

Preliminary Paper No. 5

COMPANY LAW

A discussion paper

The Law Commission welcomes your comments on this paper  
and seeks your response to the questions raised

by Friday, 15 March 1988

These should be forwarded to:  
The Director, Law Commission, P.O. Box 2590, Wellington

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The Law Commission was established by the Law Commission Act 1985 to promote the systematic review, reform and development of the law of New Zealand. It is also to advise on ways in which the law can be made as understandable and accessible as practicable.

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## PREFACE

On 5 September 1986, the Minister of Justice asked the Law Commission to review the law relating to bodies incorporated under the Companies Act 1955 and to report on the form and content of a new Companies Act.

The text of the reference forwarded to the Law Commission by the Minister of Justice pursuant to s.7(2) of the Law Commission Act 1985 reads:

"The Law Commission is asked to examine and review the law relating to bodies incorporated under the Companies Act 1955, and to report on the form and content of a new Companies Act.

The continuing work of the Securities Commission in the fields of takeovers, insider trading, and company accounts will form part of this overall inquiry. Also related to this reference is the review being conducted by the Department of Justice of the law and practice of company liquidations and individual insolvency".

The reference envisages an inquiry wider than a review of the Companies Act 1955. Companies incorporated under that Act are affected by a number of other statutes, notably the Securities Act 1978. In the case of publicly listed companies, the rules of the New Zealand Stock Exchange have substantial impact. A comprehensive review of the law "relating to bodies incorporated under the Companies Act 1955" should consider these regimes also. This discussion paper does not purport to raise questions relating to the wider review of all the law relating to companies. Instead it concentrates upon the Companies Act 1955 and the law outside that Act which affects the matters dealt with in it.

The Companies Act 1955 came into effect on 1 January 1957. In the thirty years since, the Act has been amended almost every year. It was reviewed by a special committee established in 1968 under the chairmanship of Mr Justice Macarthur. The committee produced an interim report in August 1971, and a final report in March 1973. Many of the recommendations of the committee have been incorporated into the 1955 Act by subsequent specific amending legislation. The report of the Macarthur Committee did not however lead to a new Companies Act.

The purposes of this discussion paper are three:

- . to indicate how the Commission is conducting the reference
- . to identify the main issues which will shape the form and content of a new Companies Act

- to seek wide public comment as to the preferred solutions for the issues raised.

The Law Commission set up an informal committee to assist it in its review, to advise upon the way in which the inquiry should be handled and to identify the major policy issues which will shape the form and content of a new Companies Act. The Committee comprised P. Baines of Jarden & Co., Wellington; J. A. Farmer Q.C. of Auckland and the Sydney Bar; Professor J. H. Farrar of the University of Canterbury; T. N. McFadgen, partner in Simpson Grierson Butler White, Auckland; M. C. Walls, partner in Chapman Tripp Sheffield Young, Wellington, and P. G. Watts, Lecturer in Law, University of Auckland. The Commission is very grateful to all of them for the time and trouble they have taken as members of the Committee. In addition, the Commission has received a great deal of valuable assistance from informal consultation it has held in New Zealand and Australia with legal practitioners, teachers of company law, business people, the Accountants Society, the New Zealand Stock Exchange, the Securities Commission and officials from the Reserve Bank, Treasury, Justice Department and the Department of Trade and Industry. In the final preparation of the discussion paper the Commission has had the benefit of consultation with Dr L. S. Sealy, Fellow of Gonville and Caius College, Cambridge.

The scope of the present reference is such that the Law Commission is anxious to obtain as much public participation as possible. It is particularly keen to obtain comment from all those affected by company law in practice – officers, shareholders, financial advisers and economists as well as from accountants and lawyers.

In order to stimulate comment it has been thought desirable to indicate preferred options wherever possible. It is emphasised that these preferences are tentative. Whether they will be maintained by the Commission will depend very much upon the response to this discussion paper. The success of the final reform proposed will be largely dependent upon the responses received.

Following consideration of comment upon the discussion paper, the Law Commission has decided to put out a preliminary report in the form of draft legislation with supporting commentary. This technique was used by Professor Gower in his report on the Company Law of Ghana and by the Dickerson Committee in its proposals for a new business corporations law for Canada. Such a technique should ensure that all implications of a proposal can be seen and should help to focus criticism. It should also enable speedier implementation, if the proposals are thought to have merit.

It is then proposed to allow a further period for public comment upon the preliminary report before a final report is submitted to the Minister.

The discussion paper has been prepared to provide a framework for discussion on matters of principle. It does not purport to traverse any

but the more significant issues. The Commission is interested not only in responses to the particular questions it has posed, but also in any omissions of importance.

In order that the Commission can move promptly to the next stage of the review, which will involve more detailed analysis and drafting, it would appreciate written responses to the major areas of principle identified in this discussion paper by 15 March 1988. If anyone responding to the discussion paper would like to have an opportunity to speak with members of the Commission to supplement a written response, it would be appreciated if an early indication could be given of that preference so that meetings during the next few months can be arranged.

All submissions should be addressed to:

The Director  
The Law Commission  
P.O. Box 2590  
Wellington (Telephone: (04) 733-453)

by 15 March 1988.



## INTRODUCTION

1. The 1955 Companies Act can be traced directly from the Joint Stock Companies Act 1844 (U.K.) through the New Zealand Companies Acts of 1860, 1882, 1903, 1908 and 1933.
2. The United Kingdom remains the primary source for our company law. Thus the Companies Act 1955 was modelled on the United Kingdom Companies Act of 1948.
3. The declining volume of trade with the United Kingdom and the influence upon United Kingdom companies legislation of the directives of the European Economic Community have meant that the policy rationale for following for the United Kingdom model is substantially diminished.
4. Harmonisation of New Zealand and Australian law is on the agenda for the second stage of the C.E.R. negotiations which are to take place in 1988. If harmonisation with Australian company law is regarded as the most important consideration for company law reform, then New Zealand law could simply be brought into conformity with the Australian legislation. In that event many of the reforms suggested in this discussion paper will not proceed. The Law Commission is conscious that this is an option which must be seriously considered. For the purposes of discussion, however, it has been thought preferable to indicate the issues for company law reform and discuss the options available, rather than to start with a conclusion that the Australian approach is to be preferred unless there are compelling reasons to depart from it. The Commission has been concerned to ensure that better options are considered where available if only because Australian company law itself is presently subject to a number of proposals for reform and has been the subject of some substantial criticisms from Australian practitioners and business people. That does not mean the Law Commission is committed to rejecting the Australian model. It does mean that it wishes to be informed of the benefits perceived from harmonisation of the company law (as opposed to securities laws and other commercial regulation). It is not readily apparent that the laws to do with company structure, particularly as they affect companies without trans-Tasman trade connections, require harmonisation to achieve trade or capital markets benefits.
5. Of increasing influence in New Zealand, Australia and the United Kingdom has been the company law jurisprudence developed in North America. The Canadian reforms introduced within the last ten years are of particular interest because based upon the United Kingdom model but substantially modified by exposure to the United States legislation. In the preparation of this discussion paper the Law Commission has been especially interested to consider the North American solutions to company law problems.
6. For the purposes of this discussion paper, tax neutrality has

been assumed. Choice of corporate form and many company decisions are tax-driven. The introduction of imputation tax, as is proposed, will largely remove the incentive to arrange company organisation for tax advantage. But the revenue implications of some of the reforms discussed (most obviously the proposal for share repurchase) are matters upon which the Law Commission would like to have comment.

7. As appears from the discussion of directors' duties below, the Law Commission does not favour the establishment of procedural or regulatory checks on director action in order to safeguard against abuse of power. Instead of putting directors through procedural hoops (as, for example, in a requirement of approval by a disinterested and informed quorum in the case of self dealing), the Law Commission has suggested imposition of requirements of fairness. Such standards inevitably depend for their enforcement upon the Courts. The quid pro quo for not subjecting directors to procedural straight-jackets is to improve the means of enforcing the standards required of directors. Enforcement may be achieved through a State agency or be left to shareholder suit. In most jurisdictions a combination of the two systems is usual.

8. At present in New Zealand the Registrar has significant powers under the Act to police its requirements. These powers (contained especially in ss. 8A, 9A and 9B of the Act) were largely conferred after the recommendations of the Macarthur Committee. The Law Commission suggests that it is not sensible to expect the Registrar to ensure that documents comply with the Act or for him to have extensive investigatory powers. It doubts whether it is realistic to expect that adequate resources will be made available to the Registrar to enable him properly to carry out these functions. Nor does it consider the problem of securing effective enforcement would be best resolved by setting up a new regulatory agency outside the Companies Office or by adding to the powers of the Securities Commission to create a Companies and Securities Commission. The inclination of the Law Commission is that enforcement of company obligations in ordinary circumstances is most effectively left to shareholder enforcement through Court action. In extraordinary circumstances, particularly where the public interest is affected, the Companies (Special Investigations) Act 1958 provides a procedure for investigation of a company's affairs.

9. The Law Commission is suggesting reform of the circumstances in which duties can be directly enforced by shareholders. In addition, the Law Commission is interested to know whether it is desirable to provide for procedural reforms to facilitate derivative actions (brought to enforce obligations to the company) and class actions (brought on behalf of other shareholders of the same class). The funding of such litigation may require attention. In the absence of the contingency fee system which applies in the United States, increased reliance for enforcement purposes upon shareholder suit may require a statutory system to enable the actual costs of shareholder suit to be recovered from the company, upon a prima facie case being established (thus adapting the approach

adopted in respect of derivative actions in *Wallersteiner v. Moir* (No. 2) [1975] QB 373, 508n).

10. A significant matter not covered in this discussion paper is the topic of transition. The lesson of the ultra vires reforms is that where significant change is proposed transitional provisions should be carefully considered. Comment is specifically sought on any suggestion for transition in implementation of substantive reform proposals.

11. Some of the proposals made in this discussion paper have implications for groups of companies (see especially the discussion on nominee directors and use of corporate opportunities). In the context of company accounts the Law Commission has asked whether the present treatment of group accounts is satisfactory. The Law Commission also wishes to know whether the law in any other respect is deficient in its treatment of companies associated in groups. In the case of insolvency of one member of the group, the provisions of s.315A–C enable the Court, where it is equitable to do so, to require contribution from a related company. It is the impression of the Law Commission that no further specific provision is required to deal with groups of companies, but it would like to know of any difficulties encountered in practice with groups of companies which are not sufficiently addressed by the existing legislation or the reforms proposed.

12. The discussion paper suggests a number of reforms. They are based on an approach that company law should concentrate on matters of company structure and should permit as much flexibility as is consistent with the integrity of the registration system and the prevention of abuse. The Law Commission seeks, as far as practicable, a self-enforcing Act under which access to the courts is consciously improved. It has suggested in particular –

- . a separation of company law and securities law
- . abolition of the private company/public company distinction
- . a streamlined system of registration
- . reassessment of aspects of the company constitution including the roles of the directors and shareholders in company decision-making and the duties of directors and shareholders to the company and to shareholders
- . substantial reform of the capital maintenance rules and the rules relating to payment of dividends
- . an effective and useful system of charges registration
- . reassessment of the disclosure requirements of the Act.

## I SCOPE OF THE REFERENCE

### THE COMPANIES ACT 1955

13. The 1955 Act currently performs a number of functions. First, it establishes a method of incorporation as of right, and one which permits limited liability of members. In this function, its provisions are largely facilitative. Secondly, the Act contains provisions governing the relationship of members amongst themselves and their relationship with the company. These provisions state in statutory form much that the members might choose to insert themselves were they to establish a private contractual regime. Some provisions are obligatory (often reflecting a concern for shareholder protection); others permit variation. A third function of the Act is protection of the public. This is seen often as the price extracted for limited liability. Fourthly, the Act also contains a number of provisions which have been inserted to modify or avoid developments of the common law which have been considered to be undesirable.

14. The original model had an internal consistency. Its frequent amendment in response to changing commercial circumstances has undercut some of the assumptions upon which its older provisions are based. The Act is overdue for rethinking from basic principle and for a systematic reorganisation. That does not necessarily mean however that it will be necessary to adopt an entirely different statute, perhaps on the model of the recent Canadian or Australian reforms. It may be that modernisation of the basic existing model will serve.

### FORM AND STYLE OF LEGISLATION

15. Company law ideally should be readily intelligible to the business person who needs to be informed of what the law is in order to conform with it. Intelligibility and accessibility are important goals in company law reform and would of themselves justify overhaul of the Companies Act 1955. While bulk is not always a bar to intelligibility, the present Act, which runs to something over 500 sections and covers almost 400 pages of the latest reprint (the Ontario statute, by comparison, runs to 185 pages), could be substantially reduced by rearrangement and editing.

16. The Law Commission's own statute requires it to advise the Minister of Justice on ways in which the law of New Zealand can be made as understandable and accessible as is practicable and requires it to have regard to the desirability of simplifying the expression and content of the law, as far as that is practicable. Although this discussion paper refers to substantive topics for law reform, the simplification of expression and content of company law is itself a major goal for the review. The Law Commission is conscious that there are real costs for business in operating under a system which is complex and difficult to understand.

17. Comment is also invited on the question of terminology. Terms such as "members" and "company" might be replaced by "shareholders" and "corporation". There may be advantages, in a new Act, in reviewing old labels. But it is suggested that existing terms should be retained, where their meaning remains constant.

## CODIFICATION

18. It will be noted that the Commission is required to examine and review the law relating to companies and not simply the Companies Act 1955. Much of the more important law relating to companies is to be found not in the statute but in the decisions of the Courts. (The fiduciary duties and standards imposed upon directors in the management of the company, for example, are to be found in the case law and not in the Act.) The Law Commission does not believe that it would be feasible or desirable to attempt comprehensive codification of the common law. It would be extremely difficult to restate many of the common law and equitable rules in detail with precision and such an exercise would not be without cost while the relationship of the new statutory provisions with the earlier case law is resolved.

19. On the other hand our system of company law would be made more accessible and understandable if certain of the major legal rules developed by the Courts (for example, those relating to capital maintenance, payment of dividends, and directors' duties) were identified in the legislation. This is the approach that has been adopted in the Canadian, Australian and United Kingdom reforms.

## A SINGLE CORPORATE STATUTE

20. In New Zealand, in order for a body to be a business enterprise (in the sense of being an enterprise created to enhance the wealth of its shareholders) it is not necessary to be incorporated under the Companies Act 1955. In some other jurisdictions separate statutes apply to "profit" and "non-profit" corporations. The benefit of providing distinct statutes for each type of corporation is that it enables the proper purpose of the organisation (and corresponding duties and powers of officers) to be addressed explicitly in the legislation. On the other hand such purposes, duties and powers will always require reference to the company's own particular constitution so that a general overarching assumption of purpose may be of little real value. The present inclination of the Commission is that a single company statute for profit and non-profit companies is to be preferred as being well understood and avoiding legislative duplication.

21. While the Commission suggests that the Companies Act should continue to be available as an alternative form of incorporation for non-profit associations, it is interested in the relationship between the Incorporated Societies Act 1908 and the company limited by guarantee. The Law Commission is interested to know –

- . whether the Incorporated Societies Act is thought satisfactory in practice
- . whether there are perceived to be distinct roles for the incorporated society and the guarantee company.

22. In addition to the Incorporated Societies Act there are a number of corporate bodies formed under a patchwork of legislation. Those incorporated bodies include, for example, industrial societies, industrial and provident societies, building societies, friendly societies and charitable trust boards. Some of these statutes are very much out of date. The Law Commission would like to hear whether these various forms of incorporation cause any difficulty in practice and whether there is demand for their rationalisation under a single statutory system. Any such demand would affect the present preference of the Law Commission to devise a Companies Act that applies to both profit and non-profit corporations.

23. The provisions of the Companies Act 1955 also extend to a number of bodies incorporated under distinct legislation (a recent example being State-owned enterprises). The Law Commission is interested to know whether there are any difficulties in practice with the application of the Companies Act in this way.

24. The Law Commission is aware that the legal status of Maori iwi and hapu in New Zealand law is of concern. It has not sought in this paper to discuss whether the Companies Act is an appropriate vehicle for the recognition of legal corporate identity in iwi and hapu. But this is a topic on which comment and suggestions are invited.

## THE SECURITIES ACT 1978

25. The Law Commission is working closely with the Securities Commission in its review of the distinct aspects of company law mentioned in the reference. While the topics of takeovers, insider trading and company accounts have particular significance for companies subject to the Securities Act, they are also topics which must be addressed in relation to companies which do not offer securities to the public. In the case of companies whose shares are traded upon the New Zealand Stock Exchange, additional rules relating to these topics are imposed by the Stock Exchange.

26. To a substantial extent therefore an additional regime is imposed upon companies offering securities to the public. There are advantages in explicitly recognising a distinction between the two systems. Those advantages include:

- . permitting the securities legislation to concentrate upon the promotion of securities market efficiency and investor confidence in the market
- . permitting the companies legislation to

concentrate upon the incidents, benefits and abuses of the corporate form.

27. The objectives are not entirely distinct. Transferability of shares is a critical factor in the success of corporate form. But the Commission favours the view that the concerns of the securities legislation should be an additional system imposed upon those whose securities are offered to the public and that the company law system should not attempt to impose upon all companies safeguards required for securities market purposes.

28. In the fields of takeovers, insider trading and company accounts, there may well be securities market reasons for provisions which are not apt for all companies. For this reason the Law Commission proposes in the course of its companies reference to deal with these topics on the basis that the rules appropriate for security market regulation need not determine the content of rules dealing with the same topics for the purposes of company law.

#### COMPANY INSOLVENCY

29. As is apparent from the terms of the reference, the Department of Justice is reviewing the law and practice of company liquidation and individual insolvency. Quite clearly proposals for reform in this area must consider alternatives to winding-up (such as a system of statutory management). Alternatives to winding-up will require reassessment of the powers and duties of receivers, a topic itself inextricably linked with the question of company debt securities. Some of the most important company law provisions for protection of creditors are found in the winding-up part of the Companies Act. For all these reasons, the general topic of insolvency cannot be ignored in reviewing the law relating to companies. The aspects of the Companies Act relating to winding-up, moreover, are among those most frequently mentioned as being in need of urgent reform. The Law Commission therefore is working closely with the Department of Justice and will itself be concerned to ensure that both reform projects are consistent.

#### QUESTIONS:

1. Should an attempt be made to codify the major rules of law relating to companies?
2. Should the Companies Act leave regulation of the companies which offer securities to the public to the Securities Act?
3. Should the Companies Act continue to apply both to business enterprises and non-profit companies?
4. Should the Act provide a single vehicle for incorporation?

## II THE PURPOSE OF COMPANY LAW

30. The central enabling provision in the Companies Act 1955 is s.27(3) which provides –

"From the date of incorporation mentioned in the certificate of incorporation, the subscribers of the memorandum, together with such other persons as may from time to time become members of the company, shall be a body corporate by the name contained in the memorandum, capable forthwith of exercising all the functions of an incorporated company, and having perpetual succession and a common seal, but with such liability on the part of the members to contribute to the assets of the company in the event of its being wound up as is mentioned in this Act."

This permits the use of the corporate mechanism as a system of organisation.

31. The enormous success of the company rests upon its efficiency as a system of organisation in permitting aggregation of capital and specialisation of management. These ends are secured by the corporate form which permits –

- . continuity and perpetual succession (notwithstanding death or departure of individual members)
- . separation of ownership of the assets of the company from the suppliers of equity capital in it
- . the creation of flexible units of property in the form of the share (which is the residual claim of the supplier of capital), facilitating transfer
- . recognition of the company as an entity distinct from all its members.

32. These attributes have meant that the withdrawal of capital need not require the sale of the corporate undertaking, they have ensured that companies need not be affected by the mortality of their shareholders, and have enabled specialisation of management.

33. The ability to secure limited liability upon incorporation set the seal on the utility of the corporate form. The limited liability company has made possible the scale of modern private industrial and commercial enterprise. It remains the chief vehicle for commercial expansion and economic advance.

34. As at 31 March 1987, there were 147,158 companies registered in New Zealand, 12,563 of them formed within the year while 1,938 were struck off or dissolved.

35. Given the success of the company and its importance in the New Zealand economy, recourse to corporate form should not be inhibited without real cause. Nor should burdens be placed upon business enterprises which have chosen the corporate form unless they are clearly necessary. The purpose of company law is to enable efficient use of the corporate mechanism. It should therefore promote effective management of business and enable business to adjust to changing circumstances.

36. Company law performs two main functions: enabling and regulatory. Economists suggest that company law, in its enabling aspect, can be seen as a standard form contract which reduces the cost of organising business enterprise. The Law Commission accepts that this approach is a useful aid to analysis.

37. It is necessary that the statutory standard form make provision for the essential internal organisation of the company. It is also necessary for company law to protect against abuse of management power and to provide protection for minority shareholders and creditors where the market fails. But regulation of corporate activity should be commensurate with real danger of abuse and should not inhibit legitimate business activity. The Commission would prefer to see legislation for companies in a form which is primarily enabling rather than regulatory except where the risk of abuse is clear.

38. It is hoped that responses to the substantive issues raised in this discussion paper will also indicate a preferred form for enabling legislation. It may reduce transactional costs if standards are expressed presumptively where there appears to be a wide measure of support for the provision or where the absence of specific provision in the articles through oversight would lead to difficulty in the administration of the company. An existing example is the presumptions contained in s.138 relating to meetings and votes. On the other hand, there may well be powers which the legislation might usefully facilitate only if the company chooses deliberately to adopt them. An example might be a power to enable directors' meetings to take place through the medium of the telephone.

39. The Law Commission inclines to the view that –

"... the problems of regulating business as to production, distribution, competition, monopoly, labour relations, and undue concentration of wealth are not properly to be dealt with by corporation laws, ... but by specific statutes". H. W. Ballantine, *Law of Corporations* Chicago (rev. ed. 1946 p.42)

40. The present view of the Law Commission is that competition, employment and environmental objectives, for example, should not be pursued by company law. It would be interested to know whether there is support in New Zealand for a statutory requirement of worker participation in management such as was proposed in the United Kingdom in the 1970s by the Bullock Committee and as is proposed for the E.E.C. by the revised Fifth Directive. It

would also like to gauge the support for the insertion of a less specific provision such as is found in s.4 of the State Owned Enterprises Act 1986 by which every State enterprise (bodies incorporated under the Companies Act 1955) is required to operate as a successful business. Success in this sense is defined as being measured by profit and efficiency, good employment practices and community responsibility. The legislation accepts by implication that decisions which reduce value to shareholders can be justified by benefiting other interests. The present view of the Law Commission is that a similar provision should not be included in the Companies Act.

#### QUESTIONS:

1. Should Company Law seek to impose competition, employment or environmental objectives?
2. Should worker participation in management be considered as part of the present review?
3. Should all companies be subject to a statement of purpose equivalent to that contained in s.4 of the State Owned Enterprises Act 1986?

### III LIMITED LIABILITY

41. As is implicit in what has already been said, the Law Commission does not propose any rejection of the company form. It proved to be durable and may be expected to be the form through which most commercial activity will continue to take place. Limited liability has demonstrated its worth as a necessary device for risk management if mobilisation of capital is to be achieved and new enterprises undertaken. The social utility of limited liability is such that it is misleading to see it simply as a "privilege". The benefits of limited liability can, moreover, be over-stated particularly in the case of small incorporated firms. In theory, creditors have the means by contract to obtain security or guarantee for debts owed to them by a company. In reality small trade creditors and consumers who have made pre-payments for goods and services are at risk. But even there, in the case of recklessness or perhaps negligence, they may have redress against the directors, at least if the company goes into liquidation.

42. There are a number of provisions in the present Act under which limited liability is overridden (for example, ss. 41, 320, 315A, 315B, 319, 364). In addition, there are some circumstances in which Courts have lifted the corporate veil in order to impose liability on members of a company. The Law Commission wishes to know whether the existing provisions of the Act require to be added to or modified.

#### QUESTIONS:

1. Should the reform proceed on the assumption that limited liability and corporate personality should, in general, provide protection for members of a company?
2. Should the legislation attempt to identify further the circumstances in which members will be held liable, despite separate legal personality of the company and limited liability?

#### IV CORPORATE FORM

43. Under the Companies Act 1955, registered companies may be –

- (1) companies limited by shares;
- (2) companies limited by guarantee;
- (3) unlimited companies;
- (4) no liability companies.

44. Companies limited by guarantee appear to be mainly used by charitable bodies as an alternative to the trust mechanism. Table D currently provides for a hybrid form of company limited by guarantee *and* having a share capital. This form has been abolished in some jurisdictions as an anachronism and a source of confusion. It is suggested that the form serves no useful purpose and should be removed. Unlimited companies seem often to be formed by professional groups who are unable because of ethical rules to limit their liability. No liability companies are available for mining companies.

45. The Law Commission wants to know if these different forms of incorporation should be retained. It is interested to know of their existing and potential use and in particular wishes to know whether variations on the no liability company should be a form that is generally available as an alternative to limited liability.

#### QUESTIONS:

1. Should the four present forms of company classified according to the liability of their members be retained?
2. If so, should they be modified or augmented by the addition of other options?

## V PUBLIC AND PRIVATE COMPANIES

46. Since 1903 New Zealand has drawn a distinction between public and private companies. The private company is by far the more popular form, comprising over 95% of all registered companies. The private company is not permitted to issue a prospectus inviting subscription for shares (s.354(2)). Membership of a private company is limited to 25. Its share capital must be subscribed for in the memorandum.

47. Public companies are defined negatively as companies which are not private companies. Although small in number compared with private companies (approximately 1,600 out of the 152,332 registered companies), they are by far the more significant in economic terms.

48. Private companies have some privileges and immunities not available to public companies. They are based on an assumption that such exemptions and immunities are desirable to permit informality, and achieve efficiency in what are generally small firms.

49. Thus, for example, the minimum number of shareholders is two, whereas seven are required for a public company. There need be only one director and, provided three-quarters of the members sign, a resolution may be passed simply by entry in the company's minute book without the need for a formal meeting. Generally speaking, unless "non-exempt" (a company indebted in respect of a deposit or loan to which the Securities Act 1978 applies or a subsidiary of an overseas company), a private company need not file its accounts with the annual return and can resolve not to appoint an auditor.

50. In addition the Ninth Schedule to the Act lists eight further sections which do not apply to private companies. They include the prohibition of loans to directors (s.190) and the general rules as to removal of directors (s.87).

51. The Law Commission questions whether the distinction between public and private companies should be maintained in its present form. In particular it questions:

- . whether the existing classification is sensible
- . whether the concessions made by the Act to private companies could not also be extended to public companies
- . whether the existing provisions relating to private companies are not, in any event, too restrictive.

### CLASSIFICATION

52. It is suggested that companies should be classified simply according to whether they offer securities to the public or not.

Those companies which offer securities to the public will have additional requirements imposed upon them by the Securities legislation. The requirements imposed by company law, it is suggested, should be standard for all companies so that no further classification of companies would be required by the Companies Act.

53. If as a result of the responses received to this discussion paper that view is not maintained by the Commission, then it is suggested that the present classification should in any event be re-thought. At present, the private company form can be used by extremely large business enterprises and subsidiaries of large public companies as well as what is, in effect, the one-man trader. It applies to companies structured to achieve specialisation of management as well as to those closely controlled by the members and operating virtually as partnerships with limited liability.

54. A more rational division might be along the lines of the North American concept of the "closely-held corporation", generally identified by reference to turnover and/or numbers of members. Australia makes express provision for "exempt proprietary companies" (which have no shares owned by a public company) and "close" corporation legislation in other jurisdictions sometimes excludes any corporate membership.

55. Such a classification would enable different provisions to be made for closely-held companies in two areas –

- (1) informality of organisation
- (2) the needs of minorities especially –
  - . to provide for their participation in management
  - . to guard against their being locked in because of the more limited market for shares.

56. The classification is, of course, to some extent arbitrary. Informality and privacy may be as valid for companies falling outside the classification as within it as a matter of company law (as opposed to competition law or securities law).

57. The protection of minorities within smaller companies which are in effect partnerships has been the subject of Court decisions which suggest that, in the case of closely-held companies, equitable considerations will modify company law theory (*Ebrahimi v. Westbourne Galleries Ltd* [1973] AC 360; *Clemens v. Clemens Bros Ltd* [1976] 2 All E.R. 268). The remedy now available to a disaffected minority shareholder pursuant to s.209 explicitly empowers the Court to make orders for buy-out of a member who complains of unfair discrimination or prejudice in the conduct of the affairs of the company. It seems that s.209, taken with the attitude of the Courts to what is equitable in the case of closely-held corporations, largely removes the need for any distinct

classification and remedies.

58. Rather than have a distinct classification within the scheme of the Act it might be preferable to enable alternative articles which would give rights of appraisal and buy-out to be activated by a shareholder without recourse to the Courts. This is discussed further at para. 278.

#### **SIMPLIFICATION OF PROCESSES FOR PUBLIC COMPANIES**

59. The Law Commission suggests that the burdens from which private companies are currently excused should not continue to be imposed upon public companies.

60. The exemptions can generally be classified according to whether they relate to the formality of the internal operation of the company or to public disclosure. In the case of informality, it does not seem that risk of abuse is enhanced by permitting equal opportunity for efficient dispatch of business to public companies. Public disclosure, under the Companies Act, is primarily aimed at creditor protection. As the Macarthur Committee pointed out, in relation to private companies, the accounts filed with the annual return provide very little protection for creditors because they are out of date by the time filed. This acknowledgement appears to be as apt for public companies. In the case of publicly traded shares, continuing disclosure obligations arise under the Securities Regulations and the Stock Exchange Listing Requirements.

#### **RESTRICTIONS ON THE USEFULNESS OF PRIVATE COMPANY FORM**

61. In the event that it is decided to maintain a distinction between private and public companies, the Law Commission is interested to know whether the existing system can be improved.

62. The present upper limit on membership and the inability to invite subscriptions for shares may themselves be unduly restrictive. In addition, the formalities prescribed by the Act may remain a further brake on the efficient dispatch of business. It would be useful to know the ways in which formal requirements under the Act, applying to both public and private companies, can safely be cut down.

#### **QUESTIONS:**

1. Should the distinction between public and private companies be retained?
2. Should there be a separate classification for closely-held corporations in the scheme of the Act and with what incidents attaching to them?

3. Should the Act itself make no basic distinction between companies but contain in its Schedules draft articles catering for closely-held corporations (for example, by permitting rights of appraisal and buy-out)?
4. What distinct needs for informality and simplified organisation exist in the case of small companies?
5. Do larger companies have similar needs?
6. Is there a public interest in requiring greater formality in and more public information about larger companies? If so, what form should it take?

## VI COMPANY FORMATION

### INCORPORATION BY REGISTRATION

63. The Law Commission proposes that incorporation continues to be a public act requiring registration. It favours simplification of the process.

### PRE-INCORPORATION CONTRACTS

64. Comprehensive reforms to this area of law were introduced in 1983 by the new s.42A. The Commission believes these reforms were sound, but that there is scope for clarification of the effect of the Contracts (Privity) Act 1982 and a need for explicit reform to deal directly with the technical problem which arose in *D.F.C. v. McSherry Export Kilns Ltd (In Liquidation)* (1986) 2 BCR 151 without recourse to the Contractual Mistakes Act 1977. It is suggested that s.42A should be a code in the case of pre-incorporation contracts, although specific comment is sought upon this point.

### NAMES

65. The selection and authorisation of a company's name is a time-consuming process which can cause substantial delays in the process of company formation. The Macarthur Committee noted that a number of companies appear to be formed with the sole object of protecting rights to names and indicated support for the introduction of a system of registration of business names, such as exists in New South Wales. The Law Commission is interested to know whether there is support for a system of registration of business names, distinct from the Companies Act and applying to unincorporated as well as incorporated bodies. Alternatively it might be thought sensible to empower reservation of name, with the Registrar of Companies, without requiring formation of a company, thus avoiding delays in incorporation.

66. The Law Commission wishes to know whether the basic system of acquiring rights to a name upon registration under the Companies Act should be retained at all. It may be that the whole system of conferring property rights to a name in this manner should be abandoned, leaving protection of interest in names to the general law of passing-off. If registration by name continues to be required, then it would be necessary to require that no company could incorporate under a name identical to that of another company, although the Registrar would not be able to decline to register a company under a name similar to that of another. The Law Commission suggests, however, that incorporation should be by number and not name. Once a company is incorporated and wishes to operate under a name rather than a designating number, its choice of name can, if so wished, be registered (under the Companies Act if no separate system is adopted) on the basis that while identical names

can be rejected, similar names are acceptable for company registration purposes. Under such a process, name adoption would not hold up incorporation or the start of business.

67. A company formed to promote a charity or object useful to the community and which applies profits to its objects and is prohibited from paying dividends to members can be authorised by Order-in-Council to dispense with the word "Limited" in its name. It is suggested that the requirement of an Order-in-Council is too restrictive. In some jurisdictions consent of the Minister or Registrar is substituted. The Law Commission favours automatic entitlement upon the directors making a statutory declaration of compliance with the conditions for exemption.

### SHELF COMPANIES

68. Does the law cater adequately for the formation of companies needed urgently? Although registration by number instead of name should speed up the process of company formation, other suggestions for improvement of the system are sought. In particular comment is invited as to whether the Registrar should be empowered to sell "shelf" companies.

### MEMBERS

69. At present private companies can incorporate with a minimum of two members and public companies with a minimum of seven. Since *Salomon v. Salomon & Co. Ltd* [1897] AC 22, the Courts have recognised the legality of what is in reality the "one-man" company. The Dickerson Committee in Canada recommended the abolition of the minimum membership, noting that –

"... the formal requirements of the present Act are invariably met by the use of 'dummy' incorporators, usually stenographers in lawyers' offices. The minimum membership requirement affords no significant protection to creditors, nor does it present any serious obstacle to irresponsible corporation. Its abandonment will therefore expose creditors to no greater risks than those to which they are at present subject ..." (Dickerson Report, para.48)

70. In accordance with its policy of "dispensing with meaningless formalities" the Committee recommended abandonment of the minimum requirement, a suggestion adopted in the Canadian Business Corporations Act. The Law Commission proposes the same reform in New Zealand.

### DOCUMENTS NECESSARY TO OBTAIN REGISTRATION

71. The process of registration should be simplified. In particular, it is suggested that the aim should be to introduce a one-document

constitution for a company, replacing the distinction between the Memorandum and the Articles of Association.

72. It may be questioned whether much of the information required to be filed is necessary. It is suggested that it is essential to have on a public register the following information:

- . the designation of the company (whether by name or number)
- . the address of the registered office
- . the basis of liability of its members (for example, limited or unlimited)
- . any limitation upon its capital structure (for example, by number of shares)
- . names and addresses of directors
- . formal acknowledgement of incorporation.

73. It is arguable that any objects of the company and details of its internal constitutional arrangements should not be held on the register because such details invite applications of the doctrines of constructive notice or knowledge, despite the reforms introduced by s.18A. The Commission wishes to receive submissions as to whether the intention to lay to rest the doctrine of ultra vires has been completely achieved by s.18A. It would also welcome comment as to the extent to which the register should hold details of the constitutional arrangements within the company. It has been suggested to us that the record-keeping of some companies may be inadequate to ensure that access to the company constitution can be obtained at the registered office. Because companies are artificial entities and are defined by their constitution, the present view of the Commission is that the corporate constitution needs to be maintained on a public register for safe-keeping.

74. Speedy access to information about the shareholders of a company does not seem to be a matter critical enough to warrant the expense of duplicating shareholder lists on the public register, provided the information is required to be available at the registered office. The Commission would therefore prefer to remove the requirement for notification of shareholders. It is, however, keen to know the extent to which the register is used to search shareholding and for what purpose and the extent to which those making use of the register value the anonymity of using a public facility. If the register is to contain details of shareholding, should it provide a complete historic record (as is the case now, through filing annual returns) or should it simply be a current record?

75. The Commission seeks comment upon the view that the function of the Registrar in keeping the register should be purely administrative and should not extend beyond checking to see whether documents, upon their face, are in conformity with the formal requirements of the Act.

## COMPANY SEALS

76. The Commission questions whether any useful purpose is served by the company seal and favours making it optional for a company to adopt one.

### QUESTIONS:

1. Should s.42A be an exclusive code in connection with pre-incorporation contracts?
2. Should companies be able to incorporate by number?
3. Is there a need for a register of business names distinct from the Companies Act?
4. Should the Company Register be used to prevent the adoption of names similar to those of other companies?
5. Should charitable, non-dividend distributing companies be entitled to be exempt from the inclusion of the word "Limited" in their name upon application supported by statutory declaration of compliance?
6. How can urgent company formation be facilitated?
7. Should it be possible to form companies having only one member?
8. Should the application for registration be accompanied by the constitutional documents of the company?
9. Should the functions of the Registrar on incorporation extend beyond checking the form of documents to ensuring their compliance with the substantive law?
10. Should the identity of shareholders be maintained on the Register? If so, should the Register maintain current information only or provide an archive of past shareholding?
11. Should the company seal be made optional?

## VII SHARE CAPITAL

### MINIMUM CAPITAL

77. The Macarthur Committee was of the view that the imposition of a minimum capital of not less than \$2,000 would provide some deterrent for the formation of grossly undercapitalised companies. The Law Commission is not convinced that a requirement as to minimum capital would provide any real measure of protection for creditors. It also considers that the imposition of a minimum capital requirement is not practicable given the variety of corporate enterprise.

### NOMINAL CAPITAL AND PAR VALUE

78. A share, as its name implies, is the residual claim of the member on the profit and net assets of the company. Because of the company law rules derived from the imposition of nominal capital and par value it is, as Professor Gower has pointed out, impossible to describe the difference between book assets and liabilities by the one word "capital".

"The initial capital will have to be divided into share capital and share premiums (assuming that shares are issued for more than par) and these two items remain fixed irrespective of any fluctuations in the value of the assets and liabilities. If the net book value exceeds the capital yardstick, a further balancing item, 'reserve', will have to be added." Gower, *Principles of Modern Company Law*, 4th ed., p.222

79. In turn, the complications introduced by company law into the notion of capital cause substantial contortions in terms of payment of dividends.

80. It is suggested that par value should be abolished. It is considered that it is not sufficient to make par value optional. No par value was recommended by the Jenkins Committee in the United Kingdom. Par value has been abandoned in most North American jurisdictions largely because it is arbitrary and misleading, inhibits flexibility in arrangement of a company's capital structure and causes unnecessary complication and resulting confusion in company accounts.

81. If par value is abolished for ordinary shares, there seems to be no good reason to retain it for redeemable shares and preference shares.

82. The concept of nominal capital has never been applied to no-liability companies or incorporated societies. The Law Commission at present is of the view that the concept of nominal capital serves no useful purpose and may be dangerously misleading. It also leads to complexity in company accounts, with results which are wholly artificial.

## STOCK WATERING

83. The concept of par value provides protection against stock watering by issue of shares below the value established as par. This protection, however, in practice achieves little in circumstances where the shares in an enterprise are worth substantially more than par or where shares were issued for a consideration other than money. The common law has traditionally refused to go into the adequacy of the consideration obtained by directors on issue of shares. (See for example *re Wragg Ltd* [1899] 1 Ch 796, 829, 836; *re White Star Line Ltd* [1938] Ch 458.)

84. Where shares are issued *pari passu* to existing shareholders there will be no shareholder prejudice through under-valuation. Where there are no pre-emptive rights entitling shareholders to participate in an issue on a *pari passu* basis, and where shares are issued in exchange for property, it may be questioned whether the statute should not oblige the directors to require fair value and terms of payment for any shares issued by the company. Fair value is required of issues for consideration other than money in Ontario (Business Corporations Act 1982, s.23). The U.S. Model Business Corporation Act goes further in requiring the directors in all cases before the company issues shares to determine that the consideration is adequate. It is expressly provided that inadequacy of consideration will not affect the validity of the issue; the purpose of the requirement being to establish a standard against which liability of directors can be assessed.

85. It is arguable that the question of the value obtained for shares is simply one particular aspect of the directors' general duties (as to which, see below). There is, however, a problem in ensuring that the older authorities do not inhibit the Courts from applying the general principles in cases of stock watering, and the Commission suggests that explicit recognition of the duties owed by directors when issuing shares should be made.

86. Allied to the question of under-valuation of shares is the question whether shares should be able to be issued for future services or benefits or on promissory notes. In some jurisdictions in North America there is a prohibition against issuing shares for promissory notes or future services. The matter is raised for consideration, but it is suggested that the general rules relating to director duties, including any duty imposed to obtain a value that is "adequate" or "fair", is sufficient protection against the danger of stock watering in these circumstances also.

## DIVIDENDS

87. Associated with a reform of the company law concept of capital is reform of the very complicated rules relating to payment of dividends. The rules are not contained in the statute and it is suggested that, if retained, they should certainly be reduced to statutory form for the sake of clarity.

88. While the cases are in agreement that dividends should be paid out of profits and not out of capital, the concepts of profit and capital are not clearly stated. In particular, the cases draw a distinction between fixed and circulating capital which may be quite artificial. Losses on fixed capital need not be made up before dividends are paid. A dividend can be paid out of the trading profits of one year without making good the trading losses of the previous year. Realised profits on the sale of fixed assets are available for distribution and it appears that unrealised gains on fixed assets may also be distributed as dividends.

89. The Law Commission is of the view that these rules are unsatisfactory. It considers that the present rules should be replaced by a solvency test, such as has been adopted in Canada, by which a dividend cannot be declared or paid –

"... if there are reasonable grounds for believing that –

- (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
- (b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes."

(Canada Business Corporations Act, s.40)

90. The virtue of the first limb of the test is that measuring current assets against current liabilities may not be sufficient to establish solvency. The test ensures that decisions are based on a cash-flow analysis that known obligations of the company can reasonably be expected to be satisfied during the time they will fall due.

91. Further comment is invited on the question of whether the concept of "stated capital" as used in the Canadian test is a useful one if nominal capital is abandoned. "Stated capital" is the full amount of any consideration received by a company for shares issued by it. It is a concept that has been discarded in a number of United States company statutes. The U.S. Model Business Corporations Act prevents distributions, including dividends, to shareholders where, after giving effect to the distribution:

- "(1) The Corporation would not be able to pay its debts as they become due in the usual course of business; or
- (2) The Corporation's total assets would be less than the sum of its total liabilities plus (unless the Articles of Incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution."

92. This test, in effect, treats preferential dissolution rights of classes or series of shares for distribution purposes as being equivalent to liabilities, rather than equity interests. The Law Commission at present prefers the United States model.

#### PURCHASE BY A COMPANY OF ITS OWN SHARES

93. The principle that a company cannot purchase its own shares was established in *Trevor v. Whitworth* (1887) 12 App Cas. 409. The main rationale behind the decision is the maintenance of capital, for the protection of creditors and to preclude opportunity for abuse of shareholder interests.

94. Company share repurchase is permitted in Canada, the United States, and the United Kingdom. Proposals for reform to permit company repurchase are current in Australia.

95. It is suggested that the protection of creditor rationale for the existing restriction is sufficiently satisfied by treating repurchase as a distribution subject to the solvency test for other distributions. That is the solution adopted by the Canadian Business Corporations Act and by the Business Corporations Act of Ontario.

96. The more controversial aspect of relaxation of the rule has related to the possibilities for shareholder abuse. It has prompted some fairly complicated safeguards in the United Kingdom legislation, although the North American statutes leave shareholder protection largely to the common law to police as an aspect of the directors' duties of care, good faith and proper purpose.

97. The Law Commission considers that there are considerable benefits in permitting companies to repurchase their own shares. The matter has recently been considered by the Australian Company and Securities Law Review Committee which in September 1987 published a report to the Ministerial Council on the topic. That report conveniently summarises the benefits of permitting share repurchase and its dangers.

98. The benefits for companies result from the greater flexibility in organising their capital and gearing, permitting prudent investment and reduction of administrative overheads, enabling easier exit from a company for dissident shareholders, who may otherwise disrupt management of the company, and a sensible way of returning surplus resources to shareholders. Closely held companies may benefit from the greater flexibility in achieving shareholder buy-out without jeopardising control of the company. The Australian report also sees an advantage of permitting self-purchase as improving the competitiveness of Australian securities in international financial markets. Since self-purchase is permitted in North America and the E.E.C., and at a time of rapid internationalisation of the financial markets, it is thought that Australian companies may be at a disadvantage when competing on world share markets if they lack the same flexibility of control.

99. The disadvantages generally perceived as arising from a self-purchase power are –

- . the potential for improper discrimination among shareholders (permitting favoured members to be bought out at premiums or purchase at under-value)
- . market price manipulation (which the Australian Committee thought to be adequately controlled by the Securities Industry Code)
- . insider trading
- . improper attempts to secure or consolidate corporate control
- . the increased risk of corporate failure.

100. The Australian Committee favours the solution adopted by the United Kingdom over the North American system with its reliance upon the general duties of directors. In particular, it favours the United Kingdom requirement that shares which are repurchased must be cancelled (in Canada, the shares can be resold by the directors although they cannot be voted while retained by the company).

101. The Australian Committee suggests that the power of self-purchase be subject to a number of restrictions (which would of course be supplemented by the common law rules as to fiduciary duty). It suggests:

- . Where the articles so permit, companies can purchase up to ten per cent of their own shares in on-market transactions or by pro rata acquisition from shareholders.
- . Where it is desired to acquire more than ten per cent of the shares in any year, the approval in advance of the shareholders by ordinary resolution be required except where the purchase is made on the market. The resolution must be a special resolution and the shares affected are not able to be voted. Shareholders should be required to settle the terms of the authorisation (price, numbers of shares, method of buy-back – whether on-market or pari passu, any minimum time period for the holding open of the offer).
- . The time period for which the authority is effective must be set by the shareholders and must not exceed 18 months from the date of the resolution.
- . Selective buy-back (that is to say from targeted shareholders) requires the prior approval of shareholders by special resolution, for the purposes of which the votes of the proposed vendor and associates are excluded.

- . Detailed disclosure.
- . Cancellation of self-purchased shares (and rejection of the "Treasury share" concept).
- . No automatic invalidity for unauthorised transactions, but criminal and civil liability for directors and officers.
- . No repurchase when the board has reason to believe that a takeover offer will be made.
- . A requirement imposed on non-dissenting directors to make a declaration of solvency both at the time of authorisation by shareholders and as a pre-requisite to their entry into buy-backs and resultant personal liability (joint and several) to compensate the company for the total funds expended on self purchase in the six months prior to insolvency. (It is proposed that it be a defence for such a director to establish that at the time of making the declaration there were reasonable grounds for the opinion.)

102. The Law Commission is anxious to receive comment upon the options available in this area. It is of the view that remedies against directors where the company becomes insolvent should be imposed under the general law relating to company insolvencies. It is concerned to find out how restrictive the detailed procedural safeguards imposed by the United Kingdom regime and as proposed in Australia would be in practice. It suggests that there is little point to reform in this area until the tax implications have been made clear and it invites specific comment on how share repurchases should be treated for the purpose of taxation.

103. The Commission is interested to know whether some of the complexities of the United Kingdom model may be usefully avoided without cutting down upon the safeguards imposed by the general duties owed by directors. In particular, it wishes to know whether prior shareholder approval and cancellation of shares is necessary if there is –

- . prompt disclosure of self purchases (which is supported by the Law Commission in any event as assisting in the prevention of "greenmail" and "ramping" of the market price of the company's shares)
- . restriction on the price the company may pay for shares by reference to the market or (in cases where there is no market) fair value, unless the purchases are *pari passu* from all shareholders
- . prohibition on self purchase where a takeover offer for the company's shares has been made or is known to the directors to be imminent

- . prohibition on self purchases which would cause a listed company to lose its listing
- . a restriction on self purchase to a percentage of issued shares per annum
- . a prohibition on the voting of repurchased shares.

## REDEEMABLE SHARES

104. Linked to reform of the rules against self-purchase, is reform of s.66 which limits redemption to preference shares. In the United Kingdom and in a number of North American jurisdictions all shares can now be made redeemable.

## FINANCIAL ASSISTANCE IN THE PURCHASE OF A COMPANY'S SHARES

105. Section 62 of the Companies Act 1955 makes it unlawful for a company to give –

"... directly or indirectly, and whether by means of ... any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company, or, where the company is a subsidiary company, in its holding company".

106. Certain loans are excluded, including in particular the provision of funds for employee share schemes. Section 62 is subject to the validation provisions of the Illegal Contracts Act 1970 and it appears that the Courts will validate transactions in breach of s.62 where the interests of creditors and shareholders are not prejudiced.

107. The Commission understands that s.62 causes great difficulty in practice because of its breadth. It may also operate to make it difficult for companies to restructure their shareholding in circumstances where there is no possibility of prejudice to creditors or shareholders.

108. The rationale for s.62 is similar to that of *Trevor v. Whitworth*. The protection of creditors should be sufficiently secured by the application of a solvency test, as in the case of a purchase by the company itself of its shares. Abuse of shareholders' interests, similarly, may adequately be protected against by the directors' equitable duties and shareholder remedies and by providing that shares being financed by a company cannot be voted while the system of support continues.

109. The Law Commission would welcome indications as to difficulties caused by the operation of s.62 in practice and indications of abuses and the extent to which they can be adequately controlled by the general law relating to directors' duties and shareholders' rights. In particular it would be useful to know

whether effective control of abuse is possible without a mandatory disclosure to shareholders when assistance is provided.

## **PRE-EMPTIVE RIGHTS**

110. The rules of the New Zealand Stock Exchange require share issues to be offered to existing shareholders subject to a discretion to place ten per cent of the company's shares in any financial year. The Dickerson Committee in Canada recommended that a pre-emptive right be presumed unless the articles specifically excluded it. The aim was to protect existing shareholders against dilution not only of the voting strength of their shares but of their interest in the net assets of the company. That suggestion was not however accepted in the Canadian Business Corporations Act or in the Provincial Acts. In some cases of closely-held corporations the Courts have apparently been prepared to infer such a right and the same position arguably could be contended for in New Zealand as a matter of equity or as justifying shareholder action under s.209. The cases may however be confined to those where the right is conferred by separate contract or "understanding". In the United States, pre-emptive rights are provided for in the statutes of most States and in the Model Business Corporations Act. The provisions can be excluded by the constitutional arrangements of the corporation. The United Kingdom has mandatory pre-emptive rights for public companies and presumptive rights for private companies. They may be excluded by special resolution in particular cases. It is understood that the requirement of a special resolution causes some difficulty in practice.

111. As is indicated further below, the Commission is sympathetic to a legislative presumption of pre-emptive rights and is particularly interested to receive comment upon their perceived desirability.

## **QUESTIONS:**

1. Should companies be required to have a minimum capital upon formation?
2. Should company law continue to apply the notions of par value and nominal capital?
3. Should directors be required to obtain fair value and terms for all shares issued otherwise than *pari passu* to existing shareholders?
4. Is it desirable to enact a rule for the circumstances in which directors may pay a dividend?
5. If so, is the test contained in the United States Model Business Corporations Act appropriate?

6. Should companies be permitted to purchase their own shares in some circumstances?
7. If self-purchase is permitted, are the reforms proposed by the Australian Law Reform Commission preferred?
8. Is prior shareholder approval of repurchase and automatic cancellation of repurchased shares in all circumstances necessary?
9. Should all shares be able to be redeemable?
10. What difficulties are currently experienced with the workings of s.62 in practice?
11. Should companies be permitted to finance purchase of their own shares provided that disclosure to shareholders is made?
12. Should pre-emptive rights be presumed in the case of share issues unless specifically excluded by the articles of the company?

## VIII REGISTRATION

### THE PRESENT SYSTEM

112. The Registrar of Companies is obliged to keep –

"such registers as he considers necessary, in which shall be recorded all matters required by this Act or by rules or regulations under this Act to be recorded by the Registrar" (s.7, Companies Act 1955).

113. The registers and all documents required to be filed under the Companies Act and its Regulations are open for public inspection (s.9). Under the present Act much of the information held by the Registrar must also be made available for search at the company's own office. It seems to the Law Commission that some duplication could safely be eliminated while preserving the obligation upon the company to supply to members upon request copies of certain documents (for example, the memorandum and articles, the most recent accounts).

114. Public disclosure through the registration process includes:

- (1) The memorandum of association and articles of association (s.26).
- (2) Allotments of shares (return to be delivered within thirty days of the making of any allotment giving details in accordance with s.60).
- (3) Alteration of share capital (ss. 71, 72 and 78) –
  - . Consolidation or conversion of shares into stock, subdivision, cancellation of shares or redemption of redeemable preference shares (s.71)
  - . Increase in share capital with particulars and memorandum of subscription (ss. 72 and 361).
  - . Reduction of share capital by Court (s.78).
- (4) Charges (ss. 102 to 114) –
  - . Registration (ss. 102 and 104)
  - . Satisfaction of charge (s.107)
- (5) Situation of registered office and notification of change seven days before the date of the change (s.115).
- (6) Annual Returns (ss. 130 to 133) and comprising –
  - . the address of the registered office of the company

- . notification of where the register of members is kept
  - . a summary of share capital
  - . particulars of total indebtedness in respect of charges registered
  - . particulars of directors and secretary
  - . a list of past and present members
  - . (where annual meeting required) the date of the last annual general meeting
  - . (where annual meeting not required pursuant to s.362) the date on which compliance with s.362 was made
  - . (where s.354(3) applies) the text of the resolution that no auditor be appointed together with a certificate that details of the resolution are correct
  - . a certified copy of the balance sheet required pursuant to s.152, together with a certified copy of the auditor's report and the directors' report accompanying the balance sheet.
- (7) Declarations of compliance by directors with conditions imposed pursuant to s.117 (restrictions on commencement of business where public invited to subscribe for shares)
  - (8) Situation of register of members (s.118(3)).
  - (9) Statutory report preceding the statutory meeting to be held within three months of the date from which the company is entitled to commence business (s.134).
  - (10) Special resolutions, extraordinary resolutions and resolutions effective (s.147), and resolutions requiring voluntary winding-up of a company (s.147).
  - (11) Particulars of directors and secretary (s.200) comprising –
    - . present and former names
    - . usual residential address
    - . nationality
    - . business occupation or other directorships
  - (12) Notices of steps in winding-up pursuant to Part VI of the Companies Act, comprising –
    - . order staying winding-up (s.250)

- . Court order sanctioning compromise or arrangement (s.205)
- . order of dissolution (s.267)
- . statutory declaration of solvency in case of proposal to wind up voluntarily (s.274)
- . order declaring dissolution void (s.335) report of final meeting in the case of a members' voluntary winding-up (s.281)
- . report of final meeting in the case of a creditors' voluntary winding-up (s.291)
- . notice of appointment of liquidator (s.296)
- . statements by liquidator as to proceedings in and position of the liquidation (s.329)
- (13) Notices relating to receivers and managers pursuant to Part VII of the Companies Act 1955 comprising –
  - . receiver's statement of affairs (s.348)
  - . receiver's abstract of receipts and payments (ss.348 and 350)
- (14) Application for change in status from public to private (ss.365 and 366)
- (15) Resolution, in the case of a private company, that no auditor be appointed (ss. 354, 147 and 132)
- (16) Information required from overseas companies (ss. 397 to 399, 401 to 402, and 409)
- (17) Copies of takeover offer, and notice and statement to be sent to offerees pursuant to s.4 of the Companies Amendment Act 1963 (s.7, Companies Amendment Act 1963).

115. This list is not complete and is supplemented by other legislation, most notably the filing requirements under the Securities Act.

## THE PURPOSE OF REGISTRATION

116. Under the Companies Act 1955 the registration of the information supplied by the company is the most significant way in which disclosure of important information is ensured.

117. Disclosure has always been the fundamental principle underlying the New Zealand Companies Acts and the United Kingdom

models from which they are derived. We do not have a central regulatory commission with wide powers to ensure that the standards set by the legislation are met. While the Registrar on the face of things has wide powers, the company law system relies mainly on enforcement by those most affected: shareholders and creditors. Such a system can work only if those particularly affected have access to the information which will enable them to take action in relation to the companies with which they are associated.

118. The value of disclosure in the scheme of company law is not questioned. But it is important to ensure that the costs inevitably associated with disclosure are in keeping with the benefits obtained. The Law Commission intends to make a critical examination of the existing disclosure requirements and the means adopted for disclosure and enforcement. It is also important to try to establish whether there are needs for information which are not being met at present. A public register in the present form has the advantage that a searcher can get an historical picture of the company which may of value in spotting trends in the conduct and ownership of the company. The value of anonymity of the search may also be a matter of public importance.

#### THE SCOPE OF DISCLOSURE THROUGH THE REGISTER

(apart from registration of company charges  
and upon insolvency)

119. Those with needs for access to information about a company are –

- . shareholders
- . creditors (including employees)
- . those who wish to take legal action against, or enter into legal relations with, companies
- . potential investors
- . members of the public.

#### *Shareholders*

120. It may be doubted whether disclosure in a public register is the most efficient and effective way to disseminate such information to shareholders. Some of the information can be expected to be furnished to shareholders by the company directly (as, for example, in the case of annual accounts). Other information might be left to be made available upon request (for example, the company's constitutional arrangements). In some cases, information having a material effect upon shareholders' rights or the confidence of the shareholders in the directors will need to be notified to shareholders promptly. Ideally, for maximum effectiveness, communication will be direct but in some circumstances that may be extremely costly.

Notification to the Registrar will not of itself be sufficient notification to shareholders. The Law Commission is interested to know whether the Act should provide for communication to shareholders of material information by publication in, say, the *New Zealand Gazette* or the public notice columns of newspapers, as an alternative to or in addition to direct communication or public registration. If such a facility is desirable, should it be available to all companies, or companies whose membership exceeds a certain number or should it be a procedure only available to listed companies (where the New Zealand Stock Exchange is a further aid to dissemination of the information)?

### *Creditors*

121. The disclosure required by the Companies Act is not matched by similar disclosure in the interests of creditors in the case of unincorporated sole traders, partnerships or incorporated societies. The basis for requiring further disclosure in the case of companies is generally given as the benefit available to companies of limited liability.

122. Creditors are in theory able to secure their own needs for disclosure as a matter of contract. Those in the business of extending credit will have much better information available to them upon which to judge the credit-worthiness of a company than is available to members or currently through the register. In theory, trade creditors and consumers who make pre-payments are in the same position although it may be doubted whether in reality they commonly seek information relating to the company's financial standing before supplying goods or services or making payments. The Law Commission is interested to know whether trade creditors and consumers make use of the financial accounts held by the Companies Office (in the case of private companies in summary form only) otherwise than for the purposes of enforcement. The impression is that the register is little used for this purpose and that the information obtained from a search is too out of date to be relied upon in any event. The Law Commission inclines to the view that creditors receive no real benefit from disclosure through the register.

### *Those needing to take action against or enter into legal relations with a company*

123. Those wishing to sue a company or deal with it need to have prompt access to information which sufficiently identifies the company and its responsible officers. This information needs to be reliable and readily accessible. It seems to the Law Commission that it should be maintained on a public register in the Companies Office. The essential information for these purposes is –

- . the name and/or identifying number of the company
- . its status (as limited, unlimited, limited by shares or guarantee)

- . its registered office
- . the names and addresses of past and present directors with the dates on which they held office
- . evidence of incorporation (perhaps a certificate).

124. As appears from the discussion at paras. 73 and 140, the Law Commission wishes to know whether it is thought necessary or desirable (given the abolition of the doctrine of constructive notice) for the constitution of the company to be available for inspection on the public register. Its tentative view is that registration may be necessary to ensure safe-keeping of the constitution.

### *The general public*

125. Does the public interest require disclosure to go beyond identification of the company and its responsible officers? It is suggested that it is difficult to discern any independent public interest in much of the material currently required to be placed on the register.

126. In the case of company accounts, potential investors will have access to more accurate information for public listed companies through private information agencies (such as stockbrokers), the financial press and through the disclosure requirements of the securities legislation.

127. At present private companies – some of them of significant economic size – are not subject to the same disclosure provisions as apply to public companies. Limited liability of itself has therefore not been seen as sufficient reason to justify the level of disclosure.

128. The utility of the information obtained from the register is doubtful. The Dickerson Committee in Canada thought the annual return a "superfluous nuisance" and suggested its abolition (a suggestion not, however, acted upon in the Federal legislation). The Law Commission is sympathetic to that view.

129. Large public companies and some large private companies do control substantial economic resources within New Zealand. If it is thought that there is a need for better access to information about such companies, it may be thought more suitable for disclosure to be required under a statute such as the Commerce Act 1986 or under an extension to the Official Information Act 1982 rather than as a matter of company law. If such a rationale is advanced as justifying disclosure under the Companies Act, then if all companies are not to be subjected to the same requirement it will be necessary to determine the basis for discriminating between them. The test is likely to be an arbitrary one based, perhaps, on turnover. It will also be necessary to make specific provision for diversified companies operating through divisions or "closely-held" companies. The benefits may not be commensurate with the costs of achieving the test.

130. Even if the public interest requires greater disclosure in the case of larger companies, registration may not be the best means to secure it. It may be preferable for some information to be made available upon request to the company.

## ENFORCEMENT AND THE ROLE OF THE REGISTRAR

131. If the information required to be maintained by a company on the register is reduced to the information which is essential for the purposes of identification of the company and its officers, then the task of ensuring compliance should be greatly reduced. This, it seems, is a matter of some importance. It is notorious that the register is consistently in arrears. The Macarthur Committee recommended increasing the powers of the Registrar to secure compliance. The impression is that the state of the register is little improved by the reforms introduced as a result of its recommendations.

132. If the information required to be registered is only that relating to the status of the company, updating will be reduced to notification of change in the registered office and change in directors. Out of date information should continue to attract penalties for companies and officers in default. The difficulties in achieving updating might be reduced by providing for personal service of documents upon directors of a company and continued liability of a director whose name remains on the register (thus providing an incentive to the outgoing directors to ensure that the records are updated promptly). A further aid to ensuring currency might be the introduction of a "shuttle" system, where the Registrar sends to each company annually a copy of all current information and the company has to confirm or correct each item.

133. Following a recommendation of the Macarthur Committee, the powers of the Registrar were expanded to make it clear that the Registrar has power to refuse to register or receive documents where the substantive provisions of the Act have not been complied with. It is suggested that the function of the Registrar in maintaining the register (as opposed to his investigative and other enforcement functions which are considered further below) should be simply to keep the records in a way that ensures compliance with form prescribed rather than to test the information registered for accuracy. The impression of the Commission is that there is considerable doubt whether the Registrar is best placed to police documents submitted for accuracy and whether the effort and resources required to enable him to perform the task might not be better used elsewhere. In particular, if financial disclosure by registration is retained, it is questionable whether the Registrar can sensibly be asked to ensure that the accounts submitted present a "true and fair" picture of the company. Indeed, it may be doubted whether it is desirable for approval to be given in this way at all since it may lead to reliance upon the fact of acceptance for registration as an endorsement of the accuracy of the accounts.

## REGISTRATION AS DISCIPLINE

134. Where the statute requires companies to take particular steps (such as completion of annual accounts), it may be that some requirement of public notification that the step has been taken at least imposes a check for compliance and is an aid to the Registrar in checking and monitoring. The Law Commission would like to hear views on the matter but it suggests that the registration system is a clumsy way to reinforce the primary obligation. If some formal discipline is thought desirable it might be in the form of a statutory declaration of compliance by the directors, which declaration need not be registered although the fact of compliance might be recorded in a "shuttle" return to the Registrar.

**QUESTIONS:**

1. Should the information relating to a company maintained on the Register be limited to the information necessary to identify the company, certify its incorporation, its address and the names and addresses of its directors?
2. Should public disclosure of a company's accounts on the Register by annual return be required?
3. If so, should such disclosure be required of all companies?
4. Should an annual return be required (either in the present form or on the basis of a "shuttle" request for confirmation that existing information is current) or should the notion be replaced by an obligation imposed upon directors to maintain currency of the information registered?
5. Should the Registrar have power to reject documents which comply with the form prescribed if it is considered that they do not achieve the standard of disclosure required by the Act?

## IX THE COMPANY CONSTITUTION

### THE CAPACITY OF THE COMPANY

135. At present the constitutional arrangements of the company which are not imposed by statute or by the common law are to be found in the memorandum of association and the articles of association. Typically, the memorandum of association has been concerned with the objects of the company and with the amount of share capital registered. The articles regulate the internal workings of the company.

136. The memorandum can only be altered in the manner prescribed by the Act. Generally speaking that enables alteration upon special resolution but if a provision in the memorandum affects class rights, the provision can only be altered by a scheme of arrangement pursuant to s.205 of the Act.

137. The implications of restrictions in the memorandum upon the capacity of the company led to the excesses of the ultra vires rule which, with registration and the application of the doctrine of constructive notice, bedevilled dealings between the company and third parties. These problems were substantially eliminated by the reforms to the Companies Act made in 1983 and 1985. A number of difficulties remain however, despite the reforms. In particular –

- . Although a company registered after January 1984 now has the rights, powers and privileges of a natural person, a company registered before that date has such powers only if it has altered its memorandum to take advantage of the change. In Australia and Canada similar reforms were either applied directly to all companies or required re-registration of all existing companies within a certain period. Since most companies were registered before 1984, the reforms are substantially undermined.
- . It appears by implication from s.15A(2) (which permits a company in connection with cessation of business to benefit employees "whether or not it is in the best interests of the company") that the powers of the company may not be exercised unless "in the best interests of the company". Where transactions are not in the best interests of the company, other remedies will be available to those directly affected. It seems unfortunate for there to be any suggestion of a restriction upon the capacity of the company in this way.
- . Invalidity of a transaction is still preserved by s.18C where there is knowledge of a breach of the memorandum or articles or there should have been knowledge by reason of the position or relationship of

the other party to the transaction with the company. It is not clear what the meaning of "knowledge" is for the purpose of this section, or who will be caught by the constructive knowledge which is the second part of the proviso.

Shareholders and floating charge-holders are given rights to obtain injunctive and other relief against the performance by a company of its obligations under ultra vires contracts. Similarly, creditors are given standing to oppose amendment to the memorandum. Giving creditors standing in this manner involves an assumption that creditors may in practice rely on restrictions in the memorandum. That seems unlikely and the better view may be that there is no necessary connection between limited liability and the ability to alter stated businesses. If creditors do not contract for specific limitation, arguably they have no interest in a company other than its continued solvency.

138. It seems that the ultra vires reforms need to be perfected. The Law Commission would like to know of any difficulties in practice with the workings of the present provisions and would also like to be informed of any reasons why creditors should have an interest in the capacity of a company.

139. For the purposes of discussion, the following reform proposals are made:

- . the memorandum should be abolished and a single form of company constitution adopted
- . non-members of a company should be unaffected, in their dealings with the company, by transgressions of the memorandum although where a company chooses to set limits to its powers, shareholders will still be entitled to enforce the limitation
- . creditors should not have standing to object to alteration of the company's constitution
- . all companies should now have full capacity unless they file a constitution with restrictive objects (that is, repealing ss. 15A(4) and 16).

140. The Law Commission has some sympathy with the suggestion that the company's constitution should not be filed. For the reasons discussed above at para. 73 however it presently is of the view that the public interest in having recourse to accurate records of the company constitution requires registration.

## THE FORM OF THE COMPANY CONSTITUTION

141. The articles regulate the internal government of the

company. Generally speaking the Companies Act permits great freedom in the choice of arrangements to be adopted by a company for its internal regulation and articles may be supplemented by shareholder agreement.

142. The articles are concerned primarily with –

- . allocation of power between the organs of the company (the directors and the members in general meeting)
- . the rights of shareholders and allocation of risk among them
- . the duties of officers of the company.

143. The memorandum and articles bind the company and the members "as a deed" (s.34). They therefore constitute a contract between each member and the company and may also give rise to a contract between individual members.

144. The contractual analogy in company law can be pushed too far. It needs to be considered whether s.34 should be retained in its present form. The implications of the Contracts Enforcement Act 1956, the Contractual Mistakes Act 1977 and the Contracts (Privity) Act 1982 may cause some difficulties, if applied to the company. The Law Commission is interested in hearing whether the provisions of the contracts legislation should be excluded from application to company law.

145. The contract described by s.34 is, moreover, a peculiar one. The members of a company do not have complete freedom of contract. Some of the provisions of the Companies Act are mandatory: articles inconsistent with them will be invalid. Others permit contracting out. The Law Commission suggests that it would assist understanding if the Act clearly identified a scheme of those provisions which may not be contracted out of and of others that will be presumed in the absence of different arrangements being adopted.

146. Examples of provisions which the articles would have to contain would include any maximum number of authorised shares and their classification (specifying the rights attaching to each class). In the case of a company the shares in which are divided into classes, it would be mandatory for at least one class of shares to carry voting rights and residual rights of distribution.

147. Presumptive provisions (able to be excluded or limited by the articles), might include:

- . pre-emptive rights
- . change of articles by special resolution
- . management of the company by the directors

- . delegation of powers of directors to a managing director
- . permitting the company to purchase its own shares
- . telephone meetings of directors
- . the terms on which directors may be indemnified by the company.

148. In practice, the popularity of articles based on Table A has operated to achieve standard effect except where specifically modified. It would be possible to annex draft articles to the statute which are to be applied unless excluded by specific provision. But it is thought that provision of such drafts does not remove the need to cover the essential matters of company constitutional regulation in the body of the statute.

#### COMPANY DECISION-MAKING

149. The Companies Act envisages that company decisions will be taken by two bodies –

- . members in general meeting
- . the directors.

150. For the purposes of the company constitution, the 1955 Act does not recognise the role of management below board level. Where the directors delegate their powers, they do not thereby exclude their own responsibility and accountability. The Law Commission tends to the view that no more elaborate recognition of the company power structure is necessary.

151. The division of powers between the general meeting and the directors is left to the articles. Where Table A or an equivalent provision to its Article 80 is adopted, the management of the company is given to the directors. In those circumstances the directors are not the agents of the members in general meeting. The only way the general meeting can control the powers of management is by alteration of the articles, or removal of the directors.

152. Apart from powers reserved by the Act to the general meeting (such as changes in capital structure and the decision for voluntary winding-up) the powers of the general meeting are not free from doubt. They seem to be limited to alteration of the articles, ratification of transactions entered into by the directors which exceed their powers under the articles, and residual powers in exceptional circumstances where the board is unable to act.

153. Although the comparative powerlessness of the members is viewed by some with concern, the specialisation of function permitted by division of powers is often required in the interests of efficiency. The potential for its abuse can be limited by –

- . the adoption by the company of a constitution which allows members greater participation
- . the power of the general meeting, by special resolution, to alter the decision-making power within the company
- . the fiduciary and statutory duties imposed upon directors in the exercise of their powers
- . the right of shareholders to remove directors
- . the ability of the shareholders to sell their shares.

154. In Canada, the statutory powers of the directors to manage are subject to any unanimous shareholder agreement. If companies are able by their articles to vary the general powers of management such a provision may not be essential. It may however be a useful tool to enable specific transactions or decisions to be authorised by the members of a closely-held company. Arguably the unanimous shareholder resolution needs no legislative recognition. Comment on the desirability and necessity of such a provision is invited.

155. The Law Commission does not at present propose any reassessment of the basic constitutional roles of directors and members. It seems sensible in a matter of such importance to have Article 80 contained within the Act itself. It is suggested therefore that the statute should provide that the directors manage the business of the company subject to any other arrangement adopted by the articles.

156. The Law Commission at present does not favour statutory recognition of the position of executive officers or principal officers (as in Australia). It invites comment on this matter.

## CHANGE TO THE CONSTITUTION

157. A company can alter or add to its articles by special resolution (s.24). This general power of alteration is not able to be excluded by the articles. The contract described by the statute has therefore the feature that its terms can be altered without the consent of all parties to it.

158. The power to alter the articles is qualified in some important respects:

- (1) It cannot be used to increase the financial liability of the members (a result that would strike at the principle of limited liability). (Section 36)
- (2) It is subject to compliance with any class rights procedures contained in the articles and, where there are different classes of shares, an alteration may be attacked in application to the Court under s.81.

- (3) If not exercised "bona fide for the benefit of the company as a whole" change may be challenged by a minority shareholder through the Court as being a fraud on the minority, as oppressive conduct justifying winding-up, or as conduct unfairly prejudicial under s.209.

159. The power to alter by special resolution only may be too restrictive in the case of some alterations. Alterations of capital (other than reduction) may already be made by ordinary resolution (s.70). Should the Act empower companies to set up their own system of alteration, reserving a mandatory special resolution procedure for "entrenched" provisions identified by the statute on the basis of their importance? Change of company name, prescription of form for transfer of shares, the form and manner of notice of meeting, the form for appointment of proxy, any shareholding qualification for directors, the procedure of directors' meetings, the remuneration of directors, the number of directors, the manner in which dividends may be declared and the form of notices are perhaps all provisions that could be altered, where the company wishes it, by a procedure other than special resolution.

160. Alteration only by at least a special resolution might perhaps be prescribed by the statute in the case of –

- . changes to the authorised business (if any)
- . the creation of new classes of shares
- . numbers of shares authorised (if any) or capital restrictions
- . changes to rights, privileges and restrictions attaching to shares or any class of shares
- . changes to or creation of restrictions on the issue, transfer or ownership of shares.

161. Where class rights are affected, it is suggested that the Act should itself entrench the need to obtain at least a three-fourths majority of the members in each class affected. (At present such a provision is found in Article 4 of Table A.) Class rights should be defined to include all rights relating to entitlement to dividends, voting, redemption rights, pre-emptive rights, the issue, transfer or ownership of shares in the class, and the residual claim to assets upon winding-up. The Law Commission recognises that the Courts have never developed any rule that requires shareholders voting as a class to consider the interests of the company as a whole. If class rights provisions are not to be used to oppress the majority, it may be necessary to consider adapting s.209 to permit relief.

162. In Canada and the United States, in addition to the general rights of shareholders to challenge alteration to the articles by application to the Courts (pursuant to ss. 81 or 209, on the basis of

fraud or oppression), dissident minority shareholders, in the case of fundamental change, can require the company to buy them out at a fair value. Such a procedure has the virtue of permitting minority shareholders to take their own decision without having it subject to the discretion of the Court. And it permits the majority a great deal of flexibility in changing the nature of the organisation. But where the company lacks the resources to buy out dissidents, they may effectively be able to block change. It may be thought that the wide powers given to the Court to make orders for purchase of shares under s.209 are sufficient protection to the minority against unfairness, without fettering the company's ability to change unreasonably.

163. Alteration of class rights and dissident rights are discussed further below under "Shareholders".

## THE GENERAL MEETING

### *The meeting*

164. The general meeting is the instrument by which the members exercise the powers reserved to them and is the forum in the company within which they can hold the directors accountable.

165. In the case of closely-held companies the formality of actual meeting may be inappropriate. In recognition of this, the Act presently provides for resolution by minute book entry in the case of private companies. Similarly the Courts have given effect to informal unanimous shareholder agreement.

166. The Law Commission suggests that unanimous shareholder assent should be recognised by the Act. It also suggests that the ability, subject to the articles, to make resolutions by minute book entry should apply to all companies. Clearly both such provisions would in practice facilitate shareholder decision-making only in closely-held companies.

167. The Law Commission is, however, concerned to examine the validity of the concept of meeting as the instrument through which voting is done. The requirement of a meeting may discourage shareholder participation. The proxy voting mechanism may not be a sufficient answer because it is itself dependent on the proxy's attendance and because there may be limitations on the proxy's ability to participate in a vote by show of hands. In many cases proxy voting may be weighted in favour of the directors of the company. Comment is invited on the desirability of permitting companies to provide in their articles for postal voting and telephone "meetings" either in substitution for or as supplementary to physical meetings. Should a general meeting be held except upon requisition if a better system can be devised for transacting the business of the meeting?

*Notice and voting*

168. The conduct of meetings is at present largely determined by the company's articles and by the case law. It is desirable for the main definitions and rules to be stated in the statute. Some, such as the definitions of special and ordinary resolutions, the notice required in respect of each, and the power to requisition a meeting, may be mandatory. Others such as the right to vote, the manner of voting, or number constituting a quorum may be presumptive only and therefore able to be varied by the articles. The aim should be to balance legal certainty with business flexibility.

169. It is suggested (as was recommended by the Macarthur Committee and the Jenkins Committee in the United Kingdom) that the distinction between special and extraordinary resolutions be abolished and that the special resolution be substituted for extraordinary resolutions wherever required.

**QUESTIONS:**

1. Should a single document company constitution be substituted for the present division into Memorandum and Articles?
2. Should all companies registered before 1984 be required to register any limitation of their objects or be deemed to have unrestricted capacity?
3. Is further reform of the ultra vires provisions desirable?
4. Should the standing of creditors to object to the alteration of a company's constitution be removed?
5. Should s.34 of the present Act be removed or modified to ensure that general contractual legislation is not to be applied to the relationships between the company and its members?
6. Should the Act provide that the management of the company is for the directors, subject to the constitution of the company?
7. Is it desirable to recognise that unanimous shareholder agreement prevails over the general powers of the directors to manage?
8. Should the Act prescribe the role of officers of the company?
9. Is a power to alter the company constitution by special resolution too restrictive? Is so, what alterations should require a special resolution?

10. Should a special resolution requirement or alteration of the constitution be presumptive or mandatory?
11. In the case of alteration of class rights, should it be mandatory to obtain a special resolution of the class affected?
12. If so, will it be necessary to adapt s.209 to ensure access to relief where the majority is oppressed?
13. In the case of alteration of class rights, should buy-out rights be provided in the Act for dissident minority shareholders?
14. What alternatives to meeting should be available to transact company business?
15. Should the distinction between special and ordinary resolution be abolished?
16. What changes are required to the rules regulating notice and calling of meeting and manner of voting?

## **X DIRECTORS**

### **DEFINITION**

170. The present definition covers anyone who in effect exercises the functions of a director, including anyone who instructs the directors how to act. It is suggested that the definition might make it clear that a person (including a company) who can instruct even one director may be treated, for the purpose of the Act, as a director. The Act should also be revised to eliminate inconsistencies in the application of the definition.

### **FUNCTIONS**

171. Although the model articles contained in Table A provide that the business of the company shall be managed by the directors, it may be thought curious that the question of the general functions of the directors is not dealt with directly in the body of the statute. It is proposed that the Act should specifically require the directors to manage the business of the company. This requirement could be subject to any unanimous shareholder agreement. It might also be argued that the general rule should be able to be displaced by the articles. The Law Commission is interested to hear views on this point, but at present it is not convinced that the principle of director responsibility and accountability should be able to be affected except in circumstances where the members all assent and themselves assume direct responsibility.

172. There remains the question whether director management is a sensible assumption for company law to make. In the case of large companies, there is a great deal of evidence to suggest that the directors, far from managing the company, may not even exercise effective supervision. Except in times of crisis their main function may be advisory only. Alternative systems discussed as being more in accordance with reality involve prohibiting outsider directors, and creating two boards (or at least giving the company the option of going to a two-tier system), in which managerial and supervisory functions would be clearly segregated. Comment is specifically invited upon the adoption or option of a two-tier board. The present suggestion, however, is that the division of responsibility and accountability in this manner is undesirable. The Law Commission suggests:

- (1) that an obligation to supervise cannot sensibly be separated from the obligation to manage without diluting accountability to an extent that is unacceptable
- (2) that the standards exacted by the Courts from directors in fact may recognise a distinction between insiders and outsiders

- (3) that the right to manage includes the right to delegate while continuing the responsibility to set up safe systems and ensure competence in the managers to whom powers are entrusted
- (4) that the ability of the outside directors to supervise is enhanced by their participation on the board with insiders
- (5) that in New Zealand business conditions the unitary system and the responsibilities it imposes upon directors are well understood and there appears to be no wish for any great change
- (6) that it is not necessary to provide for a board which is advisory only (since the directors can set up such formal or informal systems for outside advice as they think necessary, as part of their powers of management)
- (7) that there is a risk in a two-tier board system that the function of advising the managerial board would obscure the necessary function of providing effective supervision.

#### AUTHORITY TO BIND COMPANY

173. The Law Commission is interested to know whether the new law contained in ss.18C-D is working satisfactorily. The Prentice Report in the United Kingdom has recommended the enactment of a statutory rule that any director has ostensible authority to bind the company. A similar rule would provide certainty for third parties dealing with the company. Comment is sought as to whether a statutory authority to bind the company should be conferred upon any one director or upon any two directors (where there is more than one director of the company).

#### NUMBERS AND QUALIFICATION

174. It is proposed that -

- . The minimum number for the directors of all companies should be reduced to one. (To avoid any lacuna it may be sensible to provide in the statute that the personal representatives of a deceased sole director are empowered to act as directors.)
- . The requirement that directors be natural people be retained.
- . If there are no directors, there is a presumption that all shareholders are directors.

The disqualification of undischarged bankrupts and those convicted of certain offences (ss. 189 and 188A) be retained.

175. Although comment is invited, it is suggested that it would be undesirable to extend the disqualification to those who have been directors of companies which have failed unless a disqualification order has been made by the Court.

## APPOINTMENT

### *Voting*

176. Under the present Act directors must be voted for individually unless a decision to vote on a "ticket" has been taken, without dissent (s.186, which does not however apply to private companies).

177. In practice, it may be doubted whether this provision achieves more than procedural complexity. Views on its retention are invited.

178. Views are also sought on whether it is desirable to permit companies to adopt articles providing for cumulation of votes for directors. Such a system is provided for in the Canada Business Corporations Act. It provides for multiplication of votes by the number of directors to be elected to enable concentration of votes. In the absence of a right to cumulate, the votes of a simple majority will be sufficient to ensure election. The purpose of cumulative voting is to enable minority interests to secure representation at board level.

179. The topic of cumulative voting is discussed further under "Shareholders".

### *Nominee directors*

180. In the case of closely-held companies nominee directors to the board may be particularly useful. If that result is required in a closely-held company, it can be provided for in the constitution of the company by allocation of voting rights. In cases where the constitution does not set up a partnership in management then arguably nominee directors are inherently undesirable as cutting across notions of corporate identity, director responsibility and shareholder equity which are fundamental to our system of company law. On the other hand the nominee director is a fact of life and perhaps should be explicitly recognised while being under the same general duty to the company and all shareholders as other directors.

181. The Law Commission is particularly interested to obtain views on this question, which is discussed further below under "Directors' Duties".

### *Alternate directors*

182. Is there a demand for statutory recognition of the position of alternate director, either in the Act itself or (as in the United Kingdom) in Table A?

### REMOVAL OF DIRECTORS

183. Directors can be removed at any time upon ordinary resolution (s.187). That provision does not apply to private companies. It is suggested that a power to remove directors upon ordinary resolution should be presumed for all companies unless modified by the articles. In the case of companies which offer securities to the public, it may be that an ordinary majority should continue to be able to remove a director unless the voting in the company is structured to achieve some level of entrenchment. In the case of all other companies it may be unobjectionable to permit a special or other majority, should the constitution of the company so permit it. It is suggested that it is not desirable to withdraw any power in the shareholders to remove a director except by resorting to the Court. The Law Commission does not at present favour a greater majority than a three-fourths one. In closely-held companies where control is sought to be more substantially entrenched the voting of shares can be structured to make the director secure should that be desired.

### PAYMENT TO DIRECTORS

184. Directors are not entitled to remuneration unless the power to remunerate is provided for in the articles. Details of the remuneration paid must appear in the annual accounts. The common law prohibition on payment to directors is derived from the analogy between directors and trustees.

185. The same analogy appears to lie behind the provisions of the Act relating to payments for loss of office (sections 191–194). Such payments are unlawful unless approved by the company in general meeting.

186. The trustee analogy may not be appropriate and may not reflect the role of the director in the modern company. Although the possibility of abuse must be recognised (particularly where the company is the target of a takeover), it is suggested that payments for loss of office should be treated on the same basis as remuneration in office. On that basis, companies by their articles, could provide for such payments on the terms they think fit, with disclosure of any agreements entered into or payments made. The exercise of the powers would, of course, be subject to attack if not bona fide for the good of the company or if unfairly prejudicial to the shareholders, or for an improper purpose.

187. If it is thought that payments for loss of office should remain

unlawful where not approved by the company in general meeting then the existing statutory provisions will require tidying up in any event.

188. At present the intention of the statute may be avoided if the payment is –

- . one to which the director is entitled under a contract of employment
- . for compensation in a capacity other than that of director
- . for loss of office as a director of a subsidiary
- . made in the course of a sale of assets or the undertaking of the company, leaving the director still in office.

189. Although such payments may still be avoided if in breach of the directors' general duties, it is suggested that it would be preferable for the provisions to extend to all agreements to benefit a director, whether in his capacity as director or not, upon –

- . his ceasing to hold office in the company or any subsidiary of it
- . sale of company or subsidiary assets
- . transfer of all or any of the shares in the company or its subsidiary.

## THE COMPANY SECRETARY

190. The Act makes specific provision for the office of company secretary. The Law Commission is interested to hear views as to whether it is necessary or desirable to retain the statutory office or whether the powers and duties of the secretary should simply be the responsibility of the directors which they can delegate to appropriate officers. The office is not recognised by the Canadian legislation. In view of the fact that the company secretary now has been recognised by the Courts as having a sphere of ostensible authority, that removal of the statutory recognition may be a retrograde step. Retention is favoured, although comment is sought as to whether the authority to bind (as is suggested in the case of the directors) should be made a statutory one. The Law Commission suggests that the office should be optional.

## DIRECTORS' DUTIES

### *Scope of duties*

191. In New Zealand the basic duties of directors are not set out in

the Act at all. Instead they have to be discerned from a large volume of complex case law. It is suggested that this position is undesirable. It is clear that it would be impossible to encapsulate all the current legal principles and unwise to inhibit development of the standards appropriate in particular cases by attempting codification. But the general themes reflected in the cases can be simply stated and should aid understanding of the standards required. Such a statement of principle was recommended by the Jenkins Committee in the United Kingdom and by the Macarthur Committee in New Zealand, although neither jurisdiction adopted the suggestion.

192. Although the duties imposed by the Courts upon directors to enforce the equitable principles of good faith and benefit for the company are strict, the standards of care and skill imposed have been extremely low. The Law Commission is of the view that a statement in the legislation of the duty of care owed by the directors should raise the standard now required. The Dickerson Committee pointed out in its report (at para. 242) that the standards required of directors should be no lower than that required by law of everyone else. And thought it "... cold comfort to a shareholder to know that there is a steady supply of marginally competent people available under present law to manage his investment".

193. The fiduciary duties imposed by the Courts upon directors are to act honestly and in good faith for proper purpose and in the best interests of the company.

194. The notion of proper purpose by raising the spectre of capacity has been complicated by questions as to when an action taken with improper purpose by the directors can be ratified by the shareholders. The Canadian reformers for that reason thought it preferable to avoid reference to concepts such as "proper" or "collateral" purpose, and to express the principle in terms of the best interests of the company and a duty of good faith.

195. The Law Commission is concerned that the scope of fiduciary duties imposed by the common law upon directors should not be cut down in any statutory restatement. At present directors may be liable where they have exercised their powers for a purpose different from that for which the powers were conferred upon them, even if they have acted honestly in what they believe to be the best interests of the company (*Howard Smith Ltd v. Ampol Petroleum Ltd* [1974] AC 821). It is not clear that the imposition of a standard of good faith of itself would prevent the exercise of a power for a collateral (that is, improper) purpose where the directors believe it to be in the interests of the company.

196. The standard Canadian section provides:

"Every director and officer of a corporation in exercising his powers and discharging his duties shall –

- (a) act honestly and in good faith with a view to the best interests of the corporation; and

- (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."

(Canada Business Corporations Act, s.117)

197. Duties of honesty and reasonable care and diligence are imposed by the Australian Companies Code.

198. In the United States, the Model Business Corporation Act requires a director to act –

- "(1) in good faith;
- (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
- (3) in a manner he reasonably believes to be in the best interests of the corporation."

(Section 8.30)

199. The Law Commission favours a general statement of directors' duties. As to the form of such a statement, it suggests:

- . The Australian Code's requirement of "honesty" is insufficient to meet the fiduciary obligations imposed at common law.
- . The Model Business Corporation Act requirement of reasonableness of the belief that the action is in the best interests of the company and measurement of standard according to those in like positions, represents an improvement over the Canadian statement.
- . It is desirable to retain the duty to act in accordance with the purpose for which the power was given to the directors.

### *Excuse*

200. The Ontario and Canadian Acts excuse the director who relies in good faith upon –

- (a) financial statements of the corporation represented to him by an officer of the company or the auditor of the company fairly to reflect the financial condition of the company; or
- (b) a report of a lawyer, accountant, engineer or other person whose profession "lends credibility to a statement made by him".

201. The Law Commission is not convinced that such a provision is appropriate. Any honest reliance upon such statements and accounts will often be directly relevant where breach of a duty of care is raised without the need for a direct statutory reference.

202. If direct reference is thought necessary, good faith in itself should not justify the reliance on the statement in the absence of care. The Model Business Corporations Act excuses a director only if his reliance is reasonable and he has no knowledge which makes reliance unwarranted.

203. It is suggested that no specific reference be made to the circumstances in which reliance upon others will excuse a director. If it is thought that such reference is desirable, however, exculpation is suggested only in circumstances where the reliance is in good faith and reasonable.

204. The Court at present has power to grant relief to directors who would be liable if they have "acted honestly and reasonably, and ... having regard to all the circumstances of the case ... ought fairly to be excused ... either wholly or partly" (s.468). Retention of this provision is proposed.

### *Evidence of participation*

205. Under the Canadian legislation directors are deemed to have assented to actions taken by the board unless they take steps to dissent. The provision applies to absent directors also, who are given a week within which to dissent after becoming aware of an action taken by the board. This provision may be considered to be a useful discipline to ensure that abdication of responsibility does not excuse.

### *To whom the duty is owed*

#### *(a) The Company*

206. Duty to the company is plagued by the ambiguity that "the company" traditionally is understood to mean the shareholders as a collective group, rather than the commercial entity itself. Often the difference in the concepts will be immaterial. But in many contexts, particularly where decisions are made in the long term interest of the entity (for example, decisions to benefit employees or to benefit the communities in which the company operates), the difference will be critical. In the case of large companies it may be flying in the face of reality to deny that the duties are owed to the commercial entity; and yet in the case of a closely-held company it may be clearly intended by those who form the company that it will be run in the interests of the shareholders as a whole. The topic is an extremely difficult one and is central to a consistent theory of company law. If, as is suggested below, more explicit recognition is given of the duties owed by directors directly to shareholders, then perhaps the case for equating the company with the shareholders as a body is less compelling. The range of interests which affect the

benefit to the commercial entity will of course have to be determined in the context of the particular commercial enterprise, so that in the case of the closely-held company the result may in practice give as much emphasis to the shareholders' interests as exists where the company is viewed as the shareholders as a whole.

**(b) Shareholders**

207. The traditional view has been that the duties of directors are owed exclusively to the company (*Percival v. Wright* [1902] 2 Ch 421). It is not clear to what extent it is still the law that directors as a general rule do not owe duties to shareholders. Where there are special facts suggesting a relationship of confidence, a director may be held to owe fiduciary duties to a shareholder (*Coleman v. Myers* [1977] 2 NZLR 225). The principle that the directors' duties are owed to the company and not to shareholders has been substantially undermined by s.209 of the Companies Act which enables any shareholder who complains that an action is "unfairly prejudicial" to him to apply for relief to the Court.

208. The law in this area is developing and it may be inopportune to stifle development by statute. But the matter is a critical one for company law and it is proposed that it should be addressed in any reform. The Law Commission proposes:

- (1) Some general statement of director duty to act fairly towards shareholders where not inconsistent with the best interests of the company (in the sense of the commercial entity).
- (2) A specific duty of good faith and care in circumstances where the company or a director has direct dealings with a shareholder in a transaction affecting the rights attaching to or the value of the shareholder's interest in the company. (This duty might arise only where the identity of the parties to the transaction is known to the other or in any case of direct dealing. Arguably, this is the direction in which cases like *Coleman v. Myers* are moving.)

209. A duty to act fairly is already recognised in cases where directors have to reconcile the conflicting claims of different categories of shareholder. It is the standard required by s.209. Fairness permits the Courts the flexibility to deal with differing circumstances. In the case of direct dealing, however, it is suggested that the higher duties owed to the company of good faith and care should be owed to the shareholders affected.

**(c) Creditors**

210. Directors of a company do not owe fiduciary duties to creditors of a company as a general rule. Statutory and common law

liability may arise, however, in circumstances of recklessness or negligence which results in the insolvency or near insolvency of the company (s.320, Companies Act 1955; *Nicholson v. Permakraft (N.Z.) Ltd* [1985] 1 NZLR 242).

211. The inclination of the Law Commission is that, as a matter of general company law directors of solvent companies ought not to owe duties of care or good faith to creditors. It can be said that the general insolvency law should be exhaustive of the circumstances in which liability should be imposed. The Law Commission is, however, interested to receive comment upon this position.

## LIMITATION OF LIABILITY

212. The Model Business Corporation Act specifically provides that a director is not liable for any act or omission as director if he performs his office in compliance with the statutory duties of good faith and care. Such a provision makes it clear that a director will not carry the can for damage caused by a company action unless he himself was negligent or in breach of good faith in connection with the action. Is such a provision necessary or desirable?

## CONTRACTING OUT OF DUTIES

213. It is suggested that the fiduciary duties and duties of care imposed by the statute upon directors should not be able to be waived nor should breaches be exonerated by contract, the articles or a resolution of the company. A corresponding provision is contained in the present s.204 of the Companies Act 1955, but its meaning (and that of its United Kingdom equivalent, s.310 Companies Act 1985) is not entirely clear. Some of the obscurity at present surrounding s.204 will perhaps be overcome if the general duties of directors are stated in mandatory form in the statute. It seems that breaches of directors' duties may at present be ratified by shareholders on a case by case basis, although s.204 should preclude blanket exoneration or reduction of the standard required by agreement, whether in the articles or otherwise, in advance.

214. The Law Commission proposes:

- (1) It should not be possible to contract out of any of the duties in advance (for example, by provision in the articles or shareholder agreement). Exoneration except by unanimous resolution after the event in the case of breach of good faith or the duty of care is considered undesirable because the minority in such circumstances –

- . should not be dependent upon a complacent or implicated majority for remedy of a primary obligation

- . should be entitled to insist upon the highest standards of probity and care without having to show unfair

prejudice, in order to be able to resort to s.209.

- (2) It should not be possible for the company to exonerate a director for a breach of the duties of good faith or care except by unanimous shareholder resolution after disclosure of all the material circumstances (see further discussion under "Shareholders").
- (3) Exoneration for breach of a duty to act for proper purpose or specific authority to act for collateral purpose could be permitted after disclosure of all material circumstances by the majority required for alteration of articles (on the basis that it would have been open to such a majority to confer power for the purpose for which it was or is intended to be used in any event). If such exoneration would unfairly prejudice the minority, it could still be attacked under s.209
- (4) Breach of the duties owed to the company or to shareholders will not affect the validity of transactions made with third parties without actual notice of the breach (see further discussion under "Shareholders"). The Law Commission considers it important to recognise that business transactions may proceed at a pace that precludes special procedures and that, unless third parties are implicated, in winding-up the transaction should stand, although the directors may still be personally liable to the shareholders.

## INDEMNIFICATION

215. At present s.204 of the Companies Act limits the circumstances in which directors can be indemnified by the company in respect of liabilities and expenses incurred by them in proceedings for breach of some duty to the company. Relief is restricted to –

- . an indemnity after the successful defence of civil and criminal proceedings
- . what may be ordered by the Court under s.468 where the director has acted honestly and reasonably and ought fairly to be excused.

216. Although the English and Australian Acts limit indemnity in a similar way to our own, the North American companies legislation permits companies to be more generous. The aim of indemnification has been said to be to "seek the middle ground between encouraging fiduciaries to violate their trust, and discouraging them from serving at all" (Johnston "Corporate Indemnification and Liability Insurance for Directors and Officers" 33 Bus. Law 1993, 1994).

217. In some jurisdictions mandatory indemnification is provided for the reasonable expenses incurred in connection with legal proceedings in which the director was wholly successful and in which he was a party simply because he was a director of the company. Some of these jurisdictions also provide for advances for expenses in circumstances where the director undertakes to repay the money advanced should he not be successful in his defence.

218. If it is recognised that a director may only be liable for actions taken as a director if he is in breach of the duties of good faith and care owed to the company, the indemnification provisions set out in ss. 204 and 468 are, it is suggested, sufficient. The restriction does not appear to have had an inhibitory effect on the availability of directors. Section 204 itself was introduced because of widespread use of indemnity agreements to negate the primary duties owed by directors. It is suggested that accountability is necessary to ensure responsibility and that it is contrary to the aims being pursued by imposition of duties which cannot be waived to permit indemnification by the company except in circumstances where the director is not liable or in circumstances where the Court, in the exercise of its discretion under s.468, thinks in all the circumstances the director ought fairly to be excused.

219. Although the Law Commission at present suggests that no indemnification beyond the circumstances set out in s.204 should be permitted by a company, it believes that a company should be permitted to purchase insurance for directors provided details of the insurance premiums paid are disclosed to members in the same manner that direct payments to directors by way of remuneration are disclosed. Although it may seem inconsistent to prohibit indemnification and permit purchase of insurance policies to achieve the same result, the purchase of insurance –

- . will cost the company less than indemnification
- . will be subject to the market assessment of risk which qualifies the coverage to provide incentive for care
- . is a reality of business risk management which it would be unworldly to ignore
- . if not paid directly by the company, may be paid indirectly by an adjustment of payments by way of remuneration to directors in order to meet the premiums.

## CONFLICT OF INTEREST

220. Because they are fiduciaries the common law has insisted that directors must not place themselves in a position where there is conflict between their own interests, whether direct or indirect, and their duty to the company. This rule is derived from general principles applying to trustees. Its application has meant that even

where there is no bad faith and no loss to the company directors will be liable to the company for breach of their obligations if they get into a position where they might have a conflict of interest, will have to account to the company for any profits made by them from such a position, and risk having any contract made by them with the company avoided.

221. Because of the strictness of the common law and its application of principles derived from the law of trusts and the often inconvenient consequences of restricting the actions of companies and directors in this way, the strict principles have to a large extent (although not completely) been modified by statute and by the articles of the company. In New Zealand the strict common law is supplemented in particular by s.199 of the Companies Act 1955 and by article 84, although the relationship between those more permissive provisions and s.204 of the Companies Act 1955 is not entirely clear.

222. Conflict of interest will arise in cases –

- . of loans by the company to the director
- . of direct dealing between the director and the company
- . where a director uses an opportunity or information he has come to know of through the director's position as director
- . where the director is placed in a position of potential conflict by reason of the director's position as director of or shareholder in another company entering into a transaction with the company or in which the company has an interest
- . where he is a nominee of a shareholder or creditor of the company who is in a position to use information or opportunities made known to the nominee through his position as a director.

223. At present, the extent to which these conflicts of interest are permitted or excused varies to some extent although all modifications of the general prohibition are premised upon effective disclosure.

### *Loans*

224. Loans to a director are regarded with particular disfavour. Public companies in New Zealand cannot lend money to or guarantee or give security for directors except where the company's business includes lending money and the terms are normal business ones or where the company is putting a director in the position to meet expenditure for the purposes of the company. Private companies are not under any restriction in New Zealand, although they are in the United Kingdom.

225. Loans made to directors will of course be subject to the general duties of good faith, proper purpose and care. It is suggested that a general prohibition upon loans is too restrictive. It certainly should not be applied to closely-held companies where the shareholders and directors may have an identity of interest. It is suggested that, where permitted by the company constitution, the directors should be able to lend money to or to guarantee an obligation of a director provided that the loan or guarantee is of benefit or fair to the company. Details of any such loans should be disclosed to the shareholders in the same manner as remuneration of directors.

### *Company contracts*

226. Directors who are interested in a contract with the company are under a duty to disclose their interest to the directors under s.199 of the Companies Act 1955. The section imposes a penalty for non-compliance and purports not to "prejudice the operation of any rule of law restricting directors of a company from having any interests in contracts with the company". Since, however, the section assumes that there will be circumstances when directors can contract with the company, where the articles provide for waiver of the strict prohibition of the common law in advance (as in article 84 of Table A), the contract will not be voidable if disclosure is made. There are a number of serious deficiencies in both s.199 and article 84 (see, generally, K. R. Farnham "Interested Directors – Reform Please" [1983] NZLJ 51), and its equivalents. In particular –

- . the impact of the Contractual Remedies Act 1979 is not clear
- . although the matter is not free from doubt it is arguable that article 84 requires interested directors to disclose any conflicts to themselves
- . where the directors are interested in a transaction by reason of any guarantee they have given on behalf of the company or where the transaction involves related companies with common directors or shareholders, the disclosure requirements can lead to absurdity
- . the efficacy of disclosure to fellow directors may be doubted (see Gower, "Modern Company Law" (4th ed., p.586). The Jenkins Committee considered this problem but thought that disclosure to members was not practicable.

227. The Law Commission considers that it is appropriate that interested directors be required to disclose their conflicting interest to disinterested directors (if any). But it suggests that no civil consequences to third parties follow from the failure to disclose.

228. The circumstances in which the shareholders may excuse the

directors are discussed below under "Shareholders". The Law Commission suggests that disclosure to shareholders of all transactions involving a conflict should be made annually and a register of them should be maintained and available for inspection by members at all times.

229. Statutory provisions in North American jurisdictions on conflict of interest generally require disclosure and adoption by either a disinterested quorum of directors or a disinterested shareholder vote or require that the transaction be fair. Even where there is disclosure, fairness of the transaction has been required by the Courts.

230. It is understood that disclosure to directors causes considerable practical difficulties in many companies. It suggests that director endorsement should not permit transactions which are unfair to the company. Shareholder ratification, at least in the case of large companies, may well be difficult to achieve and, again, the minority should not have to stomach a transaction which is unfair and indeed would be able to bring a claim under s.209 if that were the result. The Law Commission presently does not favour prescribing an elaborate procedure for disclosure and ratification and believes that it is not too onerous for directors to be required to ensure that the company is fairly treated in cases of self dealing.

231. The Law Commission suggests:

- (1) transactions involving third parties with no actual knowledge of the conflict should be valid (changes will be needed to s.18C)
- (2) in all other cases a transaction will be voidable (even after winding-up) unless it is proved to have been fair, in the light of all the information which the directors or officers who enter into it possess
- (3) where a transaction involving a conflict is not fair, the directors or officers will be liable to the company for any loss suffered by the company and to account for any profit made by them.

232. It is further suggested that the circumstances where a conflict arises ought to be, non-exhaustively, defined. A situation of conflict should include a transaction involving –

- . a close relative of a director or officer
- . another entity in which the director or officer has a material financial interest or of which the officer is an officer or trustee.

233. On the other hand, a conflict should not be deemed to arise merely by virtue of the fact that a director or officer is an officer of another company where one of the companies is the wholly-owned subsidiary of the other.

### *Use of company information or opportunity*

234. The rule by which directors are liable to account for profits made from opportunities they come to know of through information available to them in their capacity as director is not referred to in the legislation at all. It is a strict rule, applying even where the company suffers no loss (*Regal (Hastings) Ltd v. Gulliver* [1942] 1 All E.R. 378). The scope of the rule at common law is not entirely certain, nor are the circumstances in which a director can be absolved.

235. This matter, because it is grounded in information which the director receives in confidence, is similar to the questions discussed below under "Insider trading". The distinction is that the information or opportunity, while it may be valuable in itself, may not have any impact upon the company's share price.

236. The Law Commission suggests that use of company information or opportunities justifies a more rigorous rule than is the case proposed for transactions where there is a mere conflict of interest. Such use of information obtained as a director involves direct breach of the normal duties expected of fiduciaries.

237. On the other hand, in modern business practice, nominee directors, subsidiary companies and interlocking directors are facts of life which company law theory cannot ignore. In many cases the director is on the board with the explicit task of obtaining information about the company for use. The company which discovers an opportunity may not be the vehicle in which it may most conveniently be used. This is a particularly difficult area.

238. The suggestion put forward for discussion is that the prohibition against use of company information or opportunities should be a strict one. The rule would not apply in the case of use of corporate opportunities by subsidiaries or their parent companies where the subsidiaries are wholly-owned. In all other cases, the prohibition will be applied, and the directors will be liable for its breach unless they can demonstrate –

- . the company decided not to make use of the information or opportunity itself
- . the use of the information or opportunity by the director was approved by a disinterested authority on behalf of the company (either the shareholders or the disinterested directors)
- . any fair value in the information or opportunity was paid to the company.

### *Nominee directors*

239. The Law Commission suggests that nominee directors should be subject to the same duties to the company on which

they serve as director as other directors except where there is unanimous shareholder consent or the constitution of the company –

- . provides for directors to be appointed by distinct shareholders or shareholders of a distinct class
- . permits the nominating shareholder access to company information and the right to instruct the director how to vote.

240. In other words, the general rule would be that applying in any case of conflict of interest.

241. Where directors are appointed by voting rights attached to specific categories of shares, then it could be provided (following the Ghanaian Code s.203(3)) that directors appointed by or as representatives of a special class of members may, in considering whether a transaction or course of action is in the best interests of the company, "give special, but not exclusive, consideration to the interests of that class" if the articles so provide. It may be that such a proposal would add little to the present law.

242. The result would be that nominee directors as such would not be recognised by the Companies Act except where their position arises from the structure of the company. Directors are not relieved of their fiduciary duties by the fact that they are nominated by a shareholder or combination of shareholders, although the duties are modified where the company constitution so provides. Moreover the definition of director will mean that a shareholder who exercises control over a director will be caught within the definition of director and will therefore be subject to the same statutory duties to the company and the other shareholders.

### *Insider trading*

243. For the purposes of company law, as opposed to securities law, trading in securities of the company by a director or officer using information as to the value of the securities obtained in confidence by reason of his or her office should properly be regarded as an aspect of the general fiduciary rule. The matter is complicated in company theory, however, by the fact that the company itself, to whom fiduciary duties are traditionally owed, is not directly prejudiced by insider trading. Arguably, the position in theory changes if, as is recommended above, companies are permitted to purchase their own shares although it is difficult to see how the company, as insider par excellence, is really affected by the change.

244. The rule that the fiduciary duties of directors are owed only to the company results in large measure from the decision in *Percival v. Wright* [1902] 2 Ch 421. It is substantially undermined where there are special circumstances from which a fiduciary relationship between director and shareholder can be inferred (*Coleman v. Myers* [1977] 2 NZLR 298). The law is evolving

in this area and it may be that in time the Courts will develop a workable law to cope with insider trading. In particular, there are indications in the recent cases that the Courts are prepared to use the s.209 jurisdiction to give relief to shareholders in cases of insider trading. Both the Jenkins Committee and the Macarthur Committee, however, recommended that directors be prohibited from using price sensitive information in dealings and that they be required to compensate those who suffer loss as a result of any such dealings. Those recommendations have not been adopted in New Zealand although statutory prohibitions against insider trading have now been enacted both in Australia and in the United Kingdom.

245. For the purposes of company law reform it is not necessary to enter into the complex economic debate about the extent to which insider trading on the securities market requires regulating. It may well be that, apart from the economic efficiency of such regulation, a securities law regime would have to take into account public reaction to the practice. On the other hand, regulating insider trading is an extraordinarily difficult exercise and at some point the law of diminishing returns may set in.

246. In the case of directors and officers, however, prohibition of the practice is in accordance with the fiduciary duties already owed to the company. Whether or not the company suffers loss, the directors are benefiting from confidences which have come to them through their position. The rationale is an aspect of that behind the prohibition on directors of use of company information and opportunities. If the suggestion made above, in relation to those to whom the directors' duties are owed, is accepted, then shareholders who deal directly with a director are entitled to his good faith in the transaction. That may well be the position that the common law will achieve, in development of the principles applied in *Coleman v. Myers*, in any event. That leaves the position of complete outsiders and members in impersonal transactions (where the identity of the director is not known). It is suggested that the company itself has an interest in ensuring that such people are treated fairly. Transferability of shares or securities is one of the main reasons for the success of the company form. The company has an interest in ensuring that public confidence in its securities is maintained. Directors who make use of confidential information for personal profit abuse their position and do not act in the best interests of the company.

247. The Securities Commission has undertaken a comprehensive review of the possibilities for reform of the law relating to insider trading. The Law Commission raises, for the purposes of discussion, some points for reform of the Companies Act which may be inadequate to meet Securities Act purposes. For the purposes of securities market fraud, for example, criminal sanctions may be appropriate. The Law Commission at present does not favour criminal penalties for insider trading as a matter of company law, largely because the standard of proof appropriate for criminal penalty will make enforcement more difficult.

248. Views are sought on these suggestions and also on the practicability of maintaining two regimes for dealing with insider trading.

249. The Commission suggests:

- (1) directors be under a duty to all shareholders to ensure that information which may materially affect the value of the shares of the company or any associated company is released to all shareholders without discrimination as soon as it is not in the best interests of the company for the information to be confidential
- (2) before information which may materially affect the value of the shares of the company or any associated company is made available to shareholders that information is confidential to the company and the directors owe a duty of care to ensure that confidentiality is maintained (this might mean in a particular case that careful directors would ensure that employment or consultancy contracts impose duties of confidence) and a duty to the company not to profit from the information
- (3) directors who have acquired confidential information which may materially affect the value of the shares or securities of the company or any associated company, are prohibited from dealing in such shares or debentures
- (4) where a director, contrary to the prohibition, deals in shares those with whom the transactions were entered into will be entitled to set them aside within twelve months, or seek an account of profits.
- (5) the directors are obliged to maintain a register, open to members, of all dealings in the shares or securities of the company on their behalf or for the benefit of themselves and their immediate families.
- (6) these obligations and duties extend to any one who receives price-sensitive information from a director knowing it to be confidential.

#### QUESTIONS:

1. Should the definition of director be amended to ensure that a person (including a company) who can instruct even one director is treated as a director?
2. Should the present unitary board system be retained?
3. Should the statute recognise the authority of the sole director (where there is only one) or any two directors to bind the company?

4. Should all companies be able to appoint a single director?
5. Are the present rules as to disqualification satisfactory?
6. What changes are desirable to the system of voting for directors? In particular, should s.186 be abolished and should cumulative voting be permitted where authorised by the company constitution?
7. Should there be statutory recognition of alternate directors and the circumstances in which they can be appointed?
8. Should the general meeting in all companies be able to remove a director from office and if so, upon what majority vote?
9. Should payment to directors for loss of office be permitted, provided this is disclosed to shareholders and not in breach of the general duties owed by directors?
10. Is there a need for statutory recognition of the office of company secretary?
11. Should the Act establish the general duties of good faith and care owed by directors to the company?
12. If so, is a statement similar to that adopted by the U.S. Model Business Corporation Act preferable to the Canadian and Australian formulations?
13. Is it necessary to provide that a director is excused if he relies reasonably and in good faith upon information supplied to him?
14. Should s.468 be retained?
15. Should directors be deemed to have assented to actions of the board unless they actively dissent?
16. Should the Act recognise a general duty of fairness owed by directors to shareholders where not inconsistent with the best interests of the company?
17. Should there be a specific duty to act in good faith and with care to a shareholder in all cases of direct dealing?
18. Should directors owe the creditors of a solvent company duties of care and good faith?
19. Is it necessary to limit the liability of a director for company actions to cases in which the director is in

breach of his duties of care or good faith?

20. Should the shareholders, except by unanimous resolution, exonerate a director who has breached the duties of care and good faith?
21. Should the shareholders by special resolution be able to exonerate a director for an action taken not for proper purpose?
22. Should indemnification of directors be permitted?
23. Should a company be permitted to purchase insurance for directors provided the cost is disclosed to the shareholders?
24. In what circumstances should transactions entered into by directors in case of conflict of interest be set aside?
25. Should a company be permitted to lend money to or guarantee the debts of a director where the loan or guarantee is disclosed to shareholders and fair to the company?
26. Should contracts in which a director is interested be valid and no duty to the company breached by the directors in entering into it if it is proved to be fair?
27. What disclosure should be required for contracts where a director is interested?
28. Should use by a director of company information be absolutely prohibited except where explicitly permitted by the company constitution?
29. Should a nominee director be subject to the same duties as any other director? Should the general rule be relaxed where the nominee relationship is recognised by the structure of the company?
30. Should directors be under a duty to release price sensitive information to shareholders as soon as it is not in the best interests of the company for the information to be confidential and until such release to refrain themselves from dealing in the company's shares?
31. Where a director deals in shares when in possession of confidential information, should he be subject to criminal sanctions?
32. Should directors' dealings in shares be required to be disclosed?

33. **Should similar prohibitions and liabilities attach to those who receive information from a director knowing it to be confidential?**

## XI SHAREHOLDERS

### GENERAL

250. Although shareholders are the ultimate owners of the company, their powers to control the actions of the directors are, in most cases, extremely limited. Shareholder objectives may be disparate, giving rise to lack of unity of interest between them. The rights and remedies which define the role of the shareholder in company law in New Zealand are derived only in part from the statute. To a substantial degree they are determined by the particular constitutional arrangements adopted by the company in its articles and by Court decision.

251. Most companies in New Zealand are small companies where the shareholders have direct involvement in day-to-day management. In such companies the distribution of power between the directors and the shareholders will not normally be of concern, and the obligations of the shareholders among themselves may be more important. But where the shareholding and the management of the company are distinct, effective control of directors is limited both in terms of the remedies available to the shareholder and by reason of the procedural and cost difficulties associated with them.

252. It has been said:

"It is paradoxical, and not altogether healthy, that it should be easier for the modern shareholder to litigate against his corporation than to play a constructive role in the shaping of the corporation's general policies" Studies in Canadian Company Law, Vol.2, 62 (ed. J. Ziegel).

253. It was no doubt reasons such as these which prompted legislative provisions to improve the access of shareholders to information about the company and to the general meeting. It has also led to requirements for shareholder consent as a pre-requisite to some corporate decisions. There are however two problems in seeking to impose a greater measure of "shareholder democracy". In the first place there is little evidence that shareholders want such participation or that, when the means to participate are provided, they use them. Secondly, shareholder involvement comes at a price both in terms of delay and in the very real costs of circulating requisitions and information to shareholders. The Law Commission wishes to gauge the extent of any support for extension of the scope for shareholder participation and improvement of the means by which it is to be achieved. It is of course necessary to strike a balance. Some level of shareholder participation in management may be more beneficial all round than shareholder litigation. It is not clear that the balance achieved by the existing legislation should be greatly altered.

## INFORMATION AVAILABLE TO SHAREHOLDERS

### *Register of shareholders*

254. Under the present provisions of the Companies Act 1955 the company is obliged to keep and make available for inspection, a register of shareholders. It has been suggested by the Securities Commission (in its report of May 1982) that the present disclosure provisions as to shareholding are inadequate in that –

- . the beneficial ownership of shareholding may be concealed behind nominees (indeed, the provisions of s.125 of the Companies Act 1955 probably preclude notification of beneficial ownership)
- . they do not require prompt disclosure of dealings of significance for corporate control.

255. The Securities Commission is of course primarily concerned with the efficient operation of the securities markets. Both the Macarthur Committee in New Zealand and the Jenkins Committee in the United Kingdom were of the view that shareholders in a company have themselves legitimate interest in the same information. Their reasoning was that shareholders are entitled to know whether there are substantial shareholdings which may affect control and, if so, who controls those shareholdings.

256. Legislation to achieve disclosure of beneficial interest has been enacted in the United Kingdom and in Australia. It is complex legislation requiring both notification and registration of significant interests (which are set at comparatively low levels of voting strength, because an aim of the legislation is to identify potential changes in control), and powers to investigate the beneficial ownership behind legal title. While the company laws of North America do not provide for the reporting of beneficial ownership, such notification is required pursuant to the securities regimes.

257. Identification of and access to the legal shareholders in order to disseminate information and solicit proxies is necessary if shareholders are to exercise their powers in general meeting. But the Law Commission is not convinced that there is a need, in isolation, for shareholders to be informed as to the identity of the beneficial owners behind the names on the company's register. The main reason for requiring disclosure of beneficial ownership is to ensure that the significant dealings in shares cannot be concealed by the use of nominees. Disclosure of significant interest is directed to shifts in corporate control. It is no doubt because issues of control are central to the Securities Commission's review of the law of takeovers, that the Securities Commission has decided to incorporate its review of nominee shareholder disclosure in the takeovers review. That review is well under way. The recommendations of the Securities Commission will clearly have substantial implications for New Zealand company law and will be carefully considered for the purposes of its own reference by the Law Commission. In the meantime it would be helpful to know to what extent it is thought

desirable to provide in the Companies Act for compulsory disclosure of beneficial ownership and significant interests in the shares of a company. At present the Law Commission questions whether such knowledge is of real benefit to shareholders and whether knowledge of changes in shareholding structure which may affect control is a matter on which a shareholder is entitled to be informed. Where the structure of shareholder control has not been provided for in the constitution of the company it can be argued that the issue of control is not of legitimate shareholder concern in company law except where there are special circumstances giving rise to a fiduciary duty.

258. Disclosure of dealings in shares by substantial shareholders has also been justified (particularly in the United Kingdom) as an aid to the detection of insider trading. Owners of significant interests in a company may be well placed to obtain inside information which is price sensitive. The Law Commission seeks views as to whether this is sufficient reason for the maintenance of a register of dealings by those with significant interests in the company. It remains to be convinced that the costs of maintaining such a register would be worthwhile. Few significant shareholders, unlike directors, will be fiduciaries of the company. Those significant shareholders who acquire and use inside knowledge will be liable as fiduciaries themselves by an application of the principles of constructive trust. The question is whether the maintenance of a register of dealings is warranted in all cases in order to obtain evidence of abuse in some cases.

#### *Register of dealing in shares by directors*

259. Disclosure of director dealing in shares is at present required by ss. 195 and 198 of the Companies Act 1955. The Law Commission suggests that this information should continue to be required of directors.

#### *Financial information*

260. Every shareholder who is entitled to receive notice of general meeting must at present be sent a copy of the company's balance sheet together with annexures (profit and loss account, directors' report and auditor's report). All other shareholders are entitled to copies on demand without charge. This section does not apply to private companies. It is suggested that, unless waived by the shareholder, the same information should be supplied to shareholders of all companies.

261. It is not proposed to alter the requirements that companies should furnish their shareholders with annual financial statements. The right to receive such information is critical. It would be useful to know, however –

- whether there is a need to provide for waiver by a shareholder of the obligation to supply accounts (particularly if the general rule is applied to all companies)
- whether there is a need for more frequent reporting.

### ***Company books***

262. Every company is required to keep:

- Proper accounting records. The obligation imposed by the section is a continuing one to maintain accounts which enable the financial position of the company to be determined "with reasonable accuracy" at any time and which record and explain the transactions of the company (s.151).
- Minute books of the meetings of the company and of all meetings of directors and managers. Shareholders have direct rights to inspect only the minute books relating to the general meeting. Although inspectors and auditors can see the company accounts, a shareholder cannot as of right.

263. The U.S. Model Business Corporation Act permits a shareholder to inspect and copy upon notice:

- excerpts from minutes of any meeting of the directors or a committee of the directors or records of action taken by the directors without a meeting
- accounting records of the company

provided that

- (a) his demand is made in good faith and for a proper purpose;
- (b) he describes with reasonable particularity his purpose and the records he desires to inspect;
- (c) the records are directly connected with his purpose.

264. This circumscribed right of inspection cannot be modified or abrogated by the company's articles.

265. The Law Commission seeks comment as to whether an equivalent provision should be included in the Companies Act.

266. In Australia, s.265B of the Code permits inspection of the company books by a lawyer or accountant on Court order. Should an equivalent provision be introduced in New Zealand?

## PROCEDURAL RIGHTS RELATING TO MEETINGS

267. At present shareholders have powers to requisition meetings of the company and to require the company to circulate to its members details of any resolution proposed by the shareholder. These powers can only be exercised, however, when invoked by not less than 100 members having the right to vote or members holding, in the case of requisition of meeting, one-tenth in nominal value of the shares of the company or, in the case of members resolutions, one-twentieth of the total voting rights.

268. The Law Commission is interested to know –

- (1) to what extent these provisions are used
- (2) whether the restrictions imposed by the statute are appropriate or whether they should be relaxed to enable five per cent of the voting rights to requisition
- (3) whether financial assistance to shareholders wishing to circulate resolutions or information to shareholders should be provided for.

269. In addition comment is sought as to the general procedural machinery available to shareholders who wish to take action through the general meeting. The impression the Law Commission has is that no more elaborate process is required because shareholder interest in using such procedures is not high. It is conscious, however, that the procedures themselves may be too limiting to appeal to shareholders who wish to participate in corporate decision-making.

## PRE-EMPTIVE RIGHTS

270. The issue of pre-emptive rights (discussed at para. 110) is one on which the Law Commission is anxious to receive submissions. Pre-emptive rights limit the scope for dilution of shareholder control. Where provided for, they generally permit exceptions in the case of employee shares and shares sold otherwise than for money. (See, for example, s.6.30 of the Model Business Corporation Act which provides for pre-emptive rights on an "opt-in" basis.) Pre-emptive rights are also often subject to an equivalent provision to the New Zealand Stock Exchange rule permitting unrestricted placement of up to ten per cent of the company's shares in any financial year. It is suggested that pre-emptive rights should be conferred, subject to these exceptions.

## RIGHT TO DETERMINE MATTERS RESERVED TO SHAREHOLDERS IN GENERAL MEETING

271. The matters reserved to the shareholders by the Companies Act 1955 include –

- (1) alteration of name
- (2) reduction of share capital
- (3) increases in and alterations to authorised capital
- (4) election, removal and change to the numbers of directors
- (5) appointment of auditors.

272. Where the articles of the company entrust the management of the company to the directors, the scope for shareholder action, except perhaps in cases of unanimous shareholder resolution, is limited to the decisions expressly reserved to them and to the passing of resolutions at a general meeting. The company constitution may specify additional decisions which can be taken only by the shareholders but such a restriction on the powers of the directors can be removed by alteration of the articles by special resolution (s.24).

273. The Law Commission proposes that the matters on which shareholder decision are required by the statute should be reassessed. It proposes that distribution of power between the directors and the shareholders in general meeting should be left to the company constitution except for decisions which have the effect of altering class rights, being rights relating to dividends, voting and share issue and return of capital.

#### ALTERATION OF CLASS RIGHTS

274. The circumstances in which class rights (the rights relating to dividends, voting, share issue and return of capital) can be varied under the present law depend upon whether they are contained in the memorandum or in the articles. Normally such provisions are contained in the articles and the Law Commission proposes a standardised procedure for alteration based on its suggestion that the hierarchy between the memorandum and the articles should be abandoned.

275. There are difficulties with the operation of the present law and in particular the extent to which variation procedures contained in the articles must be complied with before there can be a valid alteration of articles. It is suggested that the statute itself should deal expressly with the manner in which class rights can be altered. The company laws of both United Kingdom and Australia deal specifically with such alteration. Comment is sought upon suggestions that –

class rights can be varied only with either the consent in writing of the holders of three fourths of the issued shares of each class affected or special resolution of shareholders of the class

- additional restrictions or procedures imposed by the articles for alteration of class rights must also be complied with (for example, a requirement of unanimity among shareholders of a class)
- a variation includes the creation of shares or securities ranking equally with or in priority the shares of the class (this provision would need to be subject to the same exceptions to the pre-emptive rights)
- the manner prescribed for alteration of class rights should itself be recognised as a class right
- the class right variation procedure applies whether or not there is only one class of shares in a company.

276. It is proposed that s.81 of the Companies Act (which permits application to the Court by holders of not less than five per cent of the shares of a particular class within twenty-one days to have a variation cancelled) be retained.

277. These suggestions covering variation of class rights would go further than the United Kingdom and Australian provisions in applying to companies with only one class of share and in recognising as a variation the creation of further shares or securities of the same class, except where the new shares are offered pro rata to existing shareholders pursuant to a pre-emptive right.

## FUNDAMENTAL CHANGE

278. The Law Commission wishes to know whether provision should be made for shareholder participation in decisions which, while not altering the rights attached to the shares of any particular class, are either adverse to the interests of a class of shareholders or substantially change the nature of the enterprise. Since abolition of the ultra vires doctrine it may be said that shareholders have insufficient protection against substantial and rapid change which may transform the nature of the business they invested.

279. Shareholder participation could be –

- by providing that all such decisions must be passed or ratified by the same majority as is required for alteration of class rights
- by providing for appraisal and buy-out rights for those who dissent.

280. Mergers and sales or acquisition of assets or businesses would trigger the shareholder rights.

281. Where restrictions upon corporate activity are contained in the articles, their alteration will require amendment in the

way specified in the articles or by special majority. Where the restrictions are not contained in the articles and do not fall within the class rights proposed to be recognised in the Act, then there may be substantial difficulties in defining what is a fundamental change. In the case of closely-held companies, the Courts have been able to resist fundamental change against the expectations of the parties by reason of a fiduciary relationship between the shareholders arising out of the special circumstances. The rights of all shareholders under s.209 in cases where change is unfair to them provides the Court with wide powers to remove the unfairness, including the right to require that the shares of the dissidents be bought out at a fair price. Although the proponents of appraisal and buy-out rights point out that the discretion of the Court may be a less satisfactory substitute for a clear right able to be implemented without recourse to litigation, the Law Commission is not yet of the view that imposition of such rights is warranted. The result could of course be achieved by companies who choose to do so providing for buy-out in their articles, should a general right of share repurchase be adopted, as suggested above.

## VOTING RIGHTS

### *No voting or restricted voting shares*

282. The issue as to whether it should be competent for companies to issue shares with no or limited voting rights caused both the Jenkins Committee in the United Kingdom and the Dickerson Committee in Canada considerable difficulty.

283. The opponents of restrictions of voting on ordinary shares suggest:

- . that it is a fundamental principle of company law that shares should carry voting rights commensurate with the equity represented by them
- . it forces non-voting shareholders into litigation where their interests are prejudiced (for example, in takeover)
- . there is a public policy in imposing responsibility for control of interests in companies
- . it permits companies to be set up with entrenched control. Non-voting shareholders, whose stake in the company may well exceed the stake of those holding the voting shares, are then vulnerable.

284. Voting trusts and voting agreements between shareholders are permitted by the present law and may have the same effect upon control as non-voting or limited voting shares without having the virtue of constitutional transparency.

285. Comment is invited as to how far the process of restricting voting can be taken. In particular comment is sought as to whether companies should be able to limit the voting rights of any holder of shares to a percentage of shares without the shares themselves being so limited. In such cases the directors would be entitled to refuse to accept votes where the limit was exceeded. The system, to be effective, would probably require statutory facilitation of nominee shareholding disclosure. A similar disclosure regime applies in New Zealand in respect of overseas shareholders and applies generally to companies in some jurisdictions. It would however run counter to New Zealand Stock Exchange and Securities Commission thinking.

286. Views are sought upon the topic of restrictions upon voting rights, which is part of the wider consideration of control of companies. It is not clear that there is anything inherently wrong in structuring control of a company through the shareholding rights allocated according to its constitution and able to be altered only pursuant to its constitution. The flexibility to achieve its own control structure maybe desirable, particularly in the case of family companies which need to expand their equity capital base while wishing to retain family control. If investors are prepared to put their money into an enterprise on this basis, there seems at first sight no reason why the opportunity should be precluded. It would be necessary of course to provide that at all times there must be at least one class of shares with unlimited voting rights and at least one class of shares entitled to receive the residual net assets of the company upon dissolution. The rights of the non-voting shareholder to fair treatment would seem to be adequately protected by –

- . requiring notice and rights of attendance at any general meeting of the company
- . access to company information in the same manner as voting shareholders
- . the ordinary remedies available for breach of fiduciary duty where appropriate, winding-up under the just and equitable ground, and unfair prejudice pursuant to s.209.

### *Cumulative voting*

287. Cumulative voting is permitted in most North American jurisdictions, if adopted by the articles. It facilitates minority representation on the board by permitting shareholders to vote all their shares multiplied by the number of vacancies for one director or any other number rather than requiring them to vote for all vacancies on the board as is presently required by the Companies Act 1955. Its supporters suggest that it leads to constructive results by providing an opportunity to shake up a complacent board of directors through representation of special interests.

288. There is a capacity for factionalism inherent in such a system.

On the other hand it is a reality that holders of significant shareholding blocks can often secure the appointment of their nominees to a board and that block shareholders acting together can often in practice achieve the proportional representation that cumulative voting leads to. It might be thought that a coalition of smaller shareholder interests or larger block holders viewed with hostility by management should be able to achieve the same result so long as the principles of director loyalty to the company are not permitted to be eroded. There may be benefits in terms of shareholder loyalty and stability which companies may wish to tap. Comment is sought as to the desirability of permitting companies to adopt cumulative voting procedures for directors.

### *Proxy voting*

289. The Macarthur Committee recommended that s.140 of the Act be amended to provide that proxies are entitled in all cases to vote on show of hands (instead of only being able to so vote where the articles permit it). That proposal has not been implemented and the Law Commission suggests that it should be. However, it is also concerned to know whether there are any deficiencies perceived in the proxy voting system. It has been suggested above that greater use might be made of systems of postal voting. There is room for concern that the proxy voting mechanism, which is largely made necessary by the system of voting through physical presence in the general meeting, favours the directors and works against effective shareholder check upon management.

## DUTIES OWED BY DIRECTORS

### *Scope of duties*

290. It has already been suggested (para. 208) that directors should owe duties directly to shareholders as well as to the company.

### *Ratification and excuse*

291. This matter has been discussed under "Directors" (paras. 200 and 214).

## DUTIES OWED BY SHAREHOLDERS TO EACH OTHER

292. The traditional approach in New Zealand law and in United Kingdom law is that shareholders owe no fiduciary duties to each other and may vote their shares and otherwise deal with them as personal property according to their own interests. This principle is modified –

- in circumstances where a "special facts" fiduciary relationship exists, usually in the case of a closely-held corporation

- . where a shareholder by participating with knowledge in a breach of fiduciary duty owed by a director or other fiduciary becomes a constructive trustee
- . in circumstances of fraud upon the minority
- . by the right of a shareholder to seek relief pursuant to s.209 in cases of unfair prejudice.

293. Some commentators have seen in the recent cases on special facts fiduciary relationships an emerging duty of fairness owed by dominant shareholders to minority shareholders. Such a doctrine is developing in the United States case law but it is not clear whether it will eventually be recognised by the New Zealand Courts. The Law Commission does not favour any attempt to codify the present position or anticipate development. It suggests that the remedy provided by s.209 is able to prevent unfairness to minority shareholders in cases where no special facts fiduciary obligation exists, and that the existing law provides sufficient redress where a shareholder participates in a director's breach of fiduciary duty. If a director acts at the direction of a major shareholder, the major shareholder by virtue of the statute is deemed to be a director and will owe the statutory duties in any event.

## REMEDIES

294. The remedies available to shareholders are:

- (1) To enforce through the Courts the contract between them and the company.
- (2) To make application to the Court pursuant to s.81 where they disagree with an alteration of class rights.
- (3) To obtain an appointment of an inspector pursuant to s.168 of the Companies Act 1955 (which requires an application by 200 shareholders, the holders of at least one-tenth of the issued shares or one-fifth of the persons registered as members in the case of a company with share capital). (This Court appointment has been superseded in most jurisdictions by the "special" investigator, usually appointed by the Minister.)
- (4) To make application for the winding-up of the company on the grounds that such an order is just and equitable pursuant to s.217(f) of the Act or on the grounds that the directors are acting in their own interests or unfairly or unjustly to members pursuant to s.217(da).
- (5) To bring a derivative claim where the company has a claim for breach of a duty owed to it, if failure of the company to bring an action amounts to fraud

(in its extended equitable meaning) on the minority.

- (6) Pursuant to s.209 of the Act where the conduct or proposed conduct of the company is unfairly prejudicial to them.

295. It seems that the s.209 remedy has substantially improved the position of minority shareholders by giving them direct access to the Courts in circumstances where the restrictions on standing imposed by the rule in *Foss v. Harbottle* (1843) 2 Hare 461 were formerly a substantial impediment. It also appears that the concept of "unfairness" has now largely come to supplant the old concept of fraud on the minority. If that is so, the rule in *Foss v. Harbottle* no longer provides a major obstacle for litigants even where recourse is not made to s.209. In Australia the equivalent to s.209 has been extended to apply to circumstances where the conduct is "contrary to the interests of the members as a whole" to ensure that it is not simply available in circumstances of discrimination between shareholders. The Law Commission favours a similar extension.

296. If the proposals made above for recognition of duties owed directly to shareholders is accepted, then of course the rule in *Foss v. Harbottle* is largely spent although it would still apply to a derivative action brought to enforce the duty owed to the company.

297. The Canadian solution to the procedural problems derived from *Foss v. Harbottle* is to confer a right to bring a derivative action upon each shareholder, subject to the leave of the Court being obtained. It is suggested that the company by ordinary shareholder resolution could decide not to bring an action in its own right. In that case, in the absence of fraud (in its equitable sense), no derivative action could be brought (although the facts might support a claim under s.209.). It seems to the Commission that this result is appropriate and recognises the common sense behind the rule in *Foss v. Harbottle*. In any event, views are sought as to whether the rule in *Foss v. Harbottle* as a procedural impediment should be explicitly removed, allowing the internal decision-making to be raised where not unfair as a substantive defence in a derivative action.

#### QUESTIONS:

1. Is there a need to facilitate greater shareholder participation in the management of a company?
2. What disclosure of beneficial ownership in the shareholding of a company should be required?
3. Should substantial shareholders be required to disclose their dealings in the shares of a company?
4. Should all companies be required to furnish shareholders with annual financial statements?

5. Should a mechanism be provided to enable a shareholder to waive the requirement?
6. Is there a need for more frequent financial reporting?
7. What rights of inspection of company record books should a shareholder have?
8. Is it too difficult for shareholders to requisition company meetings?
9. Should pre-emptive rights be required as a general rule where shares are issued?
10. What decisions of the company should be reserved for the shareholders in general meeting?
11. Should class rights be able to be varied only by special resolution?
12. What shareholder participation should be required in the case of fundamental change?
13. Should appraisal and buy-out rights be available to those who dissent in a decision which effects a fundamental change?
14. To what extent should companies be able to restrict the voting of shares?
15. Is cumulative voting for directors desirable as an aid to shareholder participation in management?
16. Should a postal voting system be authorised for general meetings?
17. What deficiencies are there in proxy voting?
18. Should the Act recognise the circumstances in which shareholders owe fiduciary duties to each other?
19. To what extent are the procedural restrictions on shareholder standing derived from *Foss v. Harbottle* of concern?
20. Should s.209 be extended to make it clear that relief does not depend upon discrimination in treatment between shareholders?
21. Should the leave of the Court be a necessary and only pre-requisite to shareholder derivative suit?
22. Should the general meeting be able to prohibit derivative suit except in cases of fraud?

## XII TAKEOVERS AND MERGERS

298. At present, takeovers and mergers are governed by the provisions of –

- . the Companies Act 1955
- . the Companies Amendment Act 1963
- . the Overseas Investment Act 1973
- . the Commerce Act 1986.

299. The Companies Act provides a procedure pursuant to s.205 for amalgamation by scheme of arrangement approved by the Court upon approval by a three-quarter majority of each class of shareholders. Section 278 of the Act provides for a system of compulsory acquisition and compulsory buy-out where ninety per cent of the shares of a company are acquired by one offeror. The Commission is interested to hear of practical difficulties which have arisen with both these provisions.

300. The whole matter of takeovers is under review by the Securities Commission which has already published one paper with proposals for reform and has almost completed its report. The Securities Commission review is expressly referred to in the reference to the Law Commission as being part of the overall inquiry into company law. Because the work of the Securities Commission is well advanced, the Law Commission does not itself propose to deal with the subject of takeovers in any detail at this stage although it invites some preliminary comment to assist it in formulating its proposals for company law generally.

301. The main statute designed to regulate takeovers is the Companies Amendment Act 1963. That Act has many shortcomings. It is easily evaded. Its aim is to ensure that shareholders of an offeree company have enough information upon which to exercise their decision to sell and are not stampeded into a precipitate decision. The conduct of takeovers is also regulated by the fiduciary obligations of the directors of offeree companies. In the case of companies which are listed on the New Zealand Stock Exchange, the rules of that body provide a significant level of control under the sanction of delisting.

302. Australia, the United Kingdom, the United States and Canada all have takeover codes built on a regulatory approach providing for –

- . dissemination of information together with time for evaluation
- . encouragement of competitive bids
- . equal opportunity to sell

equal treatment of all target shareholders.

303. There is arguably less case for establishing a regime based on offeree director evaluation and advice where shares are publicly traded because the market itself constitutes advice as to price. There may be sound sense as well as statutory construction in the fact that the 1963 Act does not apply to stands in the market. In such circumstances statutory regulation of the type provided by the 1963 Act may simply provide incumbent directors with power to entrench themselves. In the United Kingdom virtually all defensive action by a board is prohibited. Can it be said that the present New Zealand system unduly favours an incumbent board?

304. The Law Commission accepts that takeovers are an important mechanism to achieve efficient utilisation of assets and resources. It accepts that there are significant costs associated with regulation of takeovers and that regulation should be commensurate with the risk of abuse to shareholders. It considers that the fiduciary duties upon directors imposed by the existing law and as proposed for reform (see para. 199) constitute significant safeguards for offeree shareholders.

305. The Law Commission seeks comment as to:

- (1) the basis on which the market in shares requires regulation not applied to the market in other property
- (2) the basis on which equal treatment of shareholders is a proper objective for takeover law
- (3) the benefits obtained from mandatory delay provisions
- (4) the extent to which takeover regulation can safely be largely left to individual company prescription by restriction in the articles of rights of transfer and to vote and provision of the power to enforce the prescription which has been set.

306. As appears in the discussion at para. 292, the Law Commission is not yet convinced that shareholders owe fiduciary duties to each other. Except in the case of "special facts" fiduciary relationships it is arguable that target shareholders should be free to deal with their shares in takeover as they see fit and, in particular, should not be obliged to account for any premium they may receive for strategic shares either to the company or to the other shareholders. This is a topic upon which the Law Commission is particularly anxious to receive submissions.

**QUESTIONS:**

1. Is the approach of the Companies Amendment Act 1963 sound in imposing time delays and information requirements in takeovers?
2. Should company law encourage competitive bids in takeovers?
3. Is equality of treatment of target shareholders an appropriate end of takeover regulation?
4. Should all defensive action by directors of takeover targets be prohibited?
5. Should companies be permitted to include in their constitutions provisions to limit their attraction as takeover targets?

### **XIII CREDITORS**

307. It has already been indicated that the Law Commission does not at present favour extension of directors' duties to creditors by legislation outside the insolvency system.

308. In Canada, however, certain creditors have standing, with leave of the Court, to invoke the equivalent provision to s.209. The Law Commission seeks comment as to whether such a reform should be adopted in New Zealand.

309. In theory creditors can protect their position by contract and provide a right to intervene in a company before it becomes insolvent. In reality, trade creditors (apart from those who can insist upon Romalpa clauses and similar provisions preventing loss of title) and consumers who make pre-payments (for goods, services, holidays and so on) lack effective power to protect themselves by contract.

310. Creditors will often be more informed and motivated to protect their interests than shareholders, and the Law Commission seeks comment as to whether the usefulness of providing for access to the Court pursuant to s.209 and subject to the safeguard of leave of the Court, outweighs theoretical purity in this matter.

#### **QUESTION:**

1. Should creditors have standing with leave of the Court to apply for relief on the basis of unfair prejudice to their interests through company actions?

## **XIV COMPANY ACCOUNTS**

### **FORM OF FINANCIAL DISCLOSURE**

311. The question of company accounts is under review by the Securities Commission which expects to complete a major report with its proposals. The Law Commission does not itself propose to duplicate the work of the Securities Commission and does not wish to anticipate its proposals. But it would be of assistance in the review of the Companies Act for the Law Commission to assess preferred broad directions for the treatment of company accounts in the Companies Act.

312. It is essential to the proper working of company law that companies be required to keep financial records of and to report regularly to shareholders upon the financial position of the company and the results it is achieving.

313. At present, companies are required by the Act to keep accounting records which –

- . correctly record and explain the transactions of the company
- . will at any time enable the financial position of the company to be determined with reasonable accuracy
- . will enable the directors to ensure that any balance sheet, profit and loss account, or income and expenditure account of the company gives a true and fair view of the state of affairs of the company
- . will enable the accounts of the company to be readily and properly audited.

314. Balance sheets and profit and loss accounts are required to comply with the Eighth Schedule to the Act. The Law Commission accepts that the form prescribed by the Eighth Schedule is out of date and, if its equivalent is to be retained, requires complete overhaul.

315. Although both the New Zealand Stock Exchange and the New Zealand Society of Accountants indirectly regulate the content of company accounts (in the case of the Accountants' Society by its Statements of Standard Accounting Practice), neither system of regulation is recognised or adopted by the Companies Act.

316. The general essence of financial information is fairly standard in most jurisdictions. Most require something equivalent to a "true and fair" view to enable understanding of the financial position and the results of the company. But where some other jurisdictions depart from the New Zealand approach is in attempting to prescribe

the accounting practice to be applied in preparation of the accounts. The position in the United Kingdom is similar to that in New Zealand. In the United States the authority to regulate accounting information is vested in the Securities and Exchange Commission which requires compliance with pronouncements of the Financial Accounting Standards Board, a body institutionally independent of the accounting profession. In Canada company financial statements are required by the legislation to be prepared in accordance with the standards established by the Canadian Institute of Chartered Accountants. In Australia the Accounting Standards Review Board has been created to consider the standards applied by professional bodies and to develop standards which may be given statutory backing. The National Companies and Securities Commission, which administers the Companies Code, polices compliance with the Act and is able to reject accounts it considers not to comply.

317. In New Zealand it is arguable that the Registrar of Companies can refuse to accept annual accounts which do not in his opinion comply. The Law Commission is of the view that, as presently constituted, the Registrar cannot sensibly be asked to perform this policing function.

318. Comment is sought upon the following issues:

(1) *Statutory identification of scope of disclosure*

To what extent are the general requirements of "true and fair" and "permitting the financial position of the company to be determined at any time with reasonable accuracy" adequate? In particular, should there be greater definition of some of the basic terms employed, such as "financial position"?

(2) *Standard form*

Is standardisation of form (such as is sought to be achieved by Schedule 8) worthwhile? If so, should the form be prescribed by the Act, by regulations made under the Act, or should its setting be entrusted to a regulatory body with a duty to maintain its currency?

(3) *Regulation of standards*

Are there sufficient benefits in prescribing accounting standards to justify the cost? Is identification and implementation of accounting standards by regulation feasible?

(4) *True and fair*

Should conformity with prescribed accounting standards be prima facie compliance with a requirement such as "true and fair"? Should it be conclusively presumed to achieve compliance?

**(5) *Regulatory authority***

If regulation of accounting standards is adopted, should setting the standards be a matter for –

- . the legislature
- . an independent statutory authority
- . a professional body (such as the New Zealand Society of Accountants)?

**(6) *Enforcement***

Is it desirable to have an enforcement agency to ensure compliance? If so, what sanctions should it have available to it? Should such a regulatory agency be –

- . based in a Government department (for example, the Registrar of Companies)
- . the Securities Commission
- . a new regulatory agency, based perhaps on the pattern of the Australian National Companies and Securities Commission?

**GROUPS OF COMPANIES**

319. The Law Commission seeks comment as to whether the present law relating to financial treatment of groups of companies is working satisfactorily and invites comment upon that subject. It is the impression that the definitions of subsidiary and holding companies contained in s.158 are too limited and may be unsatisfactory in practice.

**AUDIT**

320. The Law Commission seeks comment upon the role of audit in financial disclosure and in particular would like comment upon –

- (1) whether audit should be required for all companies
- (2) if some companies are to be exempt, the basis on which a distinction should be drawn
- (3) whether audit should be in the discretion of the directors as a prudent step in discharging their primary responsibility to ensure that the accounts fairly describe the financial position of the company
- (4) whether the statute should recognise or limit the duties and liabilities of auditors to:

- . the company
- . shareholders
- . creditors

### **QUESTIONS:**

1. Is "true and fair" an adequate standard?
2. Should the form of company accounts be prescribed by statute or by a regulatory body?
3. Should compliance with prescribed accounting standards be presumed (on a rebuttable or conclusive basis) to be a discharge of responsibility to provide accounts that are "true and fair"?
4. Should accounting standards be set by a professional body or by an independent statutory authority?
5. Should compliance with accounting standards be enforced by a regulatory agency or left to shareholder or creditor suit?
6. Is the financial treatment of groups of companies satisfactory?
7. What should be the role of audit in company accounts?
8. What duties and liabilities should auditors owe to the company, shareholders and creditors?

## XV COMPANY CHARGES

321. The Law Commission is of the view that the present system of registration of company charges is totally inadequate to meet modern commercial need. It favours a comprehensive reform such as is to be found in Article 9 of the United States Uniform Commercial Code and it believes it to be highly desirable that reform of company charges should be undertaken together with reform of chattels security. These reforms are considered to be long overdue. Although the Law Commission for the purposes of discussion indicates a preference for the United States Article 9 approach rather than that adopted in Australia, it wishes to know whether there are benefits in this area to be achieved by harmonisation with the Australian law.

### THE PRESENT SYSTEM

322. Two systems of registration of company charges are provided for in Part IV of the Companies Act 1955. The first is maintained by the company and inspection of it is permitted free of charge by a member or existing creditor and upon payment of a fee by a member of the public. A second register is maintained by the Registrar of Companies. The register maintained by the company covers all charges affecting the company's property or undertaking. The register maintained by the Registrar of Companies applies only to those charges specified under s.102(2) which are charges –

- . for the purpose of securing any issue of debentures
- . on uncalled share capital of the company
- . created or evidenced by an instrument which, if executed by an individual, would require registration under the Chattels Transfer Act 1924
- . a floating charge on the undertaking or property of the company
- . on land
- . on book debts of the company
- . on calls made but not paid
- . on a ship or any share in a ship
- . on goodwill, on a patent or a licence under a patent, on a trademark, or on a copyright or on a licence under copyright.

323. The relationship between the company registration provisions

and both the land transfer system and the Chattels Transfer Act is particularly awkward.

324. The Companies Act scheme provides an incomplete registration system. In particular –

- . Registration does not conclusively establish priority. To determine priority it is necessary to supplement the statutory scheme by reference to the common law and equitable rules of priority.
- . Unregistered charges are void only as against the liquidator and any creditor of the company.
- . The status of a floating charge with a restrictive clause is quite uncertain except in relation to chattels and book debts covered by the Chattels Transfer system (s.102(12)).
- . It seems that there is no constructive notice in respect of floating charges over properties other than chattels and book debts.
- . The position of a floating charge under the Land Transfer Act is not at all clear:
  - (a) where a floating charge is part of a purported fixed and floating charge which contains a covenant for further assurances, it would seem it may give rise to an equitable mortgage which can be protected by caveat under the Land Transfer Act;
  - (b) where there is a simple floating charge, it would appear that it is not registrable under the Land Transfer system: it is not clear whether a floating charge will support a caveat.
- . There is no provision for registration under the Companies Act of a deed of variation although it seems that the practice of the Companies Office is to accept such deeds for registration.
- . Where a charge only registrable under the Companies Act is not registered within thirty days, it is necessary to apply to the High Court for leave to register out of time pursuant to s.108.
- . Section 114 works unfairly in relation to charges granted by overseas companies.
- . The list of charges in s.102(2) is not exhaustive.
- . Other security devices (such as reservation of title clauses) are not registrable.

## THE PURPOSE OF REGISTRATION

325. Historically, the purpose of the registration provisions was to make the information registered available to members and creditors. The Law Commission, however, suggests that the primary purpose of a modern system of registration should be to provide clear rules of priority.

## THE ALTERNATIVES FOR REFORM

326. The Law Commission seeks comment on the ambit of reform. It suggests that there are two principal alternatives. The first is to seek to reform the present system, as the Australian reforms of 1981 have done. The second is to engage in a wholesale reform of the whole area of security relating to personal property to produce a coherent and integrated scheme for individuals and companies to complement the land transfer system.

### *The Australian reforms*

327. The general characteristics of the new Charges Division of the Companies Code are:

- . It creates a statutory priority system of company charges independent of the case law rules. The new system provides that registration affords priority rather than merely providing for the avoidance of unregistered charges. Priority is accorded by the time of registration unless the holder of a later charge had actual or constructive notice of an earlier unregistered charge at the time of the taking of the interest.
- . It now covers most types of charge commonly encountered in practice.
- . Dual registration and cross-referencing in respect of the bills of sale legislation and companies legislation in the case of chattels has been avoided.
- . The position of floating charges is improved by statutory rules of priority. Restrictive clauses which retain priority over later registrable charges are given express recognition. In the absence of a restrictive clause, the holders of registered floating charges are deemed to have consented to priority having been given to later registered fixed charges.
- . There is a definition of charges by inclusion and exclusion, unlike the present system which merely defines by inclusion.

328. There are however, certain drawbacks with the Australian reforms:

- . The Code still covers only charges and therefore fails to cover other forms of securities such as hire purchase, long-term chattel leases, reservation of title, absolute transfers of title without transfer of delivery (for either tangibles or intangibles).
- . The Code excludes choses-in-action other than book debts and, in certain instances negotiable instruments and "marketable securities". (Charges on negotiable instruments and marketable securities are not registrable at all in New Zealand unless under a charge on "an issue of debentures" or a floating charge.)
- . The Code excludes "transfers in the ordinary course of business". This phrase originates from the English Bills of Sale legislation and has caused considerable difficulties in interpretation.
- . The Code still requires registration within certain time limits, although it seems that the failure has consequences only against a liquidator and an official manager.
- . The Code's schedule of priorities does not deal with priorities between a registrable and a non-registrable security interest or as between unregistrable interests inter se. The Code also fails to deal with the effect of a restrictive clause in relation to non-registrable charges or absolute transfers of property.
- . Execution creditors and other creditors are no longer protected by non-registration of charges.
- . No protection is given to absolute purchasers against registered or even unregistered charges.
- . The Code leaves in place the law permitting the realisation of an unregistered charge prior to winding-up.
- . The effect of automatic and other forms of crystallisation of a floating charge is not dealt with.
- . It is not clear whether the doctrine of constructive notice affects non-registrable interests.

### *Comprehensive reform*

329. It is suggested that it is undesirable to have separate systems of corporate and non-corporate registration of security interests.

330. The Chattels Transfer Act in particular is confusing and ineffective. The Contracts and Commercial Law Reform

Committee which considered the matter in 1973 was not enthusiastic about reform along the lines of Article 9 of the American Uniform Commercial Code. But reforms based on Article 9 have now been adopted in a number of Canadian Provinces. The Crowther Committee which reported on this topic in the United Kingdom in 1971 considered the Article 9 solution favourably and although the subsequent reform did not adopt the Article 9 model, the proposals are presently under reconsideration in the United Kingdom.

331. The main characteristics of Article 9 are:

- . It looks to the substance of the transaction not the form. It attaches to all transactions intended as security whatever the form. Article 9 does not stipulate the particular form of security which must be used. The agreement is simply a "security agreement" and the interest it creates is a "security interest".
- . It applies to security over all forms of personal property, tangible or intangible. Its approach is functional. There are special rules for inventory financing, equipment and consumer goods.
- . It provides a simple system of filing based on the concept of "notice filing". The idea is to confine the particulars to a minimum.
- . It adopts a set of priority rules based not on legal title or on equitable rules of tracing but on what is most likely to produce a fair result in the typical case. The essence of the system is that filing in the case of non-possessory securities establishes priority. In the case of possessory securities (that is where the security is held in the possession of the lender, as for example in the case of a lien or a pledge) filing is not necessary.
- . Reservation of property clauses have to be registered under such a system. The registration can be done unilaterally by the trader in advance of the dealing and need only be effected once. The statute accords priority for purchase money security interests.

332. The drawbacks to the Article 9 system include:

- . The status of the floating charge. Article 9 permits and contemplates fixed security over future property. In those circumstances it might be thought that there is no advantage in retaining the floating charge.
- . The status of a restrictive clause or negative pledge would need to be clarified by legislation.

**QUESTIONS:**

1. Are there any other major defects of the present charges registration provisions which need to be addressed?
2. Is the Charges Division of the Australian States Companies Code an appropriate model?
3. Is there a need for a single system for corporate and non-corporate securities?
4. If so, should a system based on Article 9 be adopted?
5. Should reform of the system of registration of company charges be deferred while a single system of chattel security registration is constructed or should there be intermediate reform in any event?

## XVI INSOLVENCY

333. As is apparent from the terms of reference to the Law Commission, the Department of Justice has been asked to undertake a review of the whole area of corporate and individual insolvency. The Law Commission is however interested to obtain as part of its process of consultation some general reactions to options for reform in this area because of their implications for company law generally. The Law Commission considers it desirable that corporate insolvency reforms must be completed within the same timetable as the overall company reform.

334. Corporate insolvency is governed by Parts VI and VII of the Companies Act 1955 which cover receivers and managers and winding-up. Schemes of arrangement between the company and creditors under the supervision of the Court are covered by ss. 205 to 207 of the Act. Reforms introduced to the Companies Act in 1980 clarified the rights and duties of the receiver, introduced powers to impose liability for the debts of a related company and joint winding-up of related companies, and imposed personal liability upon directors.

335. There is no provision for creditors or judicial management in New Zealand law although there were plans to introduce such a system in 1980 which were not proceeded with.

336. Major reform of insolvency law has now been implemented in the United Kingdom, consolidated in the Insolvency Act 1986. Major reforms are underway although not yet effected in both Canada and Australia. The Australian inquiry is being conducted by the Law Reform Commission of Australia which has recently published an important discussion paper after an exhaustive consultation process. Because the Australian discussion paper summarises the issues, and because the Law Commission considers the report a valuable basis for consideration of insolvency law reform in this country, the main proposals are summarised here to facilitate discussion. They are:

### *Integration of individual and corporate insolvency*

The discussion paper considered but ultimately rejected the integration of individual and corporate insolvency in the same piece of legislation. Such integration has been accomplished in the new United Kingdom Insolvency Act although the procedures are still far from being integrated within the legislation. The Australian paper considers that there are at present irreconcilable differences between the two systems and that the priority is for reform.

### *Aims of modern insolvency law*

The Australian Law Reform Commission identified the following principles as the aim of the modern insolvency law:

- . The fundamental purpose of an insolvency law is to provide a fair and orderly process for dealing with the financial affairs of insolvent individuals and companies.
- . Insolvency law should provide mechanisms that enable both debtor and creditor to participate in the process with the least possible delay and expense.
- . An insolvency administration should be impartial, efficient and expeditious.
- . The law should provide a convenient means of collecting or recovering property that should properly be applied towards payment of the debts and liabilities of the insolvent person.
- . The principle of equal sharing between creditors should be retained and in some areas reinforced although without prejudice to voluntary subordination.
- . The end result of an insolvency administration, particularly as it affects individuals, should, with very limited exceptions, be the effective relief or release from the financial liabilities and obligations of the insolvent.
- . Insolvency law should, so far as convenient and practical, support the commercial and economic processes of the community. There is little sense in promoting law that is decidedly at odds with these.
- . As far as is possible and practicable, insolvency law should harmonise with the general law.

#### *Suggested new corporate insolvency procedures*

The Australian Law Reform Commission thought that there should be two principal methods of dealing with the insolvency of a company –

- . winding-up on insolvency
- . a deed of company arrangement.

The existing distinctions between a Court or compulsory winding-up and a creditors' winding-up would be extinguished. There should only be one form of winding-up although with a variable process for its achievement. There should be a form of voluntary administration for companies capable of implementation without undue formality, cost or delay. This is to be designed to replace procedures such as creditor's voluntary winding-up and might largely replace schemes of arrangement in respect of insolvent companies.

The existing Australian procedure of official management would be abolished. It is envisaged that the process of voluntary administration would lead either to winding-up in insolvency or a deed of company arrangement. The creditors will determine which of these should apply. The paper sets out a proposed procedure which would be started by the directors appointing an administrator. The holder of a floating charge could also appoint an administrator in cases of default. The appointment of an administrator would produce a moratorium. The object of this is to provide a period during which the property and business of the company can be investigated with a view to selection of the most appropriate form of administration – whether a deed of company arrangement or winding-up in insolvency.

### *Receivers*

It is proposed that the holder of a floating charge may appoint an administrator to a company which has defaulted under the provisions to the charge. It is thought that this might encourage secured lenders to use administration so that the affairs of the company may be addressed as a whole and not in isolation or merely in the interest of the secured creditor. The paper also makes recommendations with regard to the receiver's obligations and recommends a statutory duty to take reasonable care. In New Zealand such a duty to the company is imposed by s.345B of the Companies Act 1955. The paper also recommends that automatic crystallisation of a floating charge should be restricted to circumstances where a notice of crystallisation has been filed.

### *Assetless insolvent companies*

The Australian Law Reform Commission proposed the establishment of a fund out of which could be met the costs of winding up a company without assets and a limited form of administration. The fund would be created by a levy on all incorporated companies.

### *Directors' liability*

The paper recommends the repeal of the present Australian law which provides for criminal proceedings and civil redress in the case of careless incurring of debts. (In New Zealand there is civil liability only for recklessness pursuant to s.320 of the Companies Act 1955. Criminal proceedings pursuant to s.461D can be brought only where there is an intent to defraud.) The Australian Law Reform Commission favoured the replacement of the existing law by a statutory duty on a director to prevent a company engaging in insolvent trading. Breach of the duty would be actionable by the company in insolvency through its liquidator. The proceeds of

any damages would be available for distribution amongst unsecured creditors.

*Aspects of insolvency law common to both individual and corporate insolvency*

- (a) *Recovery of property.* The Commission favoured the reform of the law covering antecedent transactions so that property can more easily be recovered and shared amongst creditors.
- (b) *Claims and priorities.* It is proposed that Crown priority be abolished and that a wage earner protection fund be set up, removing the need for employee priority.
- (c) *Insolvency practitioners.* Like the United Kingdom reforms, the Australian proposals favour one system of qualification, registration and regulation of persons entitled to be appointed to administer insolvency. The system is expected to be largely self-regulating under a statutory framework.
- (d) *Insolvency administration.* The Commission made a number of detailed proposals with respect to reform of the procedure of insolvency administration.
- (e) *Offences.* The Commission considered that there should be rationalisation of existing insolvency offences with greater reliance being placed on civil law remedies. Offences involving fraud it was thought would be better located in the general criminal law.

337. These suggestions do not of course cover the whole gamut of possible reforms. The Law Commission is conscious that both the United Kingdom reforms and the Australian proposals must be studied in depth. In the meantime however, it would be useful to the Law Commission to have some comment upon the general options for reform. It would also be useful to have indications from insolvency practitioners and those with experience of corporate insolvency of other significant defects in the law which are considered to be in need of attention.

**QUESTIONS:**

- 1. Should an attempt be made to deal with corporate and individual insolvency in a single statute?
- 2. If so, should this be by general consolidation or should an attempt be made to rationalise and integrate the two sets of provisions?

3. Should there be amendment to corporate insolvency procedure along the lines proposed by the Australian Commission, namely:
  - . winding-up in insolvency
  - . a deed of company arrangement?
4. Should the state continue to fund the administration of liquidations?
5. Should receiverships be retained?
6. Should the holder of a floating charge be able to appoint an administrator under a regime along the lines proposed by the Australian Commission?
7. If receiverships are to be retained, should there be further reform to clarify the duty of a receiver to third parties such as guarantors of the company's indebtedness?
8. Should a system of notices of crystallisation be introduced?
9. Should there be a fund for the administration of insolvent companies without assets?
10. Should the present law be amended to provide for a duty on directors to prevent the company from engaging in insolvent trading?
11. Is there a need for a reform of the law relating to antecedent transactions?
12. Should Crown priority be abolished?
13. Should a wage earner's protection fund be set up?
14. Should there be a system of registration of insolvency practitioners along the lines suggested by the Australian Commission?
15. Should insolvency offences be reformed along the lines suggested by the Australian Commission?

## XVII GENERAL ISSUES IN COMPANY REFORM

### DRAFT ARTICLES

338. The Companies Act provides by the Third Schedule for draft articles for –

- . companies limited by shares (Table A)
- . companies limited by guarantee without having a share capital (Table C)
- . companies limited by guarantee and having a share capital (Table D)
- . unlimited companies (Table E).

339. Tables C, D and E seem to the Law Commission to be altogether outdated and it is proposed that they be deleted, as has been done in Australia. Table A is out of date and requires revision. Both in Australia and in the United Kingdom new model articles to replace Table A have been adopted. The Law Commission proposes to remodel Table A as part of the present reform.

### ROLE OF THE COURT IN REDUCTIONS OF CAPITAL

340. It is suggested by the Law Commission that the role of the Court in reduction of capital pursuant to s.75 and in schemes of arrangement pursuant to s.205 is unnecessary except where the course of action is in dispute.

### SHARE CERTIFICATES AND SHARE TRANSFER

341. The Companies Act requires every company to complete certificates for its shares (s.90). The certificates are prima facie evidence of the title of the member of the shares (s.91). Failure to have ready for delivery share certificates within two months of allotment or transfer is an offence for which the company and its officers is liable to a fine.

342. The share certificate was devised in a more leisurely age. The legislation at present fails to take into account modern recording methods. It is the impression that the system is quite unable to cope in the case of companies whose shares are frequently traded. In the case of private companies, it is the impression of the Law Commission that s.90 is often not observed. The matter of share certificates and transfers is currently under investigation by the New Zealand Stock Exchange. The Law Commission is concerned to see that the Act does not preclude sensible options in this area. It suggests that the matter might be dealt with by requiring each company to maintain shareholding records which –

- . correctly record and explain the shareholding of the company
- . will at any time enable the shareholders of the company to be determined with reasonable accuracy.

Any shareholder would be entitled to a statement of his shareholding in the company at any time upon application.

343. Shares in a company are transferrable in the manner provided by the articles of the company (s.82), provided that a "proper instrument of transfer has been delivered to the company" (s.84). Where the sale of shares is made through the agency of a stockbroker, solicitor, accountant, trustee corporation, trading bank or authorised public securities dealer, the manner of transfer is governed by the Securities Transfer Act 1977. The Act was designed "to provide a simplified procedure for transferring securities". The Law Commission wishes to know whether the procedures are working satisfactorily in practice. In the case of transactions which are not affected by the Securities Transfer Act 1977 (because not achieved through the agency of a dealer), it wishes to know whether it is satisfactory for the form of transfer to be governed by the company constitution and whether the matter should not be dealt with by enacting in the Companies Act a simplified form of procedure for all companies.

#### OBSOLETE AND SUPERFLUOUS PROVISIONS

344. A number of provisions contained in the Companies Act are obsolete or not used. Elimination or updating of these provisions is proposed and the Law Commission would be glad to receive suggestions of candidates for attention. At present, it proposes abolition of:

- (1) labour shares (s.67)
- (2) the statutory report and meeting (s.134)
- (3) the power to issue shares at a discount (s.65)
- (4) the power by special resolution to resolve that a portion of share capital shall not be called up except upon dissolution (ss. 69 and 73)
- (5) the power to pay interest out of capital (s.74)
- (6) matters of evidence of title, grant of probate and effect of share warrants (which are, it seems to the Commission, probably covered by general law (ss. 91-93))
- (7) the penalty under s.94 for personation of a shareholder (which, at 14 years' imprisonment, seems to the Law Commission to be excessive)

- (8) restrictions on commencement of business (s.117)
- (9) directors with unlimited liability (ss. 201–303)
- (10) share qualification of directors (which can be covered by companies wishing to impose them in their articles (ss. 185, 184))
- (11) the procedure provided under Part X of the Act for companies formed under other Acts.

345. Some definitions also require updating, especially to allow for records to be kept electronically.