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THE SOLVENCY TEST - MAJOR INNOVATION OR REDUNDANT LEFTOVER?

LLB (HONS) RESEARCH PAPER
LAW OF BODIES CORPORATE AND UNINCORPORATE
LAWS 523

LAW FACULTY
VICTORIA UNIVERSITY OF WELLINGTON

1994

ABSTRACT

The solvency test has been widely lauded as providing a material improvement to the position of creditors. The principle aim of the paper is to examine whether this is true.

The paper seeks to examine not only the effect of the test on classical distribution transactions but on distributions as a whole. Examples of some of the common methods of distribution are analysed to see whether the changes in the form of the statute affect the ability to make these distributions. The conclusion reached is that the 1993 Act actually allows a wider range of distributions than the 1955 Act.

The paper then analyses whether the position reached is desirable by examining the economic theory of the company and by examining alternative options the law could have adopted. In the course of this analysis it is concluded that the solvency test is redundant in the scheme of the Act and that the general directors duties provide as much protection as is required.

WORD LENGTH

The text of this paper (excluding contents page, footnotes, bibliography and annexures) comprises approximately 20,000 words.

I INTRODUCTION

A *A Desire to Distribute Wealth From a Company*

A legal fiction makes the company a person with many of the same rights and powers as real persons. This legal fiction has been justified on the basis it provides an "... [efficient] and [flexible] system for organising aggregation and use of capital."[1] In the classical model the company is used as a means of combining resources contributed by various individuals under the control of a management team. The contributors receive an entitlement to some share in the net wealth of the company and are thus called shareholders.

Historically such companies were formed for individual speculative ventures with a limited life.[2] At the conclusion of the venture any debts of the company were paid and the surplus was returned to the shareholders. Increasingly however companies were created for ventures of indefinite duration. The indefinite life of the company created a desire[3] for means of distributing wealth to shareholders while the company was still in operation, and thus had debts. Several mechanisms for doing so were soon developed.

While the ability to distribute wealth to shareholders may be desirable to shareholders it also creates a risk of abuse. The challenge for the legal system is to provide

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1 New Zealand Law Commission *Company law Reform and Restatement - Report No. 9* (Wellington 1989), 2. For a more detailed discussion of the economic basis of the limited liability company see part 5 below.

2 A traditional example is the formation of a company to fit out a ship for a voyage of privateering or trade. If the ship returned from the voyage the profits from the voyage would be returned to the shareholders.

3 The economic basis of this desire is examined in detail in Kumert "State Statutory Restrictions on Financial Distributions by Corporations to Shareholder (Part I)" 59 Wash. L. Rev 359, 365-379. Obtained from Cary and Eisenberg *Cases and Materials on Corporations* , 1368

distribution rules[4] that balance the cost of abuse against any costs associated with those rules. This paper examines the response of the Companies Act 1993 ("the Act") to those challenges.

In particular this paper will examine the extent to which the Act substantively changes the law from that which existed under the Companies Act 1955[5] ("the 1955 Act") and whether the result under the Act is desirable. The first of these issues will be examined by identifying the possible types of distribution, outlining the general scheme of each of the Acts and then analysing the implications of each Act on particular distribution transactions. The practical significance of any resulting differences will be evaluated. The second issue will be analysed from a more theoretical perspective.

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4 These distribution rules are often called capital maintenance rules. However this paper will use that term only when referring to rules which do if fact require the maintenance of some level of capital. Such rules are a subset of the possible distribution rules.

5 In this paper references to the 1955 Act are to that Act before its amendment in 1993 by various Acts associated with the Companies Act 1993. Readers should therefore be aware that the numbers and or content of some sections referred to in this paper changed on 1 July 1994.

B Methods of Wealth Distribution

The focus of many commentators has been on the classical forms of distributing wealth from the company to its shareholders. These are:

(1) payment of dividends;
(2) returns of capital; and
(3) repurchase of shares.

All three devices are suited to providing a form of passive income[6] and are the most convenient means of providing shareholders with a return where there is a significant separation of ownership and management of the enterprise. However the majority[7] of companies in existence today are closely held companies.[8] . The closely held company is commonly used as a device for running a partnership, family enterprise or even a sole trader operation. In these situations the company form is used because of the availability of limited liability[9] and possibly the availability of the floating charge security mechanism.[10]

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6 Passive income is income earned from assets owned with little or no personal effort required. Stable holdings of listed equities are a classic example.

7 It is estimated that over 95% of all companies in New Zealand are private companies and thus have fewer than twenty shareholders. A.J. Robb, K.J. Leo and J.R. Hoggett *Company Accounting in New Zealand* (John Wiley & Sons, 1987), 4.

8 A closely held company is one with a small number of shareholders. It is typified by little separation of ownership and management with at least one of the shareholders involved in the day to day business of the company.

9 In a public company limited liability acts to limit potential losses to the amount of the initial investment. In closely held companies the goal is often to avoid any potential losses. A more detailed discussion of the benefits of limited liability is at part IV.

10 The floating charge is a legal mechanism by which a creditor can secure the debts owed to it by the company by creating a legal right over all property of the company not otherwise used as security. This mechanism is only available through use of the company form. Its major advantage over chattel mortgages is in transaction costs where similar assets (eg trading stock, debtors) are repeatedly consumed/sold and replaced. Company Accounting in New Zealand, above n 7, 3 suggests that given the frequency with which limited liability is by

In a closely held company the shareholders are usually also employee/directors. The return sought by shareholders in such companies is often employment and fringe benefits such as cheap goods, motor vehicles or even accommodation rather than a passive income stream and capital gains. As a principal purpose is to avoid exposing assets to liability only nominal capital is contributed. The fixed assets needed for the running of the business can be owned by the shareholders and leased to the company. Any remaining working capital requirements can be met by lending funds to the company and securing these funds by use of a floating charge. Lower tax rates available to the shareholders[11] and the relative lack of formalities involved have all encouraged closely held companies' owners to extract wealth[12] from the company in the form of:

(1) salary;
(2) fringe benefits; and
(3) rentals

rather than by the classical forms.

Another form of distribution of wealth is the use of assets owned by the company to either provide loans to shareholders or related parties or to provide guarantees of loans to such parties. Loans and guarantees are particularly common in groups of companies where assets present in one subsidiary are used to fund operations of

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passed by the giving of personal guarantees to creditors the availability of the floating charge may be the more significant reason for forming a company.

11 Historically dividends from tax paid income of the company have been taxed as income in the hands of the shareholders, creating a double tax levy on company profits. Recent amendments to the Income Tax Act 1976 such as the imputation regime and the qualifying company regime have reduced these tax driven incentives but the old habits remain.

12 Inherent difficulties in valuation of the services and goods provided by the shareholder/employees make it difficult to identify whether an exchange of value or a distribution of wealth is occurring

another or of the parent. This type of distribution of wealth is different to the other types because, prima facie, it does not affect the wealth of the company. The transaction appears to be a swap of one asset ("Loan to shareholder") for another.[13]

The company's wealth may be affected by such a loan if there is a possibility of default and the assets of the shareholder, other than the company shares, are less than the amount of the loan.[14] In this situation the value of the company's asset "Loan to shareholder" is partly represented by its own shares.[15] Netting off this share in itself will reduce the equity of the company.

Given most companies are closely held and such companies distribute wealth as part of payments for goods and services the continued focus of most writers on the classical forms of distribution or on financial assistance may seem odd. There are several possible explanations for this continued focus:

(1) the higher public profile of widely held companies;
(2) the involvement of professional analysts in studying issues relating to widely held companies;
(3) a general academic tendency to examine theory in preference to reality;
(4) the existence of less litigation on bundled distributions rather than classical distributions; and/or

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13 If the loan is not at an interest rate appropriate to the risk level a real transfer of wealth from the company to the shareholder will occur over time.

14 This may arise if the loan or guarantee is used to fund the purchase of shares in the company or if the loan is used to fund personal consumption rather than the purchase of other assets. The loan effectively makes the shareholder personally laible and makes the situation similar to that of a sole proprietor who is insolvent.

15 Where there is a prospect of default the assets available to the lender become economically significant. If the non-share personal wealth of the shareholder is less than the loan those shares will be part of the assets available to satisfy the debt to the company.

(5) the bundled distribution is dealt with by areas of law other than the law of distributions, reducing the need for it to be explicitly examined.

This paper will to some extent indicate which of these possibilities explain the current focus.

I I COMPARISON OF THE 1993 AND 1955 ACTS

A Statutory Scheme of 1955 Act

The 1955 Act regulated distributions through several mechanisms. First it had a set of capital maintenance rules to deal with the classical methods of distributing wealth. Secondly it barred the provision of financial assistance for purchase of own shares. Thirdly the 1955 Act created remedies for recovery by the liquidator of losses suffered by the company in any transactions at under- or over-value. Finally several general provisions which created liability for directors where there was fraud or negligence had an impact on distributions.

The capital maintenance regime under the 1955 Act comprised a combination of a few statutory rules and a more extensive common law regime. The statute provided detailed distinctions[16] between contributed capital, including share premiums, and retained earnings. Distributions were allowed only from the latter.[17] The 1955 Act set out a detailed procedure for the reduction of capital involving High Court approval.[18] Common law rules

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16 These distinctions can be distilled from a number of provisions in Part III of the 1955 Act.

17 The 1955 Act did not explicitly state that dividends could only be paid from profits, perhaps because the common law had already reached this result. The 1955 Act does appear to implicitly adopt the common law rules. For example the capital reduction regime would be superfluous if capital could be distributed. An even more direct indication is contained in the model Articles of Association contained in Table A. Section 22 provides that a company may adopt any or all of the Table A articles. Article 114 to 116 deal with the declaration of dividends and Article 116 states "No dividends shall be paid otherwise than out of dividends". Article 116 shows the 1955 Act envisages this principal but does not an explicit requirement as the Articles are effectively only the terms of a contract between the shareholders. The only explicit limit on the ability of shareholders to change the terms of that contract is section 24 which states the company may change its Articles "subject to the provisions of this Act". Article 116 is a therefore a mandatory rule only to the extent the Act and the common law do not allow it to be changed. The common law is thus the primary source of this principle. This is reflected in the cases which generally do not rely on the statutory provisions as the basis of their decisions.

18 Sections 75 to 80.

predating the 1955 Act prohibited repurchase of own shares.[19]

Section 62 provided a penalty of $200 for companies and their directors and officers where the company provided financial assistance for purchase of its own shares.[20] Statutory exceptions to the financial assistance rules for employees provided significant scope for avoidance of these rules. Loans and guarantees of loans to directors were barred by the 1955 Act.[21] There was no specific provision barring loans to shareholders for purposes other than the purchase of the company's own shares.

Statutory provisions allowed the avoidance by the liquidator of preferences and securities given when the company was unable to pay its debts[22] and of transactions involving inadequate or excessive consideration.[23] These provisions potentially allowed recovery from shareholders where excessive salaries, rents or fringe benefits had been provided.

The general duties contained in the 1955 Act had significant potential to allow recovery of distributions from directors. For example the failure to keep adequate accounting records could make an officer of the company personally liable to repay any resulting loss.[24] This provision could be relevant to where dividends were paid

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19 *Trevor* v *Whitworth* (1887) 12 App Cas 409 is the traditional source of this rule in commonwealth jurisdictions.

20 The section's major penalty in practice was the illegality of the transaction and the liability this potentially created for directors under the other provisions of the 1955 Act or under the tort of conspiracy. See for example Belmont Finance Corporation v Williams Furniture Ltd [1980] 1 All ER, 396.

21 Section 190.

22 Sections 309 to 311B allow avoidance of preferences given within the 2 years prior to winding up and avoidance of securities given within the 12 months prior to winding up.

23 Section 311C allows the liquidator to recover the excess received by the shareholder on transactions within the 3 years prior to winding up.

24 Section 319.

because accounting records failed to show the true financial position of the company.

The incurring of debts without an honest belief on reasonable grounds that they could be repaid when due also made an officer potentially liable for the resulting loss.[25] Any person who was guilty of any negligence, breach of trust or duty in relation to the company could be compelled to compensate the company.[26] Any distribution which made the company insolvent could be a breach of these provisions allowing recovery from the directors.

B Statutory Scheme of 1993 Act

The scheme of the Act is similar to that of the 1955 Act in that the classical forms of distribution are explicitly addressed while the more common forms of wealth extraction are left to the general insolvency provisions. However the 1993 Act is different in that as well as dividends it also specifically allows repurchases of shares and the provision of financial assistance for the purchase of shares. The statutory scheme which distinguished between capital, including share premiums, and retained earnings is abandoned.[27] The capital maintenance regime is now based around a requirement that the solvency test be met. The test is met if:[28]

(a) the company is able to pay its debts as they become due in the normal course of business; and

(b) the value of the company's assets is greater than the value of its liabilities including contingent liabilities.

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25 Section 320. This provision is often referred to as the "reckless trading" provision.

26 Section 321.

27 The removal of the capital/retained earnings distinction made the reduction of capital provisions redundant and these were not brought forward.

28 Section 4 of the Act contains the above definition. Subsections 4(2) to 4(4) specify matters which must be considered when evaluating whether the test is met.

The first limb of the test is often referred to as the "trading limb" and resembles the 1955 Act reckless trading provision. The second limb is referred to as the "balance sheet limb".

When authorising a distribution[29] the directors must sign a certificate stating they are of the opinion that the solvency test will be satisfied after the distribution and the grounds on which that opinion is based on that certificate. If, after authorising the distribution but before the distribution is made, the directors cease to believe the solvency test is met the distribution is deemed not to have been authorised.[30] Distributions include: the payment of dividends,[31] the purchase of own shares,[32] the redemption of shares at the company's option[33] and the provision of financial assistance for the purchase of own shares.[34]

A scheme for the sale of discounted goods to shareholders is not a distribution for the purposes of the Act and no certificate is required. However the directors must be satisfied on reasonable grounds that the company satisfies the solvency test before approving or continuing such a scheme and if the company did not in fact satisfy the test the scheme is treated as if it were a distribution.[35]

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29 Defined in section 2 as " - (a) The direct or indirect transfer of money or property, other than the company's own shares, to or for the benefit of the shareholder; or (b) The incurring of a debt to or for the benefit of the shareholder - in relation to shares held by that shareholder".

30 Section 52 of the Act. Section 52(4) specifies some factors to be taken into account in application of the solvency test to distributions.

31 Section 53(1).

32 Section 58 creates this power. There are several mechanisms by which the shares can be repurchased. All are subject to certification requirements (sections 60(5), 61(3) and 63(3)). Section 67(1) makes the contract of repurchase enforceable subject to satisfaction of the solvency test.

33 Section 70.

34 Section 77. Subsection 77(6) provides some amendments to the meaning of terms used in applying the solvency test.

35 Section 55.

Another innovation of the Act is the section 107(1) unanimous agreement. Such an agreement may provide a shortened procedure for the above types of distribution or for payment of remuneration to directors. The powers conferred under such agreements may only be exercised when the solvency test is met.[36] A requirement to certify the solvency test is met is also contained in the new amalgamations provisions.[37]

Failure of a director who voted for the distribution to sign the required certificate is an offence and makes the director liable to a $5,000 penalty.[38] This provision operates whether or not the test was in fact satisfied and is intended to provide an incentive for directors to follow the procedure.[39]

The distribution can be recovered from a shareholder if the company did not in fact satisfy the solvency test immediately after the distribution.[40] The shareholder can be relieved of liability where the distribution was received in good faith and the shareholder altered its position based on the distribution making full recovery unfair.

Any amounts which cannot be recovered from the shareholders can be recovered from a director if:[41]

(1) the certification procedure was not followed; or
(2) the procedure was followed but reasonable grounds for the opinion did not exist; or

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36 Section 108.
37 Sections 221 and 222.
38 Section 373(1).
39 The Act does not mention what factors should be considered by the courts when deciding on the penalty to apply. Presumably a failure to sign the required certificate would not attract a significant penalty where the test was in fact met will result in only a nominal fine.
40 Section 56(1). The amount recoverable is limited by Section 56(5) which provides that where part of the distribution would not have put the company in breach of the solvency test the shareholders and directors may be relieved of the liability to repay that part.
41 Subsections 56(2) to 56(4).

(3) after authorisation of the distribution but before it was made the director ceased to be satisfied on reasonable grounds that the solvency test was met

and that director either

(1) failed to take reasonable steps to ensure the procedure was followed; or
(2) signed the certificate; or
(3) failed to take reasonable steps to ensure the distribution was not made.

The solvency test thus provides a reasonably comprehensive set of principles for determining when a classical distribution may be made and when a distribution which should not have been made can be recovered from shareholders and directors. However the solvency test does not address other possible means of wealth extraction such as salaries, other provisions of goods and services to the company, loans and guarantees made by the company (other than for purchase of shares) and purchases of assets (other than as part of a discount scheme). These types of distribution are dealt with by a number of other provisions.

Salaries and other remuneration of directors are dealt with by section 161. Transactions in which the directors are interested are dealt with in sections 139 to 141. The provisions in sections 292 to 296 (voidable transactions) and sections 297 to 301 (transactions at under- or over-value) are all targeted at wealth removing transactions. The general duties of directors contained in section 135[42]

42 The 1993 Act section heading describes this as the reckless trading provision even though this section is very different to the 1955 Act reckless trading provision while section 136 (headed "Duty in Relation to Obligations") is almost identical to the 1955 provision. This paper will refer to section 136 as the reckless trading provision and to section 135 as the "substantial risk of loss" provision.

(substantial risk of loss) and section 136 (reckless trading) may also be of relevance as they were under the 1955 Act.

The framework of the 1993 Act thus bears many similarities to the framework of the 1955 Act. The distinguishing feature is that more of the rules relating to classical distributions are explicit in the 1993 Act. The extent to which these two frameworks differ is best examined by looking at individual transactions.

III ANALYSIS OF THE IMPACT OF THE TWO ACTS ON SPECIFIC TRANSACTIONS

A Approach Taken

Given the Act introduces a statutory scheme where the 1955 Act had relied on common law rules the question which arises is does it make any difference in practice. This question is particularly significant given the new Act in general and the solvency test in particular have been hailed by the media as a major reform with the potential to prevent abuse of the company form. The approach taken will be to analyse a range of common distribution transactions from two perspectives - ex ante[43] and ex poste.[44]

1 Ex ante

From the perspective of the directors the primary concern is to ensure that the distribution is lawful. In deciding whether a distribution should be made directors must consider:

(i) what reports are required to make the distribution decision and should these be historical reports or forecasts;
(ii) what should be the valuation basis of these reports;
(iii) to what extent can expert opinions be relied on:
(iv) what external approvals are required and from whom; and
(v) what other formalities are required.

The primary concern of the creditors is that they be informed of any material change in the equity of the company and that they are able to act to protect their interests.

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43 Before the transaction.
44 After the transaction.

Shareholders' principal concern is whether the distribution they have received can be relied on as income. Where dividends affect the distribution of wealth between shareholders the shareholders will also be concerned that they be notified of any such distribution and have the power to object.

2 *Ex poste*

Where the distribution may have been unlawful there will generally be no problem unless the company becomes insolvent.[45] A liquidator or receiver will then be appointed and may use the illegality of the transaction to attempt to recover the distribution.

The liquidator's principal concern will be how cost effective it will be to obtain judgement. Relevant factors will be:

(i) on what grounds can recovery be sought;
(ii) how easy will it be to obtain evidence to support an action for recovery;
(iii) who bears the burden of proving elements of the action; and
(iv) the amounts which are recoverable.

Shareholders will be concerned as to how much of, and in what circumstances, past distributions can be recovered. This will depend on:

(i) the availability of estoppel type defences; and
(ii) the time bar on such recoveries.

The directors will be concerned as to the extent to which amounts not recovered from the shareholders will be

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45 Issues may also arise where ownership of shares or control of the company change. This paper will focus on the instances where the company has become insolvent.

recoverable from them. The existence of civil or criminal penalties will also be of interest to the directors.

3 *Transactions examined*

This paper aims to examine bundled distributions as well as the classical forms. A number of common distribution transactions will be examined including:

(1) payment of salary;
(2) the provision of goods and services to the company;
(3) payment of a dividend;
(4) return of capital contributions; and
(5) the making of loans by subsidiaries to parents.

B *Payment of Salary*

In closely held companies salary payments to shareholder-employees are the primary means of distributing company earnings.[46] where there are shareholder employees. The shareholder-employees are usually also directors.

The example transaction which will be examined involves a closely held company whose shareholders are a married couple. W, the wife, has operated as a sole trader plumber for several years and has decided to use the company form to protect her assets. H, the husband, has helped with the books and taking phone calls etc. The couple therefore incorporate a company with a share capital of $2. The trade name of the sole trader operation and the customer list are leased to the company as are all the tools and the company van. Other working capital in the business is borrowed from the bank which uses the couple's mortgage as security for the loan.

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46 Payment of salary to non shareholder directors is not a distribution and is therefore outside the scope of this paper.

As a sole trader W earned all the income of the business directly. While H effectively gained an interest in that income due to his marriage to W he was also paid a wage for tax purposes.[47] Any other money the couple took out of the business was described as drawings. In a sole trader drawings are of no legal significance as they simply involve a change in the purpose for which a person is using his or her own assets.

By contrast a company is a separate legal person. Company money taken out of the business as drawings will now legally be a loan from the company to the couple. If the company became insolvent the couple could be compelled to repay these loans. The couple therefore need to extract the earnings of the company if they are to achieve their goal of limiting their exposure to insolvency of the business.

The husband and wife as directors/ shareholders/ employees will receive the benefits of the company's earnings whether these are paid as salary, directors' fees or dividends. However tax effects, transaction costs and risk issues may mean the husband and wife are not indifferent as to the form of the payment.

In deciding what level of salary to pay themselves the couple have two principle options, a fixed salary or a performance based salary. A fixed salary may be based on standard rates of pay for the position (e.g. typical plumber wage) or on the expected income the business will produce. A performance based salary could involve either several steps based on the company's pre-salary profit or could even be set at the company's pre-salary profit. Only the last of these options is certain to remove all profits as salary.

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47 Most jurisdictions provide for marginal tax rates so that splitting income between family members reduces the tax paid on the income of the household.

Tax may[48] affect the net economic wealth of the couple if the company profit does not equal the salaries paid. If the pre-salary profit is lower than the salaries then the shareholder will show income and be taxed on it while the company will show a loss due to the payment of the salary. Our tax system does not provide refunds for losses, although losses can be carried forward. The result is that the couple pay tax now and bear the cost losing the use of those funds until the company posts taxable profits. If the company does better than the fixed salaries the opportunity to use the lower marginal tax rates of the couple may be lost.[49]

Transaction costs favour paying out all of the wealth of the company as salary. If pre-salary profit exceeds the salaries the wealth which builds up in the company must be distributed as by other means. As will be seen in following examples this will involve additional formalities and create risks of liability. If pre-salary profit is less than the salaries the couple may have to wind the company up to avoid later liability for trading while insolvent as the company has no capital to act as a buffer to gains or losses.

The risk element involves competing desires. Where earnings are left in the company the couple's goal of reducing or eliminating their exposure to insolvency of the business is compromised. On the other hand a fixed salary will ensure the couple still receive compensation for their labour.[50] Ex ante the decision for the directors based on the risk element will thus depend on their assessment of the probability of the company doing badly.

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48 "May" is used because the qualifying company regime can eliminate these tax effects. However the company must elect to enter this regime.

49 Companies in New Zealand pay tax at a flat rate of 33% while individuals pay this rate only on income over $30,875.

50 In practice the company may not have sufficient funds to pay the salary. The couple will then get a preference in liquidation to the extent of $6,000 each and be unsecured creditors for the remainder. Attempts to extract unpaid shareholder salaries close to liquidation are a common source of voidable preference actions.

In our example the couple consider that the business is likely to do well and therefore select a performance based salary equal to the profits of the company less $10. To the extent the business grows and requires more resources these can be either loaned or leased back to the company. Now the couple have made their decision they must consider the steps which must be followed.

1 Ex ante

Neither the 1955 Act nor the 1993 Act give any direction as to the factors directors must consider when deciding on employee-director salaries. The general duty to act in the best interests of the company applies. Whether a particular level of salary is in the best interests of the company will be a question of fact.

Setting the salary level equal to the earnings of the company appears fair to the company. First all the earnings of the company are attributable to the efforts of the couple. The company has nominal assets so any return it makes on those assets is a good one. The $10 the couple intend to leave in the company would represent a 500% return on capital in the first year. The company is gaining the services of the couple on a bonus system which places most of the business risk on the couple. By working for such a small company the couple expose themselves to a high risk of redundancy while also reducing the chances that there will be any assets available to pay redundancy pay. All these factors suggest it is fair for the couple to receive most of the company's earnings.

If the couple wished to protect themselves more thoroughly then an expert opinion could be gained as to what constitutes a fair salary. However such an opinion would appear unnecessary given the facts.[51] Courts are generally reluctant to interfere in decisions as to the adequacy of consideration or indeed in directors' decisions generally.

Neither Act requires the directors to inform any party or to gain any approvals for such salaries. There are some formalities to be considered however.

Under the 1955 Act few formalities are required. The couple draft up a simple contract and sign it as employees and as directors. The couple could formally notify themselves of their interest in the contract in the minute book[52] but this does not appear to be necessary.[53]

Under the 1993 Act the formalities contained in section 161 must be followed.[54] The directors must sign a certificate stating that in their opinion the contract is fair to the company. The certificate must state the basis of the director's opinion. A short paragraph to the effect the couple bear most of the risk and therefore most of the

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51 Expert opinion would be more valuable where the salary was fixed. See discussion of the value of expert opinion below n124.

52 This procedure is set out for self interested transactions in section 199. The 1955 Act does not make explicitly state that a contract of remuneration does not fall within the interested transaction regime but the scheme suggests it does not. Section 143 of the 1993 Act explicitly separates the two regimes.

53 Section 196 is the only section dealing directly with director's remuneration. The section provides a mechanism by which shareholders can request a statement of director's earnings. There is no reference to a need to follow the self interested transaction procedure.

54 The directors could use the procedure in section 107(1) to contract out of the requirement to follow the section 161 process. In the current example the section 107(1) procedure would be undesirable as it requires certification by the directors that the solvency test is met. Further the directors would need to consider whether the solvency test was met before each payment. As shown in the classic distribution examples the solvency test entails considerably more inconvenience and risk for the directors than the section 161 procedure. The section 107(1) provision appears to be aimed at situations where other shareholders might later claim the payment was unfair rather than at this type of transaction. Even in such situations a side agreement between the shareholders not to exercise their rights under section 161 would be a more effective device than a section 107(1) agreement.

rewards would suffice. The directors must also enter the particulars of the contract in the interests register. The contract could be a long term one in which case no further certificates or interest register entries would be required.[55]

The creditors have no statutory right of notification. Under the 1955 Act only shareholders can request information on the director's remuneration. Under the 1993 Act the interests register is available for inspection only by shareholders.[56] The 1993 Act requires the Annual Report to show the remuneration of the directors[57] but this document is again only available to shareholders.

Creditors are free to contract to obtain this information and even to regulate the employment contract. In practice trade creditors and involuntary creditors[58] will not contract to obtain such information as the costs of obtaining such information will exceed the benefits. The bank is secured by the mortgage and thus can avoid the costs associated with obtaining such information. Other major creditors would probably avoid the informational costs by obtaining a personal guarantee. With a personal guarantee the creditors will be largely indifferent as to whether the company or the shareholders have the wealth.[59]

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55 The employment contract could provide for an indefinite obligation to provide employment being put on the company with the couple being able to resign on giving a months notice. This will allow the couple to sell their services elsewhere if the company becomes unprofitable.

56 Section 216.

57 Section 211.

58 The term "involuntary creditors" is used to describe persons who either have not contracted with the company (ie. people with tortious claims on the company) or persons who were in a contract with the company but became a creditor due to a failure to perform the contract (eg a customer whose house was damaged by W's negligence).

59 These creditors will be more concerned with the real economic wealth of the couple than whether those earnings are held in the company. In practice transaction costs will probably mean the major creditors will not even bother to obtain information on this point. Instead they are likely to rely on the couple's interest in avoiding personal

As the couple are the only directors and shareholders they have no interest in their rights as shareholders.

2 *Ex poste*

Suppose the plumbing business operated profitably for five years. In that time there were significant payouts to the couple. Then the company had a disastrous year. Competition in the industry reduced profit margins. A contract was taken on with a margin so tight that when events went against the company it was unable to met its obligations. The other party to the contract is entitled to significant damages for non performance. The company has only net assets equal to the $2 initial capital and the $10 retained each year for a total of $52. The creditors appoint a liquidator.

The liquidator's principle ground for recovery in this situation is contained in the sections on transactions at an over value. The 1955 Act, section 311C, allows recovery from a director of "any amount by which the value of the consideration given ... for the services exceeded the value thereof at the time of the acquisition thereof" where the transaction occurred in the three years preceding winding up. The 1993 Act provision[60] is substantially the same.

The difficulty for the creditor lies in proving the salaries in the two previous years[61] were in fact excessive. Under the 1955 Act the liquidator is unlikely to find any evidence of the couple's justification for the salary but under the 1993 Act this will be stated on the certificate. However the information provided in the certificate is very general in nature and of little assistance.

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bankruptcy as the most cost effective means of protecting their investment.

60 Section 298.

61 Note that as this year has been a bad one the only years for which a claim can be made are the two preceding years.

While section 311C is a civil provision and the burden should be one of balance of probabilities the burden on the liquidator is a heavy one. The cases have established that the evidential burden lies on the liquidator. The substantive burden also lies on the liquidator and is a hard one to meet. An intention to defeat creditors by means of a clearly artificial transaction appears to be required before the courts will intervene.[62] Given the similar wording of the 1993 Act provision it is likely that the same standards will apply. Given the strong arguments for the fairness of a performance related salary it is improbable the liquidator could succeed.

The 1993 Act provides another ground for the liquidator to bring an action under. Section 161 provides that if there is no certificate or if there were no reasonable grounds for issuing the certificate then the salary can be recovered except to the extent the directors prove the salary was fair to the company at the time it was provided. The section is

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62 In *Re Burgess Homes* (1989) 4 NZCLC 69,914 the Court of Appeal, reversing the decision of Tipping J, stated that the court should be slow to condemn a bona fide commercial or family bargain negotiated at arms length and with no intention of defeating creditors. The court suggested that while section 311C appeared to be wide in scope it was aimed at reasonably clear cases of inadequate consideration. The case involved two companies, BH and C&G. Mr Burgess senior ("Senior") had nominal shareholdings in both and was governing director of BH. BH had the bulk of the shares in BH and Mr Burgess junior had the shares in BH. As a result of disputes over management the two agreed to separate the companies. Senior's one share in C&G was made the only voting share and Senior resigned as governing director of BH. Under the terms of the agreement the one share would revert to BH on Senior's death.

Later BH went into liquidation and the liquidator attempted to gain control of C&G, the major remaining asset of BH. In court expert evidence was led showing the transfer of voting rights involved a transfer of wealth to Senior. Tipping J held that the value lost to BH was $70,000 and that no material consideration had been given. The Court of Appeal rejected both findings. The Court of Appeal considered that while the voting rights in C&G were valuable Senior had already possessed these indirectly as governing director of BH and therefore had gained nothing from the deal. The Court of Appeal's astonishing failure to consider the very real loss of rights to BH, a separate legal entity to Burgess junior, is an indication of its reluctance to interfere with decisions made in good faith.

different to section 298 as it provides a right to the company before liquidation and does not have a specific time limit. The section appears to be aimed at allowing shareholders to recover excessive salaries paid to directors. The liquidator can bring an action under this section as all the rights of the company accrue to the liquidator.

This provision improves the liquidator's position if the directors have failed to follow the formalities required by section 161. The liquidator could bring a claim under section 161(5). The directors would then have the burden of proving the employment contract was fair to the company at the time it was made. If the liquidator succeeds then any excessive salary payments will be recoverable. This covers not just in the preceding two years but in all five years of the company's operation. In this example however it is quite likely the couple could show the contract was fair.

If the formalities were followed the liquidator's position is only improved to the extent that the three year requirement is not present. However the liquidator will bear the burden of proving there were not "reasonable grounds ... for the opinion set out in the certificate".[63] The expression used suggests that the liquidator must show the decision was groundless. This is a at least as onerous a requirement as that under section 298. The directors can easily show they did have reasonable grounds for their decision.

Another possible ground available to creditors is the 1993 Act "substantial risk of loss" provision.[64] This makes the directors liable where the business of the company is carried on in a manner likely to create a serious risk of loss to the company's creditors. The provision could be

63 Section 161(5).
64 Section 135.

used as the basis of a claim that running the business with nominal capital and extracting all profits as earned created such a risk.[65] The action would be for losses due to breach of the director's duties to the company but would in effect be a means of recovering the distribution. While the meaning of section 135 is yet to be tested in court it is improbable that a court would find the couple in breach of their duties in the first five years when the company was operating profitably.[66]

Liability under the transaction at over value provisions apply to the couple in their capacity as director/employees so their capacity as shareholders is not relevant. As stated above the directors appear to be reasonably safe provided they have followed the requirements of section 161.

3 *Conclusion on this transaction*

Under the 1993 Act as under the 1955 Act salaries are an ideal method of extracting wealth from closely held companies. Only distributions in the three years before winding up are at risk. These distributions can be recovered only if the liquidator can show an intent to defeat creditors or other evidence of a lack of good faith. The only significant change in the law is the introduction of the section 161 certification process. If the required formalities are not followed the directors bear the burden of proof to show the payments were fair to the company.

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65 Over the course of time a business will have good years and bad years. Normally a company will rely on the equity to survive the bad years in the cycle. By extracting all profits the couple could be seen as placing all the risk of bad years on the creditors. However the performance based salary means there will seldom be years sufficiently bad to result in losses to the company. It would be difficult to argue there was a substantial risk of serious loss, whatever those terms may mean.

66 There is a greater chance a court would find a breach of this duty in the final year. A reckless trading claim might also succeed in relation to debts incurred close to winding up. However as no salary was paid in the loss making period this would be purely an insolvency issue and beyond the scope of this paper given the company reckless trading provision of each Act.

If the required formalities are followed then section 161 will be of little use to the liquidator.

C *Provision of Goods and Services*

1 *Ex ante*

The couple in the example above can extract all profits as salary so there does not appear to be any need for them to extract profits by means of selling goods or services to the company. Suppose however that instead of failing in year six the business grows. O, an old friend of W's is approached to join the business as a partner. The three agree on a profit sharing formula and carry out the necessary formalities to create employment contracts which put this into effect. O is given one of the two shares and a place on the board. However O has few assets and so the couple will have to buy a second van for the business. As the parties are contributing different amounts of assets it is appropriate that some form of leasing of the assets to the company occur. By splitting the income related to the assets to that due for personal services the couple's greater financial contribution is recognised.

The trio need to decide what the lease payments will be. The amount will need to be set more carefully than the salary for two reasons. First it will be easier for a liquidator to give evidence of the value of the lease. Secondly the amount of the lease payments will affect the division of income amongst the parties.[67] At the start of the venture the second reason will be more significant as being fair to O will be of greater concern than the remote possibility of liquidation.

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67 The earnings on which the salaries are based will now be earnings before salaries but after lease payments. The higher the lease payments the lower the salaries. As O receives salary only lower salaries will disadvantage O.

A lease payment is based on two factors - the loss in value of the asset over the period (anticipated depreciation) and a return on the investment in the asset based on its opening value. If the assets being leased were complex to value or expensive an expert opinion could be obtained. However the assets are tools and two vans. The trio would prefer to take the risk of some slight inaccuracy in the lease payments than pay an exorbitant fee to a valuer.

Establishing the opening value of the assets is easy. The second van is purchased so for $25,000. The trio look at the classified advertisements in the newspapers to determine that the second hand value of the old van is $7,000. W and O know the value of the tools as they both have experience of purchasing these. W's tools have a second hand value of $11,000 while O's are worth $9,000. The trio therefore decide to leave the tools out of the equation as both have similar values.

The loss in value of the vans over time is harder to assess but the trio agree that the old van probably has another three years of service in it and could be sold for $1,000. The new van has ten years service in it with a residual value of $1,000. The trio agree to use a straight line depreciation method giving a depreciation of $4,400 per annum.

Calculating the second component of the lease payments, the return on the asset is more complex. The trio agree that the rate of return on the investment should be 10%, largely for ease of calculation. This figure is more than the couple are paying in interest on their mortgage but much less than they would pay on financing the vans through a finance company. The total lease payment in the first year is therefore $7,600 being the $4,400 of depreciation and $3,200 of return on the assets opening value of $32,000.

The trio must now go through the formalities. As in the payment of salaries example the Acts do not give any guidance on valuation. The trio's formula thus appears as good as any. The 1955 Act requires directors to inform the board that they have an interest in a contract the company is about to enter into.[68] The couple should therefore ensure a minute is entered to the minute book to the effect the couple are interested in the contract. No other formalities are required. The 1993 Act has a similar requirement[69], with the added formality that the couple must also ensure the lease details are entered to the interests register.

The Acts do not contain any requirement to inform creditors or gain any external approvals. As noted in the previous example the creditors could contract for such rights but are unlikely to do so as the transaction costs would outweigh the benefits.

The shareholders have some powers to block interested transactions where these were not at fair value[70] but these powers will not be exercised here.

2 *Ex poste*

If the company later went into liquidation the liquidator would be in a similar situation to that in the previous example except that section 161 would not be available. The valuation of a lease such as this is easier to dispute than a salary agreement as it is easier for the liquidator to show objective evidence of value. The liquidator could, for example, carry out calculations of the value of the vans, their useful lives, residual values and fair rates of return.

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68 Section 199. The penalty for failure to disclose is $200 and the failure to disclose is a breach of the director's duty to the company. In this instance the directors are aware of the interest so it is improbable that there would be any penalty for failing to disclose.

69 Section 141. The section requires the disclosure of the interest and also that, if possible, the interest be quantified. Failure to comply exposes an offending director to a penalty of up to $10,000. It is unlikely a court would impose a penalty in this situation as the directors are in fact informed.

70 Section 141.

All this information would be reasonably easy to obtain and highly objective.

Unfortunately for the liquidator while both Acts phrase the requirement as an objective test with any surplus value retuning to the company the courts have interpreted the 1955 Act clause more narrowly. The liquidator must show not just that the lease amount was not the ideal lease amount but that the lease amount could not have been considered a reasonable amount. The agreement of O, an interested third party, to the lease will increase the courts reluctance to interfere.

The lack of a section 161 type certificate showing the reasoning behind the valuation of the lease is disadvantageous to the liquidator in these circumstances. If there were such a certificate the liquidator could attack any factor used which appeared unreasonable.[71] Instead the liquidator does not have any way of identifying the grounds for the valuation of the lease except going to court.

3 *Conclusion on this transaction*

The evidential problem combined with the difficult burden of proof and the likelihood that any overpayment element in the lease is small makes it the unlikely the liquidator would bring an action for recovery of the distribution.

D *Returns of Capital*

Returns of capital are generally associated with public companies.[72] Our example will therefore be a listed

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71 The absence of such a certification requirement is particularly surprising given the certificate is much more likely tc be of use to the liquidator in these types of transactions where objective and quantifiable factors are more relevant than in the remuneration context.

72 This is at least in part due to the costly court procedure required to reduce capital under the 1955 Act.

company with substantial retained earnings. The company's directors feel the company has more equity than is required for the continued operation of the business. The company does not have sufficient imputation credits to fully impute the amount they want to return. Tax implications therefore support the return of capital rather than a distribution of retained earnings.[73]

1 The meaning of capital

Capital has a number of possible meanings. Historically the courts have based their decisions on the logic flowing from a particular definition. A brief canvassing of the possibilities is thus appropriate.

The first type of capital is economic capital. Economic capital can be defined as the stock of wealth at a point in time. This economic capital can be further divided into financial capital and physical capital. The physical capital of the company is its ability to produce particular goods or services. Financial capital is a broader measure of the value of the firms assets measured in either real or nominal dollars. Under an economic definition of capital income is "the increase in the stock of wealth in the current period that can be fully distributed, without diminishing wealth".[74]

The second type of capital definition is functional. Fixed capital is represented by the fixed assets of the entity. Fixed assets are those which generate income by use. By contrast circulating capital is represented by those assets such as trading stock which are regularly purchased and sold or consumed as part of the profit making processes of the company. Under this definition income is the increase in the value of the circulating capital. To the extent that

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73 A return of capital is not taxable income in the shareholders' hands.

74 ME Bradbury, EM Hickey and W Hunt *Research Bulletin -119 The New Companies Legislation - Accounting Issues* (New Zealand Society of Accountants, Wellington, 1994), 134.

fixed capital assets are sold above or below their book value the realised gain or loss are may be treated as income.

Another meaning of capital is contributed capital. Contributed capital is the value of the assets (whether cash or otherwise) received by the company in exchange for the issuing of shares. Contributed capital is usually measured in nominal rather than real dollars. Income under this approach might be expected to be any increase in the nominal financial wealth of the entity. This approach is consistent with the notion of contributed capital as a trust fund for the creditors. Those creditors in effect rely on the existence of this amount of equity in the company as a buffer protecting their interest in the company.

Under the 1955 Act the term nominal capital was used. A company's nominal capital was stated in its memorandum of association.[75] This capital was then broken into the number of shares at the par value. Capital could be unpaid, partly paid or fully paid.[76] Where shares were not fully paid the holder was liable to the company for the unpaid portion. Shares could be issued at any price above the par value. Where shares were issued above par value the excess was to be put in a share premium account.[77] The Act also provided for the accounting treatment of share capital and a number of reserves and for a profit and loss account to be kept.[78]

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75 Section 14(4).

76 Section 60.

77 Section 64. The section further specified that "the provisions of this Act relating to the reduction of share capital of a company shall ... apply as if the share premium account were paid up share capital ... ". Exceptions to this general rule were that the share premium account could be used to pay up unissued shares as bonus shares, to pay up partly paid shares or to write off preliminary expenses of the company. All these exceptions merely change the classification of numbers on the balance sheet rather than creating any distribution of the assets of the company.

78 These accounting requirements are set out in the Eighth Schedule.

As mentioned in the outline the 1955 Act required maintenance of this capital. This capital which could not be reduced was the nominal capital in the "Ordinary Share Capital" and "Share Premium accounts. A distribution which resulted in a debit to these accounts was unlawful without the approval of the High Court.[79] However the economic capital was not required to be maintained. The nominal capital need not be represented by any assets[80] and distributions could occur when there was a debit balance in the retained earnings account.[81]

2 *Ex Ante*

The 1955 Act does not specify any matters which must be taken into account by the directors or the court in determining when a reduction in share capital may occur. Instead the Act sets out a formal procedure which creates safeguards for existing creditors.

The first formality required is the passing of a special resolution[82] agreeing to the reduction in share capital and any related changes to its Articles or Memorandum of Association.[83] The shareholders thus both receive notice and are able to vote on the reduction. Once the resolution is passed the directors apply to the High Court for a confirmation order.[84] The court then draws up a list of all creditors of the company. If appropriate the court can require the publication of notices to allow any creditors not on the list to be entered onto it. All the creditors on the

79 See the discussion on reduction of capital at Part III D.

80 Section 75(1)(b) specifies this situation as one in which a reduction of nominal capital might be applied for.

81 This result is not clear from the Act but is well established at common law. See below n XX.

82 Section 145(2) states that a special resolution is one passed by at least 75% of those voting in at a meeting of which 21 days notice must have been given.

83 Section 75.

84 Section 76.

list have the power to object to the reduction in share capital.

All creditors are therefore informed and can object. In practice the objection procedure does not allow the creditor to stop the reduction in share capital. Instead the Act provides that where a creditor objects the court may direct the company to set aside an amount to meet the creditor's claim.[85] All creditors are thus given the opportunity to be paid out before the reduction in capital. If one assumes the creditors give credit on the basis of the capital of the company then this result is sensible.[86] The court will not give the requested confirmation order until all creditors have either been paid, provided for or have consented to the reduction.[87] The confirmation order and a minute showing the new capital and how it is comprised must then be presented to the registrar of companies.

The rights of the creditors and the funding needs of the business are major factors the directors must consider before proposing a reduction in share capital. If the number of creditors wishing to be paid out exceeds the amount available to pay them and the shareholders then the reduction will not take place. Major creditors would be contacted in advance to ensure they accept the reduction as the credit they extend will generally be needed by the company. If the company intends to borrow to fund the return of capital then the need to consult major creditors will be even greater. These creditors will be concerned with the level of econcomic equity (capital, reserves and retained profit and loss) rather than the nominal capital.

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85 Section 76(2)(c).

86 This logic, with strong roots in principles of contract, was the basis of the decision in *Flitcroft's Case* (1882) 21 Ch D 519 which established the rule against reductions in capital. At 533-534 Sir George Jessel MR stated that a "creditor ... has a right to say that the corporation shall keep its capital and not return it to the shareholders, though it may be a right which he cannot enforce otherwise than by a winding up order."

87 Section 77.

Generally the contract with such creditors would require the company to maintain certain financial ratios. If these would be met after the reduction the creditors would be unconcerned by it.

Minor trade creditors will be less significant as most will continue to extend credit terms to the company.[88]

The other matter the directors must consider is the cost of the whole procedure. The High Court process will take some time and involve significant legal and administrative costs. A reduction in capital under the 1955 Act would only be contemplated where there was full support from major creditors and the amount to be returned was large enough for the tax advantages to justify the transaction costs.

3 Ex Poste

Suppose the company subsequently is wound up with several creditors from the time of the reduction still owed money. Given there were substantial retained earnings at the time of the reduction of capital it is improbable that winding up would occur within a short period of the reduction. The example will assume a winding up one year later after a catasrpohic event.

The creditors cannot object after the reduction in share capital unless they were not informed of the reduction's affect on their claim at the time of the court hearing.[89] If

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88 These trade creditors' debts are paid regularly so that while the amount owing may remain relatively constant that amount will comprise different debts at any given time. Any one actual debt will be paid in a short period. Such creditors can reduce their exposure to the company at any time by ceasing to extend credit on new sales. It makes little difference from either their perspective or the company's whether they object as any the debts at the time of the .eduction would have been paid soon after. If however the creditors cease to extend credit the "float" this credit provides will be lost. In practice few trade creditors would not extend credit to a listed company whatever its nominal capital.

89 Section 79.

the creditor can prove this was the case the court can direct shareholders at the date of the reduction to contribute funds to pay the creditor's claim.

In the present circumstance it is unlikely that there would be many, if any, such claims available. It is possible some small creditors may have been accidentally omitted but these creditors would have been paid out during the year since the reduction. Long term creditors are usually large and would be known to the board of directors. Significant claims would be unlikely unless the list of creditors presented to the court was fraudulent. The only significant claims likely outside of fraud by the directors are those of involuntary creditors who had not lodged their claim with the courts at the time of the reduction. Since such creditors will usually be rare and their claims small relative to the assets of the company the shareholders can assume there will be no claims on tem subsequent to the reduction.

The directors and other officers of the company will face a penalty of up to three years jail if it is shown they wilfully omitted the creditors name from the list provided to the court or misrepresented details of the creditor's claim. To get a conviction the prosecution would have to prove the charge beyond reasonable doubt. Directors who honestly approve the reduction are unlikely to suffer any penalties.

In addition to the possibility of a jail term delinquent directors are liable to replace any assets improperly transferred to the shareholders. This liability is founded on the directors' breach of their duty as quasi trustees of the company to protect the company's assets.[90]

Under the 1993 Act the return of capital is not an issue as there is no distinction between capital and other forms of equity for the purposes of distributions.[91] The general

90 This principle was also established in *Flitcroft's Case* above n XX.

91 At the time of writing legislation had been proposed to Parliament which would make share repurchases a non taxable return of capital

issue of distributions will therefore be considered in the next example.

4 Conclusion on this transaction

Under the 1993 Act returns of capital occur as part of ordinary distributions. Returns of capital under the 1955 Act required 75% shareholder approval and gave creditors an option to be paid out before the reduction. The major factors for the directors to consider were the support the major creditors would give the reduction and the effect this would have on cashflow and the transaction costs and tax advantages of this form of distribution. Shareholders are unlikely to be exposed to claims resulting from the distribution unless there was a fraud perpetrated. Directors and any other officers involved in such a fraud face a three year prison sentence and liability for any distribution not recovered from the shareholders, a significant deterrent.

As in the earlier transactions the major practical difference between the position under the 1955 Act and that under the 1993 Act is that under the 1993 Act the failure to follow the formalities laid down by the Act increases the probability of liability. The only other practical change would appear to be the elimination of the rules against repayment of capital. The elimination of these rules could potentially allow a larger dividend to be paid. Unlike in the previous transactions the certification requirement appears to be more useful to the liquidator as a source of information about the directors' decision.

E Payment of Dividends

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for tax purposes to the extent the contributed capital had not been returned previously. The repurchase of shares would then become a return of capital from a tax law perspective if not a company law perspective.

Under the1955 Act share repurchases were not permitted. A comparison of the two Acts might therefore suggest that the 1993 Act allows more distributions. However dividends and share repurchases are economically identical in their effect on the equity of the company.[92] The only economic differences between the two types of distribution derive from the potential of share repurchases to be non pro rata and thereby affect the relative control interests and economic position of the shareholders. For the purposes of this example share repurchases and dividends will be treated as identical distributions with the 1993 Act merely providing two alternative means of achieving the same end.

Under both the 1955 Act and the 1993 Act a company with significant retained earnings is able to pay a dividend without any real risk of liability for shareholders and directors or any need for approvals. The ability to pay a dividend becomes more questionable where the company has accumulated trading losses or realised and unrealised gains and losses on fixed assets .

In the earlier examples the financial position of the company was extremely strong (capital reduction) or irrelevant (salaries, leases) in this example the company is in between and the financial position of the company will be a more significant factor in the ability to make the distribution. A detailed examination of the company's financial position is required. The law recognises this need and both the 1955 Act regime[93] and the 1993 Act

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92 Both involve a reduction in the economic capital of the company. See the discussion at n 42 below for a discussion of the significance of the economic capital.

93 This principle was clearly established in the case law. For example in *Rance's Case* (1870) LR 6 Ch 104,122 Sir George Mellish LJ stated "... a declaration of [a dividend] without any profit and loss being made out is a malâ fide proceeding on the part of the directors." Where accounts have been prepared the court will usually be reluctant to challenge those accounts. Where no accounts were prepared the court will place the burden of proving the dividend was valid on the directors.

regime[94] require the directors to prepare a set of accounts before deciding whether to pay a dividend.

The example company is a meat processor. The company has been in existence for many years and has been listed on the stock exchange for the last ten years. The company has a paid up capital of $100 M. Unfortunately the company has had several bad years in a row and there is a $50 M debit in the retained earnings account. At balance date there is $10M of stock and $30 M of debtors. At peak season these figures would be closer to $20 M and $60 M respectively. Trade and sundry creditors total $45 M ($75 M at peak). Bank overdrafts ($30M) and a debenture trust deed ($40 M) provide working capital with the banks contributing a further $10 M at peak. The fixed assets of the company comprise two plants with a book value of $120 M and a feed lot with a historical cost of $10 M. Increases in the value of farmland mean the feed lot has a market valuation of $30 M. Based on other recent sales (eg Fortex) the two plants would probably sell for $40 M. In the year just completed the company enjoyed a profit of $5 M of which $3 M related to trading and $2 M to a gain on sale of a second feedlot.

The directors have been unable to pay a dividend the last three years and would like to pay a dividend to restore investor confidence. The directors hope to raise additional funds through a rights issue in the next year or so. However while the directors want to pay a dividend they want to ensure this is done lawfully to avoid any future liability to themselves if the company goes into liquidation.

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94 The 1993 Act requires the directors to certify the solvency test has been met. One of the things the directors must have regard to when forming an opinion as to whether the test is met is the most recent set of accounts prepared under the Financial Reporting Act 1993. These accounts could be up to seventeen months old. However the directors must also consider other circumstances affecting the company's value which would include profits and losses in the period since the last accounts. Where the last set of accounts are not up to date this would suggest directors should prepare new accounts.

1 Ex ante under the 1955 Act

From an economic perspective the capital of the company has been eroded by past years' losses. The trust fund avaliable to satisfy the creditors has been halved. It might be expected that a distribution would be prohibited in such a situation but the 1955 Act did not require that capital be maintained, merely that it could not be distributed back to the shareholders.[95] This requirement prevented a dividend from being debited to the share capital accounts or being debited to the retained earnings account where that account was in debit. While a dividend would not therefore normally be payable a "nimble" dividend might be declarable in these circumstances.

The courts created the nimble dividend by a very literal interpretation of the accounting process. Standard accounting convention keeps one account, the profit and loss account, seperate to the other owners equity accounts as a working account during the year. At the close of the year the balance of the profit and loss account is normally transferred to the Retained Earnings account. If however the directors are nimble enough they can declare a dividend from the profit and loss account before it is transferred to the Retained Earnings account. As no accounting entry is made to the capital account the rules against return of capital do not apply. Likewise the debit balance in the retained earnings account need not be considered.

The directors will therefore be able to pay a dividend if the company has a profit in the current year despite the

95 In *Verner* v *General and Commercial Investment Trust* [1894] 2 Ch D 239, 266 Lindley LJ clarified this issue stating " ... the word profits is by no means free from ambiguity. The law is much more accurately expressed by saying that dividends cannot be paid out of capital than by saying that they can only be paid out of profits".

negative retained earnings. Unfortunately determining whether there has been a profit is not easy. The definitions of income described above all focused on an accretion to the opening wealth of the enterprise. Income/profit is thus the closing wealth less the opening wealth. The difficulty which arises is measuring opening and closing wealth. The example situation demonstrates the difficulties involved in measuring wealth. Diagrams 1, 2 and 3 show possible balance sheets under three possible valuation systems. If the opening wealth had already been determined the income for the period will vary significantly under each valuation system due to the changes in Owner's Equity (the net wealth of the company).

Diagram 1 shows clsoing wealth of $55 million. This represents a $5 million increase on the previous year. Diagram 2 shows wealth of $75 million, a $25 million increase. These two balance sheets were prepared on the basis that the company is a going concern. The third diagram is constructed on a different basis. It is shows the wealth if the company went into liquidation. There is insufficient net wealth to satisfy the claims of all creditors with the unsecured creditors suffering a 53% loss and shareholders a 100% loss.

Diagram 1: Balance Sheet (historical cost accounting)

Current Assets	($M)	Current Liabilites	($M)
Stock	10	Trade Creditors	45
Debtors	30	Bank	30
	40		75
Fixed Assets		**Debenture**	40
Feedlot	10	**Owner's Equity**	
Plant	120		
		Capital Contributed	100
	130	Retained Earnings	(50)
		Current RE	5
			55
	170		170

Balance Sheet 2 (modified historical cost accounting)

Current Assets	($M)	Current Liabilites	($M)
Stock	10	Trade Creditors	45
Debtors	30	Bank	30
	40		75
Fixed Assets		**Debenture**	40
Feedlot	30	**Owner's Equity**	
Plant	120		
		Capital Contributed	100
	150	Retained Earnings	(50)
		Current RE	5
		Revaluation Reserve	20
			75
	190		190

Balance Sheet 3 (liquidation values)

Realisable Assets

		($M)
Stock	10	
Debtors	30	
Feedlot	30	
Plant	40	
Total Realisation		110
Less::		
Bank (secured over plant)		(30)
Trade Creditors (secured by Romalpa clauses)		(10)
Debenture (secured by floating charge)		(40)
Total assets after secured creditors paid off		30
Unsecured Creditors		
Trade Creditors	45	
Redundancies	20	(65)
Shortfall		35

It is the directors' responsibility to determine the wealth of the company.[96] If the decision is made honestly and reasonably the courts will not interfere. In determining whether the decision was honest and reasonable the courts have generally looked to accounting practice to see whether the practice has any support. The directors therefore have some leeway in making their decision but should consider accounting practice.

The liabilities are easy to value.[97] The trade creditors will be paid within 14 days and thus any discount would be negligible. The Bank charges interest at market rates and thus has a value equal to its face value. Redundancies, are not treated as a liability unless the directors expect the plant to be closed in the near future.

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96 See Rance's Case, above n 93.

97 Liabilities are usually the easiest item to value on the balance sheet as they are denominated in dollars and are typically either short term or interest bearing at market rates. These features make them easy to value in dollars on a balance sheet. Contingent liabilities raise more issues as the amount is uncertain and it is difficult to assign a probability to each possible outcome.

The assets represent a greater valuation challenge. Both accounting and law have historically distinguished between fixed assets and circulating assets for the purposes of valuation. The distinction is related to the fixed and circulating capital distinction discussed above.[98] Circulating assets such as stock or debtors are valued at the lower of cost or their realisable value.[99] These values are relatively easy to determine.

Fixed assets can be valued in several ways. Under historical cost accounting fixed assets are valued at cost. Where the fixed asset is consumed over time some allowance is made for this decrease in value.[100] More recently accounting practice has allowed the use of modified historical cost. This valuation system allows the balance sheet to show the realisable value of fixed assets but does not allow increases in the value to be taken to the profit and loss account. Instead the credit associated with the increase is taken to a special revaluation reserve account. Losses must be taken to the profit and loss.

The directors must determine whether to use historical cost or modified cost accounting for each asset.[101] If the valuation is to be modified historical cost accounting the directors must also decide whether the asset is to be valued at realisable value or in use value.[102] The existing use valuation would be prepared by an independent valuer but the directors might be expected to have considerable input to the assumptions the valuer used.

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98 See discussion at part III D 1.

99 The realisable value is the price which would be obtained when selling them less the costs of the sale.

100 This allowance is depreciation if the asset is tangible or amortisation if the asset is intangible.

101 The liquidation value would only be used if the directors expected the company (or its liquidator) to sell the fixed assets in the near future.

102 Statement of Standard Accounting Practice 28 (New Zealand Society of Accountants, Wellington, 1991), para 4.16, states that the existing use valuation should be used. Realisable value could only be used where the directors intended to sell the asset.

In our example the directors decide the existing use valuation of the plant would be so subjective as to mislead shareholders. However the feedlot does not have such a specialised use so the directors decide to use the valuation of $30 million they had obtained. While this results in a $25 million increase in wealth only the realised portion, $5 million, can be recognised in the profit and loss.

$2 million of the $5 million profit relates to a capital gain on the sale of the second feedlot. A capital gain may be distributed where there has been an accretion to the capital of the company. Where there has been a profit in the current year but retained earnings are negative it may not be possible to distribute a capital profit. No commonwealth case[103] has directly decided the issue but several cases have intimated that it may not be possible to pay a dividend based on capital profits where the net value of the company's assets is less than its nominal capital.[104] Given the director's concern to avoid liability in

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103 The writer was unabl to find any evidence of such a case. As a number of judges in cses reviewed have made obiter comments on the issue it is improbable a case with supportive reasoning would not be identified.

104 For example in *Australasian Oil Exploration Ltd* (1958) 101 CLR 119, 133 the Australian High Court stated "This argument asserted that if a company ... disposes of a single capital asset at a price in excess of [its book value], it may lawfully distribute the casual profit so made ... whatever the capital position of the company might otherwise be. This proposition was emphatically rejected by Wolff J and we agree with him ... It is enough on this point to say that a company has no profits available for dividend purposes unless upon a balance of account it appears that there has been an accretion to the paid up capital."

The case involved a company near insolvency. The company proposed the sale of its principle asset at a price sufficent to allow it to pay its debts. The asset was believed to be worth substantially more. The proposed sale was to a new company to be owned by the same shareholders and controlled by the same directors. The purpose was to prevent the company having to sell the asset at a firesale price in liquidation. The asset was sold above its book value but the plaintiff shareholders contended the sale was involved a return of capital as the asset comprised the major part of the company's capital and the net worth of the company after the sale would be less than the paid up capital. While tyhe facts are very different to the present example the principle appears to be the same and the New Zealand High Court expressed similar sentiments in *Hilton*, below note XXX the event the company is liquidated it would be inadvisable to distribute this $2 million.

Before deciding whether to distribute the remaining $3 million the directors must consider several other principles of company law established in the cases. The first is a requirement that the dividend not cause the company to become insolvent in a trading sense.[105] The

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105 The trading insolvency test at common law is similar to that in section 4 of the 1993 Act (i.e. will the company be able to pay its debts as they fall due after the dividend). The test is set out in *Hilton International Ltd* v *Hilton* [1989] 1 NZLR 442, 461 per Tipping J.

Hilton involved a clothing manufacturer which had begun to suffer trading losses. By October 1983 it was struggling to pay its creditors. It had been regularly in breach of its overdraft limit. By late February 1984 the company began to receive section 218 notices and such notices were soon arriving on a regular basis. At a meeting on 1 June 1984 the bank emphasised its concern and demanded accounts for the 31 March 1984 year and also the contribution of more capital. Mr Hilton had explained the delay to the bank as being the result of concerns about tax. He claimed that delaying the production of accounts until September would be benficial. The bank was unimpressed.

In July 1984 the company entered into a contract to sell its land and buildings to another company and leased them back. This was intended to introduce new funds into the company. A capital profit was anticipated and the directors intended to use this to pay a dividend to themselves to pay off loans from the company to themselves. The company showed the bank a preliminary set of accounts. This showed a drop in sales of $200,000. This was blamed on poor quality merchandise purchased and the company was confident it would be awarded damages for loss of goodwill of $200,000. The accounts also showed the purchase of two company cars - a Daimler and a Rolls Royce. The day after the meeting the company had to have a short term increase in its overdraft to avoid being wound up. In September cheques were being dishonoured on a regular basis.

On 23 October the company declared a capital dividend of $138,000 which represented the gain on the sale. No deduction was made for estimated tax on the transaction of $77,000. The next day a cheque to a major supplier was dishonoured. On 7 November Mr Hilton wrote to the bank requested assistance in getting through "the company's rather tight liquidity situation. The company continued to decline and posted a $150,000 loss for the year to 31 March 1984. By April the Hiltons were discussing winding the company up with their accountants and lawyers. The conclusion arrived at was that the company had been insolvent since August 1984 and that caution would be needed in making payments. The company went into voluntary liquidation in July 1985.

second is that the dividend not cause the company to become insolvent in the balance sheet sense.[106] Finally the directors must consider whether the dividend jeopardises the solvency of the company in either of the foregoing senses.[107]

The Hiltons had not made any effort to commission accounts before paying the dividend. The capital profit was taken in isolation and the company's trading losses for the period were not taken into account. The amount paid made no allowance for tax on the transaction. The Hiltons did not attempt to claim there had been a genuine accretion to the company's capital. A retrospectively prepared balance sheet (which seriously understated liabilities) prepared by the Hilton's accountants showed the company was close to having no shareholder's funds after the dividend payment. The court mentioned the underestimation but stated it was not appropriate to inject the court's judgement. Tipping J also made no attempt to write down the assets of the company even though the evidence regarding the existence and valuation of those assets was tenous.

The defence argument was principally based on the fact that their accountants had not advised them to have accounts prepared. The quality of the Hiltons' testimony is indicated by Mr Hilton's explanation of the dishonoured cheques. He stated the devaluation of the New Zealand dollar in July 1984 had cost the company $50,000. When it was pointed out that this did not help his claim he was unaware the company was making losses he substantially reduced his estimate of the effect of devaluation.

106 Again the rule is very similar to that in section 4 of the 1993 Act (i.e. will the company's assets exceed its liabilities after the dividend). See *Hilton*, above n105 ,461.

107 This requirement is based in part at least on an implied duty of care owed to creditors by directors where the company is near insolvency. The duty would require the directors to consider the risks to the creditors if a dividend was paid and to not pay it if they considered it created a real risk to the creditors. The existence of this duty is uncertain as no case has directly decided the point but obiter statements in several judgements have suggested the existence of such a duty. The most significant of these cases is *Nicholson* v *Permakraft (NZ) Ltd* 1 NZLR [1985] 242. Somers J felt it was clear that a distribution by a company which was insolvent would be a misapplication of company property. He considered that directors "must have regard to the interests of creditors" where the company is insolvent but declined to decide whether the same was true where the solvency was marginal or doubtful. Richardson J expressed his judgement in similar terms.

Cooke P chose to examine the wider principles involved. He found (page 250 of his judgement) "[the] duties of the directors are owed to the company. On the facts of a particular case this may require the directors to consider inter alia the interests of creditors." Cooke P adopted the objective test favoured by the English Court of Appeal (per Cumming-Bruce and Templeman LJJ in *Re Horsley & Weight*

In our example the balance sheet insolvency test will be met as the balance sheet test is usually based on the accounts prepared by the directors.[108] The payment of the dividend does not jeopardise this form of solvency.

Trading insolvency is a more difficult question. The first point which should be made is that trading insolvency is not impacted by the negative retained earnings. The trading solvency issue is different to the balance sheet aspect as it is forward looking. The directors should

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Ltd [1982] Ch 442, 454-456) "whether at the time of the payment in question the directors 'should have appreciated' or 'ought to have known' that it was likely to cause loss to creditors or threatened the continued existence of the company" He considered an action would be available either for misfeasance or based on the statutory duty in section 321 of the old Act which covered "any negligence or default or breach of duty or trust in relation to the company".

The case involved a manufacturer which had traded profitably for some years then suffered a loss, despite increased sales. Price stabilisation regulations prevented the company increasing its prices. The company was paying accounts two to three months late but the evidence suggested this had been implicitly accepted by the suppliers involved. The rapid growth in sales had made existing equity and long term financing barely adequate.

The directors arranged a scheme in which the company's assets were sold at a profit to a new company which also purchased the shares of the shareholders in Permakraft. The capital profit was paid out as a dividend to assist in the financing of the asset purchase. The assets were then leased back to the original company. The increase in costs to the company allowed it to increase its prices 15%. Forecasts prepared by the directors suggested this would result in a substantial increase in profitability. The plan was presented to the banks and to the Inland Revenue Department. It met with approval and was implemented.

Unfortunately within two years the company had lost several key accounts and became insolvent. All creditors at the time of the restructuring had been paid soon after and the company had been paying debts faster in the months immediately after the restructuring than before.

In *Hilton*, above n 105, 471-475 Tipping J endorsed Cooke P's statements in *Permakraft* but again the relevant passages do not appear to be part of the *ratio decidendi* of the case.

108 See Hilton, above n 105, 457-462 for an example of how a court will not overturn the directors' assessments unless the directors' assessment was groundless.

ideally therefore prepare a cashflow forecast to determine whether the company can meet its debts as they fall due.[109] The projected cashflow from debtor collections and creditor payments will be a significant part of this cashflow forecast but the key issue will be the support of the banks. As noted above the company will need to increase its bank borrowings at the peak of the season. The key trading solvency issue will therefore be whether the banks will continue to support the company.

The creditors do not have any statutory right to object to the payment of a dividend. However the major creditors - the banks and debenture holders - may have contracted for such a right. In this example the banks have a fixed security over the land and the plant. The banks major concern will be to monitor that the security remains adequate. Regular valuations will be the most cost effective way to monitor this. The adverse publicity to the banks which would result from a mortgagee sale will often cause the bank to also monitor the company's financial health. The bank facility is an overdraft which can be cancelled at any time. This gives the banks a lot of control over the company's actions. The directors will need to consult the bank to get approval for the dividend. The banks will want to see cashflow projections to determine the effect of the dividend on the company's borrowing requirements.[110] The banks will probably support the dividend payment as it does not endanger their secured position and may help entice the introduction of new shareholder's funds via the planned rights issue.

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109 Preparation of a cashflow forecast is not compulsory. Where a dividend was small relative to the size of the company (as it is in our example) a court would not usually question the director's judgement unless there was clear evidence that the company was struggling to pay its debts at the time the dividend was declared.

110 Note the symmetry between this contractual requirement and the common law requirement to meet the trading solvency test. Even in the absence of the contractual requirement the banks must be consulted to ensure they will support the company.

Unlike the banks the debenture holders have a long term funding line in place. This reduces their ability to control the company informally. The debenture holders also have only a second ranking fixed charge and a floating charge over the remainder. The debenture holders' position is much riskier than that of the banks. In order to protect themselves they will have created a debenture trust deed which requires the company to meet certain criteria at all times. Any breach of these criteria will allow the debenture holders to appoint a receiver to protect their position.

Unlike the 1955 Act which focuses on nominal capital and the prevention of distributions the debenture holders will focus on real economic measurements. The debenture holders will want to ensure the buffer of equity is always sufficient to protect their investment. They will be indifferent as to whether the cause of any reduction in that buffer is a distribution, trading losses or some other cause. The company will be required to maintain the buffer not only when a distribution is to occur but throughout the year.

Terms of the debenture in this example include the maintenance of a minimum ratio of equity : assets of 35% measured by the audited financial statements at year end. The equity ratio may not fall below 25% at any point during the year. The debenture requires the maintenance of at least $60 million of "free" assets at all times. certain level of assets without a prior ranking charge on them.[111] The debenture also contains a general requirement that the directors avoid taking any actions which might endanger the debenture holders' position. Unlike many debenture trust deeds there is no requirement to maintain any liquidity ratios.

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111 Free assets are the assets available as security to the debenture holders. This will be calculated by deducting prior ranking securities from assets.

As the directors have adopted the Diagram 2 balance sheet for financial reporting purposes the first calculation will be based on this. The balance sheet shows a 39.5% equity ratio. Payment of a $3 million dividend would alter this to a 38.5% ratio, well above the required 35%. The directors must be careful the minimum ratio of 25% is maintained all year however. They will therefore need to prepare projected balance sheets. At peak season with an additional $40 million of assets employed the ratio would be 31.7%, again well above the minimum allowed. The free assets total depends on the valuation basis. The debenture trust deed requires that a market valuation of all fixed assets be obtained for this purpose. Diagram 3 shows free assets of $70 million, above the required level. The general duty to not endanger the debenture holders' interests is not breached as the $2 million will have a negligible impact on the risk level of the debentures.

The articles of association provide the shareholders with the power to accept or reject the proposed dividend. The extraction of the $3 million is likely to be appreciated by shareholders as it puts cash in their pockets and signals confidence on the part of the directors

The directors would appear to be able to pay a $3 million dividend with some confidence.

2 *Ex poste under the 1955 Act*

Suppose the company went into liquidation shortly afterwards when spring storms killed lambs and intensified competition in the industry. The liquidator could recover the dividend from either the shareholders (on the basis they had received monies not belonging to them) or from the directors (for misapplication of company funds). To recover the dividend the liquidator would have to show that one or more of the legal requirements for the payment of dividends were not met.

The rules against return of capital would be the first consideration. The nimble dividend rule is well established so the $3 million could not be claimed on this basis.

The liquidator would be unlikely to claim the balance sheet solvency test was not met. While a different valuation basis might have shown a shortfall (eg Diagram 3) it is well established that the directors have the power to determine the appropriate valuation basis. There is no evidence that the directors did not act in good faith when making that decision so a court would be unlikely to intervene. The concurrence of the auditors in the valuation basis strengthens the directors' position.

Challenging the trading solvency limb is intuitively more likely to be successful. The company has become insolvent soon after the payment suggesting that it was not in fact solvent at the time of the payment. However the trading solvency test is forward looking. The directors must forecast the future, a very inexact science. The difficulties in making forecasts makes the courts reluctant to question such forecasts after the event.[112] The directors' views are again corroborated by outside parties. The auditors signed the accounts on the assumption the business was a going concern. The banks assumed the business would continue at the time they were approached about the dividend.

If the courts will not interfere in the decisions made above it is unlikely that they will interfere based on a general duty to creditors. As noted above the duty may not exist and if it does its scope is probably limited to

112 For example in *Permakraft*, above n 108, 253, Cooke P pointed out "[the] directors were entitled to consider the long term position" and "[hindsight] can lead to a subconscious applying of too high a standard". The judgements of Cooke P and Richardson and Somers JJ frequently refer to the good faith and honesty with which the directors took the decision as preventing any questioning of the directors' findings by the courts.

increasing the standard of care the directors must meet when making distribution decisions.

If the directors had failed to prepare a balance sheet or had not considered issues such as trading solvency then the courts would be more able to impose their judgement on the facts. Even so the major cause of failure would appear to be the weather rather than the dividend and a court would be unlikely to impose liability on the shareholders or directors. In a large company such as this the directors would virtually always have considered these issues as part of the process of getting the banks' approval and protecting their position under the debenture trust deed.

3 *Ex ante under the 1993 Act*

The 1993 Act does not distinguish between nominal capital and retained earnings so the issues of nimble dividends and of whether a capital profit is payable are not relevant. The directors can pay any amount as a dividend so long as the solvency test and general directors duties are met. In the current example the major constraint on the amount of the dividend would be the debenture trust deed ratios and the bank's approvals.

The balance sheet limb of the solvency test under the 1993 Act requires that "the value of the company's assets is greater than the value of its liabilities, including contingent liabilities".[113] The "matters requiring consideration"[114] include a requirement to have reference to the last set of accounts prepared under the Financial Reporting Act 1993 ("the FRA") and to consider all other circumstances which might affect the value of the company's assets. The last set of accounts prepared under the FRA could be up to seventeen months old. The 1993

113 Section 4(1)(b).
114 Section 4(2).

Act might therefore appear to weaken the 1955 Act requirement that accounts be drawn up at the time the dividend is proposed. However the "other circumstances" would include trading gains and losses in the period since the last set of FRA accounts. Preparation of a set of accounts at the time the dividend is proposed would still appear to be necessary.

The reference to the FRA accounts is a clear indication that the directors remain responsible for determining the valuations of assets within the bounds of accepted accounting practice. The balance sheet solvency test under the 1993 Act appears to be identical in operation to the 1955 Act test.

The trading solvency limb is also identical under both Acts. The discussion of factors for the directors to consider under the 1955 Act applies to the 1993 Act.

The one significant difference is the introduction of certification requirements. The directors must sign a certificate stating the solvency test is met and the grounds for that opinion.

These parties rights are not affected by the change in the legislation. The restrictions the creditors place on the company remain a second hurdle for the directors when contemplating a dividend.

4 Ex poste under the 1993 Act

Where the directors have signed the required certificate the directors' position is at least as strong as under the 1955 Act. The liquidator must prove not only that the company did not meet the solvency test at the time but also that the directors did not have any reasonable grounds for believing the solvency test was met. The liquidator's position is improved at a practical level as the certificate will provide the basis of the directors' opinion.

This allows the liquidator to examine that basis for any flaws and get a better idea of the prospects of success in court. In the current example the certificate will refer to the balance sheet, the cashflow forecasts, the debenture tests and the banks' assurances of continued support. The liquidator would be unlikely to attempt an action given these facts.

If the directors do not sign the certificate the position may be easier for the liquidator. The 1993 Act imposes liability where the procedure has not been followed and the distribution breached the solvency test. The same section[115] covers the position where the directors did sign the certificate but lacked reasonable grounds for doing so. This implies the precondition in subsection 56(1) is an objective test of whether the company was solvent. This suggests that where the certificate procedure is not followed the court should focus on the objective facts rather than on whether the directors' had acted in good faith on reasonable grounds. The court would then be able to impose its own decision rather than merely reviewing the directors' decision. The liquidator would be able to bring forward independent experts as witnesses to show the company did not meet the test whereas if the certification process was followed the liquidator could only bring forward witnesses if their evidence would show the directors' could not have had reasonable grounds for their decision.

This position is similar to the position under the 1955 Act where the directors failed to prepare a set of accounts and consider the appropriate factors before making the distribution. Under the 1955 Act the directors would then have to present evidence showing the company was solvent after the distribution. However the 1993 Act may create greater risk for the directors as if the procedure has not been followed the court would appear to be able

115 Section 56.

to impose its own judgement even if the directors have prepared their own set of accounts and considered the appropriate matters. Until a case comes before the courts it is difficult to predict how willing to interfere the courts will be when the directors failure was limited to formalities. Historically the courts have been reluctant to question the directors' decisions but the new Act may be interpreted by the courts as changing their role.

In the current circumstances a court would probably still conclude the solvency test was met but in some instances the failure to follow the formalities of the Act could significantly harm shareholders and directors.

If the liquidator is able to prove the dividend was paid in breach of the solvency test the position of the directors and shareholders is similar to that under the 1955 Act. As outlined above the liquidator can recover the dividend from the shareholders unless it is unfair to do so and any remaining shortfall can be recovered from the directors. Where the formalities were not followed the directors face an additional risk of a penalty up to $5,000.

5 *Conclusion on this transaction*

As in the earlier transactions the major practical difference between the position under the 1955 Act and that under the 1993 Act is that under the 1993 Act the failure to follow the formalities laid down by the Act increases the probability of liability. The only other practical change would appear to be the elimination of the rules against repayment of capital. The elimination of these rules could potentially allow a larger dividend to be paid. Unlike in the previous transactions the certification requirement appears to be more useful to the liquidator as a source of information about the directors' decision.

F The Provision of Loans to Shareholders

1 Ex ante

Where a company is owned by another company the owning (or holding) company will have control over the second (or subsidiary) company and an entitlement to any surplus of assets over liabilities in the subsidiary. The shareholders of the holding company will usually[116] be indifferent as to whether assets are held or profits are made by one company in the group rather than another. From an economic perspective the shareholders will treat the group as a single investment.

For creditors however the distinction between the legal entities is more significant. If assets or profits are moved between companies in a group particular creditors may be harmed or benefited as the creditors' claims are against particular members of the group. In most circumstances the creditor cannot recover the debt from other members of the group.

In some circumstances a creditor may find this legal separation a disadvantage but in others it is of considerable benefit. While the creditor cannot claim debts from other group companies the creditors of those companies can also not claim the assets of the debtor company. This increases the chances of the creditor being paid.

The group structure thus creates conflicts in the interests of different creditors even though both may be creditors of the same economic entity. The structure also creates conflicts for directors who owe a duty to the company

116 The exception is where a particular company does not have a surplus while others do. The shareholders will then have an incentive to move assets and profits from the companies with deficits to those with surpluses.

whose board they sit on but are appointed by the shareholders of the group.

As noted earlier both Acts regulate the situation where a company in a group provides financial assistance to shareholders for the purchase of shares in that company. In the group of companies the more common movement of wealth between companies will be in the form of loans or guarantees for other purposes. As noted above the giving of financial assistance to a shareholder is not prima facie a distribution. As an example when Trustbank loans money to a customer shareholder as a part of its normal business no distribution of wealth occurs. Trustbank is fully compensated for the loan by the interest payments and any collateral provided. Where the loan is within a group of companies there is a greater probability that a distribution of wealth is occurring. The company is not in the business of lending large sums so the transaction will be outside the experience of the directors. The directors will have some control over the other company and a level of knowledge of and confidence in that other company that will be higher than that of a third party lender. The directors of the provider will therefore often set the interest rate and collateral requirements lower than a third party lender would. The lower interest rate and reduced (or non existent) security requirements are the reason the funds are sought from within the group. The informational advantages may justify the lower interest rate but it is more likely that the lower rate represents a removal of wealth from the company.

Our example involves H, the holding company and two 100% owned subsidiaries. The two subsidiaries are H's only assets. A is a construction company. The industry norm is that at the end of each month the company will send the client a certificate stating the percentage completion of the project. The client will then pay this percentage of the construction fee within seven days. The company sub contracts most of its work and pays the sub contractors one month after they have invoiced the company. A ten percent retention is deducted from the payment to cover any defects of workmanship discovered later. The retention is held for six months to a year. The result is that the company is receiving money from its debtors well before it has to pay its creditors. The sums involved are significant and the cash is held in the bank. The cash rich nature of the industry has allowed the group to keep its equity in A at low levels. Profits have been extracted to pay dividends to H's shareholders and to invest in B.

B is a property investment and development company. It owns a number of parcels of land for the purposes of resale or development. Usually A would be the construction manager for any developments. Prior to the property market slump B was A's biggest customer. Post slump B is in financial difficulty. The market has fallen dramatically slashing the value of B's property portfolio from $120 million to $30 million. Any sales of the development property would be at a loss. The company's income is insufficient to pay the interest on its borrowings. The plummeting market value of B's land has caused B's banks to become concerned. There is a possibility that a receiver will be appointed.

The directors of H, A and B are identical. The directors believe that the property slump is temporary and that if B can avoid selling the properties they will recover in value within a few years. The directors decide that the solution is to loan A's cash to B. B will use the funds to repay the bank debt and will borrow further funds to pay the interest on the loan. The directors do not expect that B will need to use the cash in the next three years as the company has sufficient contracts to keep operations (and thus debt to sub contractors) at current levels. The directors believe the value of the properties (previously $100 million) will have recovered sufficiently in that time to allow realisation of some of the property. Hopefully B will also then be able to provide A with development work.

Diagram 4. Intercompany Loan

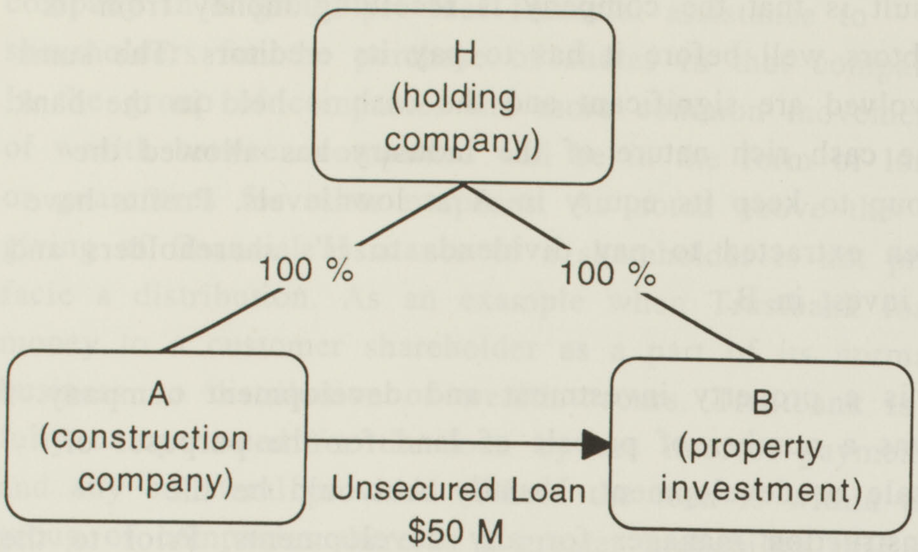

Diagram 5: Balance Sheet of A (after loan)

Current Assets	($M)	**Current Liabilities**	($M)
WIP	100	Sub Contractors	55
Debtors	15	Sundry Creditors	10
Loan to A	50	Advances from Customers	105
	165		165
Fixed Assets		**Owner's Equity**	
Plant	11	Capital Contributed	1
		Retained Earnings	10
	11		11
	176		176

Diagram 6: Balance Sheet of B (after loan)

Current Assets	($M)	Current Liabilities	($M)
Debtors	1	Loan from A	50
Development Property	30	Sundry Creditors	1
	31		51
		Owner's Equity	
		Capital Contributed	40
		Retained Earnings	(60)
			(20)
	31		31

The transaction is clearly beneficial to B. From H's perspective the transaction creates a risk that if property prices do not recover then the investment in A will be lost. However the potential loss ($11 million of equity plus the value of A's goodwill) must be weighed against the potential gain. Without the loan B is valueless. If the loan is made there is a strong chance that B will bounce back to profitability. If prices rebounded to even half their previous levels B would be worth $10 million, virtually doubling H's assets. Further developing B's properties might help retain the goodwill in A. The transaction is thus a sensible one from the point of view of H.

It is in their role as directors of A that the directors need to be concerned. If property values do not recover before A needs the cash then B will become insolvent and creditors will suffer a loss of at least $9 million. The failure of A may create a risk to clients whose projects were only partly completed. If prices do recover then A will receive back its money as well as interest calculated at a small premium on what it received from the bank. A may also gain business from B. From A's perspective the risk is high and the reward is small.

Neither Act directly addresses this situation. Only the general directors duties impact on the actions of A's directors. Under the 1955 Act the director's duties were largely to be found in the case law. Under the 1993 Act those duties are mostly stated in the Act. Nonetheless the courts will have a significant role in interpreting the scope of the duties stated in the 1993 Act.

Under the 1955 Act the fundamental duty of the directors was to act in good faith in the best interests of the company.[117] This duty is preserved by section 131 of the 1993 Act. This duty creates a problem in this situation however. The directors are nominees, that is they are appointed by H and have some responsibility to act in the best interests of the shareholders. Under the 1955 Act there was some uncertainty as to whether nominee directors could take an action not in the best interests of the subsidiary merely because it was in the interests of the person appointing them. By 1990 the courts appeared to have concluded that the nominee directors must act in the interests of the subsidiary where there is a conflict.[118] The 1993 Act expressly reverses this ruling by allowing nominee directors to act in the best interests of the holding company if the constitution so allows.[119]

The 1955 Act gave the liquidator the right to obtain a contribution from the directors where the directors had been a party to the contracting of obligations by the company without an honest belief on reasonable grounds that the company would be able to pay its debts when they fell due.[120] The 1993 Act contains a duty to not allow the

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117 For a discussion of this duty and relevant cases see JF Northey *Introduction to Company Law in New Zealand* (8ed, Butterworths, Wellington, 1976), 189-194.

118 See A. Beck, A. Borrowdale *Guidebook to New Zealand Companies and Securities Law* (5 ed, CCH, Auckland, 1994), para 313. The Privy Council, sitting in right of New Zealand, in *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1990] 3 NZLR 513 rejected earlier New Zealand and Australian cases allowing directors to act in the interests of the holding company.

119 Section 131(1).

120 Section 320.

incurring of obligations without a belief on reasonable grounds that the obligation can be fulfilled.

As mentioned above several court decisions[121] had indicated there might be a duty to creditors where the company was in or was near insolvency. The 1993 Act creates a duty to not allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the creditors of the company.[122]

The directors will not want to breach any of these duties as the potential liability is substantial. As noted above the directors strongly believe the property market will recover and that no losses will occur. The directors will want to ensure the courts accept that belief was reasonable if the market does not recover and a liquidator is appointed.

Given the significance of the decision the directors should take all possible steps to inform themselves before making a decision. One such step would be to obtain a comprehensive report on the prospects for the property market. The report could be prepared by a property consultancy or valuer. It may be beneficial to obtain reports from more than one source. A report on the likelihood that the company will need to use any of the $50 million for repayment of creditors should also be prepared. Assuming all these reports support the directors original view[123] the directors will be in a much better position to defend any action[124] for breach of the duty to avoid

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121 In particular Permakraft, above n 108, and Hilton, above n 105.

122 Section 135. J Hodder in *Company Law I - Getting Started New Zealand* (Law Society Seminar Wellington 1994) 48, 52 suggests that this provision will be treated by the courts as continuing the approach in Permakraft, above n 108. Hodder considers the effect of this would appear to be to prevent the directors from using the creditors funds to support speculative transactions.

123 Cynics would suggest that the reports will be guaranteed to do so if the directors make the conclusions they are hoping for clear to the "independent" consultants they employ.

124 Section 138 of the 1993 Act explicitly allows the directors to rely on reports from experts so long as the director has acted in good faith. The same position existed under the 1955 Act.

creating a substantial risk of serious loss to the creditors or of incurring obligations when unable to perform them. It is more difficult to see how the directors could justify the decision as being in the best interests of A. Under the 1993 Act the directors should ensure the relevant clauses are inserted in the constitution to get around this problem.

The courts have historically been reluctant to interfere in directors decisions. The courts have principally avoided doing so by the use of two devices. The first is to require some evidence of improper purpose[125] or lack of good faith before being willing to examine a particular decision of the directors. The second has been to set the standard of care required of directors at a lower standard. The term gross or culpable negligence has been used to distinguish the test of a directors' decision from that of "what might be described as ordinary or standard negligence".[126] The 1993 Act explicitly states the standard of care[127] but it is unclear whether this changes the position from that under the 1955 Act.[128]

Under the 1993 Act the directors will probably be safe from actions by the liquidator if the above steps are taken. Their position under the 1955 Act is more tenuous due to

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125 The courts might potentially be more willing to intervene in this decision as the directors have a conflict of interest in the decision by virtue of their duties to H and B. Where there is evidence of such a conflict the courts will be more willing to hear evidence that the decision was not made for the proper purposes.

126 per Gallen J in *Grayburn* v *Laing* [1991] 1 NZLR 482, 490. The case was one of the Cory Wright Salmond cases. The deputy chairman of the failed group was seeking an injunction preventing the liquidator bringing an action for breach of his duties as a director. The injunction was granted in respect of some claims of the liquidator on the basis that the liquidator had failed to present evidence sufficient to show gross negligence. Gallen J rejected the liquidator's contention that section 321 of the 1955 Act referred to ordinary rather than gross negligence.

127 Section 137 states "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 ...".

128 For a detailed discussion of this question see D.O. Jones *Company Law in New Zealand* .

the presence of the fundamental duty. While there may be some benefits to A in propping up B these are clearly outweighed by the risks. Under either Act there is sufficient uncertainty that the directors should probably also check their insurance policies to ensure this situation is covered.

The creditors do not have a statutory right to object to such a loan. The creditors could contract for such a right but this is unlikely in this situation. The banks might give themselves such a power (either formally or informally by making the loan a short term one) but the banks have exited the group in exchange for the $50 million cash. The sub contractors are unlikely to contract for such rights because they are mostly owed small amounts so the monitoring costs would outweigh the gains. Further the sub contractors are mostly tradespeople to whom such information would be meaningless. The clients of A will probably assess A's financial standing before contracting with A but are unlikely to do so in detail or to impose restrictive covenants on A.

The shareholder is H who benefits from the transaction and is represented by the directors of A. H strongly supports the making of the loan.

2 *Ex poste*

The creditors of A would appoint a liquidator who would then wind up A and seek repayment from B. The mortgages over the property would be foreclosed on and the property sold. As B has no other assets A's liquidator would not bother to seek repayment of the shortfall from B. Instead the liquidator would examine the possibility of recovering the losses from the directors of A.

In order to bring a claim the liquidator must present evidence of a breach of a duty.[129] Under the 1955 Act duties which may have been breached are the fundamental duty, the duty to creditors (if it exists) and the reckless trading provision. Under the 1993 Act the breach of the fundamental duty is allowed by the constitution but breaches of the other two duties are actionable.

Where a duty of the directors has been breached a tortious claim can be brought against the directors for recovery of the losses. As noted above it is difficult to assess how the court will treat the claim. Courts will usually adopt the view of Cooke P in *Permakraft* that "[those] minded to commence trading with and give credit to a limited liability company ... must normally take the company as it is when they elect to do business with it. Short of fraud they must be the guardians of their own interests"[130] and "[there] is no good reason for cultivating a paternal concern to protect business people perfectly able to look after themselves."[131] These factors together with the clear evidence that the directors had carefully considered the risks and obtained expert advice before making their decision will make the court reluctant to find the directors in breach of their duties. To do so would require the court to substitute its own speculation for that of the directors.

If a court found the directors had breached one or more of their duties the directors will be liable either for damages in tort for the breach of duty or for a contribution under section 320 of the 1955 Act. There are no penalties for breach of these duties. The directors face greater risks on this transaction than on the others both because the transaction is larger than the others and because most distributions are recovered from the recipients and the director is liable only for the remainder.

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129 Section 320 of the 1955 Act is not stated to be a duty but it has the same effect as the duty under section 136 of the 1993 Act.

130 Above n 108, 250

131 Above n 108, 250.

The shareholder cannot be held liable under the 1955 Act. However H may have agreed to indemnify the directors of A for any damages awarded against them. Under the 1993 Act the shareholder, H, might be treated as a director and therefore liable for any breach found by the court.

In this example H has no assets other than A and B and so it is unlikely the liquidator would seek damages or the directors seek indemnification.

3 Conclusion on this transaction

The transaction probably imposes a greater risk on creditors than the earlier distribution transactions did but is not regulated directly by either Act. The fundamental duty under the 1955 Act probably would make the transaction a breach of the directors duties. Under the 1993 Act this duty can be avoided. The reckless trading provision (cf the trading solvency test) would not appear to be breached as the directors can show they reasonably believed all obligations could be performed. The substantial risk of loss provision and the similar duty to creditors under the 1955 Act both present a greater risk for the directors. Nonetheless the directors should be able to avoid liability by obtaining expert advice before making the decision. Unfortunately the non specific nature of the duties and the lack of case law[132] on this fact situation make it impossible to be certain that the directors will not be held liable however. The directors should therefore check their insurance policies as a safety measure.

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132 The lack of case law is at least partly due to the low standard of care historically adopted by the courts. As a result there have been few cases brought for negligence by directors. Instead cases have usually been brought under the rules against oppression of minorities, acting for improper purposes etc. as these most instances where the directors could be shown to have breached the low duty of care involve one of these situations.

G *Conclusions on the Comparisons Between the Two Acts*

1 *Substance*

The 1993 Act does not materially affect either the ability of the directors to make distributions or the circumstances in which those distributions can be recovered. In some circumstances the 1993 Act specifically allows distributions which would previously have been constrained either by the capital maintenance regime or by directors' duties (eg returns of capital) however the number of methods available mean unblocking these routes may be of little practical effect.

The major difference in practice between the 1955 and 1993 Acts is the implementation of a scheme of certification for some distribution decisions. In some instances the certification requirement would provide useful information to the liquidator but in others the information content is limited. In many circumstances where such a requirement would be useful it is absent. Where the formalities required by the certification process are followed the directors position is largely unchanged. Where the formalities are not followed significant liabilities can result. The principle effect of the certification regime would appear to be to make the use of the company form hazardous to persons without the resources to obtain professional advice.

2 *Misrepresentation*

The 1993 Act may however deal with another problem under the 1955 Act, misrepresentation. The form of the capital maintenance regime under the 1955 Act could be misleading to unsophisticated parties dealing with the company. The man in street typically interprets the nominal capital as representing cash assets available as a trust fund for creditors. Even more sophisticated persons who are aware of the double entry book keeping system would expect that the nominal capital was represented by some assets. This impression can be highly misleading as was shown in the dividend transaction . There was no requirement that the capital be maintained so losses can reduce the real capital of the business. The records kept at the Companies Office showed the nominal capital but not the losses incurred. Further assets are measured on a historical cost rather than a realisable value basis so that even where no losses had been declared there may be insufficient assets to cover all debts of the company. The nimble dividend concept exacerbated this misrepresentation by allowing distributions from the company when the capital of the company was impaired.

The rules regarding capital maintenance were complex and not widely understood. The general public perceived the rules provided a greater level of protection against company failure than the rules actually did. To the extent that the rules were complex, convoluted, formalistic and misleading their restatement or reform was needed.

The distribution rules in the Companies Act 1993 are certainly easier to follow than those in the 1955 Act. Nonetheless the publicity surrounding the solvency test and its purported role as a fundamental protection against company failure probably means the misrepresentation continues. The original proposals for the solvency test included a requirement that the assets be measured at realisable value for the purposes of the balance sheet limb. The dropping of this requirement when passing the Act was not heavily publicised adding to the misrepresentation. The failure to make it clear to even the professional community that the solvency test as enacted was merely a restatement of an existing rule exacerbates the misrepresentation. As the creditors and investors become more familiar with the 1993 Act the misrepresentation aspect should be reduced as the wording of the test is reasonably clear.

IV THE DESIRABILITY OF THE 1993 ACT REGIME

The comparison of the effects of the two Acts contained in Part III suggested that the 1993 Act did little more than restate the rules which existed under the 1955 Act and implement some formalities as a trap for the unwary. No significant substantive changes occurred. The obvious question to ask is whether this is a good thing or a bad thing.

When answering this question it should be remembered that the company is merely the legal form in which a business is run. The actions of the business cannot be regulated by company law as this would merely encourage businesses to use other legal forms. Thus the company statute is not a good place to regulate workers rights or environmental issues. A nuclear power plant business will have little hesitation in using the special partnership regime to avoid any substantive restrictions relating to companies.

Another factor to consider is that the issues being dealt with involve only monetary loss rather than physical harm. Monetary loss can be as significant or more so than physical harm[133] but the fact that only monetary loss involved is important. As all benefits and costs relating to the company form are monetary company law is highly susceptible to economic analysis.[134] In determining whether the results are desirable considerable emphasis will be placed on economic analysis.[135] As in all economic

133 As an example most people would prefer losing their little finger to losing their life savings.

134 There are those who argue that all law is susceptible to economic analysis but where the issues are closely related to physical or emotional harm the problems involved in converting outcomes to a comparable unit make the analysis of limited practical utility.

135 This paper does not purport to be a comprehensive coverage of these issues. For a more detailed examination of the economic role of the

analysis the goal is to achieve the best balance between costs and benefits.

With the above two points in mind the analysis of the rules in the two Acts can proceed. The two Acts are principally enabling statutes in that they provide the legal authority for the creation of companies. The distribution rules are primarily restrictive rather than enabling. Restrictions are created to protect someone or something. The first step in analysing whether the restrictions are appropriate is to identify who should be protected and from what. The alternative regimes available need to be examined and the cost and benefits of the protection they would provide assessed. Finally the ideal solution can be compared to that arrived at under the two Acts.

A The Need for Protection

Companies deal with a wide range of parties in a wide range of situations. However as noted above the effects the company has on those parties are little different to those of a business run in any other form. The only unique aspect of the company form is that people who invest in the company can limit their exposure to the company to a fixed amount. This is known as limited liability.

One result of limited liability is that the investors face a lower level of risk than they would if they invested in a partnership or traded as a sole proprietor. However the risk of the business run by the company is unaffected by the legal form. A business that is searching for oil is inherently riskier than a business that provides rental accommodation to government departments on long term leases. Since the risk inherent in the business is fixed the reduction is risk to the shareholders must be compensated for by an increase in risk to other parties. Those other

corporation see FH Easterbrook and DR Fischel *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, 1991).

parties fall into two categories: creditors and involuntary creditors. The creditors are those who contract with the company to provide goods or services with delayed payment. Involuntary creditors are those who had not intended to become creditors of the company but did so due to some misfeasance of the company or its agents.

In a perfect market the creditors would contract to obtain a reward for the risks they had assumed. The higher the risk placed on the creditors the higher the return they would require. The existence of the limited liability company would be irrelevant to the business world as all the risks would have to be paid for. In the real world creditors and shareholders both face problems, transaction costs and monitoring costs. The limited liability form is used because it helps resolve those problems.

Both shareholders and creditors must monitor the company to determine the level of risk they face and thus the return they will require. Some creditors (eg banks) may have greater expertise at monitoring the company. Both shareholders and other creditors may then be able to reduce their own levels of monitoring. As the shareholders' investment is wiped out first the shareholders have a markedly greater incentive for monitoring the investment. In a listed company the existence of institutional investors and parties interested in taking over the enterprise may reduce the need for individual shareholders to monitor the company's management. The creditors may therefore rely on the shareholders' personal incentive to monitor performance.

Both creditors and shareholders will monitor only to the extent that they perceive the gains from additional monitoring will exceed the costs. Where the monitoring of another party serves the purpose other parties may not need to monitor. The lower level of monitoring may result in some random errors. Both shareholders and creditors can eliminate this random risk by investing[136] in many companies. If the economy as a whole continues to grow then the periodic losses from failed companies will be offset by the profits made on the successful investments.

The above logic suggest there is a need for at least some equity investment in companies as the equity investors are able to monitor more efficiently and thereby reduce the overall monitoring costs (because they also monitor on behalf of creditors) . This explains why businesses are not financed solely by debt but does not explain limited liability. Another monitoring cost does.

If it were not for limited liability shareholders would need to monitor not only the investment but the other shareholders. Because liability would be joint and several each shareholders risk would be greatly affected by the personal wealth of the others. A poor shareholder would not be able to pay its share of any liability imposing that liability on the other shareholders. Shares would not be alienable because of the risks this would impose on the other shareholders. Further shareholders could not diversify away risk because new investments would increase risk.

Without these features it would be difficult for businesses requiring substantial capital to obtain that capital as the larger the enterprise and the more the shareholders the greater the risk to each shareholder and the costs of monitoring the other shareholders and the business.[137] It would also be difficult for businesses with a high risk to

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136 The creditor is an investor. While creditors have priority over the shareholders on winding up they finance the company's assets in exchange for a return on their money.

137 It may be noted that many of these arguments are not as strong for the closely held company. For example closely held companies do not usually represent an attempt at diversification, the alienability of shares is limited by contract and shareholders are involved in the business day to day - the ultimate in monitoring. The economic and social utility of the limited liability company may not be as great in closely held companies.

obtain finance. In a limited liability world the investor's diversification allows the investor to invest in relatively risky projects on the basis the expected return will on average be achieved.[138] Without limited liability the investor would have to limit the number of investments and would be less willing to invest in risky ones as the risk cannot be diversified away.

The limited liability company thus encourages economic activity, allows the development of large enterprises with the resources to undertake beneficial research and supports the undertaking of risky projects with high rewards (eg the development of a cure for cancer). The limited liability company is thus of benefit to society.

Why then do we regulate such a social good? The answer lies in transaction costs. While each investor could contract to set a risk:reward structure that was fair to them the costs of drawing up such contracts might outweigh the benefits gained. The creditor may prefer to use a more standardised contract. The terms of the standard contract will be set based on some conception of the expected risks of companies in general. The diversification principal stated earlier would then allow the investor to eliminate the random risk associated with this standard contract.[139]

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138 Note that the debt investor achieves the same objective in the same manner - the investment is the total exposure of the creditor to the company.

139 The transaction cost problem is particularly serious for the involuntary creditor who may not have even known of the existence of the company before the accident which created the creditor relationship. The only possible ways of controlling this risk are insurance or the imposition of legal rules. Note however eliminating or heavily restricting the limited liability company would not eliminate the placing of risk on creditors. Many individuals declare bankruptcy with significant number of creditors. Often companies will have greater equity than sole proprietorships or partnerships operating in the same filed, providing greater protection for involuntary creditors. Nonetheless the limited liability company poses a particular risk as the incentive of avoiding personal bankruptcy may not be present, particularly if the company is undercapitalised. If it is accepted that the limited liability company offers sufficient social benefits to outweigh the disadvantages then the focus must be on controlling the risk to creditors to keep it within acceptable bounds.

Society has an interest in regulating to provide some minimum level of protection for creditors in order to reduce these transaction and monitoring costs. If a creditor can rely on any company as presenting no more than a certain amount of risk then the need for individual contracts and investigation of all debtors positions can be reduced. Where the creditor requires a higher level of protection this can be contracted for. The question is at what level should the protection be set. The level must not be so low as to be of no use to creditors and not so high as to impose excessive restrictions on the use of the company form.

The Law Commission noted a clear "... perception in the community that our system of company law [had] been unequal to the task of preventing abuse."[140] Abuse has two adverse consequences. The first is the unsanctioned redistribution of wealth from creditors to owners. The second is the loss of confidence in the company as a contracting party. The use of Romalpa clauses, personal guarantees and related security mechanisms have all derived from a distrust of the company as a trading partner. The development of these security mechanisms inhibits the flexibility of the company form and erodes limitation of liability. Such mechanisms also erode the transaction cost advantages associated with the company form.[141]

Since our goal is to control the risk to creditors we need to examine the factors affecting that risk. Where the creditor is fully secured the creditors risk is reflected in the risk that the value of the collateral will fall or that the security is not perfected. Where the creditor is not fully secured

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140 Above n 1, 8.

141 The increasing prevalence of such mechanisms and others, such as credit insurance for farmers sending stock to works, also provide a refutation of claims by some that parties cannot not freely contract with companies but are forced to accept the terms set.

the creditors risk will depend on the probability of the company having cash to pay the debt or a surplus on winding up. All else equal the inherent risk in the business will affect the creditors risk. All else equal the likelihood of loss to the creditors will be inversely proportional to the level of shareholder's equity in the business. The level of equity in the business will be determined by the size of the business and the amount of equity. A million dollars of equity is sufficient to provide ample creditor protection in a company running a corner diary but provides a meaningless level of creditor protection in a large oil exploration company which might spend ten of millions on investigating a single prospect. The amount of equity will be affected by three things: the amount of equity initially contributed, the amount of equity distributed back to shareholders and the amount of profits or losses experienced during the course of operation.

Diagram 7. The factors affecting creditor risk

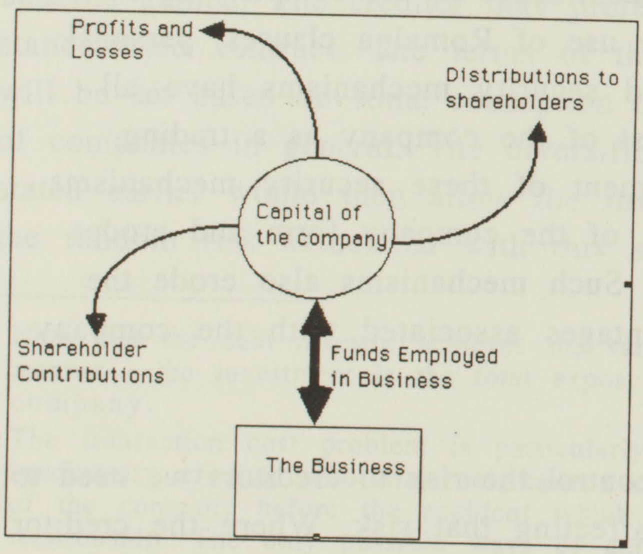

Diagram 7 above shows the factors affecting creditor risk. While factors such as the competency of management will be relevant to creditor risk this area is beyond the scope of this paper. Our discussion will focus on the net level of equity in the business. The clear point which the diagram makes is that regulating distributions rather than capital is of little value to creditors. Typically creditors will be investing some time after the formation of the company The contributed capital will be equal the true capital only by chance.

The reluctance to interfere with real capital requirements limits the utility of the protections. The greater willingness to regulate distributions no doubt arises from the fact that the distribution increases the risk of a creditor after the creditor has invested whereas capital introduction occurs beforehand. Ex poste regulating dividends seems to provide increased creditor protection. In reality sophisticated equity investors will get around this problem by establishing low levels of equity at the start. This allows them freedom to withdraw their funds (contributed as debt) more readily. In closely held companies and groups of companies the ability to extract wealth under the pretext of legitimate exchanges of value (ie. via the profit and loss) further erodes the worth of the restrictions on distributions. To be purposive the restrictions must be placed on the level of equity rather than just distributions.[142]

B Options

The first option in this area is to have no regulation of companies at all. While the company form has social benefits there are clearly risks associated. The running of a company using only debt investors funds would have few of the benefits and all of the risks associated with the company form. In the absence of principles allowing recovery from directors in cases of fraud the company would be a social liability. The existence of fraud also

142 Thus even the California rules which provide substantive restrictions on dividend payments covering not only the quantity of equity but also the quality still do not provide significant creditor protection. For a detailed discussion of the California rules see T.C. Ackerman and JK Sterrett "California's New Approach to Dividends and Reacquisitions of Shares" (1976) 23 UCLA Law Rev , 1052.

detracts from the contract with the creditor. Some regulation of companies is required.

The next option is to rely on the general directors duties. Company law inevitably has some general prohibition on actions which render the company insolvent or create a significant risk of insolvency.[143] Making a distribution or running a business with inadequate capital are actions affected by that general prohibition. The reliance on these general duties would provide a level of creditor protection which may be superior to a detailed formula. As with the introduction of any detailed legal rule introducing a specific test relating to distributions may create more opportunities for abuse than it eliminates.

The major criticism of relying on the general prohibition is based on the fact that capital maintenance and particularly dividends are unusual transactions for companies because they are intended to remove wealth rather than create it. Thus the reasonable care standard required before entering other transactions may be too low where distributions occur. The concern is that in some circumstances a board of directors might have reasonable grounds to make a run an under capitalised company based on forecast profits which never eventuate. The creditors would then lose out and no action would be available as the directors had met the required duty of care.

While the 1993 Act has the solvency test[144] in reality the standards set by that test are not higher than those set by

143 In the 1993 Act these prohibitions are contained in sections 135 and 136.

144 The solvency test may be included either as part of the intention of making the scheme of the Act clearer. It is more likely however that its inclusion is a historical accident. The original Law Commission draft, see n 1 above, contained a solvency test which used realisable value as the test for distributions, a higher standard then the general duties. The Law Commission draft also did not include section 136. The subsequent alterations to the Act by the Justice Department show little evidence of an understanding of the scheme of the Act. The

the general duties. The trading limb is identical to section 136 and the balance sheet limb is very similar to the effect of section 135. The directors are not liable for any distribution if they meet the general directors standard of care. Shareholder recovery would be possible under the general rules as a receipt of money to which they were not entitled. Further for most types of distribution the general duties are the only protections in place. Given the difficulty of distinguishing between legitimate exchanges and distributions it is appropriate that a more general test be used.

Requiring some minimum level of capitalisation has an inherent appeal given the traditional model of the company, particularly the notion that the equity investor increases the efficiency of the monitoring of the company, and the close relationship between equity and creditor rsik. The model operates on the basis that the shareholders contribute an amount of money which acts as a buffer in the event of losses protecting creditors. The shareholders thus take most of the risk and in return receive most of the reward. The existence of nominal capital companies challenges this assumption in practice.

There would appear to be merit in stamping out such companies.[145] Two options are available. The first is a statutory minimum level of contributed capital. The Macarthur Committee recommended a minimum statutory capital of $2,000.[146] Such an amount would be completely arbitrary. The amount would either be large and thus

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Department probably did not recognise the redundancy of the solvency test after the changes.

145 Nominal capital was to some extent a tax driven phenomena. Contributed capital could not be extracted without going to the High Court which is a costly procedure. Funds could be introduced as loans leaving much the same risk exposure on the shareholders as contributed capital but allowing funds to be extracted as loan repayments rather than as dividends which would be taxed. The dividend imputation credit regime has partly resolved these tax issues. The proposed ordering rules which would allow repurchased shares to be used to extract contributed capital would eliminate the first.

146 Above n 1, 54.

inappropriate for small companies or small and thus of no use. Both the Law Commission[147] and the Jenkins Committee[148] rejected the concept as being of no value.[149]

An alternative is to allow the company to set its own minimum capital.[150] Typical credit application forms request the capital of the company and could use the capital as part of their judgement of a company's credit worthiness. It has been suggested that the creditor's assumption that the capital is available as a buffer against losses is so strong as to create almost an implied term in the contract between the creditors and the company that the capital contributed to the company will be maintained.[151]

The stated minimum capital approach has a number of disadvantages however. The amount of capital contributed at the formation of a company may not be appropriate later in its life. Where a company expands using retained earnings over many years the capital may be a negligible portion of the shareholder's funds. Creditors typically lend against the shareholders funds rather than just the stated capital. Alternatively a company which has down sized might want to return part of its capital to shareholders. The general concept of a statute set minimum capital can

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147 Above n 1, 54.

148 Quoted from the Law Commission Report, above n 1, 54.

149 The discussion of the benefits of the company form suggested that closely held businesses may not offer the same benefits suggesting some way of debarring such companies is desirable. The problem which arises is in setting a meaningful rather than arbitrary level and in the many problems the regime would create for the use of companies as administrative conveniences in large company groups.

151 While capital maintenance rules were later codified they had their origins in this logic. In *Flitcroft's Case* (1882) 21 Ch D 519, 533-534 Sir George Jessel MR stated that "The creditor ... gives credit to ... the company on the faith of the representation that the capital shall be applied only for the purposes of the business and he therefore has a right to say that the corporation shall keep its capital and not return it to the shareholders..". The 1955 Act thus followed this pattern in part at least. Its major flaw was in failing to require maintenance of that capital.

thus be seen to be unsound in practice despite its inherent appeal.

A variation on the above concepts is to set the minimum capital using a percentage of assets. This approach would allow for later variations in the size of the company. The approach would also reflect commercial reality.[152] Setting the level would be difficult.

A statutory minimum would be inappropriate. As the Law Commission noted "what is an appropriate minimum capital for an enterprise depends upon what it does".[153] Relevant factors include the difficulty of realisation of the assets and the level of risk, the higher each is the higher the normal equity percentage. However allowing companies to set their own equity buffer could have some merit.[154] Companies could pick low percentages but parties dealing with them would know to take appropriate precautions. If the company's business changed a new percentage could be advertised and creditors could opt to cease trading with the company if the new level was considered too low.[155]

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152 Debenture trust deeds almost always contain a requirement that a certain equity percentage be maintained. Since companies with significant debt are usually subject to a debenture trust deed the self set equity buffer already exists in most companies. The debenture will often also contain requrements as to the quality of the equity (eg equity to be measured on realisable value or tests of company liquidity) and contain restrictions on the nature of the business the company may undertake. These debenture trust arrangements would be ideal proections for creditors. Unfortunately it is difficult for statutes to create such arrangements as individual companies require tailored agreements. Nonetheless some have tried, see the discussion at n 142 above.

153 Above n 1, 54.

154 In practice this is exactly what occurs. The debenture trust deed, an important part of company financing, implies ratios appropriate to the business. As seen in the dividend transaction these may even include seasonal variations.

155 For a discussion of the basic concept of a percentage equity buffer see M Hill "The New Company Law- Auditor v Director" (June 1991) New Zealand Society of Accountants Journal 54,.55.

The concept of a published equity buffer expressed in percentage terms may have merit but companies have the power to achieve this end already so no legislative intervention is required. Such intervention could be helpful as an educative tool however.

Having eliminated the buffer option and rejected a no rule system the only remaining alternative is maintain capital at a minimum level of zero, preferably by the use of basic directors duties..[156] This ensures that creditors funds are never distributed to the shareholders. The difficulty which arises with this option is determining when the shareholder's equity reaches zero. This could be left to general directors duties but some system must be adopted to allow the directors to confidently make assessments.

Shareholder's equity is equal to the total assets of the company less liabilities. The difficulty arises in valuing those assets and liabilities. The accounting profession has developed many valuation systems and disputes over which are appropriate to a particular situation are common. It is beyond the scope of this paper to examine such issues in detail but the general thrust is very important.

The many variations in valuation can be grouped into categories or systems. Two of these are prime contenders for the role of valuing shareholder wealth available for distribution. The first is Realisable value. The second is generally accepted accounting practice (GAAP).

The realisable value system of valuation is based on a simple premise. An asset, tangible or intangible, is worth

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156 In situations where the nature of the industry creates a substantial risk of loss for third parties there may be a need to ensure assets are available to compensate for any such loss. Legislating for that industry to have third party insurance or to provide performance bonds will allow realistic minimum levels to be set. It would also ensure use of other legal forms did not allow the statutory purpose to be avoided.

the amount it could be sold for. Generally the valuation system is based on a value realisable between a willing buyer and a willing seller not influenced by undue haste.[157]

GAAP is a theoretical line of consensus as to the appropriate treatment of accounting issues discernible in the amorphous body of accounting practice. In New Zealand Statements of Standard Accounting Practice (SSAPs) have provided guidance since 1973. More recently the enactment of the Financial Reporting Act 1993 ("the FRA") has created the Accounting Standards Review Board (ASRB).[158] The ASRB has the power to create Financial Reporting Standards (FRSs). The FRA also gives a definition of GAAP which includes following the relevant FRSs and where there are none defines GAAP as "...accounting policies that ... are appropriate in the circumstances ... and ... have authoritative support within the accounting profession in New Zealand."[159]

GAAP is based on several fundamental concepts.[160] One is that relevance (ie. usefulness) must often be compromised in order to achieve reliability. GAAP also makes three major assumptions about the entity. The first is that the entity is a going concern.[161] This has major consequences for the valuation of assets. Since it is assumed the company will continue indefinitely then unless the company proposes to sell the asset the resale value of the asset is not relevant. Instead the purchase value is used as

157 However if the reason for using this valuation system is to ensure that there are funds available to satisfy creditors in the event of a liquidation a fire sale value may be more appropriate. Depending on the class of asset the value in a fire sale may be dramatically lower than that in a normal sale.

158 Financial Reporting Act, s22.

159 Financial Reporting Act, s3.

160 See The Statement of Concepts for General Purpose Financial Reporting (issued by the Council, New Zealand Society of Accountants, 1993) for an outline of the central principles on which GAAP is based in New Zealand.

161 Above n 160, para 5.1

the most objective and easily verifiable (and thus reliable) valuation. The asset is then depreciated (if tangible) or amortised (if intangible) over the expected useful life of the asset. This is known as historical cost accounting. Historical cost accounting achieves an appropriate distribution of the cost of the asset over the periods revenue is earned from it. The result is a fair profit and loss in each period.[162]

In determining which valuation system is appropriate our goal of ensuring creditor's wealth is not transferred provides little assistance in deciding the issue. Those who favour substantial protection for the creditor might be expected to favour the realisable value system. Use of realisable value would appear to reduce the risk to creditors as after the distribution is made the company's assets are still sufficient to pay the creditors. This protection would not be not absolute however as liquidation of companies rarely occurs at the time of the distribution. In the intervening time period a substantial reduction in the value of the enterprise will typically occur.

Even without the issue of the delay the realisable value system has a number of major drawbacks. Implementing the system is difficult. The writer is unaware of any company in New Zealand already using the system as the basis of its accounts.[163] The historical cost system allows calculation of the value of an asset based on cost - a known attribute. The realisable value system requires a valuation.

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162 Accounting practice in recent years has focussed on giving a true and fair view of the profit of the entity. The result has been "that the balance sheet has played a secondary role, often being regarded as a series of left-over debits and credits. As such, its usefulness as a financial statement in its own right has been questioned seriously" J Goodwin, "The Proposed Framework - Be Aware of its Impact" (April 1992) New Zealand Society of Accountants Journal, 67.

163 The writer is not alone in this. In his article, above n 55, Michael Hill who was Chairman of the Accounting Research and Standards Board at the time and thus more likely than most to know stated that he was unaware of any company using this basis.

A responsible director is likely to require a valuation report prepared by a professional, independent valuer, particularly if the company has low equity.

Professional valuations are expensive and may serve to put the enterprise into an insolvent position. The number of valuations required would be beyond the capacity of New Zealand's existing valuation profession. It is unlikely that a substantial redirection of New Zealand's human resource into the field of valuation would be socially desirable.

A second objection to valuations is their subjective nature. Indeed in many circumstances valuations cannot have a meaningful basis. As one commentator put it "there is an element of artificiality in attempting to fix asset values [on a willing buyer/seller basis] in an over-supplied market, where there may be no buyers"[164]

There is a further issue. The valuation of individual assets on their own ignores the fact that the value of a company as a going concern "should, in most cases, add up to more than the sum of the individual tangible assets."[165] To give a fair picture intangible assets would need to be included. Intangible assets include goodwill and brands. Valuation of such assets is even more subjective than that of tangible assets. Further brand names and goodwill are very fragile assets.[166] A move to realisable value based accounts could result in a serious overstatement of assets and thus equity.[167]

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164 P Carran, "Companies Bill Trade Off" (February 1991) NZ Business 42, 43.

165 Above n 31, 42.

166 As an example consider the effect of the 1990 toxin scare on the value of the Perrier brand. In a single day its value would have been slashed. Closer to home Independent Newspapers Ltd included "The Auckland Star" brand as an asset in its accounts just before closing down the loss making paper.

167 In "What's In a Name: The Brand Controversy" (June 1989) UK Chartered Accountant's Journal 32, 33 Emile Woolf gives the example of Rank Hovis McDougall which narrowly escaped a takeover by

In summary then the realisable value system would be expensive to implement, results in asset values that are highly subjective and is at least as likely to result in greater risk to creditors as it is to reduce that risk.[168]

C Conclusion on Desirability of the 1993 Act Position

The 1993 Act provides little protection for creditors. Indeed it appears to provide no more protection than the general directors duties do. However the difficulties in maintaining any other regime, including the costs of compliance and the ease of avoidance by would be misfeasors, make this a sensible option. The only concern would appear to be that the Act purports to rather more than this. The Solvency test has little real substance and applies to few of the common methods of distribution and yet it is promoted as a substantial protection for creditors.

Goodman Fielder Wattie in 1988/89. The company reacted by bringing its brand values onto the balance sheet at £678 million, increasing assets by 68 percent and changing the gearing ratio from 42 percent to an impressive 13 percent.

168 See R Instone "Realised Profits: Unrealised Consequences" (1985) Jnl of Bus Law, 106 for a description of the problems created by the UK's attempts to limit distributions to realised profits. These include the implicit rejection in realised value accounting of the concept of prudence.

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