

A COMPANY

WHAT ARE THE BENEFITS OF FORMING A COMPANY? (Electronic Incorporation)

Introduction

In this paper we discuss some of the reasons for forming a company and some of the basic legal principles which govern companies. Before we discuss the reasons please note that the Companies Office has introduced electronic incorporation and as a result ***we can now incorporate a company the day we receive your instructions***. At the end of this paper here is a form which we invite you to complete and return if you decide to form a company.

There are many reasons for forming a company, but there are four which stand out as being the most important. They are:

1. A company has a separate legal entity.
2. A company provides limitation of personal liability.
3. A company is a recognised investment structure.
4. A company can provide registration and protection of a business name.

Separate legal identity

A company has a separate legal identity. A company is formed when it is entered on the register of companies held at the Companies Office. Following registration the Inland Revenue Department will issue separate income tax and GST numbers for a company. A trading company must file income tax and GST returns and produce an annual set of accounts comprising a profit and loss statement and balance sheet. A company must hold an annual meeting and file an annual return in the Companies Office.

A company has perpetual succession. That is, from the day it is formed, a company continues to exist until it is wound up, liquidated, or struck off the company register.

A contract with a company binds the company and not the persons who sign on behalf of the company. A contract with a company is signed by its directors or other authorised officers.

Limitation of liability

Unlike a partnership, which is also a separate legal identity but with the partners remaining personally liable for the partnership debts, the shareholders in a limited liability company are not personally liable for the debts of the company. The shareholders enjoy a liability limited to the amount that they have paid, or are liable to pay, by way of calls, on the shares that they hold in the company. Unless the shareholders or directors break the statutory requirements contained in the Companies Act or give personal guarantees they can not be held liable for the debts of the company.

One of the prime reasons for forming a company is to create a legal entity to operate a business because all businesses involve risk - some more than others. A prudent person will form a company and arrange for the company to finance the purchase of the business. In this way, if the company gets into financial difficulties, any assets of the shareholders, such as the family home, are less likely to be affected. Unfortunately, to overcome this limitation on liability it is common for lending institutions and the owners of premises leased to a company to require ***personal guarantees*** from the directors/shareholders. This requirement can, in turn, be restricted by the shareholders transferring their assets to a family trust so that the shareholders own no assets. The practical limitation on such asset protection measures is that the

company/shareholders must own sufficient assets to meet the requirements of the lending institution and landlord.

A guarantee

In the previous section we briefly discussed the disadvantages of giving a guarantee. In considering this issue it is important to keep in mind that a guarantee is demanded because the lender is not willing to accept the risk of dealing with the company. By giving a guarantee a shareholder/director is exposing himself to the potential liability for the company's loan/lease obligations. For a more detailed discussion of the issues which a guarantor should consider before signing a guarantee we recommend you to read the paper entitled "**A Guarantee**".

Investment structure

A person may lend money to a company and the loan may be secured or unsecured. A person who lends money to a company is a creditor and the creditor is entitled to be paid by the company before the company distributes any of its assets to its shareholders.

A secured creditor is usually a creditor who holds a debenture over all of the assets of the company. The difference between a debenture and a mortgage, is that the holder of a debenture is usually given the power to appoint a receiver and manager of the company's business if the company does not comply with the terms of the debenture. The receiver and manager takes over the running of the business and has the right to sell its assets. The proceeds of sale are used by the receiver to satisfy the debt owing to the secured creditor.

For a business venture a company provides the structure banks and lending institutions require to obtain security over the assets owned by the business. This is particularly important for a small business where a company can give security to a creditor over its stock to fund its stock.

Apart from borrowing money from a bank or lending institution, a company can raise capital by inviting others to become shareholders. A shareholder is anyone who has invested money in the capital of the company, or who purchases a share from an existing shareholder.

Name protection

In New Zealand it is not possible to register a business name. If you want to obtain some protection for a name, say Widgets, a company called Widgets Limited can be formed, provided there is no identical name on the company register. After Widgets Limited is formed, no one else can form a company with the same name. The company can remain non active and non trading for name protection purposes, provided the statutory requirements for annual meetings and filing annual returns are complied with.

General

Company law in New Zealand was updated and modernised with the passing of the Companies Act 1993 ("**Act**"). The Act made a number of significant changes to the previous law.

One person company

It is now possible for one person to form a company with one director and one shareholder.

Shareholders

The shareholders in a company have no power of management of the company, but as a group, the majority of shareholders can approve and remove the directors who are the managers of the company business.

The Act provides that a company must hold an annual general meeting and that all shareholders are entitled to notice of that annual meeting and to be given two copies of the company's annual accounts.

Generally speaking, shareholders must be treated equally and if the company is making a profit, the company profit can be distributed to the shareholders by way of dividend. It is the directors who decide how much profit is distributed and before making a dividend distribution the directors must certify the company is solvent.

Directors

Shareholders have an interest in the wellbeing of the company but their role is a passive one with the powers of management of the company being vested in the directors.

The directors make all the management decisions of the company and the shareholders have no right to interfere with the management. If shareholders do not like what the directors are doing, then a majority of shareholders can usually dismiss the directors and appoint replacements.

Share capital

The Act abolished the requirement for shares to have a nominal value. A company must have not less than one share and the value of that share will depend from time to time on the net assets of the company. The share must be issued for a specified sum. Because the company will need money to set up its business, that money can only come from the shareholders (share capital), or by way of a loan. The company's share capital or borrowings, are used to buy the business assets, or pay for the cost of establishing the business. In addition, the company will need working capital which is a sum of money allocated to pay the company running expenses during the period that the company carries on business and before it receives income.

Dividends

After payment of all its expenses, any profit earned by the company may be paid to the shareholders by way of a dividend. The dividend represents the rate of return to the shareholders and should be better than normal interest rates if the company is profitable.

Increase in share value

A profitable company will see the value of its shares increase, as the holder of those shares will be entitled to share any income returned by way of dividends. If the company achieves capital profits, from the sale of any of its assets, then those profits will also be reflected in the value attributed to the company shares.

Solvency test

The Act introduced a solvency test intended to protect creditors and, in circumstances where only some shareholders are to benefit from a transaction, non-participating shareholders.

Before paying dividends or making other distributions to shareholders, directors must be satisfied the company will be solvent immediately after payment of the dividend or distribution.

The test has two limbs, both of which must be satisfied - a liquidity test and a balance sheet test.

The liquidity test is satisfied if a company is able to pay debts as they become due in the normal course of its business. The balance sheet test is satisfied if the value of a company's assets is greater than its liabilities.

In determining the value of a company's assets and liabilities, directors must have regard not only to the most recent financial statements, but also to all other circumstances they know or ought to know would or may affect those values.

Directors may rely on valuations of assets or estimates of liabilities, if reasonable.

Sale as a going concern

A company which is trading profitably and has a good business, can be sold as a going concern by all of the shareholders of the company selling their shares. The company name and all its business assets remain with the company and only the shareholding is altered. This is a method by which an investor is able to set up a company, build up a profitable business and sell the shares for a capital gain. Alternatively, the company can simply sell its assets.

Invitations to the public

If a promoter wishes to offer shares in a company, or securities in a company **to the public**, the promoter must comply with the Securities Act. There are important statutory requirements for promoters and a prospectus must be issued and approved in relation to the issue of shares or securities. There are severe penalties for failing to comply with statutory requirements or providing false or misleading information.

Company constitution

The powers of a company and the object for which it was incorporated, were previously contained in a document called a memorandum of association. Under the Act, a company has unlimited powers, unless the constitution chooses to limit the company to certain objectives.

A company does not need to have a constitution, in which case, the rights, powers, duties and obligations of shareholders and directors are as set out in the Act. The constitution may however, modify some of the statutory requirements to make the administration of the company easier. We have prepared the following forms of constitution:

1. A single shareholder, sole trader constitution.
2. A partnership type constitution, where there are two or more groups of shares with the groups of shareholders being entitled to appoint and remove directors with provision for arbitration if there is a deadlock between directors and subsequently shareholders.

3. A closely held company constitution suitable for a family situation, or two or more shareholders who wish to come together and operate the company.

Investment structure

Sometimes the share structure may be used to establish different classes of shares and give the investors in those shares preferential rights. Preference shares may carry an automatic dividend of 10% pa, or have rights entitling the holders to convert the shares into ordinary shares at some time in the future at a specified price, or a price based on a formula.

Employment contracts

For a general overview on the Employment Contracts Act we refer you to the paper "***Employment Contracts***".

Forming a company

If you wish to form a company please complete and return the attached form.

Name of proposed company 1st choice: _____ 2nd choice: _____		<i>Solicitors</i> <i>PO Box 25-239</i> <i>ST HELIERS</i>		
Full name		Residential address		
			No of shares	Class of shares
		IRD No		
Address of registered office:		Postal address to which communications from Registrar may be sent:		
Address for service:		Auditor: <i>No/Yes</i>		
Proposed company balance date:		Name and contact details of accountant:		
Authorised signatories on bank account: <i>Sole/Joint</i>		Bank and branch account to be opened with:		
Do you have any particular requirements for the company constitution or require different classes of shares?				

Signature: _____

Shareholders/Directors

Date: _____