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**A CLOSELY-HELD COMPANIES ACT FOR
NEW ZEALAND**

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ABSTRACT

This paper examines the law relating to closely-held companies. The paper considers empirical data relating to companies in New Zealand and finds that the majority of companies in New Zealand are "closely-held". The paper then considers the requirements of the Companies Act 1993 for the closely-held company majority in New Zealand. It concludes that the Companies Act's regulatory requirements imposed on directors to ensure accountability to shareholders do not have any benefit where companies are closely-held. The costs arising from such regulatory requirements are therefore unjustified.

While the Companies Act makes assorted concessions to closely-held companies, these concessions have further issues.

The paper therefore argues that New Zealand should adopt a new flexible and accessible statute designed to meet the needs of closely-held companies. This statute should be in addition to the existing Companies Act, and should be informed by comparative precedent. This paper argues that the key features of this statute should include removing the distinction between shareholders and directors. This in turn removes the need to impose regulatory requirements on directors in favour of shareholders. The paper also argues that the proposed new statute should provide for limited liability, with the consequence that regulatory requirements in favour of creditors are necessary. This paper argues that these regulatory requirements should take the form of a very straightforward duty to creditors. The closely-held form company would be available to natural persons, with an upper limit of ten principals. The paper therefore proposes a range of duties in favour of other principals in the case of multi-person closely-held companies, including duties to account for the property of the closely-held company, keep the other principals informed of relevant matters, and not to compete with the closely-held company. Most of these duties would be modifiable by agreement between the principals. Finally, the paper proposes that the statute include simple provisions relating to transacting business, eliminating the duplication between accounting and tax reporting requirements and allowing considerable informality for closely-held companies. The net result is a simple, straightforward set of requirements suitable for closely-held companies in New Zealand, without onerous or unjustified compliance requirements.

STATEMENT ON WORD LENGTH

The text of this paper (excluding table of contents, abstract, footnotes, appendices and bibliography) comprises approximately 12,300 words.

Company Law – Closely-Held Companies – Small Businesses

New Zealand – South Africa – United States

I INTRODUCTION

This paper examines the law relating to closely-held companies. The paper begins by considering empirical data relating to companies in New Zealand. Perhaps unsurprisingly, the paper finds that the majority of companies in New Zealand are “closely-held”. That is, its shareholders are also its directors – there is no separation of ownership and management.

The paper then goes on to consider the provisions of the Companies Act 1993, in particular, its regulatory requirements. The paper endeavours to show how many of the regulatory requirements, designed to ensure the accountability of a company’s directors to its shareholders, are inappropriate for closely-held companies. In particular, the paper attempts to show that there is no benefit from such requirements for closely-held companies, rendering compliance with such requirements an unjustified cost.

The paper therefore concludes that New Zealand’s current law is inadequate to meet the needs of closely-held companies and proposes changes to the existing law. The paper argues that the issues would be best-addressed by a new statute designed to meet the needs of closely-held companies. It considers the general principles that may inform the design of such a statute, and makes specific design recommendations for the new statute. In the traditions of the Law Commission’s proposals for company law reform,¹ the paper also sets out possible draft clauses for the new statute. The recommendations for reform are based on this paper’s empirical findings and identified issues. The paper is also influenced by comparative international precedent, particularly that of South Africa² and the United States.³

¹ New Zealand Law Commission *Company Law: Reform and Restatement* (NZLC R9, Wellington, 1989), paras 5-7. [“Law Commission Company Law Report”].

² Close Corporations Act 1984 (ZA).

³ This paper uses the examples of the Wyoming Limited Liability Company Act, Wyo Stat title 17 chapter 15 (1977), and the National Conference of Commissioners on Uniform State Laws *Uniform Limited Liability Company Act* (National Conference of Commissioners on Uniform State Laws, Chicago, Illinois, 1996) <<http://www.nccusl.org>> (last accessed 15 July 2006) [“Uniform Limited Liability Company Act (1996)”].

II EMPIRICAL INFORMATION

This section of the paper analyses the nature of companies in New Zealand. In particular, it focuses on the ownership structure of New Zealand companies to attempt to determine the proportion that are “closely-held”. For the purposes of this paper, a company is considered “closely-held” if its owners (shareholders) are involved in, or close to (for example, through family ties), the management of that company.⁴

A The Available Information

This paper considers the following statistical and empirical information in its analysis of the nature of companies in New Zealand:⁵

- (i) Companies Office statistics.⁶ These statistics are accurate as at July 2006 and are representative of all companies in New Zealand;
- (ii) The Ministry of Economic Development’s Small Business Directorate’s report entitled *SMEs in New Zealand: Structure and Dynamics*.⁷ This report provides a statistical overview of New Zealand small and medium-sized enterprises (not companies⁸) in New Zealand;

⁴ Other factors that may be considered in other contexts include the number of shareholders, lack of a market for the shares and even the geographical proximity and relationship of the shareholders with each other – see Baruch Gitlin “When Is Corporation Close, or Closely-Held, Corporation Under Common or Statutory Law [sic]” (2003) 111 American Law Reports 5th 207, § 2[a].

⁵ Not all of this information is necessarily based on objectively-verifiable data. Each source of information has strengths and weaknesses as noted.

⁶ Companies Office Statistics (Obtained under Official Information Act 1982 Request to the Companies Office, Business Services Branch, Ministry of Economic Development). See also <<http://www.companies.govt.nz>> (last accessed 18 August 2006).

⁷ Ministry of Economic Development *SMEs in New Zealand: Structure and Dynamics – 2006* (Ministry of Economic Development, Wellington, 2006) <<http://www.med.govt.nz>> (last accessed 18 August 2006).

⁸ See below, contrasting closely-held companies with small and medium-sized enterprises and businesses.

- (iii) Small Business Advisory Group *Small and Medium Businesses in New Zealand: Report of the Small Business Advisory Group 2004*.⁹ This report is written by a group of small business owners. This report, although based on first-hand experiences, does not claim to be statistically-valid;
- (iv) PricewaterhouseCoopers *Bank Lending Practices to Small and Medium Sized Enterprises*.¹⁰ This report summarises the findings from interviews with seven major banks as to their lending practices to small and medium-sized enterprises in New Zealand;
- (v) Statistics New Zealand *Business Finance in New Zealand 2004*.¹¹ This report is based on a survey of businesses in New Zealand relating to the demand for, and access to, debt and equity finance. While it is a statistical survey, it is based on businesses' responses and perceptions rather than primary data;
- (vi) Business New Zealand and KPMG *Summary Report of the Business New Zealand-KPMG Compliance Cost Survey*.¹² This survey attempts to determine compliance cost issues for businesses in New Zealand. This survey is again based on perceptions by self-selecting respondents. It is not based on primary data; and
- (vii) Conversation of author with a chartered accountant practising in the area of small businesses and closely-held companies. This information is based on first-hand experiences and impressions.

⁹ Small Business Advisory Group *Small and Medium Businesses in New Zealand: Report of the Small Business Advisory Group 2004* (Ministry of Economic Development, Wellington, 2004) <<http://www.med.govt.nz>> (last accessed 18 August 2006).

¹⁰ PricewaterhouseCoopers *Bank Lending Practices to Small and Medium Sized Enterprises* (Ministry of Economic Development, Wellington, 2003) <<http://www.med.govt.nz>> (last accessed 18 August 2006).

¹¹ Statistics New Zealand *Business Finance in New Zealand 2004* (Statistics New Zealand, Wellington, 2004) <<http://www.stats.govt.nz>> (last accessed 18 August 2006).

¹² Business New Zealand and KPMG *Summary Report of the Business New Zealand-KPMG Compliance Cost Survey* (Business New Zealand and KPMG, Wellington, 2005) <<http://www.businessnz.org.nz>> (last accessed 18 August 2006).

It is important to note that some of the above information relates to “businesses” or “enterprises”, rather than “companies”. It is possible to operate a business in a variety of legal forms, only one of which is a limited liability company registered under the Companies Act. There are, for example, over 431,000 registered companies,¹³ but only 334,000 enterprises.¹⁴ Further, much of the available information is concerned with the size of the business (particularly small and medium-sized businesses¹⁵), rather than its ownership structure (that is, whether it is closely-held or not).

The focus of this paper is the particular legal framework that should apply to closely-held companies, regardless of their size. As will be seen, the ownership structure of a closely-held company is highly determinative of the appropriateness of the regulatory requirements applicable to it. Nevertheless, there will be overlaps between closely-held companies and small businesses. Many small businesses will be closely-held companies, often with families or friends as shareholders and directors.¹⁶

This paper therefore references all available empirical data, including data not specific to companies. The paper does acknowledge, however, that the extent of the correlation between closely-held companies and small and medium-sized businesses is somewhat uncertain. There are therefore some approximations involved in applying small and medium-sized business data to the circumstances of closely-held companies.

¹³ Companies Office statistics, see above, n 6.

¹⁴ Ministry of Economic Development *SMEs in New Zealand: Structure and Dynamics – 2006*, above n 7, 6. Given that enterprises include other non-company forms of trading entity (for example, partnerships and sole traders) logically enterprises should be the larger group. The difference is probably explained by consolidated groups of companies operating as a single enterprise, or “shelf” or non-active companies that do not undertake any business activities and do not count as an enterprise.

¹⁵ The criteria for small or medium enterprises are also not settled. The New Zealand statistics referenced in this paper primarily rely on the number of full time-equivalent employees, with 5 or less representing a “small” business and 6 to 19 representing a “medium” business – see, in particular, Ministry of Economic Development *SMEs in New Zealand: Structure and Dynamics – 2006*, above n 7, 5-6.

¹⁶ See Small Business Advisory Group *Small and Medium Businesses in New Zealand: Report of the Small Business Advisory Group 2004*, above n 9, 3-4.

B Number of Closely-Held Companies

There are no direct statistics available on the exact number of companies with shareholders involved in management. The Small Business Advisory Group however, considers that the “typical” small and medium-sized enterprise will “have the owner as the only person in a managerial position, and no board or formal governance arrangements”.¹⁷ Referencing the figures for small and medium-sized businesses, some 96 per cent of New Zealand businesses fit within this category.¹⁸

This reflects Companies Office statistics:¹⁹ New Zealand has over 431,000 limited liability companies registered under the Companies Act. Of these companies, 140,000 have only one shareholder (33 per cent of all companies), 186,000 have two shareholders (43 per cent) and 80,000 have three to five shareholders (18 per cent). In total, 408,000 companies (nearly 95 per cent) have five or fewer shareholders. The popularity of the limited liability company has undoubtedly been enhanced by matters such as a robust approach to limited liability,²⁰ ease of incorporation,²¹ succession and family planning advantages,²² and the potential for income splitting and lack of tax disadvantages.²³

While unification of ownership and management is not the same as number of shareholders in a company, there is some correlation between the number of

¹⁷ Small Business Advisory Group *Small and Medium Businesses in New Zealand: Report of the Small Business Advisory Group 2004*, above n 9, 3-4.

¹⁸ Ministry of Economic Development *SMEs in New Zealand: Structure and Dynamics – 2006*, above n 7, 6.

¹⁹ Companies Office Statistics, above n 6. Figures have been rounded to the nearest thousand.

²⁰ See *Salomon v A Salomon & Co Ltd* [1897] AC 22 (HL) and Lord Cooke of Thorndon “A Real Thing” in A Borrowdale, D Rowe and L Taylor (eds) *Company Law Writings: A New Zealand Collection* (The Centre for Commercial and Corporate Law, Christchurch, 2002), 21.

²¹ To incorporate a company in New Zealand, a person is only required to complete a straightforward form and pay a fee – see Companies Act 1993, s 12 and Companies Act 1993 Regulations 1994, First Schedule, Form 1. This can be completed entirely on-line – see Companies Act 1993, s 360(4) and <<http://www.companies.govt.nz>> (last accessed 18 August 2006). The fees are also very low. To incorporate a company, the total fee is only \$125 (\$100 incorporation plus \$25 name reservation). This drops further to \$60 (\$50 incorporation plus \$10 name reservation) if done on-line – see Companies Act 1993 Regulations 1994, reg 5 and Second Schedule, Part 1.

²² See, for example, *Maw v Maw* [1981] 1 NZLR 25 (CA).

²³ See, in particular, Income Tax Act 2004, s HG1 (relating to loss attributing qualifying companies).

shareholders and their involvement in management. In particular, it is necessary to have a relatively small number of shareholders to have them practicably involved in management (although this factor on its own is not sufficient to make a company closely-held). The number of shareholders therefore provides some guidance as to whether a company is closely-held or not. The exact number of shareholders beyond which it is not practicably possible for all shareholders to be involved in management is not settled in existing law. By any measure, however, it will be greater than five shareholders. Other New Zealand statutes that differentiate between different companies on the basis of number of shareholders without exception use a figure of at least five.²⁴

As discussed, the above figures cannot be considered conclusive as to the number of closely-held companies in New Zealand. Not necessarily all of the 96 per cent of businesses that are small or medium-sized will be closely-held, nor the 95 per cent of companies that have five or fewer shareholders. Some may have shareholders that are not involved in management; others may be subsidiaries of larger widely-held companies with professional independent directors. Nevertheless, this paper considers that it is fair to conclude that closely-held companies make up a significant number of New Zealand companies.

C Other Information

Two other matters arising from the empirical information are also worth briefly noting: synonymy and informality. These are both characteristics of closely-held companies that are relevant for the purposes of this paper.

²⁴ For example, the Takeovers Act 1993 uses (among other factors) a figure of 50 shareholders – see Takeovers Act 1993, s 2 definition of “specified company” and Takeovers Code, clause 3, definition of “code company” (note, however, that the Securities Legislation Bill will amend the definitions of “specified” and “code” companies to remove the reference to \$20 million or more assets – see Securities Legislation Bill 2005, no 234-2, cls 33 and 34.) The Financial Reporting Act 1993 uses 25 shareholders – see Financial Reporting Act 1993, s 6(g). Finally, the Income Tax Act 2004 allows companies that have 5 or less shareholders that are natural persons to elect to become loss attributing qualifying companies – see Income Tax Act 2004, s HG1. Internationally, the South African Close Corporations Act 1984 uses 10 members – see Close Corporations Act 1984 (ZA), s 2(1).

1 *Synonymy*

By definition, the directors of a closely-held company will also be its shareholders. There is obviously an alignment of interests in this respect. This synonymy is, however, reinforced by several other matters apparent from the empirical information. In particular, the livelihoods of directors/shareholders will be largely synonymous with the fortunes of their companies. A significant majority of small and medium-sized businesses' capital is contributed by the individuals in control of the business.²⁵ This is compounded by the use of personal guarantees for debt finance. While only one-quarter to one-third of small-and-medium businesses seek loans,²⁶ the directors/shareholders of those that do will probably have to give a personal guarantee for the debts of the company (there is, however, some conflicting data on this point).²⁷ Finally, the directors/shareholders will probably also be employed by the business.²⁸ This means that the principal(s) may also be

²⁵ See Statistics New Zealand *Business Finance in New Zealand 2004*, above n 11, 24 and 70. In summary, the paid-in capital for small businesses is 87 percent from the individuals in control of the business, and a further 3 per cent from family or friends of those in control. For medium businesses, paid-in capital is 84 per cent from the individuals in control of the business, and a further 1 per cent from family or friends of those in control.

²⁶ See Statistics New Zealand *Business Finance in New Zealand 2004*, above n 10, 9 and 50. In summary, 26 per cent of small businesses receive debt finance; 37 per cent of medium businesses receive debt finance.

²⁷ See PricewaterhouseCoopers *Bank Lending Practices to Small and Medium Sized Enterprises*, above n 10, 29-31. In summary, actual bank data tends to indicate approximately two-thirds of loans to small businesses are backed by security taken over residential property. The report notes that some banks estimate this figure to be as high as 80 per cent. This is also reflected in the findings of the Small Business Advisory Group, which considers that the typical small-to-medium enterprise will "have all personal assets, including the owner's home, committed as security for the business" – see Small Business Advisory Group *Small and Medium Businesses in New Zealand: Report of the Small Business Advisory Group 2004*, above n 9, 3. The PricewaterhouseCoopers report also cites, however, a further (confidential) survey that estimates this figure to be as low as 35-40 per cent – see PricewaterhouseCoopers *Bank Lending Practices to Small and Medium Sized Enterprises*, above n 10, 30. Similarly, Statistics New Zealand estimates that only 28 per cent of loans to small businesses are secured by personal assets, while only 29 per cent of loans to medium business are secured by personal assets. Of those that do give security, residential property is given as security for 82 and 73 per cent of small and medium businesses respectively – see Statistics New Zealand *Business Finance in New Zealand 2004*, above n 10, 30-31 and 78. The survey does, however, note that the overall rate of personal security for small businesses is lower than expected, and notes the findings of the PricewaterhouseCoopers report. The PricewaterhouseCoopers report is based on bank data, whereas the Statistics New Zealand report is based on business responses. This paper considers that bank data is more likely to be accurate and therefore the findings of the PricewaterhouseCoopers report more reliable.

²⁸ Small Business Advisory Group *Small and Medium Businesses in New Zealand: Report of the Small Business Advisory Group 2004*, above n 9, 3. See also Ministry of Economic

dependent on the company for their day-to-day income. The directors/shareholders' invested capital, the family home and other assets, and day-to-day income may all be at risk in the event of business failure.

2 Informality

The empirical evidence also tends to indicate that most closely-held companies operate informally, and do not strictly observe all regulatory requirements.²⁹ This lack of formal compliance can occur in a number of ways. Matters may be neglected by accident or oversight,³⁰ due to ignorance of the law or lack of capacity,³¹ failure to seek professional advice,³² or even by reckless or deliberate disregard of the legal requirements.³³ In addition to non-compliance, "informal compliance" may also occur. For example, rather than attending to ongoing obligations as they are technically required, these

Development *SMEs in New Zealand: Structure and Dynamics – 2006*, above n 7, 6 – in summary, some 63 per cent of enterprises have no employees. Without employees, the only way for the enterprise to act is through its directors (although many of this figure are likely to be asset-owning companies that do not actively trade on a day-to-day basis. No-employee companies may also be start-up or part-time businesses, where the director(s)/shareholder(s) work for the company without direct remuneration (salary or wages) in the hope of establishing a viable business, or rely on income from dividends).

²⁹ Small Business Advisory Group *Small and Medium Businesses in New Zealand: Report of the Small Business Advisory Group 2004*, above n 9, 3-4. See, for example, *Mason v Lewis* (2006) 9 NZCLC 264,024 (CA), para 58, Judgment of the Court.

³⁰ See, for example, *Re Economy Service Ltd (alt cit Caddis v Roskam)* (1997) 8 NZCLC 261,441 (HC).

³¹ See, for example, *Hale v Registrar of Companies* (28 September 2006) HC AK CRI-2005-404-241; CRI-2005-404-237, in particular paras 7, 9 and 10, Potter J. See also David Goddard "Company Law Reforms – Lessons from the New Zealand Experience" in A Borrowdale, D Rowe and L Taylor (eds) *Company Law Writings: A New Zealand Collection*, above n 20, 145, 166.

³² See, for example, Business New Zealand and KPMG *Summary Report of the Business New Zealand-KPMG Compliance Cost Survey*, above n 12, Summary Tables and Graphs, Table 47. In summary, only 28 per cent of small businesses use external advice. This figure rises to approximately 40 per cent for medium-sized businesses. Given company law is not straightforward, it is unlikely that the remaining 60 to 70 per cent are completely compliant with all relevant obligations. See also Small Business Advisory Group *Small and Medium Businesses in New Zealand: Report of the Small Business Advisory Group 2004*, above n 9, 3-4.

³³ See, for example, *Re Cellar House Ltd (In Liquidation) (alt cit Walker v Allen)* (18 March 2004) HC NEL CP13/00, paras 133, 143, 180 and 209-211, Ellen France J, and *Mason v Lewis*, above n 29, para 58, Judgment of the Court.

obligations may be addressed in an end-of-year “wash-up” of legal requirements.³⁴

III IMPLICATIONS OF THE EMPIRICAL EVIDENCE

A Regulatory Requirements

Company law imposes numerous regulatory requirements in an effort to prevent potential abuse of the corporate form. While some of these requirements fall on companies directly³⁵ (and in some exceptional circumstances, shareholders³⁶), the majority of company regulation imposes requirements on directors, as the individuals with the power to control a company.³⁷

These regulatory requirements on directors take a number of forms, including:

- (i) Imposing general duties on directors;³⁸
- (ii) Substantive restrictions on certain actions;³⁹
- (iii) Structural distribution of powers within a company;⁴⁰ and
- (iv) Procedural requirements.⁴¹

Generally, such requirements may be described as being for the benefit of shareholders and creditors⁴² – those in the position of relative vulnerability to abuse of the corporate form by directors. The interests of other stakeholders

³⁴ David Goddard “Company Law Reforms – Lessons from the New Zealand Experience”, above n 31, 165.

³⁵ For example, use of company name – see Companies Act 1993, s 25, in particular subs (5)(a).

³⁶ See, for example, *McCullagh v Gellert (alt cit Re Gellert Developments Ltd (In Liquidation))* (2002) 9 NZCLC 262,942 (HC).

³⁷ Companies Act 1993, s 128.

³⁸ See, for example, Companies Act 1993, ss 131-138.

³⁹ For example, prohibiting distributions in breach of the solvency test and prohibiting entering transactions that cannot satisfy the solvency test – see Companies Act 1993, ss 4, 52, 108 and 137.

⁴⁰ For example, reserving control of major transactions to shareholders – see Companies Act 1993, s 129.

⁴¹ For example, the assorted “disclosure” requirements that are considered immediately below – see below, n 49-52.

⁴² See Law Commission Company Law Report, above n 1, paras 19 and 23.

(for example, customers, employees, the environment and so on) are normally addressed outside company law in other specific legislation.⁴³

In relation to shareholders,⁴⁴ the regulatory requirements have a number of specific aims. First, they make directors accountable to shareholders (primarily via “the company”⁴⁵) for actions that may prejudice the position of shareholders. This includes both liability to make good wrongs suffered by shareholders⁴⁶ and liability to account for personal benefits gained that have been denied to shareholders.⁴⁷ Second, they attempt to ensure shareholders⁴⁸ are informed of relevant matters through assorted “disclosure” requirements.⁴⁹ Disclosure further promotes accountability by ensuring that shareholders can make informed decisions,⁵⁰ and by encouraging good directorial decision

⁴³ See, for example, Law Commission Company Law Report, above n 1, paras 17-19, L S Sealy “Directors’ ‘Wider’ Responsibilities – Problems Conceptual, Practical and Procedural” (1987) 13 Monash U LR 164, R Baxt “Can the Law Relating to Directors’ Duties be Reformed?” (1990) 10 Company and Securities Law Journal 110, 114-115, and Australian Senate Standing Committee on Legal and Constitutional Affairs *Company Directors’ Duties* (Australian Government Publishing Service, Canberra, 1989), paras 6.1 and following [“Cooney Report”].

⁴⁴ The position of creditors is discussed below – see below, Part V C - Creditors, Limited Liability and Regulatory Requirements.

⁴⁵ See below, Part V C 4 - Balancing mechanisms versus direct regulatory requirements.

⁴⁶ For example, supervising the share register (see Companies Act 1993, ss 90 and 169(3)). This can be considered a “negative” duty – directors must *not* act *against* the interests of shareholders.

⁴⁷ For example, requiring directors to act in the best interests of the company (see Companies Act 1993, s 131) and restrictions on self-interested transactions (see Companies Act 1993, ss 139-140). This can be considered a “positive” duty – directors *must* act *in* the interests of shareholders. See, for example, *Bridge v M B Cook & Co Ltd* (16 September 1999) HC CHCH CP53/99, Chisholm J.

⁴⁸ The Law Commission identified shareholders as the primary audience for disclosure by companies and directors – see Law Commission Company Law Report, n 1, paras 192, 494 and 610-623. Note that the Law Commission identifies the public generally in having an interest in disclosures by companies. This disclosure is, however, limited to “matters required for identification of the company and the information required by those having legal dealings with it” – Law Commission Company Law Report, above n 1, para 616. See also *Hale v Registrar of Companies*, above n 31, para 25, Potter J.

⁴⁹ “Disclosure” includes the assorted record-keeping, certification and notice requirements – see, for example Companies Act 1993, ss 41-81 (matters to do with shares, including issues, distributions, acquisitions of own shares by the company and redemptions), ss 120 and 122 (annual meeting of shareholders or resolution in lieu), s 129 (major transactions), s 140 (disclosure of self-interested transactions), ss 160, 189(1)(b), 189(1)(d), 189(1)(e) and third schedule clause 6 (recording minutes of all meetings and resolutions of shareholders and directors), ss 189(1)(h), 189(1)(i) and 194 (maintaining accounting records and financial statements), ss 208, 209 and 211 (annual report to shareholders), and Financial Reporting Act 1993, ss 10-14 (annual financial statements).

⁵⁰ For example, as to the directors’ performance in running the company and using shareholders’ funds. This in turn informs matters such as shareholders’ financial position, whether to remain in the company or whether to exercise their powers of discipline over

making⁵¹ and business disciplines.⁵² Finally, the regulatory requirements create a basis for liability.⁵³

The problem with this is, of course, that such requirements are a total nonsense for closely-held companies. There is no accountability of directors to shareholders where the directors are also the shareholders. Making good any wrongs suffered would amount to no more than a "money-go-round." Similarly, disclosure of information already known would be a "paper-go-round" of records given and received by, and for the nominal benefit of, the same set of people. Even the good decision making and business discipline rationales are undermined by the practicalities of the reporting requirements.⁵⁴ Even if a director were to breach one of the requirements of the Companies Act, a shareholder-plaintiff is hardly likely to take action against him/herself as director-defendant.⁵⁵

director management (with regard to the latter, see Companies Act 1993, s 109 (management review by shareholders), ss 153(2) and 156 (appointment or removal of directors), and ss 165 and 169 (holding directors liable for breach of their legal obligations). See also Law Commission Company Law Report, above n 1, paras 198-199.

⁵¹ For example, through the theory that "good processes are more likely to lead to good decisions". Requiring directors to minute decisions and/or certify certain actions "turns the directors' minds" to the appropriateness of the proposed action and whether it should be undertaken – see David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 155-156, England and Wales Law Commission and the Scottish Law Commission *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties* (LAW COM No 261; SCOT LAW COM No 173, London, 1999) <www.lawcom.gov.uk> (last accessed 20 July 2006), paras 4.53-4.61, Simon Deakin and Alan Hughes *Directors' Duties: Empirical Findings* (Report to the England and Wales Law Commission and the Scottish Law Commission, ESRC Centre for Business Research, University of Cambridge, 1999), Table 17, and Law Commission Company Law Report, above n 1, paras 494, 520-522 and clause 107 (paras 520-522 and clause 107 relate to the "business judgment" rule. As to the business judgment rule, see below Part V C 5 - Standard of care, in particular, n 196.

⁵² See, for example, Law Commission Company Law Report, above n 1, para 601 and clause 156, *Mason v Lewis*, above n 29, paras 85-87, Judgment of the Court, and *Hale v Registrar of Companies*, above n 31, para 25, Potter J.

⁵³ See Companies Act 1993, Part IX.

⁵⁴ Exempt companies (most smaller closely-held companies – see Financial Reporting Act 1993, section 2) usually have up to nine months after the company's balance date to prepare financial statements (see Financial Reporting Act 1993, section 10(2)). Note that this requires shareholder agreement). While this time may be necessary to prepare accounts in most cases, the timeliness is likely to have an impact on the accuracy of the financial position portrayed in the financial statements. This potential lack of accuracy may undermine any business discipline or the reliance that can be placed on the financial statements for decision making.

⁵⁵ See also R Dugan "Closely Held Companies under the Draft Companies Act", (1990) 20 VUWLR 161, 172-173.

Moreover, there is no need for such accountability. Directors do not need to be incentivised to act in the best interests of the shareholders. Self-interest and synonymy will take care of that.⁵⁶ The regulatory requirements imposed by the Companies Act are therefore inappropriate for closely-held companies.

B Costs of the Requirements

This section of the paper attempts to determine the costs of the regulatory requirements for closely-held companies, thereby assessing the scale of the problem identified in the previous section.

*1 Direct costs*⁵⁷

The direct costs of complying with the majority of the requirements are probably not high. The majority of the disclosure requirements,⁵⁸ for example, can probably be satisfied with a few lines of text.⁵⁹ Other requirements merely require directors to refrain from doing certain actions, only resulting in opportunity costs.⁶⁰ Finally, some requirements (and associated costs) only arise infrequently – either annually⁶¹ or upon the company electing to

⁵⁶ See above, Part II C 1 - Synonymy.

⁵⁷ This terminology comes from the New Zealand Government's Regulatory Impact Analysis framework. This framework requires policy makers to consider the costs and benefits of a proposal as part of a "Regulatory Impact Analysis". In particular, it distinguishes between "direct" and "compliance" costs. Direct costs are those costs incurred to substantively comply with a particular requirement (for example, the direct cost of incorporating a company is the fee payable to the Registrar of Companies). "Compliance" costs, on the other hand, are those administrative costs associated with complying with a particular requirement, but that do not go directly to substantively complying with that requirement (for example, the compliance costs of incorporating a company are the time and effort, or the cost of professional advice, necessary to determine the legal requirements to incorporate a company). Direct costs could also be considered as the costs of the "end" and compliance costs the costs of the "means to the end" – see generally Ministry of Economic Development *A Guide to Preparing Regulatory Impact Statements* (Ministry of Economic Development, Wellington, 1999), in particular, paras 1-3 and 63-71 <<http://www.med.govt.nz>> (last accessed 18 August 2006).

⁵⁸ See above, Part III A - Regulatory Requirements, in particular, n 49-52.

⁵⁹ For example, Companies Act 1993, s 140 (disclosure of self-interested transactions), and ss 160, 189(1)(b), 189(1)(d), 189(1)(e) and third schedule clause 6 (recording minutes of all meetings and resolutions of shareholders and directors).

⁶⁰ For example, Companies Act 1993, s 149 (restrictions on share dealings by directors). See also *Thexton v Thexton* [2002] 1 NZLR 780 (CA).

⁶¹ For example, Companies Act 1993, ss 120 and 122 (annual meeting of shareholders or resolution in lieu), ss 208, 209 and 211 (annual report to shareholders), and Financial Reporting Act 1993, ss 10-14 (annual financial statements).

undertake a particular course of action⁶² (although these requirements are more detailed and therefore more likely to be onerous).

2 *Compliance costs*

Much more significant are the compliance costs associated with the regulatory requirements. The technical nature of company law means that closely-held companies and/or their directors are likely to expend significant costs determining their exact legal obligations.⁶³ If they choose to do it themselves,⁶⁴ this will take the form of time and effort reading the Act or textbooks. Alternatively, it may take the form of the cost of professional advice.

3 *Quantitative assessment*

There do not appear to be any available quantitative assessments of the actual costs associated with the disclosure requirements of the Companies Act.⁶⁵ A recent survey does, however, provide some guidance in this area.⁶⁶ Businesses were asked to rank their compliance cost "priorities". The joint requirements of the Companies Act, Takeovers Act 1993 and Securities Act 1978 were ranked the seventh top "priority".⁶⁷ The Companies Act aspect of this is most

⁶² For example, Companies Act 1993, ss 41-81 (matters to do with shares, including issues, distributions, acquisitions of own shares by the company and redemptions).

⁶³ The Law Commission proposed a "codified" reference point of directors' disclosure obligations – see Law Commission Company Law Report, above n 1, clause 179. This clause did not find its way into the Companies Act 1993. In relation to accessibility of statute law, see also Rt Hon Sir Geoffrey Palmer, President, Law Commission "Law Reform and the Law Commission after 20 Years – We Need to Try a Little Harder" (Address to the New Zealand Centre for Public Law, Victoria University of Wellington, 30 March 2006), Speech Notes, paras 34 and following.

⁶⁴ As is apparently the case for most smaller businesses – see above, Part II C 2 - Informality.

⁶⁵ In writing this paper, information to this effect was requested from both the New Zealand Law Society and New Zealand Institute of Chartered Accountants. Neither responded, however.

⁶⁶ Business New Zealand and KPMG *Summary Report of the Business New Zealand-KPMG Compliance Cost Survey*, above n 12.

⁶⁷ That is, these Acts impose the seventh highest compliance costs for business – see Business New Zealand and KPMG *Summary Report of the Business New Zealand-KPMG Compliance Cost Survey*, above n 12, 5 and 7, and Summary Tables and Graphs, Table 14. The first six compliance cost issues are, in order of highest to lowest: tax, employment relations, health and safety, Accident Compensation Corporation requirements, holidays, Statistics New Zealand requirements, and "other" requirements. Interestingly, resource management was eighth, after the Companies Act.

significant, given that virtually no small businesses have to comply with the Takeovers Act⁶⁸ or Securities Act.⁶⁹

The compliance costs may be mitigated somewhat for experienced directors and professional advisors through the use of standard-form templates. At best, however, this may reduce the Companies Act disclosure requirements to “nuisance” status – that is, something that must be done, but is not a significant compliance burden.

4 Liability “traps”

In addition to costs, regulatory requirements also carry the potential for liability “traps”. As discussed, there does not appear to be any particular incentive for directors of closely-held companies to comply with the assorted regulatory requirements. There is neither any benefit, nor any particular likelihood of shareholder enforcement.⁷⁰ In fact, many directors of closely-held companies may not even be aware of the assorted requirements.⁷¹ There are, however, a number of liability “traps” that may cause significant difficulties for unwary directors of closely-held companies.

First, in terms of civil actions, if a company were to go into liquidation, its directors may find themselves pursued by the liquidator of the company for any failure to comply with the regulatory requirements. For example, if the directors have been paid remuneration by the company without complying

⁶⁸ The Takeovers Act 1993 only applies to listed and formerly-listed companies, and companies with 50 or more shareholders and \$20 million or more assets – see Takeovers Act 1993, s 2 definition of “specified company” and Takeovers Code, clause 3, definition of “code company”. It is very unlikely a company could have 50 shareholders and still be considered “closely held”. A company could, however, potentially be listed or formerly-listed and be closely-held. See also above, n 24.

⁶⁹ The Securities Act 1978 only applies to issuers of securities to the public – see Securities Act 1978, s 3 and Part 2. While closely-held companies could issue securities to the public (particularly debt and participatory securities), the majority of closely-held companies very probably do not.

⁷⁰ See above, Part III A - Regulatory Requirements.

⁷¹ See, in particular, Small Business Advisory Group *Small and Medium Businesses in New Zealand: Report of the Small Business Advisory Group 2004*, above n 9, 3-4, and above, Part II C 2 - Informality. See also, for example, *Mason v Lewis*, above n 29, para 58, Judgment of the Court.

with the necessary formalities,⁷² the remuneration may be treated as a loan from the company and the liquidator (acting for the company) may pursue the directors to “claw back” the deemed debt.⁷³

Moreover, in the case of liquidation, directors may be required to make a contribution to the company if they have been guilty of negligence or default in complying with the Companies Act requirements, particularly the accounting requirements.⁷⁴

Finally, state-enforced criminal sanctions may also be imposed for failure to comply with assorted requirements,⁷⁵ in addition to any civil sanction.⁷⁶ There is therefore the prospect of criminal sanction, even if no-one has suffered any loss or harm (although prosecutorial discretion would probably mean that breaches of the law that do not cause any harm would not be prosecuted).

5 *In summary*

In summary, the regulatory requirements of the Companies Act have some direct costs, significant compliance costs, and the potential for very significant liability traps. It should be re-emphasised, however, that the Companies Act regulatory requirements do not appear to have any significant benefit in the case of closely-held companies. No matter how small the costs, they will never be justifiable on a cost-benefit analysis if the benefit is zero. This paper therefore argues that the requirements are an unjustified burden on closely-held companies.

⁷² See Companies Act 1993, s 161.

⁷³ See, for example, *McCullagh v Gellert*, above n 36, *Crichton v Amaru* (2001) 9 NZCLC 262,549 (HC), *Kiwibilt Engineering Ltd (In Liquidation) v Pavlovich* [2004] DCR 193, and *Macfarlane v Barlow* (1997) 8 NZCLC 261,470 (HC) (note, however, that this latter case was brought by a minority shareholder not involved in management of the company, rather than a liquidator. The company does therefore not satisfy this paper’s definition of “closely-held”).

⁷⁴ Companies Act 1993, ss 300 and 301. See, for example, *Mason v Lewis*, above n 29, *Re Cellar House Ltd (In Liquidation)*, above n 33, and *Re Hilltop Group Ltd (In Liquidation)* (*alt cit* *Lawrence v Jacobsen*) (2001) 9 NZCLC 262,477 (HC).

⁷⁵ For the list of criminal sanctions in the Companies Act (including penalties), see Companies Act 1993, ss 373-374.

⁷⁶ See, in particular, Companies Act 1993, ss 300(4) and 301(2).

C Concessions to Closely-Held Companies

The inappropriateness of certain regulatory requirements in the case of closely-held companies⁷⁷ was recognised by the Law Commission. As a result of the “excessive formalities on the day-to-day operation of small (and, in particular, one-shareholder) companies”,⁷⁸ the Law Commission proposed introducing a new section to the then-Companies Bill that would permit shareholders to effectively opt-out of these formalities.⁷⁹ In the Law Commission’s view, shareholders should be entitled to waive matters for their benefit if they so desire.⁸⁰ The Companies Act was eventually enacted with such opt-out provisions.⁸¹ There are, however, problems with these concessions as enacted. The net result of these issues is to undermine much of the greater flexibility anticipated by the Law Commission.⁸²

Putting aside the obvious additional compliance burdens associated with an opt-out rather than opt-in mechanism, the first issue is that not all regulatory

⁷⁷ While such measures are not necessarily limited to any particular sort of company, the practicalities of seeking – and obtaining – unanimous shareholder agreement mean that it is only likely to be used where the company is closely-held. Such opt-outs will presumably only occur where it is in the interests of shareholders to do so.

⁷⁸ New Zealand Law Commission *Company Law: Transition and Revision* (NZLC R16, Wellington, 1990), para 45.

⁷⁹ New Zealand Law Commission *Company Law: Transition and Revision*, above n 78, para 45 and clause 78A. These comments were made in the Law Commission’s follow-up report on company law following criticisms made of the initial report’s rather limited concessions to closely-held companies. As to the criticism made of the initial draft, see, New Zealand Law Commission *Company Law Reform – Supplementary Paper No 2 – Closely Held Companies – Unanimous Shareholder Agreements* (31 January 1990), paras 4-5 (Obtained under Official Information Act 1982 Request to the Regulatory and Competition Policy Branch, Ministry of Economic Development), and R Dugan “Closely Held Companies under the draft Companies Act”, above n 55.

⁸⁰ This is similar in concept to the doctrine of shareholder ratification – see Companies Act 1993, section 177. Note, however, the potential limitation in subsection 177(3) – see also *Morrison’s Company Law (NZ)* (Service 82, LexisNexis NZ Limited), paras 25.42-25.44 (updated July 2006) <<http://www.lexisnexis.co.nz>> (last accessed 11 August 2006).

⁸¹ See, for example, Companies Act 1993, ss 107(1)-107(3) (unanimous consent for matters including dividends, share transactions, financial assistance, director remuneration and other transactions where the director is interested), s 196(2) (unanimous resolution not to appoint an auditor), and s 211(3) (unanimous agreement that certain matters not be included in the annual report).

⁸² The Companies Act 1993 as enacted departs from the report of the Law Commission in a number of respects – see David Goddard “Company Law Reforms – Lessons from the New Zealand Experience”, above n 31, 156, Jenni McManus “Law Commission v Justice Department – Squabbling Officials Stall Company Law Reform” (25 October 1990) *The Examiner*, New Zealand, 5, and Bob Dey “Company Law – the Slow Job of Reform” (28 October 1990) *The Dominion*, Wellington, 23.

requirements are subject to shareholder opt-out. The majority of the disclosure requirements, for example, fall into this category.⁸³ Closely-held companies must therefore comply with these regulatory requirements, even though they are a "paper-go-round" without benefit.

Second, even where shareholders are able to opt-out, different sections require different procedural formalities in order to opt-out.⁸⁴ There is no common, simple framework for closely-held companies to address these assorted matters. This has resulted in a confusing array of differing provisions that closely-held companies must carefully consider, with ensuing compliance costs. One matter in this regard that may particularly frustrate shareholders is the inability to opt-out of some matters permanently, either by incorporating a permanent opt-out in the company's constitution or by passing "standing" unanimous resolutions.⁸⁵ This compounds the procedural formalities, as it is not possible for shareholders to turn their minds to the matter once and resolve it permanently.⁸⁶

Finally, some of the procedural formalities of the Companies Act to effect an opt-out are problematic themselves. It is not clear what purpose these procedural formalities are intended to serve. The initial regulatory requirements which shareholders are seeking to opt-out of are to protect the interests of shareholders. In the disclosure requirements discussed above for example,⁸⁷ the directors disclose some matter to the shareholders; the shareholders are the "recipients" of the protection. While in practice the "givers" and "recipients" of the disclosures will be the same person(s) for a closely-held company, they may be distinct groups. There is therefore some theoretical coherency to such requirements. The situation is different where

⁸³ See above, Part III A - Regulatory Requirements, in particular, n 49-52.

⁸⁴ For example, s 107 requires the opt-out agreement to be in writing. This is not apparently required for, for example, the agreement that certain matters not be included in the annual report - compare Companies Act 1993, s 107(4) with s 211(3).

⁸⁵ For example, it is possible to opt-out "generally" from the requirements of s 107 until further notice, but the resolution not to appoint an auditor must be re-executed each year - compare Companies Act 1993, ss 107(5)(b) and 107(6), with Companies Act 1993 s 196(2).

⁸⁶ See also David Goddard "Company Law Reforms - Lessons from the New Zealand Experience", above n 31, 156-158.

⁸⁷ See above, Part III A - Regulatory Requirements, in particular, n 49-52.

shareholders opt-out of regulatory requirements, however. There are no obvious candidates to be the “recipients”⁸⁸ of the “benefits” of the procedural requirements. Shareholders are both in theory and in practice “disclosing” matters to themselves.

IV PROPOSALS FOR REFORM: GENERAL PRINCIPLES

The previous section of this paper outlined the issues arising from the Companies Act that affect closely-held companies. Given the prevalence of closely-held companies in New Zealand, this paper considers that the issues raised above are matters that should be addressed. This paper recommends adopting a new statute allowing businesses to register as closely-held companies. The requirements of such a statute would be tailored towards the specific needs of the up to 95 per cent of companies in New Zealand that are closely-held. This section of the paper considers some of the general principles that may inform the design of such a statute; the next section considers some specific features of the new statute.

A The Need for Specific Legislation

The first point to be made is the need for specific legislation. The Law Commission recommended that a single company law statute be adopted. The Commission considered that an appropriately-drafted statute could provide sufficient flexibility for every sort of company.⁸⁹ This paper disagrees with the proposition that company law is infinitely “scale-able” in this fashion. This paper considers that the needs of widely- and closely-held companies are fundamentally different.

Widely- and closely-held companies are designed to achieve very different corporate objectives. Widely-held companies are designed to undertake endeavours that are either too expensive or risky for any individual to

⁸⁸ For example, Companies Act 1993, s 107(4) requires shareholder agreements under s 107 to be in writing. It is not necessary to give anyone a copy of this written agreement, however.

⁸⁹ Law Commission Company Law Report, above n 1, paras 16-18, 66-72, 232-241 and 293-294, and New Zealand Law Commission *Company Law Reform – Supplementary Paper No 2 – Closely Held Companies – Unanimous Shareholder Agreements*, above n 79, para 3(a).

undertake him/herself through encouraging aggregation of capital and specialisation of management.⁹⁰ Closely-held companies, on the other hand, provide a mechanism for small business ventures without the same need or desire for aggregation of capital or specialisation of management.

Separation of ownership and management is fundamental for widely-held companies, but it has the potential for abuse.⁹¹ There is therefore a need to impose regulatory requirements on the directors of such companies.⁹² Such separation of ownership and management, and therefore the need for regulatory requirements, does not arise in the case of closely-held companies. It is therefore necessary to provide two separate legal frameworks catering to the particular requirements of both widely- and closely-held companies. While the Companies Act adequately caters for the needs of widely-held companies,⁹³ it does not adequately address the situation faced by closely-held companies. Specific legislation that caters for the needs of closely-held companies is the best solution.⁹⁴ Such new legislation would be in addition to the Companies Act. This paper does not advocate the repeal and replacement of the Companies Act, as it caters for the needs of widely-held companies.

⁹⁰ This also reflects historical notions as to the nature of "companies". Traditionally, companies were only formed for large, risky or otherwise significant undertakings – see, for example, Companies Act 1993, long title, para (a), Len Sealy "Perception and Policy in Company Law Reform" in A Borrowdale, D Rowe and L Taylor (eds) *Company Law Writings: A New Zealand Collection*, above n 20, 1, 11, Andrew Hicks "Reforming the Law of Private Companies" (1995) 16 Comp Law 171, footnote 3, and Adam Smith *An Inquiry into the Nature and Causes of the Wealth of Nations* (Edinburgh, 1776) Book V, Chapter I, Part III, Article I <<http://www.gutenberg.org>> (last accessed 22 August 2006).

⁹¹ See, for example, Robert Flannigan "Fiduciary Duties of Shareholders and Directors" [2004] JBL 277. Note that for these purposes the classification of directors' duties as fiduciary or nominate is largely irrelevant. See also, for example, the situation of the South Sea Company and other "bubble" companies of the 18th Century in Charles Mackay *Extraordinary Popular Delusions and the Madness of Crowds* (1852) <<http://www.gutenberg.org>> (last accessed 22 August 2006) or <<http://robotics.caltech.edu/~mason/Delusions>> (last accessed 27 August 2006).

⁹² See, for example, New Zealand Law Commission *Company Law: A Discussion Paper* (NZLC PP5, Wellington, 1987), para 37, and Law Commission Company Law Report, above n 1, paras 21 and 85.

⁹³ Aspects of the Companies Act 1993 may be criticised even for widely-held companies. This is beyond the scope of this paper, however.

⁹⁴ See, for example, Johan Henning "The Company Law Reform Bill, Small Businesses and Private Companies" (2006) 27 Comp Law 97, 97, and David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 163.

B Comparative Precedent

There is a significant amount of comparative precedent to consider in formulating a new closely-held companies statute. Internationally, a number of jurisdictions have implemented statutes specifically designed for closely-held/private companies.⁹⁵ Most relevant for New Zealand are the examples of the United States and South Africa. In the United States, Wyoming first adopted a Limited Liability Company ("LLC") statute in 1977.⁹⁶ Since then, all fifty states and the District of Columbia have adopted LLC statutes,⁹⁷ and the LLC is the fastest-growing business form in the United States.⁹⁸ This popularity is due to a combination of flexibility, limited liability and favourable tax treatment.⁹⁹ The broadly-comparable South African Close Corporations Act¹⁰⁰ has met with similar success.¹⁰¹ These approaches have been described as a "hybrid" of company and partnership law.¹⁰² This "incorporated partnership" model has been put forward by a number of

⁹⁵ Particularly civil jurisdictions. The German Gesellschaft mit beschränkter Haftung or "GmbH" is often attributed the status of the "first" private companies statute. As to the actual comparability of United States-style Limited Liability Companies with the German GmbH, see Dominik Kallweit *The US Limited Liability Company: A Role Model for German Company Law* (LLM Research Paper, Victoria University of Wellington, 2003).

⁹⁶ Wyoming Limited Liability Company Act, Wyo Stat title 17 chapter 15 (1977). For the history of the Limited Liability Company in the United States, see Dominik Kallweit *The US Limited Liability Company: A Role Model for German Company Law*, above n 95, 4-6, Hannah L Thompson "New Business Options in Pennsylvania: A Critical Analysis of the Pennsylvania Limited Liability Company and Limited Liability Partnership Act of 1994" [1995] *University of Pittsburgh Law Review* 129, 130-133, Fallany O Stover and Susan Pace Hamill "The LLC versus LLP Conundrum: Advice for Businesses Contemplating the Choice" (1999) 50 *Alabama Law Review* 813, 813-821, and Carol J Miller "LLPs: How Limited is Limited Liability?" (1997) 53 *Journal of the Missouri Bar* 154, 154-155.

⁹⁷ Uniform Limited Liability Company Act (1996), prefatory note, 1.

⁹⁸ See, for example, Jeffrey K Vandervoort "Piercing the Veil of Limited Liability Companies: The Need for a Better Standard" (2004) 3 *DePaul Business & Commercial Law Journal* 51, 63.

⁹⁹ Uniform Limited Liability Company Act (1996), prefatory note, 1.

¹⁰⁰ Close Corporations Act 1984 (ZA).

¹⁰¹ See Rehana Cassim and Femida Cassim "The Reform of Corporate Law in South Africa" (2005) 16 *ICCLR* 411, 413. In particular, the article cites the fact that South Africa has approximately 880,000 actively registered close corporations, but only 300,000 private companies and 6,000 public companies.

¹⁰² Jeffrey K Vandervoort "Piercing the Veil of Limited Liability Companies: The Need for a Better Standard", above n 98, 51.

commentators recommending changes to company law in jurisdictions without such statutes.¹⁰³

The United States and South African statutes have been successful in practice; New Zealand should carefully consider whether there are any compelling reasons for departing from proven-success.¹⁰⁴ This papers' proposals proceed on this basis. While the overall framework and some specific features are worth emulating, however, there are a number of changes that could usefully be made to this international precedent, particularly with the goal of simplification in mind.¹⁰⁵ For example, the United States model is carefully-structured so as to provide sufficient options to enable LLCs to take advantage of the particular tax situation in the United States.¹⁰⁶ This would not be necessary in New Zealand, and so some of this complexity could be removed. This paper also considers other options for simplification.

From a domestic perspective it is worthwhile considering the provisions of partnership law.¹⁰⁷ Partnerships are effectively closely-held businesses where the partners have both equity stakes¹⁰⁸ and management rights¹⁰⁹ in the business. Partnerships provide significant advantages in terms of flexibility,¹¹⁰ although do lack some of the features of company law, most notably, limited liability.

¹⁰³ See, for example, Andrew Hicks "Reforming the Law of Private Companies", above n 90, in particular, 176-177, Johan Henning "The Company Law Reform Bill, Small Businesses and Private Companies", above n 94, 97, and David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 163.

¹⁰⁴ David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 165-166.

¹⁰⁵ David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 165-166.

¹⁰⁶ Uniform Limited Liability Company Act (1996), prefatory note, 1, Hannah L Thompson "New Business Options in Pennsylvania: A Critical Analysis of the Pennsylvania Limited Liability Company and Limited Liability Partnership Act of 1994", above n 96, 130 and footnotes 6-7, Fallany O Stover and Susan Pace Hamill "The LLC versus LLP Conundrum: Advice for Businesses Contemplating the Choice", above n 96, 815 and footnote 8, and Carol J Miller "LLPs: How Limited is Limited Liability?", above n 96, 154 and footnote 7.

¹⁰⁷ See Partnerships Act 1908.

¹⁰⁸ See Partnerships Act 1908, in particular s 27(a).

¹⁰⁹ See Partnerships Act 1908, in particular s 27(e).

¹¹⁰ See Partnerships Act 1908, s 22.

As discussed in the preceding section, this paper argues that the new statute should be in addition to the Companies Act. It is therefore also important to consider the precedent of the existing Companies Act too. Consistency with the existing law where possible would be advantageous: precedent and knowledge of existing concepts will make the new statute more readily understandable. Perhaps more importantly, the statute should not impose substantially more onerous obligations than the existing Companies Act. Otherwise, businesses would simply incorporate under the existing statute rather than the new closely-held companies statute.

C Form of the New Legislation

This paper further recommends that this new legislation be self-contained so far as possible. As discussed above, many closely-held companies operate informally and without professional advice.¹¹¹ It is therefore necessary to state the law clearly and concisely to make it as accessible as possible to closely-held companies.¹¹²

This paper does not consider that the current approach of the Companies Act (allowing closely-held companies to opt-out of particular provisions) is appropriate. Even if the assorted inconsistencies could be and were addressed,¹¹³ such an approach is not as accessible as a self-contained statute.¹¹⁴ Currently, the entire statute must be considered and the applicable provisions determined by reference to the dis-applying section. An understanding of what one is opting out of is necessary. Further, there are many irrelevant provisions. Finally, additional procedural requirements are necessary to effect an opt-out.¹¹⁵ This paper therefore considers that

¹¹¹ See above, Part II C 2 - Informality.

¹¹² See Law Commission Company Law Report, above n 1, paras 121-126, and Rt Hon Sir Geoffrey Palmer, President, Law Commission "Law Reform and the Law Commission after 20 Years - We Need to Try a Little Harder", above n 63, paras 34 and following.

¹¹³ See above, Part III C - Concessions to Closely-Held Companies.

¹¹⁴ See also, for example, the comparative table of numbers of sections and pages in selected companies statutes in David Goddard "Company Law Reforms - Lessons from the New Zealand Experience", above n 31, 164.

¹¹⁵ See also the Companies Bill 2005, no 190 (UK), and Johan Henning "The Company Law Reform Bill, Small Businesses and Private Companies" above n 94, 97.

accessibility would be better achieved either by means of a separate, stand-alone statute, or by adding a self-contained part to the Companies Act.

D Flexibility

The new closely-held companies statute should also provide sufficient flexibility to enable principals to conduct their own affairs as they desire.¹¹⁶ The general approach to these matters should resemble how a reasonable person would run his/her individual affairs. This is the basis on which many small businesses currently operate.¹¹⁷ Moreover, it would provide smaller businesses and their stakeholders a realistic and understandable standard of conduct.

Excessive flexibility may, however, compromise the accessibility of the statute.¹¹⁸ The statute should therefore provide suitable "default" provisions that would apply unless the principals otherwise agree.¹¹⁹ This would provide guidance and accessibility for basic closely-held companies and their principals, while ensuring flexibility for specific purposes or more-advanced closely-held companies. Similarly, for certain requirements, it may be appropriate to provide general flexibility, but also to set out "safe-harbour" provisions. Safe-harbour provisions are useful, as flexible legislation is necessarily drafted with a degree of generality. Safe-harbour can provisions provide certainty that the law has been satisfied.

V PROPOSALS FOR REFORM: SPECIFIC FEATURES

The previous section of this paper discussed the need for a new self-contained statute addressing the needs of closely-held companies and some principles that may inform its design. This section of the paper considers and recommends some specific features of the new statute. In the traditions of the

¹¹⁶ See David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 162.

¹¹⁷ See above, Part II C 2 - Informality.

¹¹⁸ See, for example, Partnerships Act 1908 and its failure to provide a "standard form" partnership agreement.

¹¹⁹ David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 167.

Law Commission's proposals for company law reform,¹²⁰ the paper also sets out possible draft clauses for the new statute.¹²¹

The intent of this section is to set out the most important provisions of the new statute. It has not considered some of the technical detailed elements that would be necessary for the statute, for example, name¹²² and registration requirements,¹²³ service of legal proceedings¹²⁴ and the standard of knowledge required to impugn transactions.¹²⁵ Finally, and perhaps critical to the success of the closely-held companies statute, the paper has not considered matters relating to taxation. These matters have not been able to be included within the scope of this paper.

A No "Directors" and "Shareholders"

The essential feature of a closely-held company is that its shareholders are also its directors.¹²⁶ Recognising this fact would be the single most important element of the new statute. Most importantly, such an approach would clearly obviate the need to impose any regulatory requirements on "directors" to ensure accountability to "shareholders".

Rather than having "directors" and "shareholders", this paper instead proposes that the new statute refer to "principals" of closely-held companies. This encompasses the notion that principals both own and run closely-held companies. This approach is utilised in the United States¹²⁷ and South

¹²⁰ Law Commission Company Law Report, above n 1, paras 5-7.

¹²¹ The draft clauses are inserted as appropriate throughout the paper. The draft clauses are also reproduced in the appendix to this paper.

¹²² See, for example, Companies Act 1993, s 25, Close Corporations Act 1984 (ZA), s 22, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-105(a) (1977), and Uniform Limited Liability Company Act (1996), s 105(a).

¹²³ See, for example, Companies Act 1993, ss 13-14, Close Corporations Act 1984 (ZA), ss 12-13, Wyoming Limited Liability Company Act, Wyo Stat §§ 17-15-106 and 17-15-108 (1977), and Uniform Limited Liability Company Act (1996), ss 206 and 208.

¹²⁴ See, for example, Companies Act 1993, s 387, and Close Corporations Act 1984 (ZA), s 25.

¹²⁵ See, for example, Companies Act 1993, s 19, Close Corporations Act 1984 (ZA), s 17, and Uniform Limited Liability Company Act (1996), s 102.

¹²⁶ See above, Part II - Empirical Information.

¹²⁷ See, for example, the Wyoming Limited Liability Company Act, Wyo Stat §§ 17-15-106, 17-15-107, and 17-15-113 - 17-15-116 (1977), and the Uniform Limited Liability Company Act (1996), Article 4. Note, however, that these statutes also provide the option for LLCs to

Africa,¹²⁸ both of which refer to "members" to encompass this concept. This paper uses "principals" to denote this member/shareholder/director concept.

Ultimately, it would be possible to duplicate the existing Companies Act, amend the references to "directors" and "shareholders" to read "principals", and strip out all the regulatory requirements intended for the benefit of shareholders. This would be a significant improvement on the status quo. It seems, however, that further improvements can also be made to cater to the needs of closely-held companies.

B Definition and Eligibility

The prospect of distinguishing a closely-held company from an ordinary company caused the Law Commission some concern.¹²⁹ This paper proposes, however, that the new closely-held companies statute be in addition to the Companies Act. Under this paper's approach, there is no need have a "bright-line" test to distinguish between the two sorts of companies. Whether to incorporate under the Companies Act or under the new closely-held companies statute would simply be a decision of the individual(s) concerned.

There does, however, need to be some eligibility criteria for closely-held companies. The proposed closely-held companies statute has been designed on the basis that all principals of a closely-held company would be involved in its management. This is not practicable where there are too many principals.¹³⁰ South Africa has a limit of ten principals;¹³¹ this paper proposes the same number. It is acknowledged, however, that this is something of an arbitrary figure. In any event, however, the vast majority of businesses

have "managers" if they chose to do so (see Wyoming Limited Liability Company Act, Wyo Stat § 17-15-116 (1977), and Uniform Limited Liability Company Act (1996), s 404). This flexibility is primarily due to the United States tax provisions – see Uniform Limited Liability Company Act (1996), prefatory note, 1.

¹²⁸ See Close Corporations Act 1984 (ZA), s 1(1), definition of "member" and Part IV.

¹²⁹ New Zealand Law Commission *Company Law Reform – Supplementary Paper No 2 – Closely Held Companies – Unanimous Shareholder Agreements*, above n 79, para 3(b).

¹³⁰ See also above, Part II B - Number of Closely-Held Companies, in particular, n 24.

¹³¹ Close Corporations Act 1984 (ZA), ss 2(1) and 28.

wishing to utilise a closely-held company structure will fall below this threshold.¹³²

This paper also proposes that only natural persons be able to be principals. The same approach is adopted in South Africa.¹³³ The intent of the statute is to address the issues associated with the Companies Act for closely-held companies. The needs of, and appropriate requirements for, subsidiaries of other companies are different to those of small owner-operated businesses. Such needs and requirements are outside the scope of this paper. A particular concern is the fact that principals exercise management power directly; another company is not able to do this under current New Zealand law.¹³⁴ It is also worth noting that other legal avenues are available for matters such as venture capital investment.¹³⁵ The new statute may therefore provide, for example:

Draft Clause: Eligibility for Membership of a Closely-Held Company

A Closely-Held Company must have at least one, but not more than ten, Principals, all of whom must be natural persons.

C Creditors, Limited Liability and Regulatory Requirements

This paper criticises the regulatory requirements of the Companies Act for closely-held companies. The situation is quite different, however, for creditors and other contractual third-parties (collectively, “creditors”).

¹³² See above, Part II B - Number of Closely-Held Companies.

¹³³ See Close Corporations Act 1984 (ZA), s 29.

¹³⁴ The Companies Act 1993 requires directors to be natural persons – see Companies Act 1993, s 151(1).

¹³⁵ Limited partnerships in particular are apparently the preferred vehicle for the venture capital industry. New Zealand’s limited partnership regime is currently under review – see Ministry of Economic Development *A Limited Partnership Regime for New Zealand* (Ministry of Economic Development, Wellington, 2005) in particular, para 5 <<http://www.med.govt.nz>> (last accessed 18 August 2006). There does not seem to be any reason why a closely-held company could not be the general partner in a limited partnership. This would allow equity investment in the business venture operated by the closely-held company while avoiding the difficulties described in this paragraph.

Unlike director/shareholder interests, there is no synonymy of interests with creditors in the case of a closely-held company.¹³⁶ Self-interest cannot be relied upon to prevent abuse. Limited liability means that creditors may not be able to practically recover against a debtor-company due to its impecuniosity, even where the company is clearly liable to the creditor. It is therefore necessary to impose some form of regulatory requirement to prevent abuse of the corporate form to the detriment of creditors. The costs of such requirements will be justified, so long as greater benefit flows to creditors.

There are a number of possible alternatives for such regulatory requirements. This section considers and rejects both the possibilities of removing limited liability, and imposing minimum capital requirements. Rather, the paper proposes imposing duties for the benefit of creditors. It also considers the form and standard of such duties, as well as some practical considerations.

1 No limited liability

Limited liability is typically considered as a key feature of company law. It encourages entrepreneurship and taking business risks without fear of recourse to the other assets of the shareholders.¹³⁷ It is not, however, universally acclaimed. Objections have been raised both as a matter of principle¹³⁸ and practice.¹³⁹ At least one commentator has proposed a closely-held business statute without limited liability.¹⁴⁰ The essential rationales for this are that the majority of closely-held businesses do not want or need

¹³⁶ Although it is possible for the principal of a company/closely-held company to lend the company money. The principal would be the creditor of his/her own company. The synonymy of interests would mean that there is no need for regulatory requirements to ensure accountability or prevent abuse. This is likely to be the minority of cases, however.

¹³⁷ See, for example, Companies Act 1993, long title, para (a), *Rainham Chemical Works Ltd v Belvedere Fish Guano Co Ltd* [1921] 2 AC 465, 475 (HL), Lord Buckmaster, New Zealand Law Commission *Company Law: A Discussion Paper*, above n 92, paras 33 and 41, and Law Commission *Company Law Report*, above n 1, para 22(d).

¹³⁸ See, for example, John Farrar "Frankenstein Incorporated or Fools' Parliament? Revisiting the Concept of Corporation in Corporate Governance" in A Borrowdale, D Rowe and L Taylor (eds) *Company Law Writings: A New Zealand Collection*, above n 20, 59.

¹³⁹ Andrew Hicks "Reforming the Law of Private Companies", above n 90, in particular, 174 and following.

¹⁴⁰ Andrew Hicks "Reforming the Law of Private Companies", above n 90, in particular, 176-177. The author also identifies some existing problems with partnership law that should be addressed - see 175-176.

limited liability,¹⁴¹ and may abuse limited liability.¹⁴² Removing limited liability would also remove the potential for abuse of the company form. There would therefore be no need to impose regulatory requirements to counter this potential for abuse. The argument is that closely-held businesses would get greater benefits from the removal of limited liability than its retention.¹⁴³

This ignores, however, the fact that it is possible to limit liability in other ways. It will, of course, be possible to limit liability by incorporating a company under the Companies Act rather than a closely-held company. It is also possible to limit liability contractually by including express terms to that effect with third-parties.¹⁴⁴ Contractual limitation or disclaimer of liability may even include some claims sounding in tort.¹⁴⁵ Moreover, regardless of one's normative views as to the appropriateness of limited liability, it must be accepted that limited liability is now a feature of the commercial environment. Limited liability does not appear to have been seriously challenged in any

¹⁴¹ Andrew Hicks "Reforming the Law of Private Companies", above n 90, 175-176. In summary, statistical information tends to indicate that the majority of businesses are not incorporated, and of those that are, limited liability is undermined through the use of personal guarantees (note that this is a United Kingdom article and cites United Kingdom empirical sources). The latter finding, at least, accords with the empirical findings presented in this paper – see above, Part II C 1 - Synonymity.

¹⁴² Andrew Hicks "Reforming the Law of Private Companies", above n 90, 174-175. The author's primary concern is under-capitalisation to the detriment of creditors and the relative paucity of sanctions against delinquent company directors.

¹⁴³ Andrew Hicks "Reforming the Law of Private Companies", above n 90, 176-177.

¹⁴⁴ If the bargaining position is such that third-parties will not agree to such terms (for example, banks), then it is likely that limitation of liability through incorporating a company would not be acceptable either, and a personal guarantee would be required by those third-parties. As to the "standard form contract" model for company law, see, for example, New Zealand Law Commission *Company Law: A Discussion Paper*, above n 92, para 36, and David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 146. One intriguing possibility flowing from this standard form contract model is the prospect of providing for a Closely-Held Companies "Act" not as an Act of Parliament, but rather through common adoption of contractual terms – for example, making the "Act" publicly available, and allowing those that wish to "incorporate" under it to reference the terms of the "Act" contractually.

¹⁴⁵ See, for example, *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 (HL), where the plaintiffs would have been successful in an action for negligent misstatement, but for the defendant's disclaimer of liability. It is also possible to implement a form of asset protection through family trusts and property relationship agreements. Asset protection is not the same as limited liability, however; personal bankruptcy is a necessary precursor for asset protection to be necessary. This is discussed further below – see below, Part V C 7 - Asset protection.

major review of company law.¹⁴⁶ South Africa¹⁴⁷ and the United States¹⁴⁸ both provide for limited liability for their closely-held companies. Indeed, the trend seems to be to increase the scope of limited liability protections.¹⁴⁹ Finally, rejecting limited liability would be open to criticism on the basis that a nominally-enabling and facilitative statute does not adequately cater for the New Zealand business environment.¹⁵⁰

Realistically, if a new closely-held companies statute were adopted without limited liability, parties that desire limited liability will either adopt contractual terms or incorporate under the Companies Act. The former will result in transactional inefficiency, while the latter will simply render the new statute redundant. It therefore seems appropriate that the new closely-held companies statute make provision for limitation of liability:

Draft Clause: Limited Liability

The Principal(s) of a Closely-Held Company are not liable for the debts of the Closely-Held Company.¹⁵¹

2 *Minimum capital requirements*

Maintaining limited liability means that it is necessary to resort to other avenues to ensure the corporate form does not lead to abuse of creditors. Minimum capital requirements are a traditional feature of company law.¹⁵² Such requirements theoretically prevent the formation of, or trading by, companies that run the risk of failure due to undercapitalisation. Set at an appropriate level, minimum capital requirements may also discourage “over-incorporation” – that is, companies that are incorporated for a single, short

¹⁴⁶ See, for example, Law Commission Company Law Report, above n 1, the Department of Trade and Industry *Better Business Framework: Companies Bill* (Department of Trade and Industry, London) <http://www.dti.gov.uk> (last accessed 6 September 2006).

¹⁴⁷ Close Corporations Act 1984 (ZA), s 2(3).

¹⁴⁸ See, for example, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-113 (1977), and Uniform Limited Liability Company Act (1996), ss 201 and 303.

¹⁴⁹ For example, allowing law firms to incorporate – see Lawyers and Conveyancers Act 2006, s 6 definition of “incorporated law firm” and Part 2.

¹⁵⁰ This is the same criticism levelled at the Companies Act 1993 by this paper.

¹⁵¹ See, for example, Companies Act 1993, s 15, Close Corporations Act 1984 (ZA), s 2(3), Wyoming Limited Liability Company Act, Wyo Stat § 17-15-113 (1977), and Uniform Limited Liability Company Act (1996), ss 201 and 303.

¹⁵² For example, stated and par value shares. This does not include the solvency test.

business venture that are wound up immediately following the completion of the venture (with the inherent risks to creditors). This limits incorporation to “serious” business ventures of a certain size.

Such requirements have significant problems, however, and were abolished in New Zealand in the current Companies Act. This paper considers that problems identified by the Law Commission with such requirements are compelling, and minimum capital requirements should not be introduced.¹⁵³ Even if the Law Commission’s reasons were not so compelling, the likely imposition of minimum capital requirements could not be required in isolation only for closely-held companies. Businesses would again simply chose to incorporate under the Companies Act instead.

While New Zealand arguably allows incorporation too easily,¹⁵⁴ this is a matter that would need to be addressed across company law, not just in the context of closely-held companies. Limiting companies to serious business ventures of a certain size would, however, simply create greater risks and barriers to entry for the smallest businesses, those that are most likely to take advantage of a closely-held companies statute. This paper therefore does not consider such a proposal would be appropriate for a new closely-held companies statute for New Zealand.

3 *Duties to creditors*

Having rejected the abolition of limited liability and the introduction of minimum capital requirements, it is necessary to consider other means of ensuring creditors’ interests are upheld. The Companies Act, which also has limited liability and no minimum capital requirements, attempts to do this by means of imposing directors’ duties in favour of creditors.¹⁵⁵ This recognises that although the principal(s) of a closely-held company may be liable to

¹⁵³ See Law Commission Company Law Report, above n 1, paras 84 and 223-228.

¹⁵⁴ See above, n 21.

¹⁵⁵ Note that some duties are owed to the company, and some are owed to creditors directly. This is considered below – see below, Part V C 4 - Balancing mechanisms versus direct regulatory requirements.

creditors for damages, even though the principal(s) are not liable for the debts of the closely-held company directly.

The Companies Act imposes a number of different duties in favour of creditors. First, the Companies Act imposes a duty on directors not to trade "recklessly" – that is, a director must not agree, cause or allow the business of a company to be carried on in a manner "likely to create a substantial risk of serious loss to the company's creditors".¹⁵⁶ Second, there is a duty not to enter into obligations that cannot be performed.¹⁵⁷ Third, there is a duty to keep accounting records.¹⁵⁸ Fourth, in specific relation to payments to principals, there are two further different duties/tests – payments to a principal as a director must effectively be reasonable,¹⁵⁹ while payments to a principal as a shareholder must satisfy the solvency test.¹⁶⁰ Finally, the Companies Act includes something of a catch-all duty on directors (and certain others) not to act negligently or otherwise breach any duty or trust.¹⁶¹ Related to this catch-all duty, there is also a common law duty to creditors not to cause loss, at the least in the case of insolvency or potential-insolvency of a company.¹⁶²

The United States and South Africa similarly impose duties on principals of closely-held companies in favour of creditors. The United States approach varies between jurisdictions. The more robust view as to limitation of liability only holds a principal liable in a limited range of circumstances: a principal is

¹⁵⁶ Companies Act 1993, s 135.

¹⁵⁷ Companies Act 1993, s 136.

¹⁵⁸ Companies Act 1993, ss 194 and 300.

¹⁵⁹ Companies Act 1993, ss 161(4) and 161(5).

¹⁶⁰ Companies Act 1993, ss 4, 52, 53, 107 and 108. As to directors' liability, see Companies Act 1993, s 52(2), 56(2) and 108(2), as well as s 134. Note that the recipient of the payment may also be liable for any distributions received that the recipient knew were in contravention of the solvency test (see Companies Act 1993, ss 56(1) and 108(4)). For a closely-held company, such differentiation of liability is not particularly useful.

¹⁶¹ Companies Act 1993, s 301. Note that this is phrased as a discretionary remedy, rather than a duty.

¹⁶² *Nicholson v Permakraft (NZ) Ltd*, [1985] 1 NZLR 242, 249-250 (CA) Cooke J. See also *West Mercia Safetywear Ltd (in liq) v Dodd* [1988] BCLC 250; [1988] BCC 30 (EWCA), *Morrison's Company Law (NZ)*, above n 80, paras 24.8, L S Sealy "Directors' 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural", above n 43, 178-179, Francis Dawson "Acting in the Best Interests of the Company – For Whom are Directors 'Trustees'?" (1984) 11 NZULR 68, 68-70, and Cooney Report, above n 43, paras 5.1 and following.

liable for company property and money;¹⁶³ for capital he/she has agreed to, but has not yet, contributed;¹⁶⁴ and for distributions received in breach of the solvency test.¹⁶⁵ The slightly less robust view adopts generally the same approach,¹⁶⁶ but with the addition of a general duty not to engage in knowing violations of the law, intentional misconduct, reckless conduct, or grossly negligent conduct.¹⁶⁷ That is, a principal has a general duty of care to the standard of gross negligence not to cause loss. It is, however, important to note that this apparently robust approach is countered by the well-established United States “piercing the corporate veil” doctrine. Under this doctrine, it is possible to set aside limited liability protections in a range of circumstances, including fraud, undercapitalisation, the “alter ego” doctrine, and, in some circumstances, failure to observe the formalities of the corporate form.¹⁶⁸

The South African approach is again broadly similar. Principals are liable for promised contributions¹⁶⁹ and distributions made in breach of the solvency test.¹⁷⁰ Like the less robust approach in the United States, South Africa also has general duty of care provisions. Unlike the United States, South Africa’s

¹⁶³ See, for example, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-121(b) (1977).

¹⁶⁴ See, for example, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-121(a) (1977).

¹⁶⁵ See, for example, Wyoming Limited Liability Company Act, Wyo Stat §§ 17-15-119 and 17-15-120 (1977). The solvency test used in the Wyoming Limited Liability Company Act is a simple test of assets exceeding liabilities – see Wyoming Limited Liability Company Act, Wyo Stat § 17-15-119 (1977).

¹⁶⁶ See, for example, Uniform Limited Liability Company Act (1996), ss 409(b)(1) (company property), 402 (liability for contributions) and 406-407 (distributions in breach of the solvency test). The solvency test used in the Uniform Limited Liability Company Act is a two-stage test of assets exceeding liabilities and ability to pay debts in the ordinary course of business – see Uniform Limited Liability Company Act (1996), s 406(a).

¹⁶⁷ See, for example, Uniform Limited Liability Company Act (1996), s 409(c). See also Uniform Limited Liability Company Act (1996), s 303, comment.

¹⁶⁸ See generally, Jeffrey K Vandervoort “Piercing the Veil of Limited Liability Companies: The Need for a Better Standard”, above n 98, 58-63. Note that failure to observe formalities has generally been questioned as a factor (see Jeffrey K Vandervoort “Piercing the Veil of Limited Liability Companies: The Need for a Better Standard”, above n 98, 59-61), and in some cases, statutorily abolished – see, for example, Uniform Limited Liability Company Act (1996), s 303(b).

¹⁶⁹ Close Corporations Act 1984 (ZA), ss 24(5) and 63(b).

¹⁷⁰ Close Corporations Act 1984 (ZA), s 51. South African adopts a broader meaning of distribution (any payment to a principal by reason only of his/her status as principal – that is, excluding only contracts for services) and a three part solvency test (balance sheet, ability to pay debts as they become due, and whether *in fact* the distribution will mean debts will not be able to be paid – see Close Corporations Act 1984 (ZA), s 51(1)).

statute provides for two standards of care: both ordinary negligence,¹⁷¹ and gross negligence.¹⁷² Additionally, South Africa requires accounting records to be kept, although the direct penalty for breach is criminal, rather than civil.¹⁷³

The approaches of the United States and South Africa, although somewhat simpler than New Zealand, are still complicated. Much of this complexity is due to the fact that company law seldom imposes direct regulatory requirements. Rather, most regulatory requirements are owed to "the company" in a type of balancing mechanism.

4 *Balancing mechanisms versus direct regulatory requirements*

As discussed in this paper, company law imposes a number of regulatory requirements. While some regulatory requirements on directors are owed to shareholders directly,¹⁷⁴ the majority of duties, both in New Zealand¹⁷⁵ and overseas¹⁷⁶, are owed to "the company" as part of the balancing mechanism to resolve competing interests.

In a company (particularly a widely-held company), there may be a number of competing interest groups, including directors, shareholders and creditors, and potentially subgroups of shareholders and creditors ("stakeholders"). There may be tensions between the interests of such stakeholders – for example, a shareholder's interest in the company maximising its dividends may be opposed to creditor's interests in the company maintaining sufficient assets to pay its debts.

Company law therefore attempts to provide a mechanism to resolve the competing interests of the assorted stakeholders in a company. Rather than owing separate and potentially conflicting duties to ensure the various groups of stakeholders' interests are maintained, the majority of directors' duties are

¹⁷¹ Close Corporations Act 1984 (ZA), s 43.

¹⁷² Close Corporations Act 1984 (ZA), s 64.

¹⁷³ Close Corporations Act 1984 (ZA), s 56.

¹⁷⁴ For New Zealand, see especially Companies Act 1993, s 169(3).

¹⁷⁵ See especially Companies Act 1993, s 169(3).

¹⁷⁶ See, for example, Close Corporations Act 1984 (ZA), s 43, and Uniform Limited Liability Company Act (1996), s 409(c).

instead owed to the company. The primary duty is to act in the best interests of the company.¹⁷⁷ This mechanism effectively allows certain interests to trump other interests. So in the shareholder/creditor interests example above, it is in the interests of the company not to become insolvent, therefore it is not in the interests of the company to distribute all cash received to the shareholders as quickly as possible.

Taking the example of a one-person closely-held company,¹⁷⁸ however, it is clear that there are no competing interests to “balance”. The only major group of stakeholders in a one-person closely-held company would be its creditors. Following this reasoning to its conclusion, there is no need to impose on the principal a duty to creditors via “the company” at all. Instead, it would be possible to simply impose a direct duty on the principal of a one-person company in favour of creditors. This is similar to the current common law approach in New Zealand as expressed in *Nicholson v Permakraft*.¹⁷⁹

This would have the advantage of simplicity. The complexities and vagaries of the balancing exercise have been criticised.¹⁸⁰ This approach would also avoid situations where wrongdoers indirectly benefit from actions taken against them. For example, the situation where a director has breached a duty to a company and the company successfully sues him/her for that breach. If, however, the director were also a shareholder in that company, he/she would indirectly benefit anyway due to the increase in value of his/her shares.

¹⁷⁷ Companies Act 1993, s 131. See also Law Commission Company Law Report, above n 1, paras 184-196 and 504-509, and clause 101. In summary, the Law Commission recommended that a duty of directors to act in the best interests of the company be the “fundamental” duty of directors, effectively trumping other directors’ duties by its place at the top of the proposed “hierarchy” of duties. Note, however, that the Companies Act 1993 was not enacted in this form following the redrafting of the then-Companies Bill by the Department of Justice and the Commerce Select Committee – see Companies Act 1993, s 131, David Goddard “Company Law Reforms – Lessons from the New Zealand Experience”, above n 31, 156, Jenni McManus “Law Commission v Justice Department – Squabbling Officials Stall Company Law Reform”, above n 82, and Bob Dey “Company Law – the Slow Job of Reform” above n 82.

¹⁷⁸ Considering a one-person company also forces greater focus on the specific considerations of the corporate form, without the diversions associated with multiple shareholders. The position of multiple shareholders is considered below – see below, Part V D - Multi-Principal Closely-Held Companies.

¹⁷⁹ Above n 162.

¹⁸⁰ See, in particular, L S Sealy “Directors’ ‘Wider’ Responsibilities – Problems Conceptual, Practical and Procedural”, above n 43, 175.

Further, it would obviate the need for more-complicated enforcement mechanisms such as a derivative actions.¹⁸¹ Such mechanisms are arguably disadvantageous for shareholders,¹⁸² as they must effectively satisfy the court twice of the appropriateness of the action.¹⁸³

Further, this approach would avoid the need for particular provisions relating to shareholder ratification. Ratification allows shareholders to "cure" defalcations by directors in something akin to an "after-the-breach" form of the concessions to closely-held companies provided in the Companies Act.¹⁸⁴ Such ratification could also have consequences for creditors of the company, however. Ratification could mean that money owed to the company by its directors does not have to be paid, even if that money would otherwise be available to a company to pay its creditors. This is a particular problem for closely-held companies. In the case of a one-person company, it would be a simple matter to ratify all breaches.

New Zealand law therefore recognises that, in certain circumstances, ratification would amount to a fraud on creditors and imposes liability on the ratifying party.¹⁸⁵ This has been statutorily recognised in other jurisdictions, whereby ratification is not effective as against creditors.¹⁸⁶ This is again, however, a rather convoluted process of ensuring creditors' interests are upheld. Imposing duties on the principal of a closely-held company directly in respect of creditors would resolve this issue by removing even the possibility of ratification.

¹⁸¹ See Companies Act 1993, Part IX, and in particulars ss 165 and 169. See also Law Commission Company Law Report, above n 1, para 318.

¹⁸² Although there are costs advantages – see Companies Act 1993, s 166.

¹⁸³ Leave of the Court is required to bring a derivative action – see Companies Act 1993, s 165, and *Vrij v Boyle* [1995] 3 NZLR 763 (HC). See also Securities Markets Act 1988, s 18, and *Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152 (CA).

¹⁸⁴ See above, Part III C - Concessions to Closely-Held Companies, and *Morrison's Company Law (NZ)*, above n 80, paras 25.42-25.44. See also the ratification provisions in the South African and United States closely-held company statutes – Close Corporations Act 1984 (ZA), s 43(2), Wyoming Limited Liability Company Act, Wyo Stat § 17-15-121(c) (1977), and Uniform Limited Liability Company Act (1996), s 103(b)(2)(ii).

¹⁸⁵ See *McCullagh v Gellert*, above n 36.

¹⁸⁶ For example, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-121(c) (1977).

As discussed in the preceding two sections, this paper recommends imposing a duty of care on the principals of a closely-held company in respect of the company's creditors. The appropriate standard of care for that duty must be considered. Imposing liability too readily will discourage what may be justifiable business risks because of fear of individual liability; making it too difficult to hold delinquent principals liable will not uphold creditors' interests.

There are a number of possibilities for such a standard. New Zealand,¹⁸⁷ the United States¹⁸⁸ and South Africa¹⁸⁹ all currently provide for a solvency test for some matters. This is effectively a "strict" standard, in that it is either satisfied in the particular circumstances or it is not. Both the United States¹⁹⁰ and South Africa¹⁹¹ uses a gross negligence test for some matters; South Africa also uses ordinary negligence in some circumstances.¹⁹² New Zealand has an array of tests,¹⁹³ the standard of which is not always clear.¹⁹⁴

Into this already-confusing mix must be added the common law "business judgment rule". This rule reflects the courts' traditional reluctance to become involved in matters of "business judgment" and to not second guess particular

¹⁸⁷ Companies Act 1993, s 4.

¹⁸⁸ For example, Wyoming Limited Liability Company Act, Wyo Stat §§ 17-15-119 and 17-15-120 (1977), and Uniform Limited Liability Company Act (1996), ss 406-407. See also above, n 165 and n 166.

¹⁸⁹ Close Corporations Act 1984 (ZA), 51(1). See also above, n 170.

¹⁹⁰ For example, Uniform Limited Liability Company Act (1996), s 490(c). See also above, n 168.

¹⁹¹ Close Corporations Act 1984 (ZA), s 64. See also above, n 172.

¹⁹² Close Corporations Act 1984 (ZA), s 43. See also above, n 171.

¹⁹³ See, for example, Companies Act 1993, ss 131-138 and 300-301, and *Nicholson v Permakraft (NZ) Ltd*, above n 162.

¹⁹⁴ See, for example, Companies Act 1993, s 135. Notwithstanding the title of the section being "reckless" trading, the section itself refers to "likely to create a substantial risk of serious loss" [*emphasis added*]. See also *Re Global Print Strategies Ltd (In Liquidation) (alt cit Mason v Lewis)* (25 November 2004) HC AK M459-IM03, para 38, Salmon J (note that while this case was reversed on appeal, the observations on s 135 were not challenged – see *Mason v Lewis*, above n 29), and *Fatupaito v Bates* [2001] 3 NZLR 386; (2001) 9 NZCLC 262,583, paras 60-67 (HC) O'Regan J. Goddard goes further and describes some of the duties (Companies Act 1993, ss 135 and 136) as "extraordinary" – see David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 159 and footnote 35.

decisions of directors.¹⁹⁵ It is effectively a presumption of non-liability where the transaction is not self-interested, is undertaken on an informed basis, and is not irrational.¹⁹⁶ A form of the business judgment rule is recognised in the Companies Act,¹⁹⁷ although it does not appear to have been interpreted as such.¹⁹⁸

Out of this multitude, one common theme is perhaps that greater scrutiny needs to be paid to self interested transactions. Other than this, it is difficult to determine any general trends or any particular standard of international best practice. While it is clearly necessary to strike an adequate balance between protecting creditors' interests and not unduly fettering business discretion, there will always be some dispute about whether the correct balance has been struck.

¹⁹⁵ See, for example, *Re City Equitable Fire Assurance Co* [1925] Ch 407 (CA).

¹⁹⁶ See Corporations Act 2001 (Aus), s 180(2), and *Aronson v Lewis* (1984) 473 A 2d 805, 812 (Supreme Court of Delaware) Moore J for the Court (note that *Brehm v Eisner* (2000) 746 A 2d 244 (Supreme Court of Delaware en banc), overrules the case in part, and *Kamen v Kemper Financial Services, Inc* (1990) 908 F 2d 1338 (7th Circuit Court of Appeals), rejects in part, but neither is relevant to the business judgment rule itself). See also L S Sealy "Reforming the Law on Directors' Duties" (1991) 12 Comp Law 175, 177, Len Sealy "Directors' Duties Revisited" (2001) 22 Comp Law 79, 79, R Baxt "Can the Law Relating to Directors' Duties be Reformed?", above n 43, 111-112, R Baxt "Proposals for Reforming Company Law – The Duties of Directors" (1992) 10 Company and Securities Law Journal 139, 139-140, Karen O'Flynn "Australia: Corporate – Directors' Duties" (2005) 11 International Trade Law & Regulation N37, N38-N39, Demetra Arsalidou "Objectivity vs Flexibility in Civil Law Jurisdictions and the Possible Introduction of the Business Judgment Rule in English Law" (2003) 24 Comp Law 228, 228 and 230-233, Demetra Arsalidou "An Examination into the Recent Approach of the Courts in Articulating a Standard of Care for Company Chairpersons in Australia" (2005) 26 Comp Law 155, 156, Mohammed B Hemraj "Company Directors: the Defence of Business Judgement Rule" (2003) 24 Comp Law 218, 218-219, Mohammed B Hemraj "The Business Judgment Rule in Corporate Law" (2004) 15 ICCLR 192, 192-194, David Tan "Delivering the Judgment on a Statutory Business Judgment Rule in Australia" 1995 AJCL LEXIS 39, in particular, 4-12 and 17-24, Robert Flannigan "Fiduciary Duties of Shareholders and Directors" [2004] JBL 277, 289-290, Cooney Report, above n 43, paras 3.30-3.35, and England and Wales Law Commission and the Scottish Law Commission *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties*, above n 51, paras 5.21-5.25.

¹⁹⁷ See Companies Act 1993, s 138, and Law Commission Company Law Report, above n 1, paras 520-522 and clause 107.

¹⁹⁸ Compare, for example, the Court of Appeal judgment in *Mason v Lewis*, above n 29, in particular paras 77-83, Judgment of the Court, with the High Court judgment in the same case (*Re Global Print Strategies Ltd (In Liquidation)*, above n 194), in particular paras 41-42 and 67-68, Salmon J.

With the factors considered in the previous sections in mind, as well as the general principle of flexibility,¹⁹⁹ this paper proposes a general duty not to conduct the business of a closely-held company in such a way that causes loss to creditors. This duty would be imposed on principals directly in favour of creditors, without resort to “the company”, as is outlined in *Nicholson v Permakraft*.²⁰⁰ That case phrased the duty as only arising in the event of insolvency, however.²⁰¹ It seems that this could be approached more simply as a duty to refrain from prejudicing the interests of creditors generally. This is effectively a duty not to become insolvent. This paper therefore recommends that the new closely-held companies statute provide that:

Draft Clause: Duties of Principals to Creditors

- (1) The Principal(s) of a Closely-Held Company must not conduct the business of the Closely-Held Company in such a way that causes loss to creditors of the Closely-Held Company.

This clearly favours creditors too much. It is therefore necessary to introduce a range of exceptions/defences for principals. Broadly, this paper recommends that there should be two standards of care: one for non-interested transactions and one for self-interested transactions. Self-interested transactions require much greater scrutiny and therefore a higher standard of care. This paper therefore recommends that the new statute provide:

- (2) A Principal that breaches the duty in subsection (1) is liable to creditor(s) that suffer loss due to the breach, unless:
 - (a) The Principal, in causing the Closely-Held Company to undertake the actions that are alleged to have caused the breach:²⁰²
 - (i) Did not have a personal interest in the actions, or the outcome of the actions;
 - (ii) Acted in an informed manner; and

¹⁹⁹ See above, Part IV D - Flexibility.

²⁰⁰ Above n 162.

²⁰¹ *Nicholson v Permakraft (NZ) Ltd*, above n 162, 249-250 Cooke J.

²⁰² See, for example, Corporations Act 2001 (Aus), s 180(2).

- (iii) Had a rational belief that the actions would not cause loss to creditors; or
- (b) The actions that are alleged to have caused the breach would have been undertaken by a reasonably prudent business person acting as a Principal of the Closely-Held Company.
- (3) For the purposes of subsection (2)(a)(iii), a belief is rational unless it is a belief such that no reasonable person in the position of the Principal could hold it.²⁰³

This approach would utilise a version of the business judgment rule for non-interested transactions. So long as a principal is not interested in the transaction, and makes the decision on an informed and rational basis, it is not open to challenge. This should empower principals with sufficient security from liability to encourage business decisions.

This paper proposes a reasonableness standard for self-interested transactions. This effectively extends the current New Zealand position for non-distribution payments to principals²⁰⁴ to all self-interested transactions, including dividends. This is more flexible than the traditional solvency test. The use of a “reasonably prudent business person acting as a principal of the closely-held company” acknowledges that the nature of business undertaken by closely-held companies will vary from company to company.²⁰⁵

The courts have traditionally been reluctant to interfere with business decisions or formulate a “reasonable businessman” standard of care.²⁰⁶ In practice, however, such a standard has been developing in relation to prohibitions of delinquent directors.²⁰⁷ There does not seem to be any reason

²⁰³ See, for example, Corporations Act 2001 (Aus), s 180(2). This is akin to a public law/*Wednesbury* reasonableness test – see *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223 (EWCA).

²⁰⁴ Companies Act 1993, s 161.

²⁰⁵ See also above, Part IV D - Flexibility.

²⁰⁶ See, for example, *Re City Equitable Fire Assurance Co*, above n 195.

²⁰⁷ See Companies Act 1993, s 385, National Enforcement Unit *Banned Directors and Managers / Director Prohibitions* (Ministry of Economic Development, Wellington, 2006) <<http://www.enforcement.med.govt.nz>> (last accessed 6 September 2006), Company Directors Disqualification Act 1986 (UK), Insolvency Service (United Kingdom) *Director Disqualification & Restrictions* (Insolvency Service, London, 2006) <<http://insolvency.gov.uk>> (last accessed 23 September 2006), and Len Sealy “Directors Duties in the New Millennium” (2000) 21 Comp Law 64, 64, and Len Sealy “Directors’ Duties Revisited”, above n 196, 79-80.

why such a standard should not extend to liability as well as potential prohibition. Punishment through prohibition is likely to be of little comfort to out-of-pocket creditors. Reasonableness (in varying forms) is also used by South Africa and the United States.²⁰⁸

Out of concern that reasonableness may be uncertain for some risk-averse principals, it may be appropriate to introduce a safe-harbour provision for self-interested transactions:

- (4) For the purposes of subsection (2)(b), the actions that are alleged to have caused the breach shall be deemed to be reasonable if, at the time the actions are undertaken:²⁰⁹
 - (a) The Closely-Held Company is able to pay its debts as they become due in the normal course of business; and
 - (b) The value of the Closely-Held Company's assets is greater than the value of its liabilities, including contingent liabilities.

This approach would deem any transaction that satisfied a solvency test to be reasonable. Principals that were willing to undertake the necessary steps to determine whether the solvency test is satisfied (probably by taking accounting advice) would be safe from liability to creditors. This would be an optional safe-harbour.

7 *Asset protection*

As discussed, separate legal personality and limited liability are not universally acclaimed.²¹⁰ Much of the criticism focuses on the potential injustice resulting from abuse of the corporate form. Assets can be placed

²⁰⁸ See above, Part V C 3 - Duties to creditors, and Part V C 5 - Standard of care

²⁰⁹ See, for example, Companies Act 1993, s 4, and Law Commission Company Law Report, above n 1, paras 330-333 and clause 3(3) (note that the Law Commission's formulation is preferred as it provides greater flexibility). See also, for example, Close Corporations Act 1984 (ZA), 51, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-119 (1977), and Uniform Limited Liability Company Act (1996), s 406(a).

²¹⁰ See above, Part V C 1 - No limited liability.

beyond the reach of rightful creditors.²¹¹ There are, however, two points to be made in this regard.

Asset protection is not a problem of limited liability companies. Assets can be protected through a number of legal mechanisms, including trusts²¹² and relationship property agreements,²¹³ as well as through companies. Moreover, it should also be noted that while a company may incur debts without recourse to the assets of the principals, equally principals may incur debts without recourse to the assets of the company.

The issue of asset protection is therefore not limited to company law. It is unfair to criticise company law exclusively, when in fact, greater problems arise from combining the assorted asset protection mechanisms. If this is an issue that does need to be resolved, it is more appropriate to do so through general mechanisms of property law, rather than through company law.²¹⁴

8 *Practical considerations: enforcement*

The temptation to impose ever-increasing regulatory requirements has been attributed to the fear of potential abuse of the corporate form.²¹⁵ This paper has proposed a relatively minimalist set of regulatory requirements. If there is concern regarding the potential for abuse of the corporate form, this paper considers that greater emphasis should be placed on enforcing the existing regulatory requirements, rather than applying additional regulatory requirements across all businesses.

²¹¹ See, for example, Andrew Hicks "Reforming the Law of Private Companies", above n 90, 174-175. The author's primary concern is under-capitalisation to the detriment of creditors.

²¹² See, for example, *Official Assignee v Wilson* [2006] 2 NZLR 841 (HC).

²¹³ See, for example, *Felton v Johnson* [2006] NZSC 31 (SC).

²¹⁴ In this regard, this paper notes that the Government has announced its intentions to revise the Property Law Act 1952 in accordance with the recommendations of the Law Commission. The Law Commission does not, however, recommend substantial changes to the current provisions relating to the disposition of property to the prejudice of creditors – see New Zealand Law Commission *A New Property Law Act* (NZLC R29, Wellington, 1994), and Law Commission Media Release "Palmer welcomes legislation implementing reports" (8 September 2006) Press Release <<http://www.scoop.co.nz>> (last accessed 16 September 2006). Also compare Property Law Act 1952, s 60 and New Zealand Law Commission *A New Property Law Act*, paras 51-52 and draft Bill, Part 5, Subpart 2 (cls 63-69).

²¹⁵ David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 164.

Enforcement of duties to creditors is a particular issue. Creditors may be reluctant to pursue actions against delinquent principals due to the time and cost involved. In particular, creditors are likely to be reluctant to “throw good money after bad” pursuing principals. This may be compounded if principals have adopted some of the asset protection mechanisms described in the preceding section.

One method of improving enforcement is through mandatory liability insurance for principals. Principals could be required to insure against liability to creditors under the duties proposed above. This would ensure that creditors would be able to recover, even if principals have employed some measure of asset protection. Moreover, it could lower the costs of enforcement. If it was more economical for insurers to pay out valid claims, court action would not be necessary. Finally, and perhaps most importantly, if insurance was mandatory for all principals, then principals with a history of dereliction of duty to creditors would either pay much higher premiums or perhaps even be entirely uninsurable. The market would itself reduce the incidence of delinquent principals.

Such a proposal would clearly be contingent on the availability of such insurance. In drafting this paper, a number of insurers offering “director and officer” insurance were contacted directly. While such insurance does exist for smaller companies, it is tailored more towards larger companies. Moreover, several of the insurers only provide insurance to directors/officers/principals with an established history of compliance with legal obligations. At least one other insurer’s coverage for non-established principals excludes claims if the company becomes insolvent.²¹⁶ New principals may therefore find it difficult to arrange the required insurance. Introducing a mandatory insurance requirements may create barriers for people to establish new closely-held companies.

²¹⁶ Interview with B, anonymous insurer (the author, by telephone, 28 July 2006), correspondence with C, anonymous insurer (the author, by email, 19 July 2006), correspondence with D, anonymous insurer (the author, by email, 19 July 2006), and correspondence with Insurance Council (the author, by email, 18 July 2006). As the information provided could be commercially sensitive, an undertaking not to disclose the detailed information was provided.

If the insurers were not willing or able to establish the requisite insurance market, an alternative would be establishing an “assetless company fund”, as was recommended by the Law Commission,²¹⁷ or increasing the scope of the existing Liquidation Surplus Account.²¹⁸ This would effectively provide a legal aid fund to assist creditors in pursuing claims against delinquent principals. This would ensure that delinquent principals could be held to account, even where it may not otherwise be economically-justifiable to pursue a claim. Draft clause(s) would depend on which approach is adopted.

D Multi-Principal Closely-Held Companies

Multi-principal closely-held companies introduce some complications. The closely-held companies statute will have to provide for the relations of principals among themselves. As for the previous discussion of duties to creditors, however, it seems that a relatively simple set of rules will cater for the needs of closely-held companies.

1 Relations of principals to each other: default rules

The closely-held companies statute will need to provide certain rules relating to the relations of principals among themselves. Obviously, single-principal closely-held companies will be able to disregard these rules. These should be “default” rules, able to be modified by agreement.²¹⁹ Default rules make matters as simple as possible for basic closely-held companies, while making allowance for the particular needs of individual companies if appropriate.²²⁰

2 Rights of principals

A consideration of comparative precedent reveals some fairly common themes for these default rules. First, they consider the rights of principals. These

²¹⁷ See Law Commission Company Law Report, above n 1, paras 647 and 710, and cls 243-249.

²¹⁸ See Companies Act 1993, s 316. See also Insolvency and Trustee Service “Liquidation Surplus Account” (December 2002) *Insolvency Quarterly Newsletter*, Volume 13, Wellington, 5 <<http://www.insolvency.govt.nz>> (last accessed 23 September 2006).

²¹⁹ Modification of default rules is considered in the next section of this paper – see below, Part V D 6 - Modification of default rules.

²²⁰ See also above, Part IV D - Flexibility, and below, Part V D 6 - Modification of default rules.

include the straightforward rights to be involved in the management of the closely-held company and to access information:

Draft Clause: Rights of Principals

The Principal(s) of a Closely-Held Company have the right to:

- (a) Be involved in the management of the Closely-Held Company;²²¹ and
- (b) Access all information relating to the affairs of the Closely-Held Company.²²²

3 *Shares, interests and distributions*

Second, it is necessary to make provision for dividing the interests in a closely-held company among principals. Again, the comparative precedents adopt a common approach. Contrary to company law, none of the comparative precedents provide for "shares". Only the South African statute makes express reference, by providing that interests are to be determined by way of percentage.²²³ The other statutes are silent, allowing principals to make their own arrangements if appropriate.²²⁴ Without express agreement to the contrary by the principals, however, the default position is for an even distribution of interests. This is a simple and seemingly effective approach, particularly for basic equal-share companies that will not vary the pro rata distribution of interests. Given a general duty to creditors has already been provided elsewhere,²²⁵ it is possible to stay silent as to interests, and provide a very simple approach to making distributions, for example:

²²¹ See, for example, Close Corporations Act 1984 (ZA), s 46(a), Wyoming Limited Liability Company Act, Wyo Stat § 17-15-116 (1977), Uniform Limited Liability Company Act (1996), s 404(a), and Partnerships Act 1908, s 27(e).

²²² See, for example, Uniform Limited Liability Company Act (1996), s 408, and Partnerships Act 1908, s 31.

²²³ See Close Corporations Act 1984 (ZA), s 30(1).

²²⁴ See, for example Close Corporations Act 1984 (ZA), s 12(e), and Partnerships Act 1908, s 27(a). See also below, Part V D 6 - Modification of default rules.

²²⁵ See above, Part V C 6 - Proposed duty of care.

Draft Clause: Distributions

A Closely-Held Company must make equal distributions among all its Principals.²²⁶

4 Duties of principals to each other

Next, and again similar to the rights described above, there are some common themes in terms of duties of principals. These include the straightforward accounting for property, disclosure of information, non-competition, and a general duty to comply with the requirements of the statute and operating agreement. A draft clause may read:

Draft Clause: Duties of Principals to Each Other

- (1) The Principal(s) of a Closely-Held Company must:
 - (a) Account to the other Principal(s) of the Closely-Held Company (if any) for any property, profit or other benefit derived in the course of conducting the Closely-Held Company's business;²²⁷
 - (b) Keep the other Principal(s) of the Closely-Held Company (if any) informed of any matters that may reasonably affect the business of the Closely-Held Company or the position of the other Principal(s);²²⁸
 - (c) Not compete in business with the Closely-Held Company or otherwise utilise the information or business opportunities of the Closely-Held Company for private gain;²²⁹ and
 - (d) Not breach, or conduct the business of the Closely-Held Company in such a way that the Closely-Held Company breaches, the Operating Agreement of the Closely-Held Company or this Act.
- (2) A Principal that breaches the duty in subsection (1) is liable to the Principal(s) of that Closely-Held Company not party to the breach that suffer loss due to the breach.

²²⁶ See, for example, Close Corporations Act 1984 (ZA), s 46(f) Wyoming Limited Liability Company Act, Wyo Stat § 17-15-119 (1977), and Uniform Limited Liability Company Act (1996), s 405(a).

²²⁷ See, for example, Close Corporations Act 1984 (ZA), s 42(2)(b)(i), Uniform Limited Liability Company Act (1996), s 409(b)(1), and Partnerships Act 1908, ss 23, 24 and 32.

²²⁸ See, for example, Partnerships Act 1908, s 31, Close Corporations Act 1984 (ZA), s 42(2)(b)(ii), and Uniform Limited Liability Company Act (1996), s 408.

²²⁹ See, for example, Close Corporations Act 1984 (ZA), s 42(2)(b)(iii), Uniform Limited Liability Company Act (1996), s 409(b)(3), and Partnerships Act 1908, ss 32-33.

It is also necessary to consider entry and exit rights of principals. While the comparative precedent is largely uniform in requiring the unanimous consent of existing principals to introduce a new principal, there is no consistent approach to exit rights of principals. The United States²³⁰ and New Zealand partnership law,²³¹ for example, provides by default that principals have the right to exit at any time. South Africa adopts a more traditional company law approach, and does not allow exit at will.²³²

Allowing withdrawal at will would limit the potential for disputes to arise, as an aggrieved principal could withdraw at any time. On the other hand, it may also lead to business uncertainty if business partners can at any time go their own way, taking their capital with them.²³³ This business uncertainty may be able to be managed through appropriate notice and transitional requirements in the statute.

This paper is inclined towards the United States exit-at-will approach due to its ability to limit disputes, but this is a finely balanced matter. A draft clause may read:

Draft Clause: Entry and Exit of Principals

- (1) No person may become a Principal of a Closely-Held Company without the unanimous consent of the other Principal(s).²³⁴
- (2) The Principal(s) of a Closely-Held Company have the right to exit from the Closely-Held Company at any time.²³⁵

²³⁰ See, for example, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-120 (1977), Uniform Limited Liability Company Act (1996), s 602(a). Note however this may be due to the United States' tax position – see Uniform Limited Liability Company Act (1996), prefatory note, 1.

²³¹ Partnerships Act 1908, s 29.

²³² See Close Corporations Act 1984 (ZA), ss 33-40.

²³³ See also Law Commission Company Law Report, above n 1, paras 206-207.

²³⁴ See, for example, Close Corporations Act 1984 (ZA), s 33, Wyoming Limited Liability Company Act, Wyo Stat §§ 17-15-122 and 17-15-144(b) (1977), and Partnerships Act 1908, s 27(g).

²³⁵ See, for example, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-120 (1977), Uniform Limited Liability Company Act (1996), s 602(a), and Partnerships Act 1908, s 29.

It would, however, also be necessary to include some ancillary provisions relating to matters such as the nature of an interest that is transferred contrary to subsection (1),²³⁶ the process and timeframes for exit under subsection (2),²³⁷ and for liability before and after exit or entry.²³⁸ These are detailed matters outside the scope of this paper, however.

6 *Modification of default rules*

As discussed, the above should be default rules to make matters as simple as possible for basic closely-held companies.²³⁹ Also as discussed, it is necessary to make allowances for the particular needs of individual closely-held companies. Most importantly, there should be sufficient flexibility to allow principals to arrange internal matters to suit their particular circumstances, including modifying the default rules.

The Companies Act anticipates this through the use of company constitutions,²⁴⁰ but only to a degree.²⁴¹ The United States²⁴² and South African²⁴³ closely-held companies statutes, and even New Zealand partnership law,²⁴⁴ expressly provide for much greater flexibility. The default rules relating to relationships of principals among themselves, as well as the powers and functions of principals, are expressly subject to modification by agreement. This greater flexibility seems appropriate for the new closely-held companies statute. This paper therefore proposes the following clause:

²³⁶ See, for example, Uniform Limited Liability Company Act (1996), s 502, and Partnerships Act 1908, s 34(1).

²³⁷ See, for example, Uniform Limited Liability Company Act (1996), ss 601(1) and s 603(a)(1).

²³⁸ See, for example, Partnerships Act 1908, ss 20 and 39(3).

²³⁹ See above, Part IV D - Flexibility.

²⁴⁰ See Companies Act 1993, Part V.

²⁴¹ See, in particular, Companies Act 1993, s 31(1).

²⁴² See, for example, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-107(a)(xi) (1977), and Uniform Limited Liability Company Act (1996), s 103.

²⁴³ See Close Corporations Act 1984 (ZA), ss 44 and 46.

²⁴⁴ See Partnerships Act 1908, s 22.

Draft Clause: Operating Agreement

- (1) A Closely-Held Company may have an Operating Agreement to:²⁴⁵
 - (a) Regulate the operation of the business of that Closely-Held Company; and
 - (b) Govern the relations among the Principal(s) of that Closely-Held Company.
- (2) The Principal(s) of a Closely-Held having an Operating Agreement must act in accordance with the provisions of that Operating Agreement.²⁴⁶

Adopting an operating agreement would require the unanimous agreement of principals, as an operating agreement is binding on all principals. Unanimous agreement would also be required to amend or revoke an operating agreement. An additional consequence of this is that it is effectively possible to act outside the operating agreement if all principals agree:

- (3) An Operating Agreement may be adopted, replaced, amended or revoked at any time by the unanimous agreement of the Principal(s) of the Closely-Held Company.²⁴⁷

It is also necessary to consider whether this flexibility to arrange internal affairs should be unrestricted, or have certain limitations placed on it. Some matters should clearly be capable of being modified by agreement. Matters such as the proportion of distributions among principals will be modified almost as a matter of course. Other matters, such as entry and exit rights should similarly be able to be modified to suit individual circumstances. Even the assorted directors' duties to each other may be dispensed with (or at least breaches ratified by unanimous agreement) in appropriate circumstances. All the comparative precedents allow for modification of these matters.²⁴⁸

²⁴⁵ See, for example, Close Corporations Act 1984 (ZA), s 44, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-107(a)(xi) (1977), and Uniform Limited Liability Company Act (1996), s 103.

²⁴⁶ See, for example, Close Corporations Act 1984 (ZA), s 44(4), and Uniform Limited Liability Company Act (1996), s 409(d).

²⁴⁷ See, for example, Close Corporations Act 1984 (ZA), ss 44(1) and 44(6), and Uniform Limited Liability Company Act (1996), s 103(a).

²⁴⁸ See Close Corporations Act 1984 (ZA), ss 44 and 46, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-107 (1977), Uniform Limited Liability Company Act (1996), s 103, and Partnerships Act 1908, ss 22 and 27.

The rights of principals to access information and be involved in the management of the closely-held company may be considered more important. The general scheme of the proposed closely-held companies statute is that substantial regulatory requirements are not required. But this is based on the premise that involvement in management obviates the need for regulatory requirements. Limiting a principal's involvement in management and/or access to information is more akin to a company-style approach of separate directors and shareholders. As discussed, this is a situation that may be abused, hence the need for regulatory requirements. It may therefore not be appropriate to allow principals to alter these rights by agreement.

Although none of comparative precedents prohibit the alteration of these rights by agreement, some provide that they may not be unreasonably restricted.²⁴⁹ This strikes a balance between respecting the ability of principals to decide for themselves²⁵⁰ and acknowledging the accountability concerns if someone is a principal of a closely-held company without any access to information or involvement in management. The majority of the comparative precedent, however, allows even the information and management rights to be modified, presumably on the basis of allowing people to decide for themselves. The only limitation is that such modifications cannot be "inconsistent with the law".²⁵¹

This paper prefers the former view for the reasons outlined, notwithstanding the majority of comparative precedent favours the latter. These matters are so fundamental that they should not be subject to exclusion:

- (4) The provisions of an Operating Agreement may:
 - (a) Modify any of the provisions of sections [Distributions], [Duties of Principals to Each Other],

²⁴⁹ See, for example, Uniform Limited Liability Company Act (1996), s 103(b).

²⁵⁰ David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 166.

²⁵¹ See, for example, Close Corporations Act 1984 (ZA), ss 44(1)(b) and 46, and Wyoming Limited Liability Company Act, Wyo Stat § 17-15-107(a)(xi) (1977).

and *[Entry and Exit of Principals]* without restriction;²⁵² and

- (b) Modify any of the provisions of section *[Rights of Principals]*, but only where it is reasonable to do so.²⁵³

7 *Creditors and balancing mechanisms*

This paper proposes imposing a duty on principals of closely-held companies in favour of creditors. The discussion of these duties above²⁵⁴ used the example of one-principal closely-held companies to avoid the potential complications that may arise with multi-person companies.²⁵⁵ There does not seem to be any reason why matters should become overly-complicated simply because multiple principals become involved in a closely-held company. There is no difference between several principals and one principal owing the duties to creditors as outlined in this paper.

The balancing mechanisms associated with competing duties are nominally more complicated. As discussed, company law traditional uses a duty to “the company” to resolve disputes.²⁵⁶ This does not seem necessary, however, even in the case of multiple principals. It is difficult to envisage a situation where the very basic duty not to prejudice the position of creditors will conflict with any of the duties to other principals. In the event that it does, this paper proposes a hierarchy of duties,²⁵⁷ with the duty to creditors taking precedence over the duties to other principals (so long as there is a causative link between the wrongful act and the loss to creditors). For the reasons outlined above, this seems a far simpler method than utilising the balancing mechanism.²⁵⁸

²⁵² See, for example, Close Corporations Act 1984 (ZA), ss 44 and 46, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-107 (1977), Uniform Limited Liability Company Act (1996), s 103, and Partnerships Act 1908, ss 22 and 27.

²⁵³ See, for example, Uniform Limited Liability Company Act (1996), s 103(b).

²⁵⁴ See above, Part V C 4 - Balancing mechanisms versus direct regulatory requirements.

²⁵⁵ See above, n 178.

²⁵⁶ See above, Part V C 4 - Balancing mechanisms versus direct regulatory requirements.

²⁵⁷ See also Law Commission Company Law Report, above n 1, paras 194-195.

²⁵⁸ See above, Part V C 4 - Balancing mechanisms versus direct regulatory requirements.

E Remedies

1 General: criminal versus civil remedies

The remedies for any breach of the duties to creditors and other principals also need to be considered. There are two broad options for remedies: criminal and civil remedies.

The Companies Act imposes a range of criminal sanctions for breach of its assorted regulatory requirements.²⁵⁹ It is not clear that this is the most effective approach for enforcement. Prosecutorial discretion means that many of the more-minor offences will never be enforced,²⁶⁰ particularly where no-one suffers any harm or loss. Moreover, the criminal law has a higher burden of proof, is slow, and has more-restrictive rules of evidence. This is likely to be aggravated by the complexities of both company law and the modern commercial environment.²⁶¹ The criminal law has therefore been described as a “blunt and largely ineffective instrument for ensuring that technical or administrative duties are complied with”.²⁶²

South Africa, for example, has made a conscious choice to “decriminalise” many of the breaches of the Close Corporations Act.²⁶³ The primary remedy for any breach of the law is to impose personal civil liability. The basic approach is that a person who does not comply with the regulatory requirements of the Close Corporations Act forfeits the privileges associated with it – in particular, a person in breach effectively loses the protections of

²⁵⁹ See Companies Act 1993, Part XXI.

²⁶⁰ The most high-profile incident is perhaps that involving David Parker and unanimous resolutions not to appoint an auditor – see Ian Wishart “Attorney-General Caught Filing False Documents” (20 March 2006) Investigate Magazine, New Zealand <<http://www.investigatemagazine.com>> (last accessed 6 August 2006).

²⁶¹ See S Du Toit and J J Henning “South Africa - Corporate Law Reform and the Empowerment of the Victims of Economic Crime” (1999) 20 Comp Law 277, 281.

²⁶² S Du Toit and J J Henning “South Africa - Corporate Law Reform and the Empowerment of the Victims of Economic Crime”, above n 261, 283. See also the similar recommendations of the Cooney Report, above n 43, paras 13.10-13.15.

²⁶³ S Du Toit and J J Henning “South Africa - Corporate Law Reform and the Empowerment of the Victims of Economic Crime”, above n 261, 280-284. See also Cooney Report, above n 43, paras 13.10-13.12.

limited liability by incurring personal liability.²⁶⁴ Civil liability also has the effect of greater emphasis on self-enforcement. This means that enforcement will only be pursued where someone has suffered actual harm.²⁶⁵ This approach seems appropriate. This paper recommends that only civil remedies be imposed for breaches of duties. It may be necessary to impose criminal remedies for fraudulent behaviour,²⁶⁶ but this would be an exception to the general approach.

2 *Specific remedies*

In terms of specific civil remedies, given the nature of creditors' interests, any civil remedy for creditors will almost-inevitably be in the form of damages. For breach of duties to other principals, an account of profits will frequently arise as the most appropriate remedy, as well as damages. Both of these are well-established remedies.

One additional remedy that may be appropriate, however, is giving the court the power to (with the consent of the other principals) expel from the closely-held company a principal that has breached his/her duties. Such a remedy is provided in South Africa.²⁶⁷ As for the right to exit a closely-held company,²⁶⁸ the most effective way to resolve a dispute may be to require quarrelling principals to go their separate ways.

These remedies would be available to the court, notwithstanding anything to the contrary in the operating agreement of the closely-held company (in particular, relating to the exit of principals). While the operating agreement can alter what amounts to a breach, once that breach is established, it should not be able to limit the court's available range of remedies. Limiting the

²⁶⁴ S Du Toit and J J Henning "South Africa - Corporate Law Reform and the Empowerment of the Victims of Economic Crime", above n 261, 283.

²⁶⁵ S Du Toit and J J Henning "South Africa - Corporate Law Reform and the Empowerment of the Victims of Economic Crime", above n 261, 283. This approach was also recommended for New Zealand by the Law Commission – see Law Commission Company Law Report, above n 1, paras 318, 564, 565 and 585.

²⁶⁶ For example, filing false documents or general use of the corporate form to defraud – see Companies Act 1993, ss 377, 379 and 380.

²⁶⁷ See Close Corporations Act 1984 (ZA), s 36.

²⁶⁸ See above, Part V D 5 - Entry and exit.

available remedies may impair the court's ability to adequately address an actual breach and ensure justice in the individual case.

This paper therefore proposes the following be implemented:

Draft Clause: Remedies

- (1) Despite anything in the Operating Agreement, where a Principal is liable under section [Duties of Principals to Creditors] or [Duties of Principals to Each Other], the Court may, to the extent that it is just and reasonable, order that the Principal.²⁶⁹
 - (a) Pay damages to the person that has suffered loss due to the breach;
 - (b) Pay a sum up to the amount of personal profit made or loss avoided by that Principal to the person that has suffered loss due to the breach; and/or
 - (c) Be expelled from the Closely-Held Company.²⁷⁰
- (2) The Court may make an order under subsection (1)(c) only with the consent of the other Principal(s) of the Closely-Held Company.

It would also be necessary to provide for ancillary matters related to an expulsion order, including the appropriate payout (if any) for the expelled partner, the timeframe for such payout, and liability before and after expulsion.²⁷¹ The detail of these provisions is outside the scope of this paper.

F Transacting Business

It is necessary to provide, for the avoidance of doubt, that closely-held companies have full legal capacity to transact business. The alternative, the ultra vires doctrine, is not appropriate in the New Zealand environment.²⁷²

This also caters to the potentially informal manner of conducting business by closely-held companies, by allowing closely-held companies to undertake all actions that the principals themselves are able to do:

²⁶⁹ See, for example, Close Corporations Act 1984 (ZA), s 42(3), and Uniform Limited Liability Company Act (1996), ss 409-410.

²⁷⁰ See Close Corporations Act 1984 (ZA), s 36.

²⁷¹ These provisions will be similar to those for the exit of principals – see above, Part V D 5 - Entry and exit.

²⁷² See Law Commission Company Law Report, above n 1, paras 95 and 342-348.

Draft Clause: Capacity of Closely-Held Companies

A Closely-Held Company has all the rights, powers and legal capacity of a natural person.²⁷³

It is also necessary to consider how closely-held companies go about practically transacting business. Obviously, legal persons such as companies can not act for themselves. The Companies Act, for example, generally empowers the board of a company to manage it.²⁷⁴ In order to transact business on a day-to-day basis companies rely on agents. Theoretically at least, board authorisation is necessary to appoint a person an agent of a company. This is effectively a delegation of powers. The technicalities of agency law are probably beyond the standard closely-held company, however. As discussed in the empirical findings of this paper, the majority of a closely-held company's business will be transacted by their principals themselves.²⁷⁵

Again the comparative precedent provides a more appropriate approach for closely-held companies. The default rule is that all principals are deemed to be the agents of the closely-held company. This is a simple approach that is particularly suitable for closely-held companies:

Draft Clause: Transacting Business

- (1) All Principal(s) of the Closely-Held Company are its agents for the purpose of its business.²⁷⁶

New Zealand, however, has a particularly strong focus on form-over-substance in corporate law.²⁷⁷ Notwithstanding the generality of proposed subsection (1), it may be appropriate to provide a safe-harbour provision for closely-held companies:

²⁷³ See, for example, Companies Act 1993, ss 15-17, Law Commission Company Law Report draft bill, clauses 7-8, Incorporated Societies Act 1908, s 10, Close Corporations Act 1984 (ZA), s2(2), Wyoming Limited Liability Company Act, Wyo Stat § 17-15-104 (1977), and Uniform Limited Liability Company Act (1996), s 112(b).

²⁷⁴ Companies Act 1993, s 128.

²⁷⁵ See above, Part II C 1 - Synonymity. Note in particular that some 63 per cent of businesses have no employees at all – see above, n 28.

²⁷⁶ See, for example, Close Corporations Act 1984 (ZA), s 54, Wyoming Limited Liability Company Act, Wyo Stat § 17-15-117 (1977), Uniform Limited Liability Company Act (1996), s 301, and Partnerships Act 1908, ss 8 and 9.

²⁷⁷ See, for example, *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517 (CA), and *Ede (trading as Electro Sheetmetals Ltd) v J A Russell Ltd* (2001) 9 NZCLC 262,539 (HC).

- (2) Any act by a Principal of a Closely-Held Company who uses the expression "[NAME OF PRINCIPAL], Principal, for [NAME OF CLOSELY-HELD COMPANY]" in doing the act is deemed to be the act of that Closely-Held Company.

This would deem any transaction using the particular expression to be a transaction of the closely-held company. This safe-harbour would provide additional guidance for principals of closely-held companies, and ensure that potential liability "traps" do not arise through ignorance or oversight of the law.

G Accounting Records and Other Obligations

One obligation often set out in company law relates to accounting or financial reporting obligations. As discussed, however, such requirements can be particularly burdensome²⁷⁸ and without apparent benefit for closely-held companies.²⁷⁹ Any benefits that may be derived from such financial records, can equally be derived from other statutory reporting obligations – in particular, annual tax returns.²⁸⁰ A tax return is equally able to achieve any goals such as assessing the performance of the business in the previous financial year, or imposing business disciplines, or encouraging good decision making. This approach is adopted in other jurisdictions.²⁸¹ Any other financial records that are practically necessary or useful (for example, in the context of considering the solvency test) will be prepared or commissioned by the closely-held company as needed or desired, not by regulatory compulsion.

There does not seem to be any need to set out any other obligations in the closely-held companies statute, other than some administrative requirements relating to registration and winding up. In relation to the latter, it is probably most appropriate to simply incorporate by reference the existing provisions of the Companies Act. This is a more complicated and technical area of law that

²⁷⁸ See above, Part III B - Costs of the Requirements.

²⁷⁹ See above, Part III A - Regulatory Requirements.

²⁸⁰ Tax Administration Act 1994, section 33. In New Zealand at least, there is no obligation to file financial reports publicly for the majority of companies. The private nature of tax returns therefore does not matter.

²⁸¹ There are no reporting requirements in either the Wyoming Limited Liability Company Act, Wyo Stat title 17 chapter 15 (1977) or the Uniform Limited Liability Company Act (1996).

is normally conducted by specialists, not by closely-held companies in their day-to-day activities. Additional complexity can therefore be justified.²⁸²

H Formalities

Finally, in light of the informality of closely-held companies,²⁸³ it may be appropriate to provide that even matters required under the statute do not have to comply with any particular level of formality (other than perhaps matters which must be sent to the Registrar of Closely-Held Companies, such as applications to incorporate a closely-held company):

Draft Clause: Formalities

Every matter contemplated by this Act may be done informally (including, without limitation, not in writing).²⁸⁴

VI CONCLUSION

This paper has attempted to show how the Companies Act is inadequate for closely-held companies in New Zealand. The essential problem of the Companies Act is that the regulatory requirements imposed on directors to ensure accountability to shareholders do not have any benefit where the directors of a company are also its shareholders. With no benefit, the costs arising from such regulatory requirements are therefore unjustified. This problem is effectively acknowledged in the Companies Act through the assorted concessions to closely-held companies. These concessions have their own issues, however, particularly in terms of compliance costs.

This paper has therefore proposed enacting a new statute designed to meet the needs of closely-held companies. It argued that this statute should be in addition to the existing Companies Act; it is not possible for one statute to cater to the needs of both widely- and closely-held companies. This new statute should be based on principles of accessibility and flexibility. From these general principles, the empirical findings of this paper, and a

²⁸² David Goddard "Company Law Reforms – Lessons from the New Zealand Experience", above n 31, 163.

²⁸³ See above, Part II C 2 - Informality.

²⁸⁴ See, for example, Uniform Limited Liability Company Act (1996), s 103(a).

comparison of international precedent, the paper has set out some key features that are considered appropriate for a closely-held companies statute in New Zealand.

Perhaps the key feature of the proposed new statute is the removal of the distinction between shareholders and directors. This reflects the practical realities of a significant majority of companies in New Zealand. On this basis, there is no need to impose regulatory requirements on directors in favour of shareholders. This addresses a particularly significant issue identified with the Companies Act. Forming a closely-held company would be available to natural persons, with an upper limit of ten principals. This will ensure that all persons can be practicably involved in the management of the closely-held company.

The paper proposed a number of other features. Like the Companies Act, the proposed new statute would provide for limited liability. The consequence of this is that creditors of closely-held companies may be vulnerable to abuse of the closely-held company form. As such, there is a need to impose regulatory requirements in favour of creditors. Like the Companies Act, these regulatory requirements would take the form of duties to creditors. Unlike the Companies Act, however, this duty would be cast in very general terms and be owed to creditors directly. This makes the new statute more straightforward than the Companies Act.

The paper also proposes a range of duties in favour of other principals in the case of multi-person closely-held companies. This would include duties to account for property of the closely-held company, keep the other principals informed of relevant matters, and not to compete with the closely-held company. In the interests of flexibility, however, most of these duties would be modifiable by agreement of the principals.

Finally, the paper proposed that the statute include simple provisions relating to transacting business, eliminating the duplication between accounting and

tax reporting requirements and allowing considerable informality for closely-held companies.

The net result is a simple, straightforward set of requirements suitable for closely-held companies in New Zealand, without onerous or unjustified compliance requirements. The paper argues that such a statute should be implemented to meet the needs of closely-held companies in New Zealand.

APPENDIX: DRAFT NEW ZEALAND CLOSELY-HELD COMPANY ACT

1. Short Title

This Act may be cited as the Closely-Held Company Act.

2. Eligibility for Membership of a Closely-Held Company

A Closely-Held Company must have at least one, but not more than ten, Principals, all of whom must be natural persons.

3. Limited Liability

The Principal(s) of a Closely-Held Company are not liable for the debts of the Closely-Held Company.

4. Duties of Principals to Creditors

(1) The Principal(s) of a Closely-Held Company must not conduct the business of the Closely-Held Company in such a way that causes loss to creditors of the Closely-Held Company.

(2) A Principal that breaches the duty in subsection (1) is liable to creditor(s) that suffer loss due to the breach, unless:

(a) The Principal, in causing the Closely-Held Company to undertake the actions that are alleged to have caused the breach:

(i) Did not have a personal interest in the actions, or the outcome of the actions;

(ii) Acted in an informed manner; and

(iii) Had a rational belief that the actions would not cause loss to creditors; or

(b) The actions that are alleged to have caused the breach would have been undertaken by a reasonably prudent business person acting as a Principal of the Closely-Held Company.

(3) For the purposes of subsection (2)(a)(iii), a belief is rational unless it is a belief such that no reasonable person in the position of the Principal could hold it.

(4) For the purposes of subsection (2)(b), the actions that are alleged to have caused the breach shall be deemed to be reasonable if, at the time the actions are undertaken:

(a) The Closely-Held Company is able to pay its debts as they become due in the normal course of business; and

(b) The value of the Closely-Held Company's assets is greater than the value of its liabilities, including contingent liabilities.

5. Rights of Principals

The Principal(s) of a Closely-Held Company have the right to:

(a) Be involved in the management of the Closely-Held Company; and

(b) Access all information relating to the affairs of the Closely-Held Company.

6. Distributions

A Closely-Held Company must make equal distributions among all its Principals.

7. Duties of Principals to Each Other

(1) The Principal(s) of a Closely-Held Company must:

(a) Account to the other Principal(s) of the Closely-Held Company (if any) for any property, profit or other benefit derived in the course of conducting the Closely-Held Company's business;

(b) Keep the other Principal(s) of the Closely-Held Company (if any) informed of any matters that may reasonably affect the business of the Closely-Held Company or the position of the other Principal(s);

(c) Not compete in business with the Closely-Held Company or otherwise utilise the information or business opportunities of the Closely-Held Company for private gain; and

(d) Not breach, or conduct the business of the Closely-Held Company in such a way that the Closely-Held Company breaches, the Operating Agreement of the Closely-Held Company or this Act.

(2) A Principal that breaches the duty in subsection (1) is liable to the Principal(s) of that Closely-Held Company not party to the breach that suffer loss due to the breach.

8. Entry and Exit of Principals

(1) No person may become a Principal of a Closely-Held Company without the unanimous consent of the other Principal(s).

(2) The Principal(s) of a Closely-Held Company have the right to exit from the Closely-Held Company at any time.

9. Operating Agreement

(1) A Closely-Held Company may have an Operating Agreement to:

(a) Regulate the operation of the business of that Closely-Held Company; and

(b) Govern the relations among the Principal(s) of that Closely-Held Company.

(2) The Principal(s) of a Closely-Held having an Operating Agreement must act in accordance with the provisions of that Operating Agreement.

(3) An Operating Agreement may be adopted, replaced, amended or revoked at any time by the unanimous agreement of the Principal(s) of the Closely-Held Company.

(4) The provisions of an Operating Agreement may:

(a) Modify any of the provisions of sections 6 (Distributions), 7 (Duties of Principals to Each Other), and 8 (Entry and Exit of Principals) without restriction; and

(b) Modify any of the provisions of section 5 (Rights of Principals), but only where it is reasonable to do so.

10. Remedies

(1) Despite anything in the Operating Agreement, where a Principal is liable under section 4 (Duties of Principals to Creditors) or 7 (Duties of Principals to Each Other), the Court may, to the extent that it is just and reasonable, order that the Principal:

- (a) Pay damages to the person that has suffered loss due to the breach;
- (b) Pay a sum up to the amount of personal profit made or loss avoided by that Principal to the person that has suffered loss due to the breach; and/or
- (c) Be expelled from the Closely-Held Company.

(2) The Court may make an order under subsection (1)(c) only with the consent of the other Principal(s) of the Closely-Held Company.

11. Capacity of Closely-Held Companies

A Closely-Held Company has all the rights, powers and legal capacity of a natural person.

12. Transacting Business

- (1) All Principal(s) of the Closely-Held Company are its agents for the purpose of its business.
- (2) Any act by a Principal of a Closely-Held Company who uses the expression "[NAME OF PRINCIPAL], Principal, for [NAME OF CLOSELY-HELD COMPANY]" in doing the act is deemed to be the act of that Closely-Held Company.

13. Formalities

Every matter contemplated by this Act may be done informally (including, without limitation, not in writing).

14. Formation, Liquidations and Registrar

The following provisions of the Companies Act 1993 apply to Closely-Held Companies registered under this Act as if they were companies incorporated under the Companies Act 1993:

- (a) Part II (relating to incorporation);
- (b) Part XVI (relating to liquidations); and
- (c) Part XX (relating to the Registrar of Companies).

NB. Sections 1 and 14 did not appear in the body of the paper. They are merely provided as an indication of these matters may be addressed.

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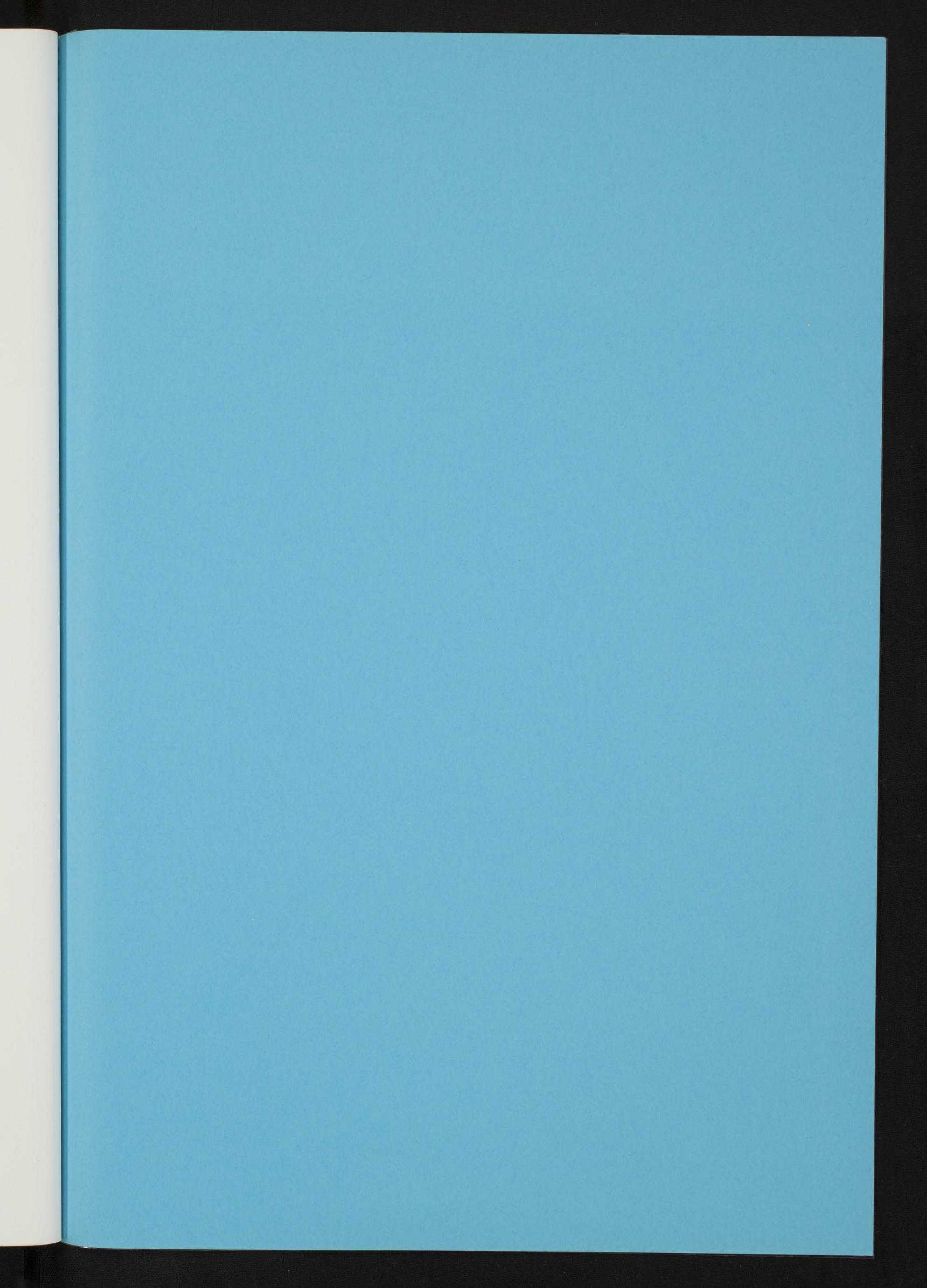
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