SPEAKMAN LAW

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Issue 32

What's inside

- Companies collapse only to rise again
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- Breaches of Shareholders Agreements

Briefly – Special Interest/Law

- Trust Act passed, triggering the transitional period for updating your trust deed.
- Tax Working Group – not all lost, as much of their work now appears in the Government tax policy work programme. This includes reviewing the land rules, particularly in relation to investment property (likely resulting in a capital gains tax restricted to property investors).
- 45 Bills are currently before Parliament. Of these, relevant to me are the Partnership Law Bill and the Venture Capital Land Bill. Less relevant is the Veterans Support Amendment Bill!
- Claire Curran, sacked from cabinet, to retire from Parliament at next election.
- Donald Trump's latest brainstorm is to nuke hurricanes before they make landfall – Brilliant or fake news?

Briefly – Sport

- RWC team announced. Gone is a great All Black Owen Franks; included is a future great All Black in the McCaw/Michael Jones class, in Luke Jacobson.
- Black Caps share lead on new test championship with brilliant win over Sri Lanka.
- Rory McIlroy wins Fedex. Would have been nice if someone likeable had won it.
- CWC final: was the 4 overthrows off Ben Stokes bat (and umpiring error to compound it) the most unlikely and unlucky moment in sport?

While the news has been monopolised by the China/US trade war, Hong Kong democratic protests (really quite worrying with Chinese tanks at the border), and locally the Ihumatao protests and Jacinda Adern's travels to the Pacific Islands, much has been going on in the legal world.

Dominating the legal scene this year has been the Government's back track on introducing capital gains tax and the Mainzeal decision (in particular the damages award against Jenny Shipley). Nevertheless, ordinary business goes on and this newsletter encapsulates some recent activity here. I hope you find it interesting.

Companies collapse only to rise again…

Companies commonly collapse leaving behind hundreds of thousands of dollars (or millions in some cases) owed to creditors yet they manage to rise from the ashes and trade on in a new company with a clean slate. How is that possible? These companies that magically reappear with the same name and same directors are known as "Phoenix Companies". Read on for the answer as to how they reincarnate.

An example of a failed company that was reincarnated some years back involved a luxury boat manufacturing company that struck problems with two particular boats it had under manufacture. The owners of the company chose to put the company into liquidation. They then transferred the entire business (minus the 2 problematic boats that were under manufacture) to a new company through which they carried on using the same name as the old (now liquidated) company. This left the problem boats behind to sink to the detriment and great annoyance of the customers who had paid the company to build the boats for them.

As you might expect, arguments raged about the propriety of all this. Those arguments centred on the absence of any goodwill for the business paid by the new company to the old company, with the result that there was no amount for the 2 diddled boat owners to claim against. The owners of the company. However, maintained that no goodwill was applicable because there would be no business at all had they personally not chosen to stay in the business. Their position was that they would have walked away from the business altogether had they been required to recognise goodwill in the old company.

They lost that argument. They became liable to account to the old company (then in liquidation) out of the ongoing profits of the new company. For how long were the profits of the new company to be sacrificed for the benefit of the old company? The court settled on 1 year of profits as the appropriate period; it was not right to extend the old company's rights to the ongoing profits indefinitely. Effectively this meant the owners of the new company had to account to the 2 boat owners whom they thwarted for a full year of trading profits.

Nevertheless we hear of circumstances where a failed company collapses and a new company under the same ownership and control replaces it. Is this acceptable?

It will be acceptable if it is effected with the blessing of the liquidator/receiver of the failed company. If done without the liquidator/receiver's blessing there are now heavy penalties, including criminal penalties carrying a term of up to 5 years imprisonment or a fine of up to $200,000.

These penalties are imposed by phoenix company provisions that have been inserted into the Companies Act to deal with these sorts of situations. Had those penalties applied at the time of the boat manufacturing company restructuring discussed above, the owners would undoubtedly have been heavily fined.

These phoenix company provisions apply broadly and effectively put a stop to the old company/new company scenario with creditors of the old company being left high and dry. The ability to trade on in a new company using the same name is now only possible with consent of the liquidator/receiver. Their consent will only be granted where fair value is paid for the old company's assets.

These phoenix company provisions not only stand in the way of rorts, they also are of great use in legitimate restructuring. A company may, for example, have 5 retail stores of which 2 trade profitably and 3 do not. The company may want to close the 3 unprofitable stores and continue to trade the other two. It cannot do that under the one company umbrella because the liabilities of the 3 unprofitable stores carry over to drown the profitability from the other 2.

The phoenix company provisions provide a neat solution here, whilst ensuring creditors are properly looked after.

Small Offer Capital Raisings

Capital raisings of less than $2m may conveniently and easily be undertaken by means of what is referred to as the "small offers exclusion". This is an offering of shares in a New Zealand company under which the uptake is limited to 20 investors and $2m in a 12 month period. Its attraction lies in its exclusion from the extensive and horrendously expensive public disclosure requirements under the Financial Markets Conduct Act.

Its attraction is also that it overcomes the restricted exclusions from the public disclosure rules for eligible investors and close business associates. It is not always possible to rely on these exclusions; the small offers exclusion bridges the gap.

Care is needed to fit within this exclusion. Most obvious, by way of conditions, are the thresholds set out above for the number of investors and maximum amount that may be raised. Also significant is the restriction on public advertising. Instead, offers may only be made on a personal basis to those whom the offeror has reason to believe, due to their personal acquaintance, that the offeree may be interested in the offer. While this would include close business associates within those to whom a personal offer may be made, it plainly goes wider than that group. Alternatively, the offer may be made to a person who has gross income of at least $200,000 in each of the last 2 years.

The convenience of a "small offer" merely requires a warning statement to the effect that the offerees are, upon acceptance, entering into binding legal obligations and so forth and notice given (after the fact) to the Financial Markets Authority.

The starting point is to establish the terms of the offer itself and clearly describe them in the offer document. As the offer usually entails an issue of shares, this is ordinarily done in conjunction with the share issue documentation which I would be most happy to help you with.

Capital Raising for Unregulated Offers

I discuss here how you might go about formulating the terms on which a share offer is to be made. The context here entails unregulated offers, being those that do not fall under the public disclosure rules in the Financial Markets Conduct Act.

The trigger for the offer is invariably an identified need for additional capital in order to facilitate growth. At what price should the additional shares be offered, and is an offer of convertible notes a better solution than shares?

Inevitably there is tension on this score between the price and control expectations of the founder on the one hand and those of the investors on the other. There is often the attitude of the founder that the company is his or her pup and a desire borne of that not to let others in too cheaply to the company or to relinquish control of it. Those attitudes will be at odds with the mindset of investors. If not managed they will de-rail the capital raising.

Principles that will help to establish the right course here reflect the proportion of capital that is sought to be raised. The higher it is, the greater the expectation the investor group will have to participate in management. On the other hand a capital raising of say 10% - 30% of the company entails a minority position. The element of control by the investor group will be commensurably small.

Recognition will sit with the investor group of their reliance upon the skills and knowledge of the founder. This is usually reflected in key person provisions by which the founder is contracted to stay on with the business. It entails a restriction on the founder selling out quickly. Desire on the part of an investor group to retain a founder is usually neither for too short nor too long a period. A three year period of restriction is common.

The tension in pricing referred to above is compounded by investors' nervousness of future share offers being made at a price lower than their entry price. That nervousness can be addressed by way of anti-dilution rights. These vary to suit whatever the participants wish and often extend to a free carry under which an investor group is issued additional shares to compensate them in the event of a later, cheaper share offering. A free carry of that type entitles the initial investor group to that number of additional shares they would have received had their own entry been at the later, cheaper issue price.

Capital raisings also inevitably prescribe the manner in which the money raised is to be applied. Success of a capital raising will be lost if additional capital is not invested in the business and instead is returned to the founder, as unpaid dividends or such like.

Finally, thought is needed as to potential for a second round of capital raising. Companies often find themselves hamstrung from doing so by commitments made to the first investor group. Obstacles in these respects can be overcome by a well written shareholders agreement that retains the ability to do so. This requires that thresholds for approval for future events need to be appropriately set.

A lot can go wrong in establishing the deal terms upon a capital raising. Best to take advice early, and I can help you with that.

Breaches of Shareholders Agreements

What are your remedies when your co-shareholder breaches your shareholders agreement? Are your remedies curtailed by your own breach?

A case a couple of years ago involving Mike Pero Mortgages Limited (MPM) answers both questions.

Mike Pero had entered into a joint venture with MPM, each obtaining a 50% stake in the joint venture company (JVCo). MPM and Mr Pero (indirectly via a company controlled by him) entered into a shareholders agreement (SHA). The SHA provided for each of Mr Pero and MPM to appoint a director to the board of the JVCo. Mr Pero did (he appointed himself); MPM did not. That was its breach. Technically, that left JVCo lacking a quorum of directors, rendering purported director decisions invalid.

Mr Pero chose to ignore that invalidity and exercised his power as the only director to substantially increase his salary. Why not? After all it was MPM's wrong doing and foolishness not to appoint a co-director and

thereby police him. So Mr Pero had free reign to do as he pleased, at least so he felt.

Standing in his way, however, was a provision in the SHA by which he agreed not to increase his salary without his co-shareholder's agreement.

Unsurprisingly, MPM filed court proceedings. They claimed they had been unfairly prejudiced, which they clearly were. MPM won, Mr Pero lost. Any argument that Mr Pero might otherwise have had was lost on the court due to his blatant intent to serve his own purposes (amongst other things contrary to his directors' duty to act in good faith).

A shareholder does not require breach of a shareholder agreement to be aggrieved. Rights of compensation reside with shareholders under general company law wherever they have been unfairly prejudiced. Nevertheless the existence of a shareholders agreement greatly enhances a shareholder's ability to establish that they have been unfairly prejudiced.

Where unfair prejudice is established, the court has a wide range of powers available to it to remedy it. Often the remedy sought will be an order for one shareholder to buy out another. Orders of that type are commonly granted as the most appropriate means of remedying a wrong. The difficulty is to establish the appropriate price and to fund it, all of which I would be happy to discuss with you.

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