SMALL BUSINESSES — IS THERE A NEED FOR A NEW LEGAL STRUCTURE?

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I. Introduction

Much has been written in recent years about the importance of the small business to the economic well-being of a country and problems associated with existing legal structures. It has frequently been suggested that a new form of organisation would be appropriate and such reform has occurred in some jurisdictions, e.g. South Africa.

In England in 1981, the government published its Green Paper "A New Form of Incorporation for Small Firms"[1] with an Annex by Professor L. C. B. Gower. These proposals were well received in some quarters,[2] but it is still uncertain whether the reforms will materialise. In Australia in 1984, the Companies and Securities Law Review Committee published its Discussion Paper Number 1 entitled "Forms of Legal Organisation for Small Business Enterprises" and invited responses to the issues raised in the paper. The Committee's views and recommendations were published in September 1985 in their "Report to the Ministerial Council on Forms of Legal Organisation for Small Business Enterprises". The major recommendation of the Committee was the introduction of a close corporation and the abolition of the exempt proprietary company.

In New Zealand in 1973, the Macarthur Committee considered the Kommandit type of company (known to German and French law) but concluded that the present form of private company is well suited to the small family business.[3] The main object of this article is to consider in the light of overseas experience whether that view is still valid.

A. *Defining the Small Business*

The terms "small business" and "small firm" are not legal definitions, nor can they be analysed by reference to a single legal structure. The United Kingdom Bolton Report defined a small firm as follows:[4]

> Firstly, in economic terms a small firm is one that has a relatively small share of its market. Secondly, an essential characteristic of a small firm is that it is managed by its owners or part-owners in a personalised way and not through the medium of a formalised management structure. Thirdly, it is also independent in the sense that it does not form part of a larger enterprise and that the owner-managers should be free from outside control in taking their principal decisions.

The Development Finance Corporation's Small Business Agency defines small businesses as those which employ fewer than 50 people in the manufacturing sector, 25 in the wholesale and retail sector and 10 in the service sector.[5]

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[1] *A New Form of Incorporation for Small Firms — A Consultative Document* (1981; Cmnd. 8171).

[2] See the editorial, (1982) 3 Co Law 2.

[3] Macarthur Report, para. 459-460.

[4] Report of the Committee of Inquiry on Small Firms (1971; Cmnd 4811).

[5] Small Business Agency, Annual Report, Wellington, 1979.

The New Zealand Planning Council in its report "Self-Employment and Small Business" considered that these size definitions are appropriate in New Zealand where most businesses are small.[6] The small business has been defined according to the characteristics of particular sectors of industry. Presumably there is substantial overlap between the small business and the family business.

The Australian Companies and Securities Law Review Committee in its Report examined the task of describing the small business conceptually and concluded that it was not possible to develop a suitable and workable definition.[7]

Regardless of what definition is adopted it has no legal equivalent — there is no separate legal structure. As a result, "problems typical for small firms often receive unpredictable and arbitrary treatment from the law".[8]

B *Existing Legal Structures*

As the law stands the proprietors of a small business may choose between a number of different legal structures — the commonest being the private limited company.[9] The other main types of business organisation are:

(a) the one-man unincorporated business, and
(b) the partnership, of which there are two types:
(i) the general partnership, and
(ii) the special partnership.

Basically, the small firm is faced with two alternatives — remaining unincorporated or becoming incorporated and each has its advantages and disadvantages. In this article it is proposed to consider the arguments for and against the present form of private company for the small business, problems associated with the other forms, and to consider the alternative forms that have been proposed.

Taxation of profits is one of the major factors in deciding the appropriate structure. However, that is a subject in its own right and is beyond the scope of this article.

A number of different types of company is provided for under the Companies Act 1955. The form considered here is the private limited company as it is the only type likely to be considered by the small business. There is now also provision for a private unlimited company which was introduced by the Companies Amendment Act (No.2) 1983. However, the small business is unlikely to see any advantage in trading as an unlimited company.

C *Advantages of Incorporation under the Companies Act 1955*

The major advantages of incorporating are limited liablility and the ability to give a floating charge over stock in trade and book debts. However, mere incorporation will not always make the obtaining of finance any easier, and in practice the lending institution is as likely as not to require personal guarantees from the principal shareholders or directors, in addition to any security for advances over the company's property. In practice, therefore, the advantage of limited liability is circumscribed. Limited liability can usually

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[6] "Self-Employment and Small Business", New Zealand Planning Council, Planning Paper No. 22, Feb. 1985, p. 7.

[7] Companies and Securities Law Review Committee Report to the Ministerial Council on Forms of Legal Organisation for Small Business Enterprises, September 1985, para 26–27.

[8] Chesterman, *Small Businesses* (2nd ed. London, 1982), p.8.

[9] Macarthur Report, para. 450.

[10] Ibid; para. 453.

be asserted only against comparatively small, short-term creditors and involuntary creditors such as a claimant in tort but not against financial institutions. There are other advantages[10] which flow from incorporation — among which may be mentioned:

(a) Protection of a business name. The Macarthur Report noted that in New Zealand private companies are sometimes formed for the sole purpose of protecting a business or a firm's name.[11] In various Australian states there is a system of business name registration. The Macarthur Committee recommended a study be undertaken with a view to the adoption of a similar system of registration in New Zealand. In England the Business Names Act 1985 is now in force. It comprises a mere eight sections (previously found in the Companies Act 1981), on the names under which businesses may be carried on in Britain. Under the former law — the Registration of Business Names Act 1916 — a sole proprietor or a partnership had to register the firm's name if it was different from the name or names of the proprietor or partners. This is no longer required.

    A system of business name registration similar to that in force in Australia would be advantageous in New Zealand. A firm could protect its name more simply and registrations under the Companies Act would decrease.

(b) Continuity of ownership of all forms of property.

(c) Facility of transfer of shares, including the introduction of additional shareholders.

(d) Perpetual succession.

(e) Ability of working directors to be classified as employees.

D *Disadvantages*

The most obvious disadvantage is that incorporation involves certain formalities with a loss of privacy and expense. The expense is a continuing expense as companies must comply with filing documents or notifications under the Companies Act 1955 within the specified time limits. A private limited company is given special privileges and immunities[12] by the Act, yet despite this it can be argued it is too restrictive. It is an offence not to comply with certain statutory obligations, e.g. every company must lodge an annual return. Non-exempt private companies[13] are in addition, required to annex to their annual return a copy of the balance sheet and auditor's report unless they have been registered solely to protect a name, in which case they may be granted exemptions under the Act in this respect.

The Companies Act 1955 contains a large number of provisions which impose liability on officers who are in default.[14] Where a section provides that the company and every officer who is in default shall be liable to a default fine this represents a daily figure. A recent case, *Evans* v *Wilfred Paull Holdings Ltd.*[15], illustrates the seriousness of such non-compliance. The Registrar of Companies laid three informations against Wilfred Paull Holdings Ltd. for failing to file an annual return for the years 1979, 1980 and 1981. The company pleaded guilty and was fined $100 on each charge. The Registrar

[11] Ibid; para. 82.

[12] See the Ninth Schedule, Companies Act 1955 which is headed 'Provisions which do not apply to Private Companies'.

[13] The term "non-exempt" is defined in s. 354 (3B).

[14] Defined in s 463 (2).

[15] (1985) 2 N.Z.C.L.C. 99, 342.

appealed by way of case stated. The grounds were that in terms of the maximum penalty provided by section 463 the penalty imposed was manifestly inadequate and that penalty was not based upon a daily rate in accordance with section 463. The issue was whether the correct method of calculation was on a per diem basis or a global basis.

It was held that the correct formula in respect of each information is to fix the appropriate daily rate, multiply it by the appropriate number of days, arrive at the total fine and make such adjustment as the Court considers proper in terms of section 45 of the Criminal Justice Act in relation to the ability to pay. Calculated in this way the potential maximum fine came to $155,560. A rehearing of each information was ordered de novo.

In recent years considerable emphasis has been given to the responsibilities and duties of officers of the company. Their duties were widened considerably by the Companies Amendment Act 1980. These provisions may seem severe but any officer (which in terms of section 2 includes a director, manager or secretary) who is reasonably conscientious should have no cause for concern. In a number of instances officers can be personally liable without limitation for the debts or obligations of the company. It is essential for any officer to be familiar with his obligations under the Act.

The obligations imposed on a company are rules for the maintenance and disclosure of information and the company's internal organisation. Many of these rules may seem unnecessary in the case of a small family business, e.g. the distinction between directors and shareholders. However it is apparent from the case law that in the case of the incorporated small business the courts may be prepared to by-pass strict formalities.[16] In *Coupe* v *J.M. Coupe Publishing Ltd.*[17] it was submitted that resolutions increasing capital in accordance with section 362(3) were invalid as they were not signed by agents "authorised in writing". The Court of Appeal in dismissing the appellant's move to amend the list of contributories stated:

> Section 362 affords a means by which a private company under Part VIII of the Act may pass resolutions without the necessity of calling a general meeting for the purpose. In that context it is the reality of the assent of a member which is important and the requirement that an agent be authorised in writing is directory rather than mandatory.

Another major disadvantage is the inability to invite the public to take up shares in the company, thus restricting the sources of funds available. However, a private company can issue a prospectus in respect of debt or participatory securities under the Securities Act 1978. Companies are also subject to technical rules restricting the range of their activities, e.g. the ultra vires rule (although this now has limited application as a result of the Companies Amendment Act (No. 2) 1983), legal restraints on the application of corporate assets in repayment of capital, payment of dividends out of capital, and in financing the purchase of shares.[18] The number of members is limited to not more than twenty-five and not less than two.[19]

E. *Sole Trader*

The one man unincorporated business is the simplest type of business to

[16] See the discussion in Farrar and Russell, *Company Law and Securities Regulation in New Zealand*, 328–329

[17] (1981) 1 N.Z.C.L.C. 95–014.

[18] Section 62, Companies Act 1955

[19] Sections 356 and 361, Companies Act 1955.

set up. The only law applicable is the law which applies to any individual in his personal financial affairs, including the law of insolvency. The 1974 amendment to the Chattels Transfer Act 1924[20] enables an individual trader to give a security over both his present and future stock-in-trade which approximates to a floating charge.

F. *Partnerships*

Partnership, in the words of section 4 (1) of the Partnership Act 1908[21] is the relation which subsists between persons carrying on business in common with a view to profit. The relationship referred to is contractual and the contract may be express or implied. A partnership can be formed without legal formality. Partnerships are not, in New Zealand, required to register the firm's name or establishment — nor are they required to disclose information on their accounts or their membership. However, they are subject to a number of limitations in that the partners do not enjoy limited liability and the partnership is not recognised as a separate legal entity. The partners are jointly and severally liable for the debts of the partnership without limitation.

Difficulties arise because of the lack of legal personality e.g. when changes in the composition constitute a dissolution thereby technically terminating employees' contracts of employment. The main disadvantages follow from the fact that a partnership is not a separate entity e.g. inability to hold land in the partnership name and the inability to grant a floating charge.

Partnerships, like the private limited company, are subject to a limitation of numbers, the maximum being twenty five, by section 456(1)(a) of the Companies Act 1955. This is less than the size definition of the small firm adopted by the Development Finance Corporation's Small Business Agency. The Companies Act recognises that certain professions should be exempted as the rules of their professional bodies forbid incorporation — in such a case the maximum number is fifty. [22] Accordingly, professional partnerships can grow beyond the "small firm".

G. *Special Partnerships*

Special partnerships, which are similar to limited partnerships under the Limited Partnerships Act 1907 (U.K.), are governed by Part II of the Partnership Act 1908. Lindley described the purpose of the legislation as follows:[23]

> The policy of the Act is to permit the free association of partners, within the limit of numbers mentioned in the Act, upon the terms that the liability of the partners (in the Act called "limited partners") shall be limited to the amount contributed by them in cash or property at the inception of the partnership; but it is essential to every such partnership that the liability of one at least of the partners (in the Act called a "general partner") should be unlimited.

The general partners are in effect managing partners and remain fully liable

[20] See s. 26(1)(d) inserted by No. 70 of 1974, s. 3(1)

[21] The New Zealand Partnership Act closely follows the United Kingdom Partnership Act 1890.

[22] The maximum number for chartered accountants is 120 — see s. 34A of the New Zealand Society of Accountants Act 1958 (as inserted by s.2 of the New Zealand Society of Accountants Amendment Act 1974). The maximum number for architects is 50 — see regulation 2, S.R. 1972/81. The maximum number for solicitors is 50. See the Partnership (Law Practitioners) Order 1982. In Australia the maximum size for law partnerships has been increased from 100 to 200.

[23] *Lindley on Partnership* (15th ed.) 929.

for the firm's debts. The special partners' liability is restricted to their capital contribution. Special partners lose their protection if they participate in the management of the business; they are enforced sleeping partners. Special partners do not enjoy freedom to withdraw their capital as they please.

The special partnership runs for a fixed term up to seven years and has stipulated formalities relating to registration and advertising.

In recent years special partnerships have become increasingly popular in New Zealand for high risk capital intensive business ventures where relatively large numbers of investors delegate management. As a result legal uncertainties surrounding them have been highlighted.[24]

The questions raised relate to the number of members allowed and whether new partners can be added or substituted. Section 49 states:

> Special partnerships may be formed for the transaction of agricultural, mining, mercantile, mechanical, manufacturing, or other business by any number of persons, upon the terms and subject to the conditions and liabilities hereinafter prescribed:
> Provided that nothing herein shall authorise any such partnership for the purpose either of banking or insurance.

As mentioned earlier, by section 456(1) of the Companies Act a partnership may not have more than twenty-five members. However, this is not the case if the partnership is formed "in pursuance of some other Act of the General Assembly".

The question to be determined is whether a special partnership is formed in pursuance of some other Act. Webb and Webb[25] in discussing this difficulty consider that a special partnership may consist of more than twenty-five members. They consider that historical reasons suggest that this may well be so, provided that there are not more than twenty-five general partners. The United Kingdom legislation specifically states that limited partnerships must in general not consist of more than twenty persons.[26] The position in New Zealand is not clear-cut — it can be argued that section 456 does not extend to special partnerships.

The English statute specifically contemplates changes in the partnership and provides [27] that upon any change the partners must lodge a statement with the Registrar specifying the nature of the change within seven days. Failure to do so means the general partners are liable to a daily default fine. Lindley[28] argues that so long as the default continues the limited partnership is deemed to be a general partnership. The New Zealand statute is silent as to any changes — it could be argued that it is necessary to register a dissolution and form a new special partnership. These uncertainties could create practical difficulties and need legislative clarification.

The major disadvantage is the prohibition contained in sections 52 and 53 of the Partnership Act against a special partner transacting partnership business.

A normal arrangement with special partnerships is for the general partner to be a private company under the Companies Act 1955. There is nothing

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[24] See the Accountants Journal vol. 6 no. 7, August 1982, 274–278, and the National Business Review, vol. 16 no. 15, 19.

[25] Webb and Webb, *Principles of the Law of Partnership*, (3rd ed.) para. 190.

[26] Limited Partnerships Act section 4 (2).

[27] Ibid; s.9.

[28] *Lindley on Partnership* (15th ed.) 94

in particular to prevent a limited liability company becoming a general partner in a limited partnership especially with the modification of the ultra vires rule. Section 4(4) of the Limited Partnerships Act 1907 (U.K.) provides that a body corporate may be a limited partner. There is no similar provision in New Zealand but nor is there any prohibition against a limited liability company being a general partner. Lindley[29] considers there is no reason to suppose that a limited company cannot be a general partner. This was not the view expressed by Kennan D. C. J. when the question was considered in an unreported judgement of the Western Australian District Court in *Gibbs Bright & Co. Pty. Ltd.* v *Pacind Pty. Ltd.* (15 August 1978). He stated:

> I pause to comment that there is no general principle of law which prevents a body corporate from being a partner with another corporation or with natural persons, so that in a limited partnership a body corporate may be a partner either limited (specifically provided for in section 4(4) of the Act) or general. The Act requires that there be at least one general partner It contemplates, I believe, that the general partner shall be a person of substance and, in the ordinary course of events, able to meet the obligations of the partnership. Of course, if the one general partner is a proprietary limited company the liability of all the partners is limited. That, in my opinion, is quite contrary to public policy and to the spirit of the legislation — even if those dealing with the firm know that it is a limited partnership. But if they do not know that it is a limited partnership the element of risk, which is present in any commercial enterprise, becomes immeasurably greater because the true nature of the risk is concealed.

Despite the increase in special partnerships in New Zealand they have not been utilised by the small family business. The special partnership would seem to offer the advantage of limited liability and the simplicity of partnership.

II Suggested New Form Of Incorporation

Chesterman[30] advocates that if there is to be reform it should be to reduce the structures available thereby minimising the time and expense involved in establishing a new firm. There should not be a proliferation of legal structures. Hadden[31] also advocates reduction of structures and suggests a unified effect. Such a result could be achieved in New Zealand e.g. by reform of the Partnership Act 1908 or the Companies Act 1955. The starting point of a new structure must be the membership — how is it to be restricted — by numbers or capital? Can corporations (as is the case with special partnerships) be members of the new structure?

The best-known proposal is that of Professor Gower, published as Annex A of the 1981 Green Paper, "A New Form of Incorporation for Small Firms".[32] Professor Gower proposes membership of his incorporated limited firm to be between two and ten — members being designated "business directors". The firms are restricted to those concerns in which there is unlikely to be a separation between membership and control and in which it is possible to maintain the mutual trust and confidence between partners. Offering

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[29] Ibid., p 935.

[30] Supra, p.261, n.8.

[31] Hadden, *Company Law and Capitalism*, (2nd. ed) 222–230.

[32] See too Hadden, ibid., n.31; Lowe, *The Incorporated Limited Firm* (Jordan 1976); Sandars, "Small Businesses — Suggestions for Simplified Forms of Incorporations" [1979] J.B.L. 14; The Australian Companies and Securities Law Review Committee, Discussion Paper No. 1, Forms of Legal Organisation for Small Business Enterprises, 1984; The Australian Companies and Securities Law Review Committee, Report to the Ministerial Council on Forms of Legal Organisation for Small Business Enterprises, September, 1985; and Naude, "The Need for a new Legal Form for Small Businesses" (1982) 4 Modern Business Law 5–13.

securities to the public is forbidden and it is suggested that full financial disclosure should be made once they fail to meet the criteria for small private companies.[33] The other features he proposes are:

1. *Registration* The firm would become registered by registering with the Registrar of Companies certain simple requirements. Public notification of the fact that its members enjoyed limited liability would be indicated by a suffix to the firm's name.
2. *Internal relations* The firm would operate largely according to partnership principles. However, it would be accorded corporate status, thereby solving many of the problems associated with a partnership under the Partnership Act. The rules in section 24 of the Partnership Act, the equivalent of section 27 of the New Zealand statue, would apply. It would not be possible to contract out of the following rules:
   (a) that every member shall be entitled to take part in the management, and
   (b) that ordinary matters shall be determined by a majority but that unanimity is required for a change in business.

   Dissolution would not be automatic on death or retirement. On death or retirement the firm would have a first option to purchase that member's share at valuation. If not purchased by the firm, the members would have a similar option to buy. Winding-up provisions would be similar to partnership provisions and a remedy analagous to section 75 of the former Companies Act 1980 (U.K.), (the New Zealand equivalent is section 209 of the Companies Act 1955), is envisaged. All changes of registered particulars would be notified to the Registrar. Firms would be required to file a simple annual return and a certificate from an auditor that the firm was solvent. Failure to comply would mean members would be liable without limitation for any obligations incurred while the default continued.
3. *External relations — general* Members would possess the same degree of authority as partners do pursuant to section 5 (in New Zealand, section 8) of the Partnership Act. The firm name should be accurately stated on business documents; if not, personal liability would result. A firm could give a floating charge as security for a loan.
4. *External relations — safeguards against limited liability* Professor Gower rejects the idea that there should be a minimum share capital. The members should be entitled to draw remuneration from capital as well as from profits provided the firm remains solvent.

Disclosure would be similar to that for "small" companies under the Companies Act 1985 (U.K.). A more important aspect to be disclosed is the solvency of the firm. If the assets were insufficient to pay the firm's outside creditors the members would be liable to contribute

(a) a prescribed amount (there is no suggestion as to how the prescribed amount is to be ascertained) plus

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[33] To be classified as a small company under the English Companies Act 1985 a company must be a private company not belonging to a group which contains a public company and must satisfy two of the following:

(a) its turnover is not more than £1,400,000

(b) its balance sheet total (i.e. the book value of its assets, in effect) is not more than £700,000.

(c) the average number of its employees is not more than fifty.

(b) the amount of all money or other property withdrawn by them or transferred to their spouse or to any other person without full consideration within the preceding two years unless immediately after the withdrawal or transfer the firm could have been shown to have been still solvent.

Former members who left within a year would also be called on to contribute unless they could establish solvency at the time of withdrawal. Similar provisions as to fraudulent or reckless trading under the Companies Act should apply.

The Standing Committee on Company Law of the Law Society of England and Wales, in its memorandum on the Green Paper[34], considered Professor Gower's model and the other proposal raised — the incorporated unlimited partnership.

The Law Society was strongly in favour of provision being made for incorporation without limited liability on the ground that a partnership should be able to become a separate legal entity. It sees this option as being of value to the professions. However it was noted that if acceptance was to be gained by the business community it would be essential to have the advantage of limited liability. Incorporation with unlimited liability involving the minimum of disclosure and administrative obligations would certainly be beneficial to professional bodies but not the small business.

The Committee listed a number of characteristics such an unlimited company might possess. Incorporation would be available to the one-man business. The number of members would not be limited. However, a limited company could not be a member.

The right to participate in management would be enjoyed by all its members unless there were agreement to the contrary. Internal relations would be a matter for agreement. It would not be necessary to file accounts. A public register of firms would be kept to maintain control over names, but only minimal information would be recorded. The fact of incorporation with unlimited liability would be evidenced by a suitable suffix. A firm would be capable of creating floating charges. All charges would be registered in a register open to public inspection.

There is a demand in New Zealand for such a structure for professional partnerships. At present work is proceeding on a draft of amendments which would be required to the Law Practitioners Act, to allow legal practices to incorporate as private companies with unlimited liability as provided for in the Companies Amendment Act (No.2) 1983. This would be beneficial to legal practices. However, there still are the administrative and disclosure obligations required by the Companies Act, and membership is limited to twenty-five.

The English Law Society's Committee considers that there is no demand for a new form of limited liability incorporation. It considers that if introduced, it would succeed only if incorporation under the Companies Act was made less attractive. Instead it prefers a relaxation of the requirements of the Companies Act. This supports the idea that there should not be a proliferation of legal structures. At present the small business has a choice of sole proprietorship, partnership and the private limited company and frequently the factors are often fairly evenly balanced. The committee favours the extension of the concept of reducing the accounting and disclosure requirements of companies which fulfil criteria which are governed by the

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[34] (1982) 79 L S. Gaz. 166-167.

size of the company rather than its structure. Further modifications suggested are:

(a) simplified articles which would allow for the conduct of internal matters to be dealt with by general agreement,

(b) a simplified form of annual return,

(c) a relaxation of the amount of information to be contained in the accounts,

(d) the filing of an abridgement of the accounts, and

(e) incorporation being available to the "one-man" company under the existing Companies Act and under any new form of incorporation.

If a new form of incorporation were to be introduced there would be a period of educating the public and marketing the product. The English Law Society's Committee considers it would be essential to make incorporation under the Companies Act less attractive. This would be the case if the new structure were to exist side by side rather than be a substitute for the private limited company.

Likewise, Wooldridge[35] in responding to the Gower proposals considers that there is no need for a completely new structure. He also advocates either alterations in the present law governing private companies (e.g. simplified articles whereby such matters as the conduct of directors' meetings were decided by private agreement) or making the limited partnership more attractive by allowing all partners to participate in management.

The Australian Companies and Securities Law Review Committee was given a general reference from the Ministerial Council to enquire into and review the question of the use of the corporate form. In its Discussion Paper[36] the Committee considered and dismissed the following schemes or proposals:

(a) The American close corporation. The Committee noted that "in the Australian context the objectives of this close corporation legislation can be better achieved by adapting the provisions of partnership legislation to a new form of incorporated partnership company".

(b) The Scottish model of the partnership with a degree of limited liability. This was rejected on the basis of liability of members for partnership debts and the concept of qualified legal personality. It was also regarded as an unsatisfactory model by the English Law Society's Committee.

(c) Gower's incorporated firm was considered inappropriate on a number of counts, namely the unalterable entitlement of participation, and the inability to vary voting majorities concerning ordinary matters (simple majority) and changes in the nature of the business (unanimity).

Another unsatisfactory feature was the solvency aspect whereby, if an incorporated partnership were wound up and unable to pay its debts, each member is under a legal obligation to meet those outstanding liabilities up to a prescribed amount, being a fixed amount per member or a total amount for the firm with each member jointly and severally liable.

(d) The Small Enterprise Incorporation Act proposed by the Company Directors' Association envisaged the creation of an incorporated partnership with two persons subject to unlimited liability. The Committee considered it is more desirable to have limited liability at the outset even if it is defeasible through a finding by the court of fraud, recklessness or negligence in management.

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[35] "A New Form of Incorporation — Responding to the Gower Proposals" (1982) 3 Co. Law 58–66.

[36] See Ch. 2, n.2.

Professor Baxt in his commentary on the Discussion Paper[37] questions why it is not possible to simplify the company law rules rather than try to create a new form of entity.

The Report of the Companies and Securities Law Review Committee to the Ministerial Council on Forms of Legal Organisation for Small Business Enterprises recommends the abolition of the exempt proprietary company for future incorporations and its replacement with a new form of corporate entity to be known as a close corporation. The Report recommends adoption of the principle of limited liability. However, in certain circumstances, the interests of creditors and the general public would be protected by the imposition of unlimited personal liability on members of an insolvent close corporation.

It is proposed that the minimum membership be one person. Membership is to be confined to natural persons, the maximum number being ten. Any increase in membership of a close corporation above the maximum constitutes a ground for winding up. The Committee rejected any eligibility criteria involving financial considerations or satisfaction of a "small business" definition. Each member will have an interest expressed as a percentange of the total equity interest in the close corporation. There is to be no minimum capital requirement.

Registration is to be achieved by lodging a "founding statement" with the Commission stating the following particulars:

(i) the full name of the corporation
(ii) the address of the corporation
(iii) the full name and date and place of birth of each member and particulars of the accounting officer.

Any changes must be notified within a specified time.

The rights and duties of the members to each other are to be determined by partnership principles. These provisions may be altered or extended by means of a written association agreement or any other agreement express or implied provided it is not inconsistent with any provision of a written association agreement. However, the agreement would not be a public document and could not alter the agency rules applicable to close corporations.

A further recommendation is that members be subject to a series of fiduciary duties and obligations drawn from relevant partnership law principles and the companies code. It is also recommended that the external relations of close corporations be regulated by common law agency rules as adapted from the partnership legislation.

A major advantage of the close corporation will be the reduction in disclosure, thereby reducing costs. There is no requirement that close corporations disclose their actual paid up capital. Nor do they need to have accounts audited or file an annual return.

The protection of limited liability is reduced in three circumstances. The circumstances when personal liability will be imposed in the event of insolvency are as follows:

(a) a provision adopting the principle underlying sections 556(1) and 557 of the Companies Code which refer to the reckless incurring of debts and fradulent conduct,
(b) compensation to the corporation for assets improperly disposed of, and

[37] (1984) 2 C. & S.L.J. 248-249.

(c) imposition of unlimited liability on members who unduly delay terminating the activities of an insolvent close corporation.

It is also recommended that the legislation include specific provisions allowing corporations to:

(i) acquire their own interests,
(ii) provide financial assistance for the purchase of their interests, and
(iii) distribute funds otherwise than pursuant to the law relating to dividends.

The interests of creditors would be protected by solvency and liquidity requirements. Similar provisions are contained in the Ontario Business Corporations Act 1982 (which is to be discussed later in this article).

An interesting recommendation is the liquidators' recovery trust fund. All close corporations would be required to contribute on their being registered and they might also be required to make periodic contributions. The Report notes there was opposition in some submissions to such a fund. Concern was expressed at the administrative costs and that fact that a large number of solvent business would be under an unfair burden in being required to contribute to a fund directed against insolvent operators. Such a fund would certainly be beneficial. It would increase public confidence and assist creditors. It will mean that the affairs of insolvent corporations can be fully investigated.

The Report suffers from the same defects as the discussion paper. A basic problem is that the structure is very limited as there is a prohibition against anyone but natural persons and membership is limited to ten. It is recommended that following enactment of the close corporation legislation, the category of exempt proprietary company be discontinued. Existing exempt proprietary companies may continue to be accorded the benefits of that status during such time as they remain continuously qualified as such companies. No doubt this will give rise to incorporation of an inordinate number of shelf exempt proprietary companies before the date on which they are discontinued as to the future. It is submitted that if the close corporation is to be a true substitute there should be a time scale within which the exempt proprietary company disappears.

If the legislation is implemented, the structures available will be sole trader, partnership, close corporation, non-exempt proprietary company and public company. If there are eleven members and limited liability is desired there is little choice other than a non-exempt proprietary company. Existing exempt proprietary companies will be able to convert to close corporations assuming the size criterion is satisfied. One wonders whether these companies are likely to convert to the new structure. Certainly many recommendations are attractive but the structure is very limited and costs including contributions to the liquidators recovery trust fund will be a decisive factor. The committee notes that the recovery trust fund principles may have useful application to all corporate insolvencies, though in the context of the Report, discussion is confined to close corporations.

Traditionally, New Zealand has followed English company law. However, it is no longer automatically relevant. In the words of Professor Gower:[38]

> The company law of the United Kingdom has ceased to be the model and pace-setter for the common law countries. Even those in the Commonwealth are increasingly influenced by developments in the United States rather than the United Kingdom.
>
> . . . The United Kingdom, having joined the European Economic Community . . . has begun to move away from the Anglo-American group. As a result of the harmonization

[38] Gower, "Whither Company Law?" (1981) U.B.C.L.R. 386

programme embodied in the flood of Common Law Directives which have emerged from or are in the pipeline, we are becoming increasingly influenced by the Franco-German system of our civil law partners.

The Macarthur Report of 1973 has been the basis of recent reforms in company law in New Zealand. The September 1984 issue of the Accountants' Journal quotes the present Minister of Justice, the Hon. Geoffrey Palmer:[39]

> The Companies Act is one of the sad examples of New Zealand law reform. I have cited it as an example of how not to do law reform. The Macarthur Committee Report took years to produce and when it was finally produced it took even a further number of years to implement. By the time some of it was implemented it was already out of date. It tended to be done on a piece-meal basis. I really believe the time has come for a modern corporation statute which contains all the necessary elements without all the prolixity and tendentious detail.

The Minister cites as a model the Ontario Business Corporations Act which is influenced by American legislation.

To mention a few of the features of this Act[40]: incorporation is by a simple document, namely, the articles of incorporation. It is not necessary to register objects, but the articles may set out any restrictions on the business that the corporation may carry on. The Act authorizes a floating number of directors, but the minimum and maximum may be stipulated and altered subsequently.

There is a basic distinction between corporation which offer their securities to the public and a non-offering corporation (equivalent in New Zealand to public and private companies).

A non-offering corporation can have one member and one director. It is exempt from the audit requirements of the Act if all shareholders consent and if its assets do not exceed $2,500,000 or its sales $5,000,000 or if it has been exempted by the Director of the Companies Division following application and hearing. In addition, the non-offering corporation is granted other privileges e.g. redemption of shares of deceased or retired members.

The Act does not provide for authorized capital as such. The articles include the classes and maximum number of shares that the corporation is authorized to issue. If no maximum is stipulated, the corporation will have an unlimited number of shares. All shares must be without nominal or par value. Restrictions can be made on transferability and ownership of shares. The Act refers to "stated" capital rather than "issued" or "paid-up" capital. The "stated capital" together with the notion of "realizable value of assets" is essential in determining whether certain transactions are legal, namely:

(i) giving financial assistance to shareholders and others,
(ii) the acquisition by a corporation of its issued shares or warrants,
(iii) the declaration of dividends, and
(iv) the amalgamation of the corporation.

The Act permits shareholder participation in decisions relating to the business and affairs of the corporation. It recognizes the rights of shareholders to make proposals, including nominations for the election of directors, and sets out the corporation's responsibilities with respect to such proposals.

In America in 1982, the Statutory Close Corporation Supplement to the

[39] At p.344

[40] See Wasserman, "A New Business Corporations Act for Ontario" (1983) 116 C.A. Magazine 9, 42 47, and (1983) 8 Can. Bus L.J. 212 213.

Model Business Corporation Act was adopted.[41] That statute also makes provision for shareholder agreements. Section 11(a) authorizes shareholders to enter into one or more written arrangements to regulate the business of the corporation or their relationship to one another. A corporation can in effect function as a partnership. The comment to section 11 states:[42]

> Close corporations where most or all the shareholders are executive employees of the corporation are often referred to as "incorporate partnerships". This section gives legal sanction to the special needs of the shareholders of such corporations. Section 17 reinforces this concept by providing that shareholder limited liability will be recognized in spite of any such agreement.

Section 10 authorizes a statutory close corporation to operate without a board of directors. Any agreement must be unanimous and in writing. The statute merely validates any arrangement. Ribbens[43] considers the ideal statute would go further still:

> It would identify an inter sese partnership arrangement as the essential feature of the association and would earmark that arrangement as the operative norm.

The supplement is elective. Any corporation except an existing corporation having more than fifty shareholders is eligible for election. The authors state that "it is doubtful that a corporation that has a substantial number of shareholders or that has made a public offering will want to remain as a statutory close corporation, but, if it does, there is no strong public policy reason why it should not be able to do so".[45]

III Conclusion

The legal structures available are not entirely suitable for the small business. Companies legislation does not easily suit a small company in the nature of a partnership and partnership legislation does not provide limited liability. Ribbens emphasises in his series of articles[46] that the true case for an alternative structure does not depend on notions of size. "The true case hinges on the distinction between incorporated partnerships proper, on the one hand, and public-issue and other companies on the other and not on "big" and "small" companies."[47] A new structure would complicate rather than simplify and there would be less flexibility. Any reform must be in the light of the total corporate structure. If New Zealand did adopt an act similar to the Ontario Business Corporations Act 1982 this "would be a dramatic break with tradition" but "tradition by itself should not be a stumbling block".[48] Many

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[41] See the Report of Committee on Corporate Laws, "Proposed Statutory Close Corporation Supplement to the Model Business Corporation Act" (1981) 37 Bus Law 269–311, and the Report of Committee on Corporate Laws, "Statutory Close Corporation Supplement to the Model Business Corporation Act" (1983) 38 Bus Law 1031 1032

[42] 37 Bus. Law at 291.

[43] Ribbens, "Legal Personality and Partnership — Quo Vadis?" (1982) T.S.A.R. 49, 128, 191, (1983) T.S.A R. 118, 201.

[44] (1982) T S A R 200-201

[45] 37 Bus Law at 273.

[46] Supra

[47] (1982) T.S.A R. at 213

[48] See Shapira, "Company Law at the Crossroads" Accountants Journal vol.64 No 3, April 1985, at 36

of the disincentives for adopting the company form would be removed, e.g. the complexity in formation and restraints on purchasing the company's own shares.

The alternative is to make better provision for the small business within the existing structure. This would best be achieved by making adjustments to the Companies Act 1955. Such a solution has been mooted and rejected in South Africa[49] on the basis that the Act would increase in complexity. Naude[50] warns that it would be unwise to make company law rules elective as is the case with the Statutory Close Corporation Supplement in America. However, it is submitted that this is preferable to the proliferation of statutes. Provision could be made in Part VIII of the Companies Act for elective shareholder agreements whereby a company could in effect operate as a partnership.

The private company, which was originally based on the Victorian legislation, was intended to provide partnerships with limited liability.[51] However, the private company form is now used by many types of business. The exempt private company does receive differential treatment under the present Companies Act e.g. concerning the filing of accounts and the appointment of an auditor. Recent amendments have also alleviated the situation. The modification of the ultra vires rule by section 14A means that now the memorandum may state but shall not be required to state the objects of the company.

Further modification of the existing law would ease the situation of the small company. The following areas should be considered for reform:

(a) Incorporation of the "one-man" company should be permissible under the Companies Act. This was recommended in the Macarthur Report.[52]

(b) It would follow that there should be no prohibition against the secretary being the sole director. Accordingly, section 355 should be repealed and related sections e.g. section 354(2) amended.

(c) The situation of the private exempt company could be ameliorated by dispensing with the annual return unless there had been changes in terms of the information required by section 130(2), or if the company is indebted to any person in respect of any deposit or loan to which the Securities Act 1978 applies.

(d) Further administrative burdens would be decreased by amending section 354(3). By that section, the exempt private company need not appoint an auditor if all members pass a resolution to that effect. Such a resolution must be registered under section 147. Section 354(3) could be amended, whereby appointment of an auditor is automatically dispensed with unless it is requisitioned. This, and protection for creditors, would be achieved by retaining a provision similar to section 354(3)(c), which states:

> The Registrar may at any time before the next annual general meeting, if he thinks fit, on the application or with the consent of any member or creditor of the company, or of his own motion appoint an auditor or auditors to hold office until the conclusion of the next annual general meeting.

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[49] See (1983) T.S.A.R. 201, and Naude, "The Need for a new Legal Form for Small Business" (1982) 4 Modern Business Law, 6.

[50] Ibid., p 6.

[51] See the Macarthur Report, para 446

[52] Para. 67.

(e) There is a number of matters relating to share capital where reform would seem appropriate. First, in the case of a company having a share capital, all shares must have a nominal value. This is no indication of their real worth. In England the Gedge Committee recommended that companies should be permitted to issue "no par shares".[53] The Companies Act could be amended to make provision for "no par shares".

A further issue that requires consideration is the fact that pursuant to sections 356(2) and 361 all share capital and increases in share capital must be fully subscribed. The English Companies Act does not contain similar provisions.

In 1981, the United Kingdom legislature introduced reforms whereby companies are permitted to issue shares which are to be redeemed or reacquired by the issuing company in the future.[54] In addition companies can purchase their own shares (including redeemable shares) if they are authorized to do so by their articles. A private company has the further ability to purchase its own shares out of capital in certain circumstances. Such reforms would provide a "new technique for flexible financing of private companies".[55]

(f) The articles of the private company could be simplified to allow internal matters to be governed by private agreement rather than by meetings and resolutions.

The need with the small private company is to confer the advantages of incorporation yet enable it to operate with complete informality. This can be achieved by further reducing the requirements of the private company. The Hon. Geoffrey Palmer has stated that the time is right for a modern corporation statute. If such a statute were to be introduced, the opportunity should be taken to introduce reforms to cater for the special needs of the small business.

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[53] Gedge Committee, *Shares of No Par Value* (1954; Cmd. 9112)

[54] See Pennington, "The Companies Act 1981 (2)" (1982) 3 Co. Law 66.

[55] See Farrar, *Company Law* (London, 1985) 148.