COMLAW 203 / Topic 1: Nature of a Corporate Entity

INTRODUCTION

- **Companies Act 1993**
  - applies to companies large and small
  - no distinction between private and public companies
  - no distinction between closely held and public companies

Company Stakeholders:

- **Shareholders**
  - generally have limited powers to collectively act as the company at a shareholders' meeting, but can dismiss company directors
  - may receive dividends if the company makes a profits and chooses to pay dividends
- **Directors**
  - have powers conferred by the Companies Act and the constitution, including a broad power of management under s128
  - owe 'duties' to the company
  - may also act as agents of the company
  - the shareholders elect directors to manage the company's interests
  - the directors are subject to fiduciary duties to the company
- **Creditors**
  - rights created by their contract with the company, e.g., may be given power over management decisions or appoint directors and/or if company is insolvent may be given power to run the company (rare)
  - can be secured or unsecured (right to be paid in event of insolvency/have certain assets sold to be repaid)
- **Employees**
  - enter into agreements with companies under Employment Relations Act 2000
  - company/directors owe no duty to employees under the Companies Act
  - can act as both an employee and director (ie CEO may also be a director)
  - employees can bind the company through their acts via agency (contracts), vicarious liability, and attribution
- **Public/CSR**
  - public has not rights against company under company law
  - CSR says companies owe rights to stakeholders affected by their actions
  - indirect power as a consumer
  - Companies Act 1993 is largely an 'enabling' legislation that aims to facilitate rather than regulate business
- **Government**
  - doesn't directly control company, unless it can appoint directors in SOE
  - can affect operation of company (through legislation, regulatory bodies, and tax laws - where the government may become a creditor of the company)

So who owns the company's assets? the company, NOT shareholders
What are the company's liabilities? bank loans, trade creditors
Who has rights to the company's profits? no-one but the company, prima facie
How does the company raise money? through debt or equity capital

DEVELOPMENT OF COMPANY LAW

- company can be formed through submitting the relevant forms and payment to companies office
- CA'93 was developed after the old 1955 act was considered outdated, and the rules governing companies were spread out in a number of different places - difficult to understand rules
- also a lack of confidence in the legislation due to stock market crash in 87
- FOCUS was on: giving more freedom to company directors & providing better protection to shareholders and creditors from abuse of power/fraud by directors
- all companies are now subject to the Companies Act 1993

FEATURES OF THE COMPANIES ACT 1993

A. Company is there to provide economic and social benefits to the economy
B. Incorporation, organisation, and operation of companies should be basic and easy to do
C. Set out in an easy to understand way, the role of directors, shareholders, and creditors
D. allowing directors a wide discretion in matters of business judgement while at the same time providing protection for shareholders and creditors against the abuse of management power
E. providing straightforward and fair procedures for realising and distributing assets of insolvent companies

- it was intended to be a complete code, collecting together all the main rules, but it is unclear whether this has been achieved as there is a significant amount of case law

'NEW' FEATURES IN THE COMPANIES ACT 1993

- one person companies permitted
- interest register for transactions with company
- interest groups of shareholders
- solvency test for previous prohibited actions (i.e. company cannot do certain things unless they will be solvent afterwards)
- major transactions require shareholder approval
- directors duties codified
- more rights for shareholders
- optional constitution
- procedures avoided by unanimous assent of shareholders

ADVANTAGES OF THE CORPORATE FORM FOR BUSINESS?

- the company can live on despite death of shareholders/directors
- limited liability (shareholders liability limited to their initial investment)
- A/L of company are separate to those of the shareholder's
- bankruptcy of shareholder/director does not disrupt company
- ease of increase of scale of operations via share issue
- ease of investment/divestment of shares via transfer
- management under a board structure = separation of 'ownership' and control and employment of professional managers
- incorporation may facilitate borrowing (but in smaller companies, a lender may demand personal guarantees from directors)
- exposure to taxation and regulation
- loss of privacy as company register can be searched by anyone

BIRTH AND DEATH OF A COMPANY

What are the essential elements of a company?

- name, 1+ shares, 1+ shareholders, 1+ directors, a registered office, an address for service

What is the method of incorporation?

- promoter must apply for name approval
- 1+ people may then apply for registration
- application made on the prescribed form must be delivered to the registrar (includes application form, consents to act from directors, consents to act by shareholders, reservation of name notice, constitution *if applicable,* and the fee)
- registrar will issue certificate of incorporation
- certificate of incorporation is conclusive evidence that company is incorporated and has complied with registration requirements

Death of a company

- company exists as entity until it is removed from register
- normally, removal from register follows liquidation
- liquidations may be initiated by the company, but are more commonly court ordered

Insolvency

- a person/company is insolvent when they cannot pay their debts
- *cash flow insolvency* involves a lack of liquidity to pay debts as they fall due
- *balance sheet insolvency* involves having negative net assets — where liabilities exceed assets

Formal procedures

- "voluntary administration" (where the company wants to make arrangements with creditors, administrator acts on behalf of creditors, and is tasked with saving the company, during the appointed's month, creditors cannot take action against the company and at the end of the month will be presented with an offer that they all vote on)
- "statutory management" (where some kind of fraud is present, and is government run)
- "receivership" (only for the benefit of a single secured creditor)
    - **can be court appointed OR can be creditor appointed**
- "liquidation" — sell assets to pay debts, normally kills the company
- "compromises and arrangements" — simplified form of VA where the company itself makes an offer to creditors, which creditors will vote on and if successful, will be binding on all creditors

Secured and Unsecured Creditors

- a secured creditor is one that has entered into a contract and as a result possesses a property right over an asset or assets of the debtor, which allows them to enforce their security over the asset(s) in order to sell the asset(s) to repay the debt
- called a "security interest"
- can have a security interest in one or more distinct assets
- can have a security interest in a class of assets (e.g. over all goods supplied by a supplier)
- can have a security interest over all present and after-acquired assets (a general security agreement)
- more than one creditor can be secured over the same asset

Creditor-appointed Receivers

- majority of receivers are appointed in this way — are given full power to take control and manage company
- one possible remedy against the debtor's assets is the appointment of such a receiver if and when permitted by the security agreement
- with no security interest, there is no property right for the creditor to exercise over particular assets of the debtor, and no right to appoint a receiver
- as a secured creditor, if a company goes into liquidation, the SC will still be able to exercise their rights over the debtor's assets it has a charge over
- a creditor-appointed receiver is only there to serve that creditor and will only try to repay that creditor
- the creditor-appointed receiver does so by taking control of the collateral, and selling it for cash to try and repay the debt
- the receiver can close down the business if they think it is the best option

Liquidation

- a company is put in liquidation by appointing a liquidator (an external person who takes charge and closes down the company and distributes the assets to those entitled)
    - **can be initiated by the company, but more often court ordered**
    - **court ordered liquidations are usually initiated by a creditor who issues a statutory demand to the company for payment which is not satisfied**
    - **intention is to kill company, sell all assets to pay all debts**
    - **unsecured creditors lose all rights (cannot sue) other than to file "proof of debt"**
    - **secured creditors stand outside the liquidation, and may grab what is charged to them**
    - **duty of liquidator is to take possession of unsecured assets, sell them, and distribute proceeds to creditors in order of priority**

Ranking of Creditors?

1. **Secured Creditors**
2. **Preferential creditors (e.g. employees, who can be paid up till $20,000)**
3. **Other secured creditors (e.g. bank with general security agreement)**
4. **Any balance due to preferential creditors**
5. **Unsecured creditors (pari passu will apply, left overs will be distributed pro-rata)**
6. **"Subordinated" creditors (pari passu applies)**
7. **Shareholders**

Separate Legal Entity

- “a company is a legal entity in its own right separate from its shareholders and continues in existence until it is removed from the NZ register” s15 Companies Act

This principle was established in **Saloman v Saloman & Co Ltd (1897) (HL)**

- either a company is a legal entity or not
- the incorporated company is a different person all together from the subscribers/shareholders
- and so, the company’s debts are not the debts of its members
- even if it is a “one person” company, it doesn’t mean it is automatically an agent of the member
- public/creditors deals with a LLC at their own peril

Lee v Lee’s Air Farming Ltd (1961)

- Lee formed company in ’54, and took nearly all the shares, and appointed himself governing director with full control of LAF; he also appointed himself chief pilot/employee of the company
- So, he was the major shareholder, governing director, and sole employee
- CA said it was not possible for Lee to be both the director and sole employee at the same time
- PC rejected this; as it was perfectly possible for LAF to have a contract with Lee as they were both separate legal entities

Judicial Lifting of the Veil of Incorporation

- in rare circumstances, the veil between company/shareholders may be lifted
- if the veil is lifted, a shareholder can be found liable for the debts of the company
- but, cases are not consistent in their treatment of this ‘lifting’
- there is considerable dicta on the subject of veil lifting, but very few instances of it occurring

Gilford Motor Co Ltd v Horne (1933)

- Horne was appointed managing director and in his employment contract it stipulated not to solicit customers of the company if he were to leave employment of GMC
- Horne was fired and he subsequently set up another business and undercut GMC’s prices (a breach of above)
- GMC advised Horne of this and so he formed a company under his wife’s name (JM Horne and Co Ltd) to carry on his business
- The directors and shareholders were his wife and an employee but Mr Horne was referred to as the boss
- GMC sought and injunction
- Issue: should the injunction apply both to Mr Horne and the company?
- Held: yes, and an injunction was issued against both (corporate veil set aside)
- Why? the company was simply a device to enable him to breach the clause, it was “a mere cloak or sham”; he was using a legal form to hide what the reality was

Official Assignee v 15 Insole Avenue Ltd (2001)

- Mr Russell formed a company called “Jojac Holdings”, original directors were fictitious and shares were issued to family members who were not aware of the issuing
- Documents were signed without the signatories knowing what they meant
- Jojac Holdings purchased a property in 1989
- Russell became bankrupt in 1994
- Held: Judge queried whether the company was a valid entity at all; given the way it was incorporated
- Even though there was a certificate of incorporation (which would normally grant legal separation) the judge held that Jojac was a “sham… a mask under which Mr Russell holds the Insole Avenue property so that it may be kept away from creditors”
- The veil was pierced under the “sham” criteria; it was considered appropriate to do so
- So, Jojac held the property under trust for Russell and then could be taken by the Official Assignee

Re Securitibank Ltd (1978)

- 2 companies (Merbank and Commercial Bills) were wholly owned subs of Securitibank
- They were involved in financing transactions, but wanted to avoid the Moneylender’s Act
- Issue: were the transactions money lending transactions? (if they were, the transactions were void for failure to comply with the act)
- The transactions were not deemed a “sham”
- The companies were separate entities and dealt with each other as such

- The court would not pierce the veil and treat them as one company, as a departure from the norm is only justified (as in *Salomon*) if strict application of the law would lead to a result that was very unsatisfactory, as to warrant some departure from said norm
- People are able to organise their affairs in such a way which keeps them outside the scope of the act… they are able to rely on the separate legal entity concept; i.e. it is legal to organise affairs in a way that benefits from the corporate veil

Savill v Chase Holdings Ltd (1988)
- Chase Holdings was a sub of Chase Corporation
- There was an agreement that the Savills would sell shares to CH *if* CC agreed to sell a piece of land to the Savills
- An agent acting for CH agreed to the offer
- CC denied this and said the agent had no authority to make the deal
- Issue: Were CH/CC bound to the agreements?
- The argument was that the courts should pierce the veil and view the 2 companies as a single entity, and therefore bind the agent's agreement to CC
- Court of Appeal said it was only appropriate to pierce the veil where special circumstances exist indicating that it is a mere facade concealing the true facts; there were no ground for the veil to be pierced, as they were genuine separate entities, there was no hiding of the truth

Chen v Butterfield (1996)
- Butterfield originally leased premised from third party as a partnership, and the third party subsequently sold the premises to the Chens
- The Chens knew that the Butterfields were forming a company to take over the lease and would not provide a personal guarantee
- The company failed to make rental payments and the Chens sued the Butterfields personally claiming that the company was a mere sham and that the veil should be pierced
- Judge defined what "mere sham" meant; *"a document will be a mere sham when it is deliberately drawn up so as to give the appearance of creating legal consequences different from those which the parties intend… for the document to be a sham it is necessary that the parties have in mind legal consequence 'A' but deliberately draw their document so as to appear to create legal consequence 'B'"*
- On the facts there was no sham, the document reflected exactly what the Butterfields intended; the company would take out the lease and the Butterfields would no longer be personally liable
- The veil should only be lifted if its presence would create injustice which the court cannot tolerate; the concept of separate corporate identity are legitimate facts of commerce and if genuinely/honestly used, should not be set aside

Note: the courts have been reluctant to lift the veil in cases where a corporate structure has been created to shield assets of a corporate group from potential liability.

Our test? First, the veil may be pierced if there is a 'sham'. Second, if the result of permitting the veil creates a substantial injustice that the courts cannot tolerate, the veil may also be pierced.

Adams v Cape Industries plc (1990)
- involved liability for harm from asbestos
- Pl was unable to sue UK parent of a US subsidiary involved in the sale/distribution of asbestos
- Potentially harmful activities were intentionally transferred to the subsidiary with a view to minimise the risk of liability
- Courts rejected that Cape should be treated as a single economic entity, that it's subs were a facade, and any agency relationship existed on the facts
- The right for Cape to use its subsidiary to bear the brunt of the legal liability to ensure future activity of the entire group is inherent in corporate law

Statutory Lifting of the Veil

- Court may order a (under sections **271, 272**):
  - **"CONTRIBUTION ORDER" (a company related to another company currently in liquidation must pay whole/part of the claims in liquidation)**
  - **"POOLING ORDER" (if two companies are in liquidation and are related, the liquidations will proceed as if there was only a single company)**

- Such orders may be made by a liquidator, a shareholder, or a creditor

- Such orders must be "just and equitable" *(the criteria are described in **272(1)**)*
  - **the extent to which the related company took part in the management of the company in liquidation**
  - **the conduct of the related company towards the creditors of the company in liquidation (positive or negative?)**
  - **the extent to which the circumstances that gave rise to the liquidation of the company are attributable to the actions of the related company**
  - **any other matter the courts think fit**
  - **(EXTRA FOR POOLING ORDER: the extent to which the businesses of the companies have been combined)**

- The companies must also be "related"
  - **this includes holding companies and subsidiaries**

- 2 broad concerns lie behind **s271**
- If one company has caused a loss to the creditors of another company (the creditors are confused about who they are dealing with)
- The business of related companies may be hard to separate and they might not have been kept clearly divided, so it might be difficult to determine the assets and liabilities of each company and so a pooling order might recognise the reality of the situation as well as removal of expensive investigation

Mountfort v Tasman Pacific Airlines of NZ (2006)

- Tasman Pacific Airlines Ltd acquired Tasman Pacific Regional Airlines Ltd in 1999, when Regional was solvent
- Airlines leased aircraft while Regional employed staff to service flights
- Regional relied on Airlines for 99% of its income
- After the takeover, the CFO of Airlines directed Regional to transfer $650,000 to Airlines
- Airlines also arranged for Regional to execute a guarantee of the group's liabilities
- Both companies went into liquidation
- The liquidator applied for a 'pooling order'
- Due to principle from Saloman, a solid reason is needed to make a pooling order; mere participation by a holding company in the management of a sub is not sufficient
- However, on facts a pooling order was made (regional was a 'slave' of airlines, it was dependent on it for 99% of its business, airlines caused regional to trade while insolvent, and the removal of the funds put regional at risk)

Other Statutes

- There are other statutes whereby shareholders and/or directors can be personally liable for their actions on behalf or in relation to a company
- e.g. Phoenix company provisions in the CA (where a director will be liable if they had a previous unsuccessful business)