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L Ba Barker, P. LLB (HONOURS) RESEARCH PAPER

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An outline of the present inadequacies ...liquidation... private companies.

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VICTORIA UNIVERISTY OF WELLINGTON

FACULTY OF LAW

LEGAL WRITING TO SATISFY THE REQUIREMENTS OF THE LL.B (HONOURS) DEGREE

"An outline of the present inadequacies in the practice of the law relating to the liquidation and winding up of private companies and proposals for reform to help limit the number of failures of private companies and to help prevent fraudulent trading."

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I would like to take this opportunity to thank Mr Gould, Official Assignee of Wellington, Mr Dibley, Assistant Registrar of Companies, Mr P.D. McKenzie, Senior Lecturer in Law Victoria University, and Mr L.M. Papps a practitioner who has had considerable experience in this field.

All have offered advice, supplied me with material and generally have helped me avoid some of the more obvious mistakes which can be made. However I add the normal word or caution that all views expressed are my own and that I alone must take responsibility for any views expressed.

I am in even greater debt to Carol England without whom this manuscript would not have seen the light of day. She typed an unintelligible manuscript into some semblance of order and went far and above the normal course of duty.

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Each year there are a large number of company failures[1] but few companies are brought before the court to account for the failures and even less are prosecuted for fraudulent trading. The purpose of this paper is to examine whether the administrative machinery can be improved and whether the scope of the law should be extended, particularly to cover reckless and incompetent trading.[2] Such a discussion inevitably covers the general question of the privilege of limited liability and whether it should be retained for private companies.

In a paper of this size I cannot hope to cover all points very thoroughly. The purpose is simply to outline some of the problems and give indications as to some possible answers. The limitations of space also do not allow me to acknowledge by way of footnotes those who have contributed material in this area. However I alone must take responsibility for any conclusions reached.

The word 'reform' in itself suggests that the present position is unsatisfactory and it is submitted that the system as it is at present is unsatisfactory.

As at December 31 1970 there were 78,891 companies registered in New Zealand of which 77,591 were private companies and of the private companies there are a significant number of companies which go into receivership or liquidation each year.

Of those that go into liquidation the Official Assignee investigates only a relatively small proportion of those companies

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2 This is the recommendation of the Report of the Company Law Committee (Jenkins Report) Cmnd 1749 1962 paragraph 503.

1 Approx. 500 companies per year are reported at the Companies Office as having gone into liquidation or receivership. Unofficial estimates would be even higher.

because he only has power to investigate those companies wound up by the court. This means that the Official Assignee acting in the public interest has little scope in which to exercise his powers.

It is important however, to distinguish between the various types of company liquidation.

1. SHAREHOLDERS VOLUNTARY WINDING UP

Pursuant to Section 268 of the Companies Act the shareholders can resolve to wind up the company and this can be done without reference to the court or to creditors. However this method can only be availed of if there is a declaration of solvency filed with the Registrar of Companies by the directors. Also there are provisions under the Companies Winding Up Rules and the Companies Act to ensure that the winding up begins to take place soon after the Declaration of Solvency so that the information in the latter does not become 'stale' and out of date. It is submitted that the present procedure is satisfactory and adequately protects creditors.

This method of winding up is usually used for companies which have outlived their purpose. Most often they will be name protection companies or companies formed purely for the purpose of supposed tax advantages. There is an even smaller percentage which are subsidiary companies being wound up because of a rationalisation by the main trading group or those companies which become redundant after a takeover.

However the percentage of companies which have been actually

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trading and use this form of company winding up is very small. The Official Assignee of Wellington, Mr Gould, in his experience, also finds that this is the case. Thus it is submitted reform in this area is not necessary because the creditors are adequately protected.

It is with the other forms of company liquidations that most criticisms arise.

2. CREDITORS VOLUNTARY WINDING UP

Here there is a resolution to wind up the company and a formal meeting of the creditors is held who then have the right, if they so wish, to appoint a Liquidator. [1]

The defect under this system is that when the company realises it is insolvent, to escape any liability under the penal provisions of the Companies Act, it goes into a creditors voluntary liquidation promising a quick realisation of its assets and the creditors will comply in order to recoup at least some of their losses.

3. WINDING UP BY ORDER OF THE COURT

This usually occurs when the company becomes insolvent and there is a petition made to the Court by an unpaid creditor. In these cases the Official Assignee is appointed as provisional Liquidator and he normally remains as Liquidator.

The problem here is that the company which has been fraudulently trading outright will disappear underground well before a Court

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1 Such a liquidator can report any irregularities it finds to the Official Assignee who can then investigate the company. However Mr Gould notes that in practise this very rarely occurs.

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winding up if it has any sense. Otherwise it will make an informal arrangement with creditors rather than have a court investigate its trading background. Thus many of the companies which reach the court winding up stage are guilty of incompetentcy rather than fraud. Under the existing law it is difficult to bring such companies within the penal provisions of the Companies Act and investigation is hampered by the totally inadequate book keeping of these companies.

The Official Assignee mentions there is a fourth type of winding up which is prevalent and this is the informal liquidation of a company whereby a company comes to an arrangement with its creditors without notifying the Companies Office at all. By the very nature of this activity it is impossible to produce accurate figures but Mr Gould on the basis of investigating the number of companies removed from the Companies register, produces some interesting figures. In 1969 1,389 companies were removed from the Register. In that year there were 301 voluntary windings up reported and 56 windings up by order of the court. This leaves 1,032 companies unaccounted for.

Some of these companies will be companies formed for tax saving, or for name protection and will not have been actively trading. However a significant proportion, it is submitted, would be actively trading companies who have either sold up their assets and the directors disappearing, or companies coming to an arrangement with their creditors, This is not automatically sinister. A company may be in a position where it can pay 90 cents in the dollar

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to unsecured creditors, and all parties may agree to this in order to gain a quick realisation of the assets and to prevent a proportion of the assets going to an accountant, lawyer or Official Assignee as the costs of a formal winding up.

However it is clear that there are many companies which have been involved in fraudulent trading practices which escape official scrutiny altogether. This is one major defect in the system in that the Official Assignee is able to investigate only a very small proportion of companies which go into liquidation.

However, even when the Official Assignee does get a company to investigate, his problems are still not over. Mr Gould has estimated that a winding up by the Court takes from three to five years and even up to eight years.

The Official Assignee is hampered by a small budget and inadequate staff.[1] Time is absorbed in establishing a list of creditors and in gathering together and realising the company's assets. There is then the problem of investigating the company's affairs with few records to work from and even if the Official Assignee finds suspicious circumstances he still has to gather enough proof to bring a court action. And even if these difficulties are not enough the Official Assignee often finds that the creditors are reluctant to co-operate with the Official Assignee in bringing a prosecution against the company being liquidated. This in the creditor's opinion takes time and is more cost than it is worth. They feel it is throwing good money after bad and they are not particularly interested in the idea of using their money in the 'public interest'.

1 For confirmation see Parag, 43 of the Interim report of the Special Committee to the Companies Act (Macarthur Committee)

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The legal and accounting professions must also take their share of the blame in delays. Liquidations are not the most profitable part of a practice, so many firms are reluctant to handle liquidation. This means other affairs get the solicitor's more urgent attention and delays are compounded. In the end result it is not surprising that very few liquidations ever get to Court with all the difficulties that have to be surmounted.[1]

Another area that is in urgent need of reform is the powers and duties of a receiver. In many cases incorporation of a business into a company is for the purpose of obtaining bank finance on a floating debenture. If the company fails a receiver is appointed under the floating charge. The Receiver is only interested in realising assets to satisfy the debenture. He owes no duties to the unsecured creditors. A receiver in his haste to realise assets to satisfy the floating debenture may seriously prejudice the rights of the unsecured creditor.

Very often by the time the receiver has enforced his security there is so little left for the unsecured creditor that it is not worth the effort to investigate the company because there are virtually no assets to realise.

The problem is in how best to overcome the problems that have been outlined.

Those who advocate reform basically accept the capitalist system but think that the large number of company failures is commercially undesirable. This group realises the system has its defects but believes these can be overcome by some adjusting of

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1 For confirmation see parag. 44 ibid.

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the system. Although this is a very laudable aim I disagree with many of its proponents of how best to achieve the aim.

The first point to make clear is who are the people most immediately affected by company failures. This is important because many advocates who want reform have not looked clearly at this point. The most important groups would appear to be the shareholders, employees, secured creditors, unsecured creditors, and society. Small private companies do not have a large group of employees or shareholders and these are normally intimately bound up with the directors and control of the company so they are not a major problem in a company failure because they had some control over its success or failure.

So because this group normally has control over the company's affairs it is unlikely to want any stricter laws governing liquidations of private companies. Moreover these 'one man companies' may possibly be correct in claiming that they fulfill a role which is in the public interest so there should be no change in the existing law. This will be discussed later.

It is submitted that the secured creditors are not a great problem because they have security for their advances either in the land, or plant and equipment, and stock.[1] Although the holder of a floating charge does not have as good a security as the holder of a fixed charge the majority of secured creditors get paid when a company goes into liquidation or receivership.

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1 Also if a person lends a large amount to a small private company he will often get the director to personally indemnify the loan so the privilege of limited liability in these cases is merely illusory.

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Thus in many company failures it is the unsecured creditors who are left unpaid and they are the persons most immediately affected by a company failure. But if this is so why should the directors who control the company and who virtually comprise the company be allowed the privilege of limited liability? In essence the question is that in the event of a company failure should the directors or should the unsecured creditors bear the loss? This depends to a large extent on the merits of the case so the question is rephrased thus. At the present time directors can shelter behind the shield of limited liability and the scope for directors being held liable under the present law is fairly limited. The question is whether the scope should be extended.

Hadden[1] attacks the present law by claiming it is outdated. He claims that there is practically no difference between small private companies and the ordinary trading partnership, except those differences which stem from incorporation. And why should the private company be protected and the trading partnership not?

Those who take this line of argument point out the different consequences that flow in the event of failure. If a company fails there is virtually no limitation placed on the directors of the company forming a new company and trading anew. Section 189 of the Companies Act only has very limited application in this respect.

However the situation is very different for a trader who is declared insolvent under the Insolvency Act 1967. Under Section 62 of that Act a bankrupt is not allowed to be in partnership or in the

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1 Tom Hadden "The Control of Company Fraud" PEP Vol. XXXIV No. 503 September 1968.

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management of any company before being discharged and under Sections 110 and 111 the Court has power to make an order to prevent a person entering business for such period as the court thinks fit. It is argued that this is illogical.

Hadden argues that principle of limited liability is an unrealistic hangover from the time when the main reason for incorporation was to allow external investment in commercial enterprise without the risk of unlimited liability.

But today it is a far different situation when the directors, and managers are effective owners holding virtually all the shares. If the venture is successful the directors take the profits but if they fail the risk falls on the creditors.[1]

Hadden's proposal is that in the event of company failure the directors should be held personally liable unless their methods of business complied with certain standards of commercial conduct. But even if one can agree with Hadden's premises one is not forced to accept his conclusion because the inference is not correct. He is working on the assumption that his proposal is the best method to overcome the problem and this is the assumption I question.[2]

In fact there seem to be at least five basic methods of approaching the problem of company failure.[3]

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1 However there are those who would argue that there is nothing undesirable in this. This will be discussed later.

2 Moreover it is submitted that any law in this area must distinguish between stupidity and straight-out dishonesty. I will discuss this point later.

3 These overlap to some extent. Nearly all recognise that company failures have implications wider than just between the parties. Thus the legislature has a function to protect the public interest and can control trading by legislation.

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1. DISCLOSURE

This is the basic philosophy behind much of our company law and is based on laisser fair principles. The company must disclose its affairs and a creditor can ascertain the position for himself. If he decides to give credit to a company and it goes into liquidation the creditor loses out unless there has been actual fraud by the debtor.

2. CONTROLS AT INCORPORATION

Before a company would be able to incorporate it would have to comply with certain formalities.

3. ADMINISTRATIVE BODY

There would be an administrative body which oversees all companies with a power to investigate a company's affairs and power to order a company to discontinue trading if the Board considered such action desirable.

4. RECLASSIFY THOSE ELIGIBLE FOR LIMITED LIABILITY

5. MAKE DIRECTORS AND MANAGEMENT PERSONALLY LIABLE IF THE COMPANY FAILURE WAS THE RESULT OF THEIR INCOMPETENTCY

1. DISCLOSURE

The financial disclosure principle would operate to force all companies who wanted to have the privilege of limited liability to publish accounts. The decision is then one for the creditor and the law would not interfere.

In New Zealand private companies have been exempted from such requirements on the grounds it could place such companies on an unequal footing in relation to its larger rivals, who could use such financial knowledge for their own nefarious purposes such as a

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takeover. Also it can be argued that the cost of auditing accounts, would place too great a financial burden on small companies and that the accounting profession would be unable to cope with the influx of work.

A further argument against lifting exemption from disclosure is that it will not alleviate the problem. It is argued, disclosure will not prevent company failure because it is unrealistic to expect creditors will make a search at the Companies Office to look at the accounts of the potential creditor before extending credit.

However in 1967 Britain removed the exemption and made companies disclose financial details with its annual return, and I am of the opinion this should be followed (in part at least) in New Zealand.

There should be a re-classification of the private company.[1]

> "While the vast majority or private companies are small, there is a considerable number of New Zealand and overseas private companies which are larger than the average sized public company, In fact, some of the largest companies in New Zealand are private companies."[2]

For these large companies the privilege of non-disclosure is not necessary. The cost of publishing accounts would not be prohibitive and the company would be large enough to take care of itself.

There could be a number of criteria used to classify those companies which are not exempt from having to publish accounts none of which would be exclusive factors.

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1 There should also be a separate classification for those companies formed for name protection purposes only.

2 The Monetary & Economic Council Report No. 10 on the Financial System (1968) p. 41.

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Factors such as size of market, value of a company's assets, and number of employees would all be relevent.[1]

Thus if there could be some practical formula evolved the financial disclosure principle should be extended to the larger private companies.

It is also suggested that the argument of publishing accounts putting a small private company at a disadvantage to its rivals is somewhat of a myth. It is submitted that the public companies are not very interested in their smaller rivals in the normal course of events and even if they are they can gain the information easily enough if they so wish through other sources.

It has been also argued that disclosure is not necessary because creditors would not use the information made available.[2] This is a far too sweeping statement. It is submitted that there is a percentage of creditors who do check every available source before giving credit and the percentage increases with the amount lent. If the financial disclosure principle was invoked in full it is arguable that in time more people would avail themselves of the information.[3]

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1 See Messrs McKenzie and Szakats Submissions to Special Committee on the Companies Act (N.Z.).

2 See the debates in the English House of Common on Section 2 of the Companies Act 1967.

3 There are signs also that New Zealand is beginning to adopt overseas methods. In Australia, Dun & Bradstreet specialise in collecting and compiling financial data and preparing reports. If a company wishes some information on another company it can obtain a confidential report which contains details of how the company pays its other suppliers, the past record of both the company and its directors and financial details. This gives the creditor a clearer background of the potential debtor and can help cut down bad debts which it normally does. Some of the information is collected from the company being investigated. It is remarkable that such information is given at all and even more so that the information is nearly always accurate. The company being investigated however, gives the information because they know that they will get a bad credit rating if they do not co-operate while they realise that false information can be checked out. I believe the building trade in Wellington operate a similar system and it is to be hoped that it will in time be extended to other industries.

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The main practical problem in introducing the disclosure system is the ensuring that the accounts would be filed with the Companies Office. The Companies Office is not equipped to handle such matters and the evidence would indicate that such problems would occur. The Companies Office made a survey in 1967-68 to see to what extent annual returns were filed on time. Mr Dibley, Assistant Registrar of Companies pointed out that over 25 per cent of the companies were late in filing returns.[1] Thus financial disclosure is not the full answer in preventing company failure. It should be noted that this principle leaves very much discretion to the individual creditor. I will examine this more fully at a later stage.

2. CONTROLS AT INCORPORATION

At the present time there are virtually no controls on the incorporation of companies and it is in this area I would like to see reform. I will return to this point later.

3. ADMINISTRATIVE BODY

I will state at the outset that I am of the opinion that the disclosure principle is not enough and there should be a body with some supervisory powers but I do not advocate a full scale commission.

It is important to ascertain what role an administrative body should play. Should it apply to both public and private companies and should the body have powers not only at the level of incorporation but also a general overseeing function with powers to investigate companies during the course of trading.

I am of the opinion that to invest the body with wide investigating powers in the hope that this will substantially reduce company failures is unrealistic. Hadden[2] points out the problems the British

2 Tom Hadden "The Control of Company Fraud" pp. 312-320.
1 See paras 21 and 22 Macarthur Committee Report.

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Board of Trade has in overseeing the trading of companies. The problems outlined are along the lines the Official Assignee has at the present time in the liquidation of companies. It would require a massive overhaul of the administrative machinery to make it capable of exercising overseeing powers. Even if this unlikely step was taken it is still problematical as to how effective such an administrative body would be. It is submitted that there should be reform of the administration but it would be limited to having more extensive powers at the level of incorporation because once a company is incorporated it is far more difficult to investigate and control such companies.

4. RECLASSIFICATION OF ELIGIBILITY FOR LIMITED LIABILITY

Under our Companies Act limited liability applies to managers, directors and shareholders equally. If one accepts that limited liability was allowed merely to protect external investors why should one not return to this principle, and adopt the French scheme of Societies en Commandite where only external investors benefit from limited liability?

The main argument against adopting this system is that it will change the system as it is at present and such a change is considered undesirable by some. It means lifting the privilege of limited liability for 'one man companies' and this it is thought will stifle initiative and that this is commercially undesirable. This is the firm view of at least one very experienced practitioner in this field who said when opposing any change to the existing law on limited liability;

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"Over the years the New Zealand lawyer, accountant, and business man have development a flexible corporate structure which I believe has played a very great part in the commercial development of this country. I further believe that this has been due in a very large measure to the concept of limited liability. All of those who practise in this field can quote examples of the one-man company or the small incorporated partnership whose growth has been made possible by risk capital supplied by family, friends, business associates and employees. It is highly unlikely that this capital would be supplied if it involved accepting unlimited liability for the debts of the enterprise."[1]

Thus if this view is accepted the risk should fall on the creditors rather than the companies in the event of failure because the advantages[2] far outweigh the disadvantages of the present system.

5. MAKE DIRECTORS AND MANAGEMENT PERSONALLY LIABLE IF THE COMPANY FAILURE WAS THE RESULT OF THEIR INCOMPETENCY.

Proposals for reform seem to have been concentrated on this area and accepting our commercial environment I am of the opinion such proposals are unrealistic. It should be stressed that those who push for reform in this area do not want the system changed. They hope that the threat of removal of limited liability will encourage directors to raise the standard of their commercial dealings. However it is submitted that this is attacking the problem at the wrong end. It is

1 W.G. Smith 1969 N.Z.L.J. pp. 289-90.

2 Merret A.J. and Lehr M.E. in The Private Company Today (Publication) also give support to this statement. In a survey of British private coys they found that private companies played on essential part in industry. This survey should be studied closely because it was found among other things that private companies were more profitable than public companies and that they stimulated competition within industry.

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punishing company failure rather than trying to prevent it.

This is the quarrel I have with the Jenkins Committee. That body would like to see fraudulent trading extended to include reckless and incompetent trading.[1] But it is assuming that the directors have control over the situation whereas this is overlooking cold hard facts of commercial life.

It is submitted that if the reforms suggested by the Jenkins Report were implemented they would create more injustices than they would solve and the extended liability for directors would not substantially reduce company failures.

When I state this I do not mean that dishonesty should go unpunished. I am simply stating that most companies are not incorporated for the purpose of dishonest trading. Reasons for incorporation fall into four main categories:

a. Name protection

b. Tax advantages

c. Ability to obtain advances by way of a floating charge.

d. Privilege of limited liability. This falls into two categories:

   (i) There is some proper advantage in operating as a corporate structure in business dealings

   (ii) Those forming the company wish to indulge in risky and sometimes fraudulent trading and the directors are reluctant to be personally responsible for possible losses resulting from their own actions.

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1 Paragraph 503 (iii)

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Those in the first category should be treated differently from other companies because they are not trading. Those companies in the second category which are not trading should be discouraged by higher fees on incorporation. Businesses should be allowed to obtain advances by way of a floating charge. The reasons for the differentiation are historical only and there is no valid reason why a business should not be allowed to use a floating charge. This leaves us with the fourth category. It is submitted that those which fall into d.(ii) are very much in the minority but should be punished severely if caught. However because of our economic system I believe that the incompetent trader should be treated differently.

By not differentiating between the various types of traders a law operating generally as proposed by the Jenkins Report could operate harshly and inconsistently.

Most companies fail in the first three years of business [1] as a company. The major problem is under capitalisation and the attendant problem of liquidity. [2] As Frank Taylor [3] again remarks

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1 This has been the experience of Dun & Bradstreet and Frank Taylor in an article "The risks of trading with a $4 company" Rydges Vol. XLIII No. 6 June 1970 pp. 72-80 at p.73, supports this view. "A considerable number of these new small companies seem to go to the wall in the first two or three years of trading."

2 A corollory of this is that companies which have liquidity problems very often have incompetent management by not having enough capital to work with, or misusing capital. Incompetent management also covers those directors which indulge in speculative ventures or even fraud. Another cause of company failure is redundancy through competition and takeover. However this is a topic which is too complex to cover in this present paper. Moreover it is interesting to note that J.H. Jamision (in a paper delivered to a seminar in October 1971 arranged by the New Zealand Society of Accountants in conjunction with the Wellington District Law Society) stated that the major cause of company failure was bad management. Thus this present paper has not discussed other more minor reasons for company failure. It should be noted that Jamision's remarks related to both public and private companies and the problem of bad management decisions in relation to how to use working capital is more pertinent to public companies than to small private companies whose problems are more a lack of working capital.

3 ibid p. 74.

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most small companies rely on extended credit in the first few years of trading because they do not have any liquid assets. In order to overcome liquidity problems the company needs a rapid turnover of stock so as to have monies coming in. However in order to sell, such a company must sell to outlets which do not pay by cash on delivery but normally pay after a 30 day period. The company has to rely on its debtors paying promptly otherwise there will be no liquid assets coming in, but the company's suppliers will still have to be paid. If the company has problems with its debtors[1] then it will have problems in paying its suppliers. The suppliers, naturally enough will be chary of supplying to companies which do not pay, thus they will often insist on supplying goods on a cash on delivery basis only in such circumstances. The company may then be forced to take out short term loans with high interest rates, and liquidity problems are compounded when interest and principal payments fall due. Some try to circumvent this vicious circle by expanding trade but this does not always work so there is sometimes a very thin line between the reckless successful trader and the reckless unsuccessful trader. Thus in the first few years of trading there is a very thin dividing line between success and failure and success of a venture in some cases will depend on how accommodating the company's creditors are. The problems are further compounded when the company's creditors is a large company. In many cases the large company does not pay promptly but pays on a 60 day or even 90 day basis.[2] The small company is not in a good bargaining position because it is dependent upon the other as a market and the larger company knows and exploits this position.

It is not suggested that directors are entirely blameless and that they can blame the economic system entirely for their fate. It is submitted however that once a company has begun trading in many cases there is relatively .....

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1 The problem is especially acute in the building trade because of the Wages Protection and Contractor's Liens Act 1939

2 This has been the experience of Dun and Bradstreet.

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little the small company can do.[1] If the commercial facts are as I have outlined then it would be harsh indeed to penalise failure in this situation.

Thus the area in which there is the greatest scope for reform is at the level of incorporation because the proposals would give some protection to trade creditors and be easy to administer.

(i) There should be a form filled in by the directors giving details of their past financial and trading[2] experience and whether they have every been bankrupt, or been directors of an insolvent company. Such information would have to be signed in front of a solicitor. The advantages would be two fold. Firstly it would scare off some of the 'sharks' while the Registrar could refuse to accept to incorporate the more obvious examples of incompetency.

(ii) Companies formed for name protection purposes only should be placed in a different category but all the other companies should have a higher incorporating fee in an effort to cut down on companies

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1 For further confirmation and for some heartbreaking examples see an article by John Winkler in The Director February 1970 p. 240.

2 This could be along the lines of the recommendations contained in paragraph 85(b) of the Jenkins Report.

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being formed merely for tax avoidance.[1]

(iii) As the greatest problem for newly formed companies is one of liquidity there should be a minimum paid up capital which would ensure a minimum amount of working capital.[2] This should ease some of the problems outlined earlier. Also it will prevent some sanguine traders from incorporating when they realise the problem of finding working capital. Various figures have been suggested but it is submitted that the figure of $4,000 is not unsatisfactory.[3]

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1 It may well be that the change of legislation lowering the maximum rate of tax for individuals will discourage tax and estate planners from using the company as amethod of tax saving. The maximum tax payable for an individual is now only 50% which is the same as a company pays on the maximum rate. However the individual is taxed on any dividends paid to him which brings the effective rate up to 75 cents in the dollar. Thus there is no tax saving in incorporating. However there may well be other advantages in incorporating for tax planning purposes - See E.C. Adams The Law of Estate and Gift Duties in New Zealand (4th Ed.) (Wellington: Butterworth & Co. 1970) and F.B. Aburn How to Minimise Income Tax (Rydge's Business Journal (N.Z.) 1961).

2 There have been some proposals that this capital should be set aside as a creditor's fund. However as the whole purpose is to provide working capital and not have the money tied up it is submitted that it is preferable to use the shareholder's funds as working capital. However a proposal which is perhaps more flexible is to allow the shareholders to have as much paid up capital as they wish but in the event of failure if the paid up capital is less than $4,000, for example, the shareholders shall be proportionately liable for the balance between the paid up capital and the $4,000 even though the balance has not been issued.

3 This is approximately the figure adopted by European countries. See R.R. Pennington Companies in the Common Market (Second Ed.) (London: Oyez Publications, 1970).

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The Jenkins Report rejected the idea of a minimum paid up capital.

> "Although we would favour in principle a statutory minimum paid up capital we have reluctantly come to the conclusion that its purpose would be too easy to evade and we cannot, therefore, recommend it." [1]

The reasons given for this refusal stemmed from the Committee's belief that once the company had been formed it would be too easy to return the cash to the promoters in exchange for assets such as goodwill, or by way of a loan.

The argument has some validity but one should remember that in itself it is not enough to reject such a proposal. For those traders who incorporate most do not resent putting in a paid up capital. It is simply that they do not consider it necessary. It is submitted that those who incorporate for ulterior motives are in the minority.

But even if this is not correct the problem is not insoluable. Legislation could be passed to make any return of cash either by exchange or loan prima facie fraudulent and the onus would be on the promoter. If he could not prove the bona fides of the transaction to the court's satisfaction then he could be guilty of fraud and be held personally liable for the company's debts. Another alternative would be to adopt the French system whereby the assets must be valued

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1 Jenkins Report - paragraph 27.

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by an independent valuer.[1] If it was compulsory for the report to be filed at the Companies Office such a provision would be easy to administer.

An argument which has more validity is that the amount of capital needed by a company would vary depending upon its activities and it is difficult to work out a sliding scale. However I still believe that a basic minimum paid up capital could be used and that it would be a workable provision.[2]

To return to the defects in the existing law outlined at the beginning of this paper. It is believed that stricter controls at incorporation level will help deter companies with dishonest intentions from incorporating. It is also hoped that it will cut down the number of company failures through discouraging the incompetent trader from incorporating. Once incorporated the company would be required to file accounts at the Companies Office and the Registrar of Companies should be encouraged to strike off companies which do not file audited accounts. For those companies which fail the Official Assignee should have power to investigate all such companies and the creditors' interests must be overridden in the wider public interest. If a company fails through incompetency alone it is submitted the burden should fall on the creditors and not the directors. However if there has been any

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1 See R.R. Pennington - Companies in the Common Market (Second Ed.) (London: Oyez Publication, 1970) p. 52

2 If one considers a minimum paid up capital is necessary one may find the figures for the amount of nominal capital of private between 1965-69 surprising. Of 27,493 such companies formed in this time 8,066 companies had a nominal capital under $2,000 but 6,762 had a nominal capital of between $2,000 and $4,000. This is perhaps more than one would expect but of course the figures do not indicate how much of that capital was paid up.

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attempt to try and defeat the creditors' interests by the directors the latter should be punished severely. It is submitted that the proposals outlined would be reasonably easy and not too expensive to put into operation and would reduce company failures.

I stress however, that such legislation will not eliminate company failures. It is difficult to guard against incompetent traders after the company has been incorporated but many creditors do not help to alleviate the position. Too many people have an idea of the poor innocent creditor as opposed to the evil scheming company director. Trader debtors are an unfortunate part of the system but many creditors are too easy on who they give credit to. They will supply to anyone with no investigation in the pious hope they will be repaid sone day.[1]

Perhaps the last word on creditors should go Mr Wynn-Williams talking on Bankruptcy Law.

> "Well my opinion is that no Bankruptcy Bill which the ingenuity of man can conceive will provide the remedy that is needed so long as persons in business will give credit in the indiscriminate way in which it is given. The honourable member for Akaroa blames the Acts and the debtors alone but what about the creditors? It is they who have

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1 This is perhaps an overharsh statement in many cases. The creditor knows the debtor is in difficulties but still extends the credit to keep good relations and in the knowledge that in many cases the company will overcome what is only a temporary liquidity problem.

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> the power of dealing with these people and instead of giving goods without question to every man who enters their shop or store they should make some inquiry as to the means of the person they deal with.[1]
>
> The date: 1883.

It is submitted that economic conditions have not radically changed since this date and that our companies legislation should not over protect such persons who deal with the company.[2] Also although as lawyers one is only competent to deal with legal issues one should not ignore the legal implications which flow from economic policy. It is well established that to increase trade and productivity the policy in New Zealand has been to ease credit restrictions. It may be thought that if this is considered economically desirable one must realise there is the chance of credit being extended too easily and there will be the inevitable by product of company failure. Thus the problem will be always present. It is not suggested that the proposals put forward in the paper can eliminate all company failures but it is the belief of this writer that they can help to curb the problem.

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1 New Zealand Parliamentary Debates - Vol. 44 (1883) p. 164.

2 See J.H. Jamison p. 6 who agrees with this viewpoint. Mr Jamison is an Australian accountant who has had a very wide experience in the field of receiverships and liquidations.

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APPENDIX

The interim report of the Special Committee to review the Companies Act and the paper of J.H. Jamison on Receiverships and Liquidations have become available since this paper was written.

In matters relevent to this paper they mainly confirm assertions I have made. I have included a few footnotes where possible but they do not cover all the points made by Jamison or the Report.

It is pleasing to see that the Macarthur Committee shows concern with the present state of the administration of the Companies Office, and proposals for an enlarged Companies Office and a Companies Commission, although not entirely satisfactory are a step in the right direction.

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