listed companies are generally widely held by institutional, private and overseas investors.[6] In contrast, most of the shares in smaller companies are owned by the person who started the company or his or her close associates.

6. See M Fox, G Walker and A Pekmezovic "Corporate Governance Research on New Zealand Listed Companies" (2012) 29 (1) Arizona J of Int & Comp Law 1–48.

Who owns the shares in small business companies?

Most of the shares in New Zealand companies that are classified as small businesses are owned by the person who started the business (the "founder") or the main person involved in running the business, and members of his or her family. Persons who could loosely be described as "partners" of the founder, and other personal investors, make up the next largest group of shareholders in this type of company.

¶1809 What is "shareholding"?

All companies are required to have at least one shareholder (s 10).

The company's **shareholders** are, loosely speaking, its owners. They are the people who have invested money with the company in the expectation that they will receive a return on their funds if the company is successful, either in the form of distributions (called **dividends**) paid out of the company's profits during its trading life, or in the form of a growth in the value of their investment in the company over time.

The nature of share capital – the interest in the company held by shareholders – was discussed earlier in this chapter. Shareholders in a company may hold shares of different classes, entitling them to different distribution or control rights. The concept of classes of shares was also discussed earlier.

The question of who is a shareholder is important because it is the relationship between the shareholder and the company, and between each shareholder and each other shareholder, that creates the company. Rights and remedies between and among shareholders define the company.

Who can be a shareholder of a company?

Any person who can hold property in his, her or its own name can be a shareholder of a company. This includes humans and artificial persons such as companies themselves. The only exception to this may be people who are incapable as a matter of law of entering into binding contracts to acquire shares, such as people under the age of 18 where the contract is not for their benefit and advancement.

Who are the shareholders of a company?

Section 96 of the Act says that a **shareholder** is:

- a person whose name is entered in the share register as the holder for the time being of one or more shares in the company
- a person named as a shareholder in an application for registration of a company at the time of registration of the company, or
- a person who is entitled to have his or her name entered in the share register under a registered amalgamation proposal as a shareholder in an amalgamated company.

¶1810 How does someone become a shareholder of a company?

A person can become a shareholder of a company when it is formed or after it is formed.

On registration: A person becomes a shareholder on registration of the company by being named (with his or her consent) in the application for registration as a proposed shareholder. Section 96 of the Act treats these people as becoming shareholders at the time the company is registered.[7]

After the company is registered: A person may become a shareholder after registration of the company either by:

- subscribing for new shares in the company, or
- acquiring already issued shares from another shareholder (eg by buying or inheriting them).

The person becomes a shareholder once he or she is entitled to be entered in the share register. The register is a list of the names and addresses of the shareholders. The company is required to keep such a register under s 87 of the Companies Act.[8]

How does a person subscribe for shares?

"Subscription" is the process by which a person acquires new shares in a company after its registration. The process of **subscription** is:

- The company invites a particular person[9] or people generally to subscribe for new shares in the company. The company will determine the terms (including the price) on which the shares are issued, and the rights and restrictions attaching to them. Special rules apply to companies proposing to offer new shares to investors. These rules are discussed in Chapter 19.
- If someone decides to take up that invitation, the person makes an offer by making a written application for shares and paying all or part of the subscription amount to the company. That payment may be in cash or by transferring property to the company. An example of a person paying the subscription amount in property rather than cash is found in *Salomon*'s case, where Mr Salomon transferred his business to the company in return for the

7. Application for registration is discussed in Chapter 5.
8. The requirement to keep a register of shareholders is discussed in Chapter 17.
9. Invitations to particular people are sometimes referred to as "private placements".

http://www.pbookshop.com

issue of new shares.[10] Where someone pays only part of the subscription amount, they are issued with a "partly paid" share.[11]

- After the application is received, the company's board of directors meets to decide whether to accept the application. If the application is accepted, new shares are **allotted** to the applicant, which means that the shares are set aside for that person.
- After allotment, the applicant's name is entered on the register of shareholders and the applicant is notified of the allotment. Generally, the person will be sent a share certificate or, if the company is listed on the NZX Main Board, the holding will be registered electronically and the shareholder will receive a statement, like a bank statement, rather than a certificate.

These last two steps make up the **issue of shares**. Once these steps are completed, the person is a shareholder of the company.

How does a person acquire already issued shares?

A person may also become a shareholder of a company by acquiring already issued shares in the company from an existing shareholder. Usually, this occurs where a person buys shares from another person.

Where a person acquires already issued shares, the amount paid for the shares is paid to the party selling the shares, not to the company.

Buying shares in a listed company: If the company's shares are listed on the NZX Main Board, the purchase will take place via the NZX's computerised share trading system, called FASTER or the "Fully Automated Screen Trading and Electronic Registration" system.

In this case, a person wanting to sell his or her shares will instruct a sharebroker to offer the shares for sale at a particular price or at the current market price. A person wishing to buy shares will instruct their sharebroker to buy shares at a particular price or at the current market price. The two brokers will match the offers via the FASTER system and, where the buyer and seller agree on the price, the sale and purchase will be made. Evidence of the completed sale will be enough for the purchaser to require the company to remove the name of the seller as the owner of the shares in its share register, and include the name of the purchaser in the register.

Buying shares in an unlisted company: Where a purchase is not conducted through the NZX Main Board (generally, because the company is unlisted), the

10. *Salomon's* case is discussed in Chapter 3.
11. The circumstances in which a company may choose to issue partly paid shares were discussed at ¶1806.

parties will execute a document called a "share transfer" and lodge that document with the company. The company will then register the transfer by removing the name of the seller and inserting the name of the purchaser in its register of shareholders.

Restrictions on transfer: The constitutions of some unlisted companies impose special restrictions on share transfers. These restrictions are not permitted for listed companies, because of the Main Board/Debt Market Listing Rules.

For example, some companies' constitutions require the directors to approve a transfer before it is registered. This allows the current directors to control who becomes a shareholder. The Companies Act requires the directors to enter the name of the transferee in the register forthwith, unless:

- the board resolves within 30 working days of receipt of the transfer to refuse or delay the registration of the transfer, and the resolution sets out the full reasons for the refusal or delay, and
- the Act or the company's constitution expressly permits the board to refuse or delay registration for the reasons stated.

http://www.pbookshop.com

The constitution must set out specific agreements on which registration can be refused, and any refusal must be in those terms (s 84(4)).

Acquiring shares by operation of law: A person may also become the owner of shares by operation of law, for example, where the person has inherited the shares from a shareholder who has died, or the person is the trustee in bankruptcy of a shareholder who has become bankrupt. Alternatively, a court may have made an order requiring that a person transfer his or her shares to another person.[12] In these cases, the person acquiring the shares gives the company appropriate evidence of his or her entitlement to the shares and the company then makes the necessary alterations to its share register.

Acquiring shares by compulsory acquisition: A person may be entitled to have another person's shares transferred to him or her without the consent or cooperation of that person in certain other circumstances. For example, this occurs where a person is entitled to acquire compulsorily another person's shares following a takeover of the company under which the new controller of the company has become entitled to at least 90% of the company's shares.[13]

12. For example, we saw in Chapter 16 that the court may make an order requiring one shareholder of a company to buy the shares of another shareholder, where the company's affairs have been conducted oppressively.
13. The takeover rules are discussed in Chapter 27.

¶1811 How does someone stop being a shareholder of a company?

A person will no longer be a shareholder of a company if, among other things:

- he or she transfers the shares to another person, or
- he or she transfers the shares back to the company under a "buy-back", or
- the shares are cancelled by the company under a reduction of capital, or
- the company is deregistered, and ceases to exist.

Shares can be transferred by sale and purchase, either "on market" (ie through the NZX Main Board) or "off market" (ie a sale not occurring on a registered exchange's market). Alternatively, shareholders may dispose of their shares by gift, or to their heirs after death.

Buy-backs are discussed in Chapter 19.

A shareholder who holds partly paid shares in a limited liability company may **forfeit** those shares if he or she fails to make a payment to the company when required by the company to do so, if that is what the company's constitution provides. A partly paid share is a share on which only part of the subscription price has been paid to the company. Persons who acquire partly paid shares agree to pay the balance of the subscription price when called on to do so by the company. If they fail to meet that call, their shares may be forfeited.

When a company goes out of existence, its shareholders cease to be shareholders of the company. **Deregistration**, which is the process by which a company's existence is terminated, is discussed in Chapter 24.

Shareholders' rights

¶1812 What rights do shareholders have?

We saw earlier in this chapter that companies can issue shares with different rights. Typically, the rights that attach to shares include:

- voting rights
- distribution rights
- rights to receive information, and
- class rights, where the shares are divided into more than one class.

These rights can be tailored to the particular requirements of the company and of those people proposing to invest in it. A summary of the rights that usually attach to different classes of shares is set out at ¶1813–¶1816. It is important to remember that these rights can be modified by the company's constitution or by the terms of issue of the particular class of shares.

¶1813 Voting rights

The main control device that the shareholders of a company usually have is voting rights. This control device is sometimes called "voice" (as opposed to "exit", which is a way of describing the sale option).[14] Understanding shareholders' voting rights encompasses the following issues:

- On what matters and in relation to what decisions are shareholders given a vote?
- In what circumstances can they initiate consideration of an issue (rather than just accept or reject a proposal put to them by others)?
- How many votes does each shareholder have?

On what matters can shareholders vote?

Shareholders will generally have the right to vote at general meetings of the company. However, the matters on which shareholders may vote are restricted. We saw in Chapter 7 that shareholders cannot give directions to the board of directors on how the business of the company is to be managed. The matters on which shareholders are entitled to vote are discussed at length in Chapter 8.

How many votes do shareholders have?

The replaceable rule in s 36(1) of the Act states that, subject to any rights or restrictions attached to any class of shares, each shareholder of a company with share capital has one vote on a show of hands, and one vote for each share held on a poll.

When can preference shareholders vote?

Where a company has issued preference shares, the terms of issue of the preference shares will usually provide that the holder does not have the right to vote except:

- where dividends are in arrears, or
- on resolutions to reduce the company's capital or put the company into liquidation, or
- at class meetings on matters affecting their class rights.

14. See AO Hirschman *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, MA: Harvard University Press, 1970).

http://www.pbookshop.com