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THE COMPANIES ACT 1993: A PROPOSAL FOR A CONSTITUTION TAILORED TO THE REQUIREMENTS OF THE CLOSELY HELD COMPANY

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ABSTRACT

In this paper the writer proposes to focus on the Closely Held Company ("CHC") and its treatment in New Zealand and in foreign legal jurisdictions.

In particular the paper will examine the position of the CHC under the Companies Act 1955 and under the new Companies Act 1993. There will also be a discussion and analysis of the approach of the courts to this corporate entity.

The paper contains, in Part II, a draft of a Constitution designed to meet the specific needs of the CHC under the new legislation. It is the writer's opinion that a constitution will be one of the foundation incorporation documents of the CHC. The variety and format of these constitutions will depend on the specific circumstances of each CHC. Nevertheless, there will be certain common clauses in all CHC constitutions, because of the nature of the displaceable rules contained in the new Act.

Word Length

The text of this paper (excluding contents page, footnotes and bibliography) comprises approximately 12,000 words.

INTRODUCTION

The Companies Act 1993 ("the Act") is intended, according to its drafter and major proponent, the New Zealand Law Commission, to provide New Zealand with a substantially simplified statute, containing "core" company law governing the incorporation, organisation and termination of Companies.[1] In the view of the Commission:

> "a good system of company law should provide a simple and cheap method of incorporation and company organisation which is flexible enough to meet the needs of diverse organisations.[2]

The focus of this paper is the Closely Held Company ("CHC") and the likely impact of the Act on this common corporate entity.

The paper is divided into two parts. In part I the writer, presents an overview of the CHC and proposes to demonstrate that the Act, does not provide a statutory regime flexible enough to meet the specific needs of the CHC.

In Part II, the paper contains a draft constitution designed to meet the needs of the CHC, to the extent permissible by the displaceable provisions of the Act.

In particular, Part I of the paper will:

(i) define the nature and common characteristics of the CHC.,

(ii) identify the needs that are specific to the CHC

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[1]Law Commission (NZ) Company Law Reform and Restatement Report No. 9 1989 Government Printing Office, Wellington. pp283

[2]Ibid, page 4

because of the nature of the entity.,

(iii) provide a brief overview of the position of the CHC under the Companies Act 1955 ("the 1955 Act") and at common law.,

(iv) for comparison purposes, examine the legislative approach taken in respect of the CHC in selected foreign jurisdictions.,

(v) discuss the rationale for the abolition of the distinction drawn in the 1955 Act between public and private companies.,

(vi) outline the mechanics of incorporation and reincorporation under the Act and analyse the requirements of Part IV of the Act which relate to the filing, or adoption of a constitution by a company.,

(vii) examine one example of a non-displaceable provision in the Act and its likely effect on the CHC.,

(viii) examine a number of the displaceable provisions in the Act and examine which of those the CHC may choose to opt out of by constitution.

In Part II, the paper contains a draft CHC constitution cross referenced to sections in the Act. Where appropriate the relevant constitutional clauses will be accompanied by commentary and analysis to illustrate the relevance of the clause in meeting the specific requirements of the CHC.

PART I

THE CLOSLEY HELD COMPANY - AN OVERVIEW

1. COMMON CHARACTERISTICS OF THE CHC

Commentators have identified a number of distinctive features common to the CHC. These include:

(i) A small number of shareholders.,

(ii) Those shareholders are usually also the company's directors and are involved in the day to day running of the business.,

(iii) The company does not raise capital by inviting the public to subscribe for its shares and its shares are not listed or traded on the share market.,

(iv) There are restrictions placed on the transfer of shares outside of a limited group of people.,

(v) The shareholders often derive their principal income from the business of the company and much of their personal wealth is invested in the company.,

Most CHC's are little more than incorporated partnerships. The typical CHC generally operates on an informal basis where flexibility in management, control over who can hold shares and over fundamental change are essential features, that protect the interests of each member.

By way of contrast the large public company which has shares listed on the Stock Exchange has its own distinctive features. These features include; separation of ownership and control and the provision of a ready market for the publics' investment capital.

2. REQUIREMENTS SPECIFIC TO THE CHC

Those features listed above that distinguish the CHC from other larger corporate entities also give rise to a set of specific operational requirements. These operational requirements are essential to the efficient functioning of the CHC.

These operational requirements include the following:

(i) the requirement that day to day management decisions can be made with flexibility and informality without the need for unnecessary checks and controls being placed on such decisions by legislation.,

(ii) the requirement that the members of the CHC should be able to exercise control over the transfer of shares in the company to outside interests, of whom they do not approve.,

(iii) the requirement that the members of the CHC should be able to prevent fundamental change in the business enterprise or corporate structure unless their is majority consensus or in many cases total unanimity amongst shareholders.,

(iv) the requirement that the shareholders (whom will often have contributed much of their personal wealth to the enterprise) can realise that investment even though there may not be a ready market for the shares in the company.

The requirements set out above are among the most important concerns facing the members of a CHC. Where the Bill does

not specifically meet these requirements then, as the Law Commission has stated:

> "the presumptions of the draft Act can explicitly be replaced by the constitution of the particular company".

The validity of this statement will be analysed in the course of this paper. The writer proposes to draw a sustainable conclusion with respect to the adequacy of the Law Commission's approach to the CHC.

3. PRIVATE/PUBLIC COMPANY DISTINCTION UNDER THE 1955 ACT

The closest that the CHC came to having a kind of statutory recognition in New Zealand was the distinction drawn, in the 1955 Act, between the private and public company.

A. PRIVATE COMPANIES UNDER THE 1955 ACT

The 1955 Act specifically defined[3] and provided for the incorporation of a private company.[4] The term public company, whilst not specifically defined, is by clear implication one incorporated under the 1955 Act which does not meet the criteria to be a private company under the same. The 1955 Act places significantly lesser obligations on the private company and correspondingly much greater statutory control on the public company.

The main rationale for the 1955 Act imposing greater statutory controls on the public company is a perceived and actual need to protect the public investor. One company

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[3]Companies Act 1955 s.2(1).

[4]Ibid Part VIII

text states that:

> "the directors of public companies are very much in the position of trustees managing other people's (ie the public's) funds through a Corporate structure"[5]

By contrast, the private company was often no more than an incorporated partnership where usually only a limited number of shareholders and creditors were exposed to potential loss.

Notwithstanding the contrast in size between the majority of private companies and the large publicly listed company, the economic importance of the former cannot be ignored. Approximately 95% of all companies incorporated in New Zealand are private companies. While, not all of these are necessarily closely held in the true sense of that term, this statistic alone, makes a good case for separate legislation for the CHC.

There were considerably fewer statutory controls placed on a private company under the 1955 Act. Sections 353 and 365 contained in Part VIII of that Act both defined what constituted a private company and set out a number of requirements of specific application to private companies only. These requirements included the following:

(i) The maximum number of persons forming a private company could not exceed 25.,[6]

(ii) The minimum number of persons required to form a private company was two and the company needed

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[5]Beck and Barrowdale, Guidebook to New Zealand Companies and Securities Law (CCH, Auckland 1990) at page 11

[6]Above N.3, s.253

at least one director.,[7]

(iii) Unless it was a non-exempt private company[8] the company was not required to file a balance sheet or auditors report with the Registrar of Companies.,[9]

(iv) Unless it was a subsidiary of a public company or non-exempt, the private company need not appoint an auditor and could pass a unanimous resolution to this effect.,[10]

(v) Notwithstanding (iv) above the Registrar could, at his discretion, require appointment of an auditor to the company upon application being made to him by any member or creditor of the company.,[11]

(vi) A sole director could not also hold office as the secretary of the company.,[12]

(vii) The Memorandum of Association had to state that the company was a private company.[13]

(viii) All of the share capital of a private company had to be subscribed for by the signatories to

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[7]Above N.3, s.354(2)(a)(i)

[8]A non-exempt private company was defined in Section 354(3B) and required to appoint an auditor and file its Balance Sheet

[9]Ibid s.354(2A)

[10]Ibid s.354(3)

[11]Ibid s. 354(3)(c)

[12]Ibid s.355

[13]Ibid s.356(1)

the Memorandum of Association.,[14]

(ix) There were penalties for knowingly allowing the membership of the Company to increase beyond the maximum of 25, although there were exceptions made for employee shareholders.,[15]

(x) The private company was not permitted to issue a prospectus inviting subscription for its shares.,[16]

(xi) Any increase in capital had to be fully subscribed for.,[17]

(xii) The private company could do anything authorised by the 1955 Act by resolution entered in its minute book and passed without the need to call a meeting of the company. The resolution had to be signed by at least 75% of the members holding in aggregate a minimum of 75% of the shares in the company.,[18]

(xiii) The private company did not need to hold an Annual General Meeting, provided it did all that was required by resolution entered in the minute book, within the time prescribed for holding its Annual General Meeting.,[19]

(xiv) On a Winding Up, additional powers were given to

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[14]Ibid s.356(2)

[15]Ibid s.359

[16]Ibid s.360

[17]Ibid s.361

[18]Ibid s.362

[19]Ibid s.362(2)

the court, in respect of the private company, to attribute liability to members for certain acts or omissions.,[20]

(xv) A private company could change its status and make application for re-registration as a public company.[21]

Finally, the ninth schedule set out a list of the provisions of the 1955 Act with no application to the private company.

B. PUBLIC COMPANIES UNDER THE 1955 ACT

The clear intention of the 1955 Act was to exempt the private company from many of the obligations that applied to a public company.

To better evaluate the policy reasons for favouring the private company with these exemptions it is necessary to look at some of the weightier obligations imposed exclusively on the public company by the 1955 Act.

To state the position in simple terms, all sections of the 1955 Act, with the exception of those which relate specifically to the private company distinction,[22] apply or have relevance to the public company.

Specific examples of obligations imposed by the 1955 Act on public companies exclusively, included:

(i) The requirement that the public company that issued a prospectus to the public to subscribe

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[20]Ibid s.364

[21]Ibid s.365

[22]Ibid ss.353 to 365

for its shares, only commence business and exercise borrowing powers when each director of the company, paid to the company the minimum subscription value of their own shares, such payment to be equal to that payable by or on offer to the public. The company had to confirm that this requirement had been fulfilled by statutory declaration to the Registrar before the company would be issued with a certificate authorising it to commence business.[23] By contrast the private company could commence business on the day of its incorporation, although all its shares had to be subscribed for by its members at that date.,

(ii) The requirements that the public company hold a "statutory meeting" in either the second or third months after it became entitled to commence business and to make available a "statutory report" stating inter alia: shares allotted, cash received in respect of shares allotted, details of receipts and payments made, and details of the directors and secretary of the company.,[24]

(iii) The requirement that there be a minimum of seven members and at least two directors.,[25]

(iv) The requirement to hold separate elections for each individual seeking a directorship.,[26]

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[23]Ibid s.117

[24]Ibid s.134

[25]Ibid s.180

[26]Ibid s.186

(v) The requirement to file its Balance Sheet with the Registrar.,[27]

(vi) The requirement that it hold an annual general meeting.,[28]

(vii) The requirement that an auditor had to be appointed.[29]

It can be seen from the brief summary above, that many of the requirements to which the public company was exclusively subject placed an emphasis on accounting and disclosure. The rationale of the legislature in imposing these strictures on the public company was the desirability of imposing more rigorous accounting and audit requirements to protect the public investor.

C. PRIVATE COMPANY ARTICLES

Most private companies when incorporated, filed Articles of Association. Such articles usually contained a statement that the Regulations in Table A in the Third Schedule to the 1955 Act shall not apply to the company.

As one writer has commented:

> "Table A has been drafted in terms of a large public company where there is a separation of ownership and control, an entity which has very different needs to the closely held corporation".[30]

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[27]Ibid s.133

[28]Ibid s.135

[29]Ibid s.163

[30]Bates R. J. Closely Held Companies and the Companies Bill. Too Close for Comfort? LLM Research Paper 1991 at page 7.

The regulations contained in Table A were not well tailored to meet the requirements of the private company and were therefore usually replaced with the company's own set of Articles.

By way of example, clause 84 of Table A was often modified in the Articles of the private company. Clause 84 related to Section 199 of the 1955 Act, and the requirement that a director declared any interest he may have in a contract or proposed contract with the company.

Clause 84(2) however was seen as quite restrictive to the very small two or three member company, in that it prohibited an interested director from voting or having his vote counted in respect of a contract in which he was interested. If there were only two directors, and one of the directors had to disqualify himself from voting, obvious difficulties arose, since the quorum necessary for the transaction of business could not be met.

The simple answer to the problem was for the private company to take advantage of the right to contract out of the 1955 Act.[31] The Articles registered in substitution for Table A would usually provide:

(i) that the interested director must declare the nature of his interest at the meeting; and

(ii) that notwithstanding such interest the director may vote in respect of any contract in which he is interested.

The need for this modification in the case of the closely held private company is apparent. However, the public company which will often have a large board of directors

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[31]Above N.3, s.22

would still be able to efficiently transact business notwithstanding the self-disqualification of one of its directors under Clause 84 of Table A.

As will be seen in Part II of this paper, this method of modification of a statutory rule has its parallels in the ability of Companies to file a constitution under the provisions of the new Act.

4. PRIVATE/PUBLIC COMPANY DISTINCTION AT COMMON LAW

The 1955 Act then, created two distinct entities. If the legislators had identified a need for the distinction, one might expect that the Courts would also recognise that closely held private companies should be treated differently from public companies.

The majority of the previous statutory rules relating to private companies dealt with the mechanics of structure and incorporation, and with the disclosure requirements. The courts have identified additional areas not specifically dealt with by the 1955 Act, where the distinction has lead them to treat private companies differently from public companies.

It is proposed to look briefly at one area of company law, that of winding up, where the size of a company in terms of the number of its members has been seen by the courts as a major rationale for reaching a decision in a given case.

Section 217 of the 1955 Act set out circumstances where a company could be wound up by the Court. Under Section 217(f) a company could be wound up by the Court if:

> "the Court is of an opinion that it is just and

equitable that the company should be wound up".

The leading case dealing with the "Just and Equitable" ground in relation to closely held companies is that of Ebrahimi v Westbourne Galleries Ltd [1973] AC 360.

The case involved a former two man partnership which became a two, and then a three shareholder company. A series of disputes between the original two founders of the business lead to one of the founders being removed as a director by an ordinary resolution. The dismissed director was left a minority shareholder, minus his directors income and effectively shut out from management of the business he helped found and nurture.

In part of his judgment Lord Wilberforce stated that:

> "... a limited company is more than a mere judicial entity, with a personality in law of its own ... there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations and objections inter se which are not necessarily submerged in the company structure."[32]

It was this recognition of the rights of the individual by the House of Lords and the concern that these rights should not be submerged by a corporate structure, that lead to the courts decision in Ebrahimi. The Court decided that although the resolution to remove Ebrahimi as a director was valid, it was inequitable, in that it effectively repudiated the essential (although unwritten) agreement between the parties dating from the days of their original partnership, that management and profits (or losses) would be shared.

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[32][1973] AC 360

The Ebrahimi decision recognised that many private companies (especially the small 2-3 man operations) are little more than incorporated partnerships. In these companies success or failure will often depend on being able to trust ones fellow director/shareholder. If that trust is destroyed and the members are in conflict, then it may be just and equitable for the company to be wound up.

It should be noted however, that merely the fact that a company is a private company will not necessarily mean that the equitable obligations discussed in Ebrahimi will apply. One or more additional elements must be present:

(i) The members relationship must be based on confidence and mutual trust similar to that found in a business partnership, or;

(ii) There must be a written or verbal agreement that all, or a readily identifiable number of members are able to participate in the day to day running of the business, or;

(iii) There must exist a restriction on share transfers making it difficult for a disaffected member who is shut out of management to sell his shareholding and move on.

It is submitted, that the case recognises, that the closely held private company is a different animal from its cousin the public company. Undoubtedly, public companies should also be founded on trust and confidence between members. However, it is not the same as the trust placed by one director in a two member firm in his fellow director as they operate the corner dairy business. This is a trust which is crucial to the effective conduct and survival of the business.

The trust and confidence placed in a board of directors of a public company by investors buying its shares, is not the kind of trust that the House of Lords was contemplating in Ebrahimi. It is debatable whether it should give rise to any equitable obligations when there will in any event, continue to be much greater statutory controls on the public company.

The relationship of the public company with its shareholders is not usually one of day to day contact where each shareholder is also a director and participates in the running of the business. The relationship is generally much more remote than this. There are not the same similarities with the partnership business, that incorporates to take advantage of limited liability.

In the case of the incorporated partnership, the damage that can be done by a majority of members joining forces to shut out another member or members is much greater. It can mean financial ruin for the party shut out. In the public company scenario, a disaffected shareholder will usually be able to sell his shares. It is submitted, therefore, that the rational for imposing equitable obligations on the closely held private company is clearly established. Business partners do fall out, and when they do they may need protection from the lawful, but in some cases oppressive and unjust actions of their colleagues.

5. APPROACH OF FOREIGN JURISDICTIONS

The Law Commission has acknowledged that legislative "working models" in both Canada and the United States were an influence in drafting some of the reforms contained in the Act.[33]

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[33]Above N.1, page 9

The following is a brief outline of the approach taken to company law and the CHC in particular in three foreign jurisdictions. An assessment will be made in the conclusion to this paper as to how the Bill measures up by comparison to these jurisdictions and their treatment of the CHC.

A AUSTRALIA - CLOSE CORPORATIONS ACT 1989

Australia has provided specifically for the CHC in its Close Corporations Act 1989 ("CCA"). The legislation was developed by the Companies and Securities Law Review Committee and recognises that the incorporated small business enterprise does not need to have the same extensive financial reporting requirements of the larger public company.

Some of the features of the CCA include:

(i) The Close Corporation ("CC") is still recognised as being a Company in the usual sense with perpetual succession and other common corporate attributes.,

(ii) Any natural persons not exceeding 10 in number can form a CC.,[34]

(iii) The CC must have a fully paid up share capital.,[35]

(iv) On incorporation the CC must file a founding statement which contains similar details to those found in a Memorandum of Association under

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[34]Close Corporation Act 1989 (Australia) ss 16, 60, 61

[35]Ibid s.17

our 1955 Act.,[36]

(v) In order for it to be identified as such, a company incorporating under the CCA must have the words "Close Corporation" or the letters "CC" at the end of its name.,[37]

(vi) The CC is prohibited from offering its shares for sale to the public.,[38]

(vii) It need not appoint an auditor, or file accounts in any public registry, and, although it must keep appropriate accounting records,[39] these are not required to be offered up for public scrutiny.,

(viii) The CC is required to file notice of any changes in those matters contained in its founding statement.,[40]

(ix) It must file an annual activity statement and lodge an activity statement on incorporation setting out the nature of its trading activities.,[41]

(x) The CCA allows for the CC to have only one member.,

(xi) It also abandons any distinction between

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[36]Ibid s.25

[37]Ibid s.31

[38]Ibid s.51

[39]Ibid s.82

[40]Ibid s.20

[41]Ibid s.25

director and member, but members may formally agree which member or members will wield executive power.,

(xii) Part 7 of the CCA deals with Internal Administration and allows for the members to enter into what is known as an Association Agreement analogous to Articles of Association under the 1955 Act setting out how the CC's affairs will be managed. A model association agreement has been included as part of the legislation and will apply, unless the CC adopts its own agreement.

B GENERAL CORPORATION LAW OF DELAWARE 1979 - ONE UNITED STATES APPROACH TO CLOSE CORPORATIONS

Unlike in Australia, Delaware does not have a separate Act dealing with the CHC. However, it does give statutory recognition within its company legislation to the CHC as a separate and unique entity that requires its own set of rules.

Within the General Corporation Law of Delaware 1979 there is a sub chapter XIV, that applies only to CHC or Close Corporations. The specific provisions are contained in Sections 341 through to 356. A company will not be subject to those sections unless it elects to become a Close Corporation[42] using the procedure set out in the sub-chapter.[43] Where a company does not so elect it remains subject to the provisions of the statute as a whole.[44]

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[42]General Corporation Law of Delaware 1979 s341 (Del USA)

[43]Ibid ss343 and 344

[44]Ibid s.341(a)

Where election takes place the provisions of the general statute apply except to the extent that the sub chapter otherwise provides.[45]

The elective rights given by the Delaware legislation recognise that some companies that could qualify as a CHC may not find it advantageous to be subject to the provisions of sub chapter XIV.

Some of the more important features contained in sub-chapter XIV include:

(i) A concise definition of a CHC which; limits shareholders to a maximum of thirty; requires shares be subject to restrictions on transfer and prohibits the company making a "public offering" of its shares.,[46]

(ii) The requirement that the Certificate of Incorporation contain a heading stating the Company name and that it is a Close Corporation. The Certificate is also required to contain statements confirming the maximum number of shareholders, a prohibition on public offerings and share transfer restrictions.,[47]

(iii) Provisions that contain special procedures to prevent accidental loss of CHC status and allow for restoration of such status in those circumstances.,[48]

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[45]Ibid s.341(b)

[46]Ibid s.342. It is notable that this definition echoes some of defining characteristics of the private company under the Companies Act 1955

[47]Ibid s.343

[48]Ibid ss347-348

(iv) A provision permitting the dispensing with a board of directors and allowing the affairs of the CHC to be managed directly by its shareholders.,[49]

(v) Provisions that permit the appointment of a custodian or provisional director where a deadlock occurs.

It is worthwhile noting here that The General Corporation Law of Delaware 1979 itself, independent of the sub-chapter, contains provisions that are conducive to the management of a CHC. In the words of one commentator:

> "... irrespective of the number of stockholders or whether its stock is subject to transfer restrictions or has been offered for sale publicly, a corporation is permitted by various sections of the Corporation Law to enjoy characteristics that may be useful to Close Corporation management."[50]

C CANADA BUSINESS CORPORATIONS ACT 1975

The Canadian approach contained in the Canada Business Corporations Act 1975 ("CBCA") more closely resembles the approach of our new Act, than the Delaware and Australian legislation. This is acknowledged by the Law Commission in its Company Law Reform and Restatement Report No. 9.[51]

The Canadians do not have a separate statute dealing with

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[49]Ibid s.351

[50]Folk on Delaware General Corporation Law Third Ed 1992 Volume III at page XIV:3.

[51]At paragraph 32 page 9 (see N.1, Above)

the CHC, nor do they have a separate part in their statute which contains specific elective provisions designed to benefit the CHC.

The Canadians also abandoned the public/private company distinction with the enactment of the CBCA. Much like the Act, the CBCA was intended as "core" company law applicable to, and catering for all companies including, but not specifically, the CHC.

The CBCA, unlike the Act, does continue to draw a distinction of sorts, by varying the requirements it places on a company depending on whether or not it distributes shares to the public. In the words of one commentator:

> "In terms of financial information ... Corporations which do not distribute shares to the public are relieved from the requirement of having to file annual financial statements with the administrative official supervising the Act, are not subject to the mandatory directions to appoint an audit committee and are permitted to waive, by unanimous shareholder approval, the statutory obligation to appoint an auditor."[52]

Some other important features of the CBCA, as they relate to the CHC include:

(i) Provisions giving statutory recognition to unanimous shareholder agreements.,[53]

(ii) The introduction of remedies for oppression

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[52]B. R. Cheffins "US Close Corporations Legislation - a model Canada should not follow" 35 McGill Law Journal 160, December 1989 at page 169

[53]Canada Business Corporations Act 1974/75/76. ss 117, 142, 146, 190 & 241.

against minority shareholders.,

(iii) Provisions providing for flexibility in internal regulations including, by way of example, permitting directors and shareholders by consent, to conduct business by resolution, without the requirement that a meeting be called.

Generally the CBCA does not attempt to meet the needs of the CHC through a collection of tailor-made provisions with exclusive application. It does recognise the importance of placing greater statutory control on those corporates that distribute shares to the public.

Its major concession to the CHC may well be in its recognition of shareholder agreements, whereby, a company can agree (with some legislative constraints of course) among its members as to how it will regulate itself, as it daily transacts its business.

D THE LIMITED LIABILITY COMPANY

A comparatively recent development in the United States is the Limited Liability Company (LLC). This form of business entity emerged in the late 1980s. Wyoming was among the first states to give the form statutory recognition in its Wyoming Limited Liability Company Act 1989.[54]

The most important characteristics of the LLC are that it is a non-corporate entity that nonetheless provides limited liability for its members. Those members are also permitted direct involvement in management of the business of the LLC without the loss of their limited liability.

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[54]Wyo. Stat. ss 17-15-101 to -136 (Supp. 1989)

Members of an LLC make capital contributions, the extent of which will usually be recorded in its articles of organisation, rather than by the issue of any form of certification. Most LLC statutes place restrictions on the transfer of interests in an LLC by its members. Usually an outsider may only gain membership rights to participate in management by unanimous consent of the other members.

There are therefore clear similarities between the LLC and the statutory CHC recognised in the USA in that both place restrictions on transferability of ownership to outsiders. Also, typical CHC statutory provisions in the USA permit shareholders to participate in management directly without the need to appoint a board of directors.

The emergence of the LLC appears to have been driven to a large extent by favourable tax rulings in the USA that have classified the LLC as a partnership for taxation purposes. It is clearly not a corporate entity in that, unlike a company it will dissolve upon the departure of one or more of its members. It therefore has the tax benefits of a partnership coupled with the benefits of limited liability usually only associated with the company.[55]

The Limited Liability Company is another example of a foreign jurisdiction recognising the need to cater for diversity in business. The approach in the USA contrasts sharply with that of our own legislators. The Act seeks to provide for a diverse range of corporate entities in one piece of legislation. In the USA the legislators appear to prefer to accommodate a number of different business entities, in separate and specific pieces of legislation. Whilst recognising that the two jurisdictions differ considerably in size and structure, the writer is of the view that there is a good case to be made for New Zealand

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[55]For a more detailed discussion of the LLC see R.R. Keatinge et al., 47 The Business Lawyer. 1992.

to have its own separate statute for the CHC.

6. ABOLITION OF THE PRIVATE/PUBLIC COMPANY DISTINCTION

One of the features of the Act is that it abolishes the distinction between private and public companies. It is proposed to examine this feature of the Act in more detail.

On balance the Private/Public Company distinction was not worth preserving. The distinction was in many respects arbitrary, based on the number of members of the company and not tailored specifically enough to recognise and meet the needs of the incorporated small business.

The Law Commission had no difficulty in concluding that the Private/Public distinction should be abandoned. However, it is interesting to note that it seriously considered including specific provisions for the CHC in the Act. It decided not to do so, stating, that in its view:

> "the draft Act provides the flexibility required by shareholders of closely held corporations ... " and "The only structural requirement that the company cannot opt out of is the need for at least one director. It seems to the Law Commission that this requirement is hardly onerous enough to justify the provision of a different system for closely held corporations".[56]

The abolition of the Private/Public distinction plays an important part in achieving one of the Law Commissions major aims, that of simplifying company legislation. The intention is that the Act should codify the legal requirements applicable to all companies. Accordingly, if

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[56]Above N.1, page 56

one agrees with the Commissions approach, it is not desirable for the Act to contain rules that apply to one corporate entity and not another.

Although arbitrary, the distinction drawn in the 1955 Act did have some direct benefits to the CHC by exempting the private company from a number of onerous statutory requirements. For example, as noted above in this paper, the private company need not file a balance sheet or appoint an auditor. Both are requirements for which there were no valid public policy reasons that would dictate that they should apply to the private company.

With the abolition of the distinction, a small two person company that operates a retail outlet in the local mall, is treated under the Act in the same way as the large public investment company with hundreds of shareholders.

In view of the general application of the Acts provisions, it is submitted that the CHC will need to provide for its own specific requirements where permissible, by constitution. Part IV of the Act and the extent of its application, are therefore of considerable importance to the CHC.

7. PARTS II AND IV COMPANIES ACT 1993

Part II of the Act deals with the essential requirements for a company and the method by which incorporation can be effected.

Section 6 sets out the barest of minimum requirements that must be met by the proposed incorporator, when submitting an application for incorporation to the registrar. The effect of the section is that it will be possible to incorporate with an approved company name, a single share,

shareholder, and director.

The application for registration will contain much of the information previously submitted to the registrar under the 1955 Act. This will include a name reservation, consents of directors and consents of shareholders authorising the taking by them of the number of shares specified in the document. Full addresses, of officers and shareholders and location of registered office must be supplied, together with an address for service.[57]

Neither Articles of Association nor a Memorandum of Association are required. However, section 8(1)(f) provides that where a company is to have a constitution, the application must be accompanied by a document certified by one or more of the applicants as being the company's constitution.

The provisions dealing specifically with the Company Constitution are contained in Part IV of the Act. One of the features of the provisions contained in this part of the Act is that a company need not submit a constitutional document in order to incorporate.

If a company does file a constitution it is still bound by the provisions of the Act except to the extent that the Act will allow its provisions to be modified or negated by constitution.[58] Conversely, if a company does not file a constitution, or adopt one following incorporation, the Act is designed as a comprehensive Company Law code. The drafters' intention being to provide, in the one statute, all the rules necessary to regulate the company, without it needing a constitution of its own.

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[57]Companies Act 1993 s.8

[58]Ibid, s.26B

It is submitted (as shall be demonstrated later in this paper) that the incorporators of a CHC will be disadvantaged if they do not have a constitution. They will want to opt out of a number of the unwarranted restrictions that would be imposed if they were to accept the Act as the Statutory Constitution for their company.

8. NON-DISPLACEABLE RULES - AN EXAMPLE

Section 26B(1) of the Act states that:

> "The Constitution of a company has no effect to the extent that is contravenes, or is inconsistent with, this Act."

The section presupposes that some of the provisions in the Act cannot be opted out of by a company in its constitution.

In fact a number of the rules in the Act are non-displaceable, many of these justifiably so, as they are fundamental rules of Company Law. However, some of the non-displaceable rules will undoubtedly prove unnecessarily restrictive to the CHC. For the purposes of this paper it is proposed to briefly examine here, one example of a non-displaceable rule and its likely effect on the CHC.

Section 85 of the Act provides that company shareholders may only exercise certain powers by special resolution. One of those powers is to approve a "major transaction" as defined in section 107(2).

A "special resolution" must be approved by a majority of seventy five percent of shareholders entitled to vote.[59]

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[59]Ibid, s.2(1)

For a CHC with two or more equal shareholders the effect of these provisions could prove restrictive. For example, XYZ Limited has five equal shareholders, two of whom have left New Zealand, independently, to travel overseas on business. During their absence, XYZ Limited have the opportunity to enter into a major transaction, lets say the purchase of a retail premises. They must enter into the agreement to purchase and borrow funds equivalent to the greater part of the value of the assets of the company (before the transaction) prior to the return of their fellow shareholders. In these circumstances the Act prevents XYZ Limited from entering into the transaction unless they are by some means able to have one or both of the absent directors sign a special resolution.[60]

The Act does not allow the transaction to proceed by a majority vote of the remaining shareholders even if it was the express wish of the absent shareholders.

Without doubt, it is preferable, where possible that a major transaction have the approval of all shareholders entitled to vote. The defect in the approach taken in the Act is that it does not give the members of XYZ Limited an option. Section 85 applies notwithstanding the constitution of a company.

In the CHC, the members are often from the one family or effectively an incorporated partnership. They may trust each others judgment, sufficiently to desire the flexibility to transact business by simply majority. By not permitting this option the Act takes away their freedom to contract without a valid policy reason. The requirements of having seventy five (75%) percent approval does nothing for example, to protect the interests of third parties dealing with the company.

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[60]Ibid, s.85(1)

9. DISPLACEABLE RULES - SOME EXAMPLES

It is submitted that the most important issue that the CHC will face in re-registering or incorporating under the Act, will be whether to file a Constitution. This will depend on the advantages that the CHC stands to gain by opting out of the displaceable provisions of the Act in its Constitution.

Having earlier looked at the distinctive approaches to the law relating to Companies in three foreign jurisdictions, and specifically how they endeavour to cater for, or at least recognise the CHC as deserving of special attention, a comparison can now be made with the general approach of the Act to the CHC corporate entity.

Clearly the drafters rejected the Australian approach by not creating a separate statute applicable to the CHC. Nor has the Law Commission seen fit to have a separate set of elective provisions to cater for the CHC along the lines of the Delaware Subchapter. The LLC may become an option for the New Zealand small businesses in the future.

Instead, in line with the Canadian approach the drafters have dropped the public and private company distinction and opted for a general statute with provisions applying to all companies. It has been left up to each individual CHC to provide for its own needs by constitution where it perceives that the Act does not meet its requirements. The Constitution therefore, may well become the fundamental founding document of the CHC, to be filed routinely with its incorporation documentation.

It is proposed to analyse a number of the Acts displaceable provisions here and, to examine the Law Commissions claim that the Act provides the flexibility required by the shareholders of the CHC and, that, if this is not the case

whether the company can obtain the required flexibility by filing its own constitution.

Sections 28 and 29 of the Act respectively, set out Rights and Powers attached to shares and the types of shares that may be issued. The provisions of these sections may be altered by constitution.

The provisions of Section 28 provide for all shares to have the same rights. A CHC may find it preferable to be able to issue shares with special rights. For example, in a three member company, where one member has provided capital only, and does not want to have any involvement in the management of the business, the other two members may hold shares with greater voting rights attaching to them. Their shares may allow them to vote on matters pertaining to management and the third shareholders' shares could have a restriction placed on voting rights in respect of such matters.

Section 37 allows a company in its constitution to prohibit the issue of shares by the board unless there is seventy five percent shareholder approval. Section 38, which deals with pre-emptive rights may also be modified by constitution.

The authorisation of a distribution to shareholders by the Company Board can be made subject to the provisions of a constitution pursuant to section 44(1).

Under Section 51(1) a company may only purchase its own shares "if it is expressly permitted to do so by its constitution." Most CHC's (probably without exception) will want to have the option to buy out the shares of a dissenting shareholder, wanting to leave the company.

Under Section 58(1)(b)(ii) a company may exercise an option to

redeem shares it has issued if "The option is expressly permitted by the constitution ...". Once again, most CHC's will want their constitution to provide them with this flexibility to help facilitate easy exit of dissenting shareholders.

The transfer of shares provides a further illustration of the potential importance to the CHC of being able to use a tailor-made constitution to protect its interests where the Act fails to do so.

As discussed earlier in this paper, the typical CHC is often no more than an incorporated partnership, or small two or three member family business that has incorporated. The members of such a business will usually derive their main income from the venture and have most, if not all of their capital invested in it. It is therefore highly desirable from their point of view that there are restrictions on the transfer of shares in the company to outsiders.

The Act does not contain in its provisions the type of tight control on transferability of shares that the members of a CHC would usually demand.

Section 32 clearly envisages restrictions being placed on share transfers within the company constitution. As drafted, the section merely states that the shares in a company are transferrable, subject to limitations placed on such transfer within the constitution.

Section 68 sets out the mechanics of how a share transfer is effected. Some restrictions are contained in the sections and can be varied or extended by the constitution including the right of the board to refuse or delay registration of the transfer of the shares if the holder of the shares has "failed to pay the company an amount due

in respect of those shares".[61]

It is submitted that these clauses will not meet the requirements of the typical CHC with respect to the control of share transfers. They would allow a disaffected shareholder to freely transfer his shareholding to a person or persons that the remaining members might find unacceptable.

Because these rules are displaceable in the constitution the drafters of the Act have provided an out for the CHC and any other corporate that desires to place restrictions on the transfer of its shares.

The Act, pursuant to Section 106(1) provides that the business and affairs of a company must be managed by the Board of the Company. Sub-section (3) of s.106 allows for displacement of this rule by constitution. Subject to any restrictions in the constitution of the company the board of a company may delegate its powers under s.108.

In both of the examples, in the previous paragraph, the CHC may want to restrict delegation of powers to certain persons for certain limited purposes only. Alternatively it may want to prevent any delegation at all.

Appointment and removal of directors may be provided for in a constitution. Section 127(g), enables a company to place specific qualifications (in addition to those contained in s.127) on whom can be appointed a director of the company. Section 129(2) provides an opportunity for members to entrench themselves as directors by including a suitable provision in the constitution, naming them as directors. The provision could then provide, for example, that the director could only be removed by unanimous

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[61]Ibid s.68(5)

consent of all members.

Unless altered by constitution, the provisions set out in the Fourth Schedule to the Act govern the proceedings of the board of a company. The Fourth Schedule procedures appear to provide considerable flexibility, for example, by allowing a meeting by telephone conference.[62] Nevertheless, it may be worthwhile for a CHC to modify specific parts of the schedule to meet its own business requirements in much the same way that Companies presently modify Table A of the 1955 Act.

Section 136 relating to remuneration authorised to be paid to a company director is another example of a displaceable rule. Restrictions may be placed on any of the benefits listed (a) to (e) in s.136(1).

Similarly, s.137(3) allows displacement of another of the Acts codified rules. The rule in this case prohibits the indemnification of a director or employee of a company by that company. Under s.137(3) indemnification is permissable "if expressly authorised" by the Company's constitution.

The abovementioned sections are examples of some of the more important displaceable rules contained in the Act. Left unmodified, some of these rules could operate to the disadvantage of the CHC.

Accordingly, it is the writer's view that a constitution will be an essential foundation document for the CHC. It will enable the CHC to take advantage of the Acts displaceable provisions by opting for its own rules tailored to meets its own requirements and expectations.

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[62]Ibid paragraph 3(b) Fourth Schedule

The writer anticipates that model constitutions for all manner of companies including the CHC will be available by the time the Act comes into force. The majority of them will no doubt be based to some extent on the provisions contained in Articles of Association previously used for private companies under the 1955 Act.

However, as a number of commentators have observed,[63] it is the inability of the CHC to opt out of certain non-displaceable provisions in the Act that will undoubtedly cause problems for the CHC.

PART II

A DRAFT CONSTITUTION FOR THE CLOSELY HELD COMPANY

1. THE COMPANY

A., B., and C., have been carrying on a direct mail marketing business as a partnership for approximately six months. Their business venture has to date, been quite successful, with weekly turnover on the increase.

A., B., and C. are all members of the same family, each with hands-on management control of the business. They derive their only income from the business and each has invested most of their own capital resources into the venture.

To date, the business has been operating from the home of A. and overheads have been relatively low for this reason.

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[63]See for example Bates R. J., Closely Held Companies and the Companies Bill, To Close for Comfort. LLM Research Paper 1991 Law Faculty, V.U.W. and Dugan R. "Closely Held Companies under the Draft Companies Act." (1990) 20 Victoria University of Wellington Law Review, 161

Their bankers have financed the venture with an overdraft facility which the partners have kept under close control by prudent financial management.

The business has now grown to the stage where the partners are confident enough to expand. Expansion plans involve the leasing of a premises and the purchase of a computer system with the capacity to handle the increased workload.

Accordingly, the partners decide to incorporate the business. Their reason for forming a company is the limited liability it will give them, particularly with respect to unsecured creditors, trading with the company. They will also be able to borrow from the bank on a term loan, to purchase the computer. The company will grant a debenture over its assets in favour of the Bank to secure the loan.

It has been agreed between A., B., and C. that they will all be equal shareholders and directors of the company. They therefore make application under s.8 of the Act and, having taken advice, file a constitution tailored to meet what they perceive to be the specific requirements of their company.

The following is a proposal for a draft constitution that ABC Limited might file, to meets its requirements as a typical CHC.

2. THE CONSTITUTION

THE COMPANIES ACT 1993

CONSTITUTION
OF
A.B.C. LIMITED

1. Preliminary Certification

The undersigned being the applicants for incorporation of ABC Limited under the Companies Act 1993, hereby certify that the following document shall be the constitution of the Company.

COMMENT: This certification is required pursuant to s.8(f) of the Act.

2. Interpretation

In this constitution, unless the context otherwise requires:

(a) "the Act" means the Companies Act 1993
(b) "constitution" means this constitution as amended from time to time
(c) "the company" means A.B.C. Limited
(d) Words importing the singular number only shall include the plural number and vice versa.
(e) Words importing the masculine gender only shall include the feminine gender.
(f) Words importing persons shall include corporations.
(g) Words and expressions contained in this constitution shall bear the same meaning as in the Act or in any statutory modification of the Act in force at the date at which this constitution becomes binding on the company.

3. Share Capital and Variation of Rights

3.1 Subject to the provisions of the Act and without prejudice to any special rights previously conferred on the holders of any existing shares or class of shares, any share in the Company may be issued with such preferred, deferred, or other special rights or such restrictions whether in regard to dividend, voting, return of capital, or otherwise, as the Company may from time to time by special resolution

determine.

3.2 The Company may with the sanction of a special resolution issue any preference shares on the terms that they are, or at the option of the Company are liable, to be redeemed on such terms and in such manner as the Company before the issue of the shares may by resolution determine.

3.3 If at any time the share capital is divided into different classes of shares, the rights attached to any class (unless otherwise provided by the terms of issue of the shares of that class) may, whether or not the Company is being wound up, be varied with the consent in writing of the holders of three-fourths of the issued shares of that class, or with the sanction of a special resolution passed at a general meeting of the holders of the shares of the class.

COMMENT: Clause 3.1 provides A.B.C. Limited with a general power to attach special rights to shares that it issues to its members. It may also be used for issuing shares with restricted voting rights.

For example, A.B.C. Limited may invite D. to become a shareholder, for investment purposes only. D. does not wish to work in the business or participate in management. The company could under this clause restrict the rights attached to D.'s shares to sharing in dividends and distributions only and exclude any right for D. to vote at a meeting of the company.

Clause 3.2 would enable the company to issue redeemable preference shares. Section 29(a) of the Bill requires that this right, to be available must be included in the constitution of a Company. This power could be used by the Company to issue D. with redeemable shares giving the

Company the right to repay the capital investment of D. after or within a specified time. This would be particularly appropriate if D. is interested only in making a short term investment in the company.

Clause 3.3 gives the Company flexibility to vary the rights attaching to the shares it issues.

4 Purchase of its share by the Company

4.1 The Company is expressly authorised herein to purchase or otherwise acquire shares issued by it from the shareholders of the company and such purchase or acquisition may be exercised by the Company in priority to any other proposed dealings with such shares pursuant to clause 5 hereunder.

4.2 Any such purchase or acquisition by the Company of shares it has issued shall only be made strictly in accordance with the relevant provisions of the Act.

COMMENT: These clauses are intended to give A.B.C. Limited express authorisation to purchase its own shares, as required by s.51(1) of the Act.

For the CHC the option to purchase its own shares from departing shareholders will assist the company to retain control over its membership. It is submitted, that A.B.C. Limited could use these clauses in conjunction with Section 86 of the Act to create a buy-back agreement whereby the Company rather then the remaining shareholders can purchase the shares off an existing shareholder. Section 86 requires the unanimous consent in writing of all members.

5 Transfer of Shares

5.1 The instrument of transfer of any share shall be

executed by or on behalf of the transferor and transferee, or otherwise in such manner as may from time to time be prescribed or permitted by statute. The transferor shall be deemed to remain a holder of the share until the name of the transferee is entered in the register of members in respect thereof.

5.2 Subject to such of the restrictions of this constitution as may be applicable, any member may transfer all or any of his shares by instrument in writing in any usual or common form or any other form which the directors may approve.

5.3 Transfer of shares shall be subject to the following provision:

(a) No person or member shall be entitled to sell, transfer or otherwise dispose of the beneficial interest in any shares or give any mortgage charge or proxy or make any declaration of trust or become party to any transaction intended to or which could result in the beneficial ownership of such shares being disposed of or transferred otherwise than in accordance with this constitution and whether to a member or any other person if any member or other person whom the directors are prepared to register as a shareholder is willing to acquire the same pursuant to the provisions set out below.

Where any member is a company (other than a company listed on any recognised Stock Exchange) any change in the principal shareholding of the member of any holding company of the member altering the effective control of the member shall be deemed to be a transfer of shares.

(b) For the purposes of this Clause and the succeeding

clauses of this Section 5, the term "person or member" includes (but without limiting its generality) the member, his executor or administrator, or other personal representative, trustee in bankruptcy, the trustee of any trust created by the member in respect of the shares and all persons claiming interest through or under the member.

(c) (i) Except where the transfer is made pursuant to clauses 5.4 or 5.5 hereof, any person or member (hereinafter called "the proposing transferor") who may desire to sell transfer or otherwise dispose of the beneficial interest in any shares as aforesaid shall give notice in writing (hereinafter called "a transfer notice") to the Company that he desires to transfer the same. Such a transfer notice shall specify the sum the proposing transferor considers to be the value thereof and shall (subject as is hereinafter in this clause provided) constitute the company his agent for the sale of the share to any member or members of the company or other person or persons nominated by the directors at the sum so fixed or at the option of the purchasing member or members or person or persons nominated by the directors of the Company at the fair value to be fixed in accordance with paragraph (v) of this clause. If a transfer notice shall include several shares it shall not operate as if it was a separate transfer notice in respect of each such share and the proposing transferor shall be under no obligation to sell or transfer part only of the shares specified

in the transfer notice. A transfer notice shall not be revocable without the sanction of the directors in writing.

(ii) In the event of any person or member selling, transferring or otherwise disposing of the beneficial interest in any shares as aforesaid and failing to give a transfer notice as provided in paragraph (i) above the directors may give notice requiring the holder of such shares to give a transfer notice as provided in paragraph (i) above and unless within fourteen (14) days of such notice the holder shall so give a transfer notice, he shall be deemed at the expiration of that period to have actually given such notice in respect of such shares specifying as the value thereof the fair value as fixed in accordance with paragraph (v) of this clause and thereupon the directors may proceed in all respects as if such member had so given such a transfer notice and this clause shall be read so as to include such a notional transfer notice.

(iii) Subject to the provisions of this constitution and specifically subject to the prior right of the company to purchase its own shares under clause (4) hereof until otherwise determined by the company by special resolution the shares specified in any transfer notice given to the Company as aforesaid shall be dealt with as follows:

(a) The said shares shall be offered in

the first instance to the holders of the class of shares contained in the transfer notice as nearly as may be in proportion to the number of existing shares in that class held by them respectively and the offer shall in each case limit the time within which the same, if not accepted, will be deemed to be declined, and may at the time contain a notification that any such shareholder who desires an allotment of shares in excess of his proportion should, in his reply to the Company, state how many excess shares he desires to have.

(b) If all such shareholders do not claim their proportions the unclaimed shares shall be used for satisfying the claims in excess.

(c) If thereafter any shares specified in a transfer notice and offered as aforesaid shall not have been accepted, the directors may offer such shares to any person or persons whom they are prepared to register as a shareholder or shareholders.

(iv) If the Company shall within the space of two (2) calendar months after being served with such transfer notice find a member or members or any person or persons willing to purchase the shares (herein called "the transferee" or "the transferees") whom the directors in their discretion are prepared to register as a shareholder or

shareholders, and shall give notice thereof to the proposing transferor, such transferor shall be bound upon payment of the price or fair value as herein provided (subject to any lien which the Company may have under this constitution and by deduction thereof) to transfer the shares to the transferee or transferees.

(v) In case any difference arises between the proposing transferor and a transferee as to the fair value of the shares such fair value shall be fixed on the application of either party by a person to be nominated by the President for the time being of the New Zealand Society of Accountants, or if any reason he refuses or is unable to make a nomination, then to be nominated by the President of the New Zealand Law Society. Such person when nominated and in certifying the sum which in his opinion is the fair value of the shares shall be considered to be acting as an expert and not as an arbitrator and accordingly the Arbitration Act 1908 shall not apply.

(vi) If in any case the proposing transferor, after becoming bound as aforesaid, makes default in transferring the shares the Company may execute a transfer or transfers of the shares on behalf of the proposing transferor and the Company may receive the purchase money (subject to any lien in favour of the Company as aforesaid) in trust for the proposing transferor. The directors receipt shall be a good discharge to the transferees for the purchase price

and no question shall be raised as to the title of the transferees to the shares after they are registered as the holders thereof.

(vii) If the Company shall not within the space of two (2) calendar months after being served with a transfer notice find a member or members or other person or persons whom the directors are prepared to register as a shareholder or shareholders willing to purchase the shares and give notice in the manner aforesaid, the proposing transferor shall at any time within three (3) calendar months afterwards be at liberty to sell and transfer the shares to any person at a price not lower than the value specified in the transfer notice or the fair value fixed as aforesaid and the prior paragraphs of this constitution shall not apply to such transfer.

5.4

(a) Any shares may be transferred by a member or by the trustee of any trust created by a member to any child or other issue, adopted child, wife or husband of such member or to a trustee of any trust which is in the opinion of the directors exclusively or principally for the benefit of one or more of the aforesaid persons and any shares of a deceased member may be transferred by his executor, administrator or trustee to any child or other issue, adopted child, widow or widower of such deceased member or to a trustee of any trust which is in the opinion of the directors exclusively and principally for the benefit of any of the aforesaid persons, and shares standing in the name of the trustee of the will of any

deceased member or of any such trust may be transferred upon any change of trustee to the trustee for the time being of such will or trust and the restrictions of clause 5.3 hereof shall not apply to any transfer authorised by this subclause.

(b) If any shares of a deceased member are not transferred to a relative or relatives of a class or classes referred to in paragraph (a) hereof or are not in the opinion of the directors held by the executors administrators or trustees exclusively or principally for the benefit of any such relative or relatives, the executors administrators or trustees of the deceased member's estate or other trustees shall not later then twelve (12) months from the death of such member, give a transfer notice in accordance with subclause 5.3(c) hereof and all the provisions of that subclause shall apply accordingly.

5.5 Any member may sell transfer or otherwise dispose of the beneficial interest in any shares to any person (whether or not a member of the Company) with prior written consent of not less then seventy five percent of all other members of the Company for such consideration (if any) and otherwise upon such terms and conditions (if any) as may be agreed upon by such other members and specified in the written consent AND the restrictions contained in clause 5.3 hereof shall not apply to any sale transfer or other disposition authorised by this clause.

5.6 The directors may refuse to register any transfer of a share or shares:

(a) Where the Company has a lien on the share or shares; or

(b) Where the shares are not fully paid up, or the holder of the shares has failed to pay the Company an amount due in respect of those shares; or

(c) Where the directors have notice of any agreement by the shareholder to transfer only to some specified person or persons or subject to some specified condition or conditions; or

(d) Where the instrument of transfer is not accompanied by the certificate of the shares to which it relates or such other evidence as the directors may reasonably require to show the right of the transferor to make the transfer; or

(e) Where the instrument of transfer is in respect of more than one class of shares.

The directors may also in their absolute and uncontrolled discretion refuse to register any transfer of shares to any person whether a member of not and shall not be bound to give any reason or specify any grounds therefore.

5.7

The registration of transfers may be suspended at such times and for such periods as the directors may from time to time determine: Provided that registration shall not be suspended for more than thirty (30) days in any year.

COMMENT: The main objective of these clauses is to ensure that the director/shareholders of A.B.C. Limited have as much control as possible over the transfer of its shares.

A.B.C. Limited is a typical CHC. The members want to be able to ensure that they can veto the transfer of an interest in their company to an undesirable outsider.

Clause 5.3(c)(iii)(a) is a pre-emptive provision whereby (subject to the Companies prior right to purchase), the shares of an existing shareholder must be offered to the existing shareholders first.

Clause 5.6 gives the directors an unfettered discretion to refuse to register any transfer of shares.

6 Appointment of Directors

6.1 Unless and until otherwise determined by the Company by special resolution of the shareholders in general meeting there shall be not less than one (1) director and no more than three (3) and the first directors of the Company shall be A., B., and C.

6.2 All directors of the Company shall hold office until they or any of them are removed by special resolution or until they vacate office pursuant to Clause 7.1.

6.3 The directors shall have power at any time and from time to time to appoint any person to be a director , either to fill a casual vacancy or as an addition to the existing directors but so that the total number of directors shall not at any time exceed the number fixed in accordance with this constitution.

6.4 The Company may by special resolution remove any director. Any such removal shall be without prejudice to any claim that the director may have for damages for breach of any contract of service between him and the Company.

6.5 The Company may by special resolution appoint another person in place of a director removed from office under the last preceding clause and without prejudice to the powers of the directors under clause 6·3

hereof, the Company in general meeting may appoint any person to be a director provided that the total number of directors shall not at any time exceed the number fixed in accordance with this constitution.

7 Disqualification of Directors

7.1 The office of director shall be vacated if the director:

(a) Ceases to be a director by virtue of the Act; or
(b) Becomes bankrupt or makes any arrangement or composition with his creditors generally; or
(c) Becomes prohibited from being a director by reason of any order made under the Act; or
(d) Becomes of unsound mind, or becomes a person subject to a property order under the Protection of Personal and Property Rights Act 1988; or
(e) Resigns his office by notice in writing to the Company.

COMMENT: Clauses 6 and 7 are designed to entrench A., B., and C. as directors of the Company and to give them as much certainty of tenure as possible, whilst also providing for removal and or resignation.

The restriction on the number of directors may only be amended by special resolution altering the relevant constitutional clause.[64] In the case of A.B.C. Limited this would require the unanimous consent of A., B., and C.

8 Indemnity and Insurance

8.1 Subject to Section 137 of the Act, the Company may indemnify and effect insurance for any director or employee of the Company for any costs incurred by him

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[64]Above N.57, s.26(c)(2)

in any proceeding:

(a) That relates to liability for any act or omission in his capacity as a director or employee; and

(b) In which judgment is given in his favour, or in which he is acquitted, or which is discontinued.

8.2 Subject to Section 137 of the Act, the Company may indemnify and effect insurance for any director or employee of the Company in respect of:

(a) Liability to any person other than the Company or a related company for any act or omission in his or her capacity as a director or employee; or

(b) Costs incurred by that director or employee in defending or settling any claim or proceeding relating to any such liability.

COMMENT: Clause 8 in intended to expressly authorise A.B.C. Limited (at the Company's option) to indemnify and or effect a policy of insurance for its directors or employees. Section 137 of the Act limits the extent of the indemnity by reference to the directors duties specified in s.109 of the same.

Without this express authorisation, any indemnification sought to be given would be invalid pursuant to s.137.

It is submitted that A.B.C. Limited should have the option to indemnify and or insure in its constitution. At the very least it would give the directors the opportunity to protect themselves against personal liability resulting from a successful suit against one of them by a creditor of the company.

Execution Clause

Certified this _____ day of _____ 19___ by the applicants for incorporation of A.B.C. Limited as being the

constitution of the Company.

SIGNED by A
in the presence of:

SIGNED by B
in the presence of:

SIGNED by C
in the presence of:

CONCLUSION

The drafters of the Act have attempted to codify, in a single piece of legislation, a set of legal rules to cater for all corporate entities. The extent to which this approach will succeed will only become clear after several years of practical application of the legislation.

In the course of this paper the writer has identified a number of important areas where the Act fails to adequately meet the needs of the CHC.

The draft constitution in Part II of the paper provides an example of how the displaceable rules may be modified to assist the CHC to meet efficiency and flexibility requirements.

It is not intended to be an exhaustive document. Depending on the particular CHC and the perceived needs of its incorporators, its constitution may be more or less extensive, than the within constitution. However, there is not doubt that incorporators of a CHC, will be involved in considerable expense in modifying the rules to suit their needs.

It is submitted that the legislators have, at the end of the day, been too restrictive. The Canadian Business Corporations Act has many more displaceable rules then our own. The rather large number of non-displaceable rules in the Act deny the CHC the real flexibility it deserves. Even with the existence of the unanimous assent provisions in Section 86 there are still far too many unnecessary procedural requirements placed on the CHC.

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