Fineprint

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Shareholder Agreements

The business 'pre-nup'

Disputes between shareholders can be very costly, even to the point of mortally wounding the company. A Shareholder Agreement provides a framework to allow all parties to work together for the good of the company. This article points out the benefits of a shareholder agreement and what it could include.

The rights and obligations of shareholders in listed companies are protected by a number of pieces of legislation. These include the Companies Act, the Securities Act and New Zealand Stock Exchange Listing Rules. However, the vast majority of New Zealand companies are small or medium sized and are not listed on the Stock Exchange. Of this latter group there are two main types of companies:

1. The so called 'mum and dad' type companies. Although a separate legal entity, in reality these companies are the trading entity of a self employed person. They usually have one director and one or two shareholders.
2. Companies where the shareholders are at arm's length, and have come together to pursue a common business interest. These are commonly referred to as 'closely held companies'.

Closely held companies

Typically closely held companies have between two and six shareholders. The shareholders may be related, good friends or business associates. A shareholder agreement benefits this type of company, and its shareholders, the most. Common situations of closely held companies where a shareholder agreement can be used include:

- Inter-generational business ownership e.g. father/son
- Ownership by family e.g. sister/brother
- Ownership by friends, often having a common interest in the business
- Companies formed to undertake a specific venture
- Established businesses where the owner is bringing in a successor

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- Existing businesses where the owner wants to reward employees with some shareholding but wants to retain overall control.

What is a shareholder agreement?

A shareholder agreement is, in effect, a 'pre-nuptial agreement' between shareholders. It is signed by all shareholders and the company; it sets out rules and procedures for as many situations as the shareholders want it to deal with. An agreement can be as flexible and varied as the parties require. It can deal with any number or just one or two major issues which the shareholders regard as fundamental.

Advantages

A shareholder agreement works hand in hand with a company's constitution. The shareholder agreement is a vital addition to a company's stable of documentation because it:

- Can regulate rights and obligations before incorporation of the company
- Is usually confidential
- Can protect shareholders' rights from any alteration without the shareholders' consent
- Sets out the parties' intentions from the outset and in doing so the shareholders will inevitably address and consult over a number of key issues
- Regulates entry, exit and control
- Is uniquely-tailored to the shareholders and the company, rather than being a generic document as frequently the case with constitutions.

What does it include?

The contents of a shareholder agreement can be as varied as the parties require. It can be flexible or rigid, but it should cater for the parties' particular requirements. A shareholder agreement usually deals with the issues below:

Shareholders

Who are the shareholders and how many shares do they hold?

It is common for one shareholder/group of shareholders to want a majority of the shareholding. Is the intention for the majority to always win out? This is common where one party is being brought in as a minority shareholder to an existing business or when one party brings in significantly less to the business than the others.

If there are three or more groups of shareholders the shares may be grouped into classes of shares, eg: A, B, etc. Each group has specific rights, such as the appointment of a director.

How much control do shareholders have?

Generally speaking, in a closely held company the directors make business decisions about the running of the company. Major transactions need a 75% shareholder consent. Is it intended that the 75% threshold be lower to avoid minority shareholders paralysing the company? Conversely, is a higher threshold required to ensure the majority do not run roughshod over the rights of the minority?

Some decisions may require a 100% shareholder consent, especially those involving a significant financial commitment. In those situations it is common that minority shareholders do want a right to withhold their consent to a transaction.

Directors

- Who will the directors be?
- Who can hire and fire directors?
- Do different shareholder groups have a right to appoint a director (or two)?
- How are directors removed? What is the retirement/rotation policy?
- Will shareholder groups always have a right to have a director representing their interest? Given that directors control the day to day running of the company, the make-up of the board and its ability to control appointment or removal of directors is vital.

Share purchases

Do the shares have to be paid for straight away or may payment be delayed? Is a share purchase a pure cash arrangement or are goods and/or services provided in lieu? In the latter situation, the transaction value must be recorded.

Voting rights

Do all shares have an equal vote? Is there more than a 50% majority required to pass a resolution? How many shareholders are required for a quorum?

It is common for each class of shareholder to have a say in each shareholder vote as well as each class of shareholders being represented at a vote. If shareholders refuse to attend a meeting, are there to be provisions allowing their votes to be discounted?

Exit strategies

A shareholder agreement should have provisions governing the exit of one or more shareholders. These provisions will cover issues such as:

- Can a shareholder be compulsorily bought out, or can one shareholder require the others to buy him/her out?
- Procedure to value the shares
- Will the departing shareholder be subject to a restraint of trade? If so, for how long and what geographical area and industry is involved?
- Will the payout be in one lump sum or spread over time? A lump sum often places a great deal of financial pressure on a business. Payout over a term is reasonably common. If this occurs, will the departing shareholder get security for the money owed?

Dispute Resolution

Finally, a shareholder agreement should include a dispute resolution process. A common approach is to use mediation which is extremely cost-effective. If there is no resolution, this is followed by arbitration. Mediation in particular can be a valuable tool where the parties agree on how to resolve their differences.

Summary

A shareholder agreement breaks down into three general headings:

- Entry into the company and the terms on which a person becomes a shareholder
- Governance and control
- Exit arrangements.

A shareholder agreement need not be lengthy and complex. Many shareholder concerns can be addressed in a reasonably short document. In going through this process shareholders will discuss potential issues and make at least some provision to cover them. The alternative is an agonising stalemate which will be costly and time consuming, and can ultimately cause a company to fail.

Personal Property Securities Act

Don’t get caught out

The Personal Property Securities Act 1999 has now been in force some years. However, people are still being caught out by not registering their securities to protect their money or other assets. This article reiterates the need to register securities and uses two examples to illustrate what can happen if you don’t.

Personal Property Securities Register

In 2002, the Personal Property Securities Register (PPSR) replaced the High Court Chattels Register, the Motor Vehicles Securities Register and the Companies Office Register of Charges. After a security is first created using legal documents, public notice of it should be recorded in a financing statement, which is electronically registered on the PPSR (www.ppsr.govt.nz). Registration lasts only five years, but it can be renewed if required.

Purchasers

Usually anyone purchasing assets other than bare land should search the PPSR to check no one else has security over that asset. This is particularly important for farmers purchasing livestock and for anyone purchasing a motor vehicle in a private sale. Finance companies and banks routinely have charges registered over livestock and vehicles.

If you purchase assets that are subject to a security registered under the PPSR, the holder of the security interest can re-possess the goods. This system does not apply to mortgages of land and buildings. Before buying a major asset, ask your lawyer to search the register and check if a release can be obtained from the financier of the asset you are purchasing.

There are however exceptions to these rules. For example, retail purchases are usually safe.

Leases

The Personal Property Securities Act (‘the Act’) defines a lease of goods for a term of more than one year to be a security interest; such a lease should be registered in the PPSR. Even though not legally the owner, the lessee is treated as the owner of the goods for registration and priority purposes.

Usually anyone purchasing assets other than bare land should search the PPSR to check no one else has security over that asset.

Terms of Trade

In any leasing, lending or sale arrangement care should be taken to include appropriate security terms or terms of trade where security or ownership is to be retained. The terms should usually notify the lessee, borrower or purchaser that a security interest will be registered under the Act. This should compel co-operation with registration where that may be necessary, as well as ensuring the assets involved are maintained in good order.

Legal advice on preparing and revising terms of trade can prove very valuable. Appropriate terms of trade and proper execution of documents will also usually make registration of a security interest much easier.

Some examples

Farmers

Recently a farmer arranged to lease livestock to a company which ran a farming operation. As is common practice, the company had provided a security over all of its assets to a financier. The company took possession of the livestock as part of the leasing arrangement; matters went well for a while.

However, the company was placed in liquidation. The liquidator took and sold the livestock because the company was in possession of the livestock for a term of longer than one year, and also because the financier had a registered security interest over all the assets of the company. Unfortunately the farmer who owned the livestock had not registered a security interest. The lease of longer than one year meant that the company was treated as the owner of the livestock for security purposes. The farmer should have ensured that his interest in the livestock was registered in the PPSR. The livestock could not be recovered by the farmer.

Builders

A company that leased portable buildings was also caught out. It leased its buildings out on a long term basis to a customer. The customer had granted a security to a bank over all of the customer’s assets. The company did not register its interest in the buildings. The courts held that the bank could take the portable buildings because the company had not registered a security interest in the PPSR. The terms of trade set out by the company, retaining ownership of the buildings, were not enough to protect against the impact of the Act and its failure to register a security interest.

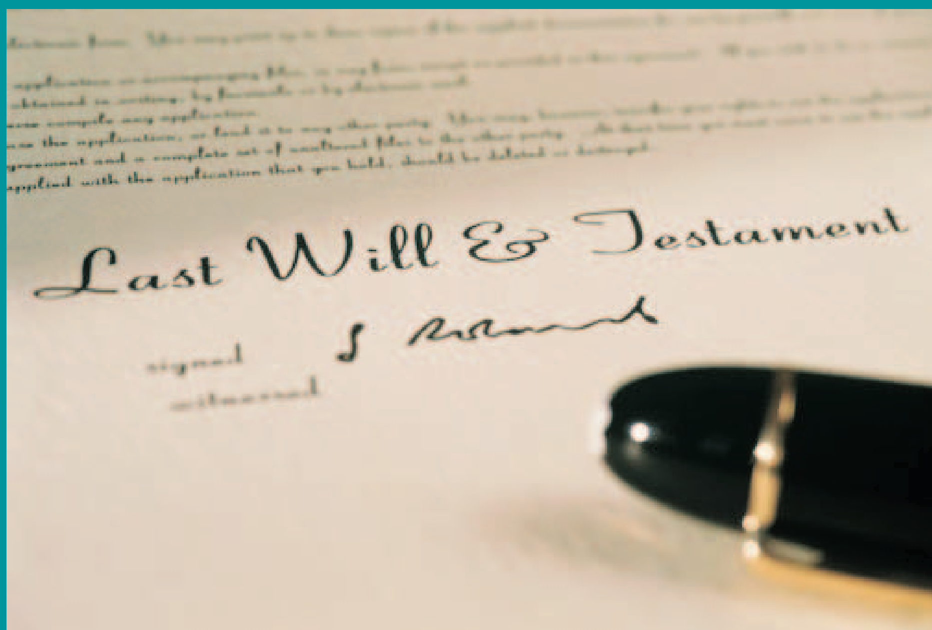
Conclusion

We recommend that you talk with us if you plan to either lease out any assets, lend money to anyone for chattels, need assistance through the registration process, or would like us to review your terms of trade. Taking a little time at the outset is a good investment to help ensure either your assets are retained or you get money back.

Minimising Tax Liability for Estates

Good drafting is essential

When a person dies the taxation implications on their estate are not always certain and there can be unexpected consequences for the beneficiaries. This article examines how tax liability for estates can be minimised by a well-drafted Will.



It is important for individuals who own tax-base property (such as farms, dairy herds, businesses or rental properties) either in their own name or in partnership to ensure their Will is correctly structured so that flow-on taxation consequences do not arise.

Until recently the taxation implications arising on the death of a tax payer who owned tax-base assets were fraught with uncertainty. However, with the recently enacted Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005 a greater measure of certainty (but not absolute certainty) has been brought to this area of law.

The legislation introduced Sub Part F1 into the Income Tax Act 2004 with effect from 1 October 2005. Sub Part F1 deals with (amongst other things) the transfer of assets on a person's death.

Transfers

There are two separate transfers which occur in the administration of an estate. The first is the transfer of assets from the deceased to the executor of the Will (or the administrator if there is intestacy, ie: no Will). The second is the transfer from the executor or administrator to the beneficiary or beneficiaries when the estate assets are distributed. Separate considerations may apply to the sale by an executor or trustee direct through a third party.

Sub Part F1 deems both transfers to have occurred at market value however this general rule does not apply in all circumstances.

Where specific criteria are met, roll-over relief is granted. The roll-over relief avoids the realisation of the assets at deemed market value and allows transfers at cost, thereby avoiding taxable income arising on death. Therefore it makes economic sense to ensure that advantage is taken of roll-over relief wherever possible.

Examples of situations where roll-over relief can be obtained include:

- Property left to a spouse or de facto partner, Section F1(4)*:
  This section grants roll-over relief where property is left to the surviving spouse or de facto in terms of the Will or intestacy. However the section requirements must be carefully complied with otherwise the roll-over relief will not be available. If there is compliance double roll-over relief is granted. This means that the transfer from the deceased to the executor or administrator, and the distribution to the spouse or partner are granted relief from the taxation consequences which would otherwise flow from the transfers of tax-base assets at a deemed market value.
  **This relief will also apply to civil union partners from 1 April 2007.*
- Property left to close relatives and charities, Section F1 (5):
  As with the roll-over relief to spouses and de facto partners above, this relief is only available if specific criteria are met. However, only single roll-over relief is available; the relief covers the distribution from the estate to the beneficiaries only. No relief is provided from the deeming of a market value for the transfer from the deceased's name to the executor or administrator.

Criteria

The roll-over relief criteria restricts the range of beneficiaries to whom a person can leave his or her estate. In addition, the ability to create life interests and testamentary trusts is removed.

Notwithstanding these apparent restrictions, the range of beneficiaries can be expanded by different structuring of the transactions that occur on death.

If you are the owner of tax-base assets it is important we review your existing Will. This will ensure the maximum taxation relief is available to your estate and, ultimately, to your beneficiaries.

Coping with Unexpected Bills

Ensure funds are readily available

Most people are pretty good at living within their budget – except when the unexpected happens. It's not usually the day-to-day and week-to-week items that blow a budget, it's the one-off things you don't see coming.

No matter how well-organised or disciplined you are with money, there will always be the occasional time when you need an extra sum, either to tide you over for a short period or to sort out a large bill.

Hopefully, you will have some funds put aside which you can access quickly. If you don't, what are your options? Applying for a bank loan or extending your overdraft limit may seem like a good idea, but there are several things to consider first. For example, the interest rate you'll be charged is likely to be much higher than for mortgage rates.

While there are mortgages with revolving credit facilities, ie: where your mortgage essentially becomes a large overdraft, these work best for people who have very disciplined money habits. Remember, debt is like fire: if used properly it can be a great tool, but if misused, you can be badly burnt!

Ultimately, the best option is to fund unexpected bills out of your own resources if you possibly can. This means holding an amount of cash in reserve, as opposed to having to sell shares or property.

As a rule of thumb, three months' living expenses is a good cash sum to aim for. With cash rates now at around 7%, on-call cash management accounts are a great place to 'park' your savings. It will ensure that those unexpected events such as a huge car or dental bill will not make a massive dent in your long-term financial goals.

If you have issues with your own budgeting or would like to speak to an adviser about an 'on call' cash management account with strong rates of interest, please contact us and we can put you in touch with a Portfolio Group financial planner who can provide you with more information and advice.

Source: Strategi Limited

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Woodward Chrisp – Gisborne

Postscript

Zipped mail

In June NZ Post announced the introduction of American-style zip codes which will allow mail to be delivered more accurately to street addresses. The country has been divided into 1850 separate postal zones.

The new four digits do not come cheaply; there is an $80 million price tag on the new processing machines – $20 million per digit one could say.

However, NZ Post says that the new system will help alleviate the misaddressing problems rampant in New Zealand. Twenty per cent of mail sent in the Auckland region is incorrectly addressed; there are 18 Beach Roads in the Greater Auckland area alone, and nationwide there are 60 George Streets and 50 Queen Streets. The new system ensures there are no streets with the same name within an urban postcode boundary.

For business customers, there is a two year transition period where NZ Post will continue to process VolumePost mail with the old post codes.

If you forget your new zip code, the mail will still get through, although it could be slow. Alternatively, look on www.nzpost.co.nz/mynewpostcode, ring 0800 736 355 or use the Postcode Directory at your local PostShop.

IRD holds fast on depreciation argument

The Inland Revenue Department (IRD) is sticking to its guns not to allow residential rental property owners to depreciate assets such as plumbing, wiring or kitchen cabinets faster than the actual building into which they are fitted.

Property owners can still depreciate chattels separately such as carpets, curtains, clothes lines and water heaters. However the plumbing and wiring are considered to be an integral part of the building and cannot be depreciated separately, nor at a faster rate.

Property owners who have split components such as wiring and plumbing, thus overstating their depreciation claims, will not be required to repay the IRD. IRD Deputy Commissioner, Naomi Ferguson says, "… they will be required to add the value of the various 'components' they have been depreciating individually into the cost of the building, and combine the depreciation claimed for those individual assets … The building should then be used to claim depreciation at the correct rate."

Water rights – a clarification

We ran a story on water rights in our Autumn issue. We should clarify that s14 of the Resource Management Act does not require a permit for domestic use and stock unless there is an adverse effect on the environment. Water may be taken for fire-fighting without a resource consent.

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