Agenda, Volume 1, Number 2, 1994, pages 189-96

Evaluating New Zealand's Companies Law

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The Companies Act 1993, which came into effect on 1 July 1994, provides for greater flexibility for corporate operations and for corporate restructuring in New Zealand. Two main areas of change are involved: equity capital and directors' powers and obligations. (The law relating to receiverships and liquidations is also amended; a new regime for takeovers was considered but not implemented.) Although the business community has generally accepted the changes, some points of contention have arisen, particularly in relation to directors' duties and obligations. The new rules have been condemned as cumbersome, a threat to managerial autonomy, and likely to restrain risk-taking. However, the critics have often misunderstood the current rules, or the new rules, or both.

The Background to Present Company Legislation

For 150 years, New Zealand company law was derived mainly from English law. In contrast, the Companies Act 1993 is based on a North American model. It was conceived in 1986, when the then Minister of Justice, the Rt. Hon. Geoffrey Palmer, requested the Law Commission to review existing companies legislation. In its initial discussion paper, the Commission took the view that English-based companies legislation was inadequate to deal with the flexibility demanded by current commercial practice: 'company law should concentrate on matters of company structure and should permit as much flexibility as is consistent with the integrity of the registration system and the prevention of abuse' (Law Commission, 1987:3). This stance is consistent with the views of Easterbrook and Fischel (1991), who argue that investors should be free to negotiate the type of business structure they desire, but that a standard statutory format that participants are able to adopt facilitates savings in transaction costs.

The discussion paper favoured the adoption of principles contained in the United States Model Business Corporation Act, a model that, in various forms, has been enacted in many North American jurisdictions. In its final form, the Companies Act 1993 drew heavily on Canadian legislation: the Ontario Business Corporations Act 1982, and the Canada Business Corporations Act 1985.

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Companies presently operating under the Companies Act 1955 have three years within which to reregister as companies under the Companies Act 1993. Under the Companies Reregistration Act 1993, those companies that do not formally apply for reregistration during that time will be deemed reregistered at the stroke of midnight on 30 June 1997. Meanwhile, under the Companies Amendment Act 1993, many of the provisions in the Companies Act 1993 have been inserted into the 1955 Act, with effect from 1 July 1994. As a consequence, some but not all of the recent reforms apply to all corporates in New Zealand from the same date.[1] Two tiers of company law will therefore operate within New Zealand until 1997: the Companies Act 1955 (as amended) governs companies yet to be reregistered; and the Companies Act 1993 governs existing companies that have reregistered as well as new companies incorporated after 1 July 1994.

Reregistration involves a range of costs. Some 155,000 incorporated companies will require formal reregistration or will be automatically reregistered. In addition to filing fees on reregistration, there is the cost of professional advice on the form reregistration should take and the opportunity cost to management of determining the best constitutional structure and the best equity capital structure to carry into the new 1993 Act regime. But the cost of reregistration can be justified if the new regime reduces operating costs, as it will do if its potential is recognised and exploited.

Company Structure

The Companies Act 1993 provides for a streamlined structure for companies. As a bare minimum, each company must have at least one share, at least one shareholder, and at least one director (s.10). The previous requirements for a company constitution and a separate memorandum of association and articles of association are repealed (s.26). A company may operate off the 'standard' constitution embedded in the Companies Act 1993. Companies may depart from some, but not all, of the standard rules by filing their own separate registered constitution.

The legal possibility of a one-share-one-shareholder company does away with the historical need for a minimum of two shareholders: a requirement satisfied by the tiresome practice of needing one nominal shareholder holding a single share in trust for the true owner of the business. A one-shareholder company reduces administration costs in those areas where shareholder consent is required. This should prove particularly attractive to owner/operator businesses in which the business may become 'incorporated individual', and to wholly-owned subsidiaries where the holding company may be the sole shareholder.

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[1] Amended into the Companies Act 1955 with effect for all 1955 Act companies from 1 July 1994 are: the codification of directors duties; enhanced minority shareholder rights; abbreviated procedures for amalgamating solvent companies and for compromises between insolvent companies and their creditors; and new liquidation procedures.

Even where a company has multiple shareholders, shareholder involvement may be minimised through use of a 'blank cheque' procedure. Shareholders may give consent, in advance, to directors operating their company other than in compliance with many of the strict statutory procedures (s.107). The consent must be in writing, and it must be unanimous; any one shareholder can withdraw consent (in relation to future actions) at any time simply by giving notice to the director(s). The requirement for unanimous shareholder consent renders this shortcut available only to closely-held companies where changes in shareholding are infrequent. Whenever there is a change in the identity of shareholders, 'unanimous consent' survives only if the new shareholders so agree. This procedure can reduce compliance costs when a company is repurchasing or redeeming shares, making a distribution to shareholders, providing financial assistance for the purchase of shares, and considering directors' remuneration. It minimises shareholder involvement in those companies where shareholders and directors are one and the same persons, but it does not minimise or reduce directors' general duties and obligations. In particular, the Act specifically requires that directors ensure that their company remains solvent while using these procedural shortcuts (s.108).

The obligation to appoint a company secretary disappears under the new regime. This gives directors some discretion over the level of compliance costs involved in meeting their statutory record-keeping and filing requirements.

Equity Capital

However, it is in the area of equity capital and distributions that the most radical change is wrought by the new Act.

Companies operating under the new regime must have shares of no par value (s.38). This does away with the accounting and legal problems that flow from shares with par value, in two ways. First, having no par value, shares can no longer be issued at a premium. The absence of a share premium account in a company's financial statements removes the historical problem of share premium being treated as part of the company's share capital and generally being unavailable for distribution to shareholders without prior court approval. Second, and by the same token, shares cannot be issued at a discount below par. Historically this has been a problem facing public-listed companies where their shares are quoted at a price below par value. The company's trading losses have eroded capital to such an extent that the shares have less value than the capital historically contributed. Under a par value regime, court approval is required to issue shares at a discount. But under the 1993 Act, directors are required simply to issue shares for a fair and reasonable consideration (s.47). In practice, this means that directors must ensure that the correct number of shares is being issued in return for the consideration being received: a calculation that directors must in any case implicitly make when issuing shares under a par-value regime.

Distributions to Shareholders

The capital maintenance doctrine is also abolished by the new regime. Directors may at any time apply company resources for shareholders' benefit as long as the company's ability to pay creditors is not harmed. The company must satisfy a statutory solvency test after making the distribution (s.4). The distinction between capital and income is done away with for company-law purposes. As long as there are sufficient resources left within the company to satisfy creditors, all other resources may be returned to shareholders. This is different from the traditional English practice, whereby issued or subscribed capital provided a buffer (often an illusory one) as creditor protection, and any 'reduction in capital' by way of a distribution to shareholders required prior court approval. The price of this new flexibility is that directors face potential liability to repay any distribution made to shareholders at a time when the company did not satisfy the solvency test (s.56). Even so, primary liability lies with the shareholder(s) who received the distribution: only if those shareholders are excused repayment by the court, or are insolvent and cannot repay, can the directors be held responsible for repayment.

Some lawyers have been critical of the 'paper war' arising under the new regime when directors decide to make a distribution. These criticisms are best evaluated by broadly comparing the provisions of the capital maintenance regime of the 1955 Act with the equivalent provisions of the 1993 Act. Under the 1955 Act dividends were payable only out of profits. Approval was required first by directors and then by shareholders. Court approval was needed for any distribution to shareholders of the portion of the company's resources held to be capital. Under the 1993 Act, in contrast, directors alone can decide to make a distribution. Before doing so, directors must ensure that the company can meet its debts. But this is not a substantial advance on the traditional obligation resting with directors to ensure that there were profits available for distribution and that creditors would not be harmed by payment of the dividend. Cases decided under the 1955 Act, such as *Hilton* v *Hilton International Ltd,*[2] make it clear that directors are always expected to consider corporate solvency before returning company resources to shareholders. The only difference under the 1993 Act is that directors must provide a certificate of corporate solvency before making a distribution. This requirement makes explicit what was an implicit obligation at common law.

From the New Zealand Court of Appeal:[3]

> The duties of the directors are owed to the company. On the facts of particular cases this may require the directors to consider inter alia the interests of creditors. For instance creditors are entitled to consideration . . . if the company is insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency.

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[2] [1989] 1 NZLR 442.

[3] *Nicholson* v *Permakraft (NZ) Ltd* [1985] 1 NZLR 242, 249 per Cooke J.

And from the House of Lords:[4]

> the company owes a duty to its creditors to keep its property inviolate for the repayment of its debts.

The obligation on directors to provide a solvency certificate whenever making a distribution to shareholders can hardly be considered an onerous obligation that negates the benefits otherwise available under the 1993 Act. Since 1980, New Zealand companies legislation has required company directors to maintain accounting records sufficient to ensure the financial position of the company may be determined at any time with reasonable accuracy (s.151 Companies Act 1955 and s.194 Companies Act 1993). There is a statutory obligation to maintain a management information system capable of providing timely information regarding solvency. It is surely a small step to confirm the use of this information with a signed certificate.

Codification of Directors' Duties in the Companies Acts 1955 and 1993

The major area that affects equally the operation of 1955 Act companies and 1993 Act companies is the codification of directors' duties. The Law Commission (1990:xxii) reported overwhelming support for the proposition that directors' duties should be extracted from the common law and made accessible in companies legislation. This would reduce costs to the business community in determining their legal obligations as directors.

Consequently, directors' duties have been codified, and the codification contained in the Companies Act 1993 has been inserted into the Companies Act 1955. Debate has been joined, not on the issue of codification, but whether the statutes as now worded reflect the common law or extend existing common-law obligations. The debate has involved a turf battle between the Law Commission and the Department of Justice over control of the process of company law reform; and business leaders with libertarian views have argued for a reduction in state intervention in business generally and corporate governance in particular. One author of the Law Commission's reports on the companies legislation has described the Companies Act 1993 as 'incoherent' (Hodder, 1994).

The rules relating to directors' duty of care and to risk-taking have attracted most criticism. A director's statutory duty of care as expressed in s.191 of the Companies Act 1955 and s.137 of the Companies Act 1993 require:

> A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation: —

[4] *Winkworth* v *Edward Baron Development Co Ltd* [1987] 1 All ER 114, 118 per Lord Templeman.

(a) the nature of the company; and
(b) the nature of the decision; and
(c) the position of the director and the nature of the responsibilities undertaken by him or her.

According to Roderick Deane (1994:3), Managing Director of Telecom New Zealand, this formulation is singularly unhelpful, and directors await case law to determine the definition of a 'reasonable director'. The statute requires a director to exercise a reasonable standard of care: the standard of care, diligence and skill expected of a director showing sound judgment in the given circumstances. A failure to meet this standard could leave directors liable to pay damages to their company. Given that the traditional common-law view as expressed in cases such as *re City Equitable Fire Insurance*[5] has been that directors (particularly non-executive directors) need display only such skill and expertise as they in fact possess, the new statutory obligation to exercise a reasonable standard of care appears to be a higher standard. However, the common law has moved on since cases from the turn of the century. The more recent view was best summarised by Justice Rogers in *AWA Ltd* v *Daniels*:[6]

> it is of the essence of the responsibility of directors that they take reasonable steps to place themselves in a position to guide and monitor the management of the company.

In the *AWA Ltd Case* the company's chief executive officer was held liable for part of the company's A$49m loss on foreign-exchange trading. He was aware that a company employee was involved in unsupervised speculative foreign-exchange dealing and that there was a lack of internal controls and a paucity of records relating to open foreign-exchange positions. Despite this knowledge, he failed to implement appropriate accounting procedures in the company's treasury section. By comparison, the company's non-executive directors were held not liable for any of the losses. They had expressed surprise at the level of profits on foreign-exchange dealing being reported to the board by the treasury section. They recognised foreign exchange dealing was a high-risk activity and sought assurances that appropriate internal controls were in place. The board was repeatedly assured by both the chief executive officer and the company auditor that everything was under control. It was not, but that was through no fault of the board, which had carried out its function of overseeing, guiding and monitoring management performance. The fault lay with management, particularly the chief executive officer. It was those who had failed to do their job properly who were ordered to pay damages.

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[5] [1925] Ch. 407.

[6] (1992) ACSR 759, 864.

The Privy Council recently affirmed the traditional views expressed in *re City Equitable Fire Insurance*, but then coloured this affirmation by stating that company directors must exercise reasonable diligence and skill in the performance of their duties as directors.[7]

The essence of this common-law obligation has been codified into the 1955 and 1993 Companies Act. At common law, directors must already exercise a measure of reasonable care and skill. At common law, there is a distinction between the respective duties and obligations of executive directors, non-executive directors and the board. The board collectively is responsible for policy, while company employees, including executive directors, are responsible for implementing policy. The board is not responsible for the defaults and failures of company employees, provided the board has in place an appropriate reporting system and a system of internal controls to monitor and review the performance of employees. These common-law obligations are now explicit in the statute. Those commentators who criticise the statute as imposing harsh new obligations, over and above those obligations existing at common law, appear not to appreciate the current common-law position. The common law does not discourage risk-taking. Neither does the statute. But it has to be a calculated risk, not an unsupervised gamble.

Another complaint is that s.189 of the Companies Act 1955 and s.135 of the Companies Act 1993 discourage risk-taking. These sections hold directors liable should their company carry on business in a manner 'likely to create a substantial risk of serious loss to the company's creditors'. The fear is that directors will become more risk-averse. The irony is that this phrase comes straight out of existing case law. In *Thompson* v *Innes*,[8] Justice Bisson said the reckless-trading provisions in statute law were designed to prevent directors 'continuing to carry on the business of the company [if this] would cause . . . serious loss to creditors'. Arguably, the new statutory provision is even more gentle on directors: they are at personal risk if continued trading would create a *substantial* risk of serious loss. Prudent directors have little to fear if the principles applied in *Thompson* v *Innes* are similarly applied in future cases. In *Thompson's Case*, the company was never profitable at any stage. Financial statements drawn up at the end of the first year's trading determined that the company had traded at a loss. Part way through the following year, the company's bankers intervened, requiring a budget and tight control of expenses in order to reduce the bank's exposure. The company's position did not improve, yet the company kept trading. In the last seven weeks of the company's existence, the directors purchased further goods on credit, removed stock for the directors' personal benefit, took cash drawings and repaid the guaranteed bank overdraft. The directors were ordered to repay NZ$25,000 for the resources extracted from the company over this last seven week period, a time when the company was hopelessly insolvent. They were not required to compensate the company for losses arising in the preceding months. The

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[7] *Kuwait Asia Bank EC* v *National Mutual Life* [1990] 3 NZLR 513, 533 per Lord Lowry.

[8] (1985) 2 NZCLC 99,463, 99,472.

courts have taken a pragmatic approach before imposing personal liability on management for company losses caused by reckless trading. Companies are given time to succeed or fail. Directors are held personally liable for debts incurred and resources extracted from the company when it is clear the company has no further chance of survival.

Conclusion

New Zealand's new companies legislation gives directors freedoms and flexibility not available under previous companies legislation. Directors are explicitly required to consider corporate solvency whenever carrying through transactions that might harm creditors. This is neither a new nor an onerous obligation. The Companies Act 1993 makes explicit those director's obligations that were implicit in earlier company law.

The question of corporate governance is addressed by a codification of directors' duties. The legislation imposes on directors a statutory duty of care. While there has been concern that this codification extends the duties imposed on directors, the sounder view is that the statute is simply declaratory of the existing law. The legislation captures recent common-law trends in corporate governance; codification of these rules makes the law more accessible.

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