Q&A

For Commercial Entities

Parry Field Lawyers

To the heart of what matters.

Q1: What is a director?

A director is a person in charge of supervising and governing the activities of the company. A company may have one director or it may have multiple directors who together comprise a 'board of directors'. If a company has multiple directors, decisions are typically made by the directors voting. Importantly, directors owe certain legal obligations (called directors' duties) to the company that they serve, which can be found in the Companies Act 1993. Directors are appointed by shareholders.

Q2: What is a shareholder?

Shareholders are the owners of a company. When you buy stocks of companies that are listed on a stock exchange like NZX, you become a part-owner of the company (i.e. a shareholder). If you start a company, you will usually give yourself all of the shares in the company, making you the sole shareholder (i.e. owner) of the company. As the ultimate owner of the business, shareholders have the right to make certain major decisions under the Companies Act 1993, the most critical of which is the right to vote for directors of a company.

Q3: Is the CEO of a company also a director?

Not always. The CEO or chief executive officer of a company is the person in charge of the daily management of the company (as compared to the supervisory/governance role played by directors). Directors appoint the CEO (and typically the other officers of the company such as COO, CTO, etc.). In smaller companies, the same person may be the sole shareholder, sole director and CEO of the Company (e.g. the person is undertaking many roles or 'wearing different hats').

Q4: How are directors appointed?

A natural person may be appointed as a company director, provided they are not disqualified under section 151(1) of the Companies Act 1993. At incorporation, a person named as a director in the application becomes a director from the date of registration. Subsequent directors are typically appointed by an ordinary resolution of shareholders, with each director voted on individually. However, this process may vary if the company's constitution specifies a different procedure.

Q5: What is the process for removing a director?

As with appointments, the process for removing a director may be set out in the company's constitution. If no specific procedure is provided, the default rule is that a director can be removed by an ordinary resolution of shareholders. The notice of the meeting must state that the removal of a director is one of the purposes of the meeting. A director may also cease to hold office due to resignation, disqualification, death, or as otherwise provided in the constitution.

Q6: What is the difference between independent and non-independent directors?

There are different types of directors. An executive director is usually an employee of the business who has the full range of responsibilities and duties of a director. A non-executive director is not part of the executive or management team. A non-executive director brings outside experience and objectivity to the board which can provide valuable guidance and judgment.

Within the non-executive classification there are independent and non-independent directors. Firstly, a non-independent director holds ties to the business, they could be a major shareholder or former employer. Alternatively, an independent director has none of these ties with the business, their only function is to sit on the board. Having independent directors comes with benefits, specifically they often come with a wealth of business experience. Of course, a key benefit is that they are fully independent, bringing a level of objectivity and a fresh perspective. Independent directors are also helpful in resolving conflict of interests.

Q7: What is the difference between directors and shareholders?

A director is a person appointed to manage the company's affairs and collectively make key decisions about the company and its operations. Directors have a number of duties and powers under the Companies Act 1993. A shareholder is a person listed in the company's share register as holding one or more shares. Shareholders still have some voice in the company, often shares have voting rights attached to allow shareholders to have a say on key issues. A person can be both a shareholder and a director however the roles are distinct.

Q8: Why is it important to balance the interests of directors and shareholders?

Directors and shareholder may have differing interests which need to be balanced to work together for the company's benefit. Directors need to balance their accountability to shareholders with the interests of the company. The law imposes a range of duties onto directors including the duty of good faith, requiring directors to act in good faith and in best interests of the company. This duty is owed to the whole company, rather than individual shareholders. For example, it might be in the company's best interests to issue new shares to raise capital. However, shareholders might oppose this if it would dilute the value of their existing shares.

In practice, directors often need to consider shareholder interests when making decisions, and the best interests of a major shareholder are often in the best interests of the company. Additionally, in some cases, the company's constitution may allow directors to consider the interests of a parent company or specific shareholders, but only under certain conditions. For example, if the director is carrying out a joint venture between shareholders they may act in a way that is in the best interests of shareholders (rather than the company), as long as it is permitted by the constitution.

Directors must also disclose where they have a conflict of interest. This occurs when a director's personal interests may conflict with the company's best interests. Otherwise, the director is breaching their good faith duty by acting in their own personal, rather than the company's interests. Additionally, the duty of directors to exercise powers for proper purpose exists to protect the interests of shareholders. A director cannot use their position in the company for personal benefit or prioritise their own interests over the company.

Q9: What is a 'legal person'?

A 'legal person' usually references an entity that is recognised in law as being able to do the same things a human being can do (e.g. enter into a contract, own property, etc.). The most common 'legal person' used in business is a limited liability company. In legal parlance, we typically refer to 'legal persons' as 'separate' to highlight the fact that the liabilities, obligations, and rights of the legal person are 'separate' and 'distinct' from those of the human beings that may govern, direct, or manage the legal person.

Q10: Why is a separate legal person important in business?

This has to do with risk mitigation. Business is inherently risky. In the distant past, if you wanted to start a business, you would have to do everything in your own name (enter the contract, buy materials, take on debt, etc.). Now, the legal system facilitates business risk-taking by allowing individuals to create a 'legal person' to hold the risks and liabilities of a business. This encourages new businesses to be started, as individuals can shield their personal assets (e.g. their family home) from business risks.

Q11: What are Terms and Conditions?

Terms and Conditions (or T&Cs) are typically a set of standard provisions that govern the relationship between a customer and a supplier of goods and services. Businesses prefer having Terms and Conditions as it allows them to have identical contracts with all of its customers, allowing for more streamlined administration of customer contracts. T&Cs are typically not the document that is signed between the customer and the business – that's typically a proposal or a purchase order, but the signed document will refer to the T&Cs.

Q12: What should I include in my business's Terms and Conditions?

Common provisions can typically be found by searching online for examples of Terms and Conditions in similar businesses. What you may wish to focus on are the specific risks that are unique to your business or circumstances. At the end of the day, Terms and Conditions are designed to allocate risks (both legal and commercial risks) between the parties of the contract. However, keep in mind that pushing a risk to the other party will typically come at a lost (e.g. lower price).

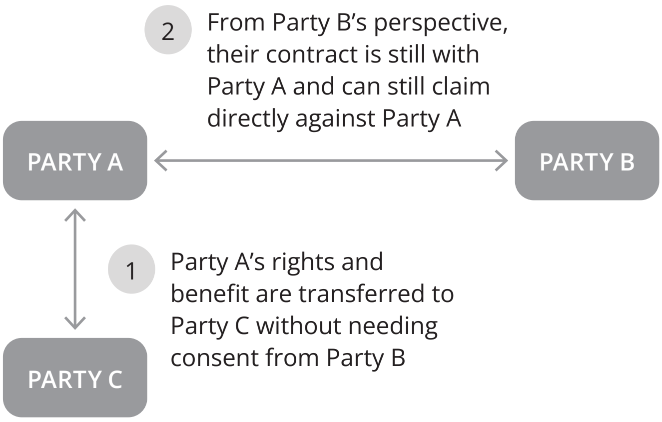
Q13: Why shouldn't I use AI/Large Language Models to create my business's Terms and Conditions?

AI and Large Language Models are fantastic tools. One risk that arises with the use of such tools, however, is that they may not have a strong grasp on the underlying law that will govern your contract. Recent experience with clients who have created a first draft of a contract with AI/LLM suggest that, although on its face the AI/LLM generated document is internally logical and coherent, the document itself is not drafted with a strong understanding of the underlying law and/or legal context, leading to provisions that, although internally logical, are nevertheless legally unenforceable.

Q14: What is an assignment?

In a contract between party A and B, if party A assigns the contract to party C, then party A's rights and benefits under the contract are transferred to party C. If the contract is silent on restriction on assignment, then normally party A can assign the contract to party C without requiring the consent of party B. However, from party B's point-of-view, the contract is still with party A, so if party A has any obligations under the contract, party B can still claim directly against party A (e.g. party A is not 'off-the-hook').

IN THE CASE A CONTRACT IS SILENT ON RESTRICTION ON ASSIGNMENT



Q15: How is an assignment different from a novation?

Novation occurs when a new contact is substituted in for a contract that is already in existence. This can be between either the same parties as the original contract or different parties. For valid novation, consent of the party that the original contractual obligation was owed is critical, therefore the consent of all parties involved should be obtained. For example, in a contract between party A and B, if party A novates the contract to party C, then all of party A's rights, benefits and obligations are transferred to party C. This will require party B to agree to the novation (usually by signing a deed of novation among parties A, B and C). In a novation, Party C completely takes over from Party A.

Q16: What is a Shareholders Agreement?

A Shareholders Agreement is a document typically signed by all the shareholders of a company and the company itself to set out the ground rules for the relationship among the shareholders and the company, including addressing key issues like deadlock, right to buy the other shareholder out, right of exit, etc. In many ways, a Shareholders Agreement is similar to a prenuptial agreement or 'contracting out' agreement as it sets out the parties' obligations and rights against each other and usually involves the shareholders thinking about foreseeable worst-case scenarios and agreeing on the course of action should that scenario materialize. Shareholders Agreement are typically 'private' and confidential.

Q17: What is a constitution?

A constitution is a public-facing document setting out the regulations as to how a company will be governed and run. A company is not legally required to have a constitution. Under the Companies Act 1993, if a company has a constitution, it must upload the constitution to the Companies Office for the public to see. A constitution can modify certain default positions for companies set out in the Companies Act 1993. Importantly, a constitution is required for a company to provide certain indemnities and obtain certain insurances for the company's directors or employees.

Q18: I'm thinking about selling/issuing/giving some of my company's shares to a potential partner, what should I be aware of?

Think of fellow shareholders in a company as being parents to a baby (the company). When the parents all agree on how the baby should be raised, then there are no problems. However, circumstances change, and to prevent future headache (and financial loss), we typically recommend for shareholders of a company to enter into a shareholders agreement.

Q19: What is the difference between preference shares and ordinary shares?

Companies can issue different types of shares, with ordinary and preference shares being the most common. Ordinary shares typically have attached the right to vote, right to dividends and return of capital. Where a company only has one class of shares, they will normally be ordinary shares. Preference shares on the other hand entitle shareholders to some type of preference compared to other shareholders (usually ordinary shareholders). The law does not provide a fixed definition of a preference share therefore how each company describes a preference share may differ. Preference shareholders may or may not have voting rights, however, typically usually holders have preference to dividends payments and on return of capital in a windup. You can also have a different type of share that is non-voting.

Q20: I hear Shareholders Agreements are expensive, do I really need one?

You can think of Shareholders Agreements as insurance policies. Sometimes, you can't afford not to buy one. It's often much cheaper to negotiate and agree before a foreseeable crisis arises rather than to address it in a vacuum. Also, similar to insurance policies, you can choose how much 'coverage' (e.g. foreseeable issues) you want to negotiate in the Shareholders Agreement. Finally, the longer you wait to legally define the boundaries of the shareholders' relationship, the harder it is to have those conversations.

Q21: As part of my company's successful fundraising, we are signing a Shareholders Agreement, that means I'm covered right?

Maybe. Lawyers have a duty to act in the best interest of their clients and in most fundraising scenarios, the lawyers who are drafting the Shareholders Agreement may be acting on behalf of the company or even the investor. Your best interests are unlikely to align perfectly with those of the company or the investor. If you're going to sign a prenuptial agreement, you wouldn't rely on your fiancée's lawyer's advice (no matter how in love you may be), so why would you rely on the company or investor's lawyer to protect your best interests? Independent legal advice for reviewing a Shareholders Agreement would be a small investment to protect your rights in a 'growing' business.

Q22: What is a 'corporate veil' and why does it sometimes get 'pierced' or 'lifted'?

The 'corporate veil' refers to the protection that a company provides to shareholders due to it being a separate 'legal person'. The veil symbolizes the separation of liability, obligations, debt, rights, etc. between a company and its shareholders. If a company practices good corporate governance, the shareholders can rest assured that the company's debts, obligations and liabilities will not fall on the shareholders personally. However, in certain circumstances, the corporate veil may be 'pierced' or 'lifted', such that a court will find that the shareholders should be personally liable for the company's debts, obligations, and liabilities.

Q23: Why are directors' duties important?

If you breach your directors' duties, you become personally liable for the losses and damages that result from your breach. For example, let's say a company is unable to pay its debts as they become due (i.e. the company is 'insolvent'), but the directors choose to have the company enter into new contracts that have the company take on even more debt. When the company inevitably is unable to pay its debt, the creditors of the company will likely file a claim against the company (which will have no assets), but they may also choose to file a claim against the directors personally, as they breached their duty to not have the company trade recklessly. If the creditors are successful in their claim against the directors, then the directors will be personally liable for the losses that they caused to the creditors.

Q24: What are guarantees?

A guarantee is a promise by a third party to be answerable for the obligations of another person. Let's say your new company needs to enter into a lease for its offices. The landlord knows that your company is new and therefore doesn't own much that is valuable. So as a condition of leasing the company the offices, the landlord asks you to personally guarantee the rent payments (and the company's other obligations under the lease). That way, the landlord knows that even if the company can't pay, the landlord can still claim against you personally under the guarantee. In our scenario, you are the third party that promises to answer for the obligations (i.e. the company's obligations under the lease) of another 'legal person' (i.e. the company).

Q25: What are 'Tag Along' rights?

Tag Along rights are rights (typically for a shareholder) to be able to sell their shares in the event that other shareholder(s) also sell theirs. These rights are negotiated for and contained in the shareholders agreement or the constitution of a company. For example, a tag along right may be triggered if shareholder(s) holding 50% or more of the total shares in a company want to sell their shares to a buyer, resulting in the non-selling shareholder(s) being able to 'tag-along' in the sale and also sell their shares to the buyer. The details of 'tag-along' rights can vary as it is a negotiated right.

Q26: What are 'Drag Along' rights?

Drag Along rights are rights (typically for a shareholder) to be able to force other shareholders to sell their shares in the event a certain threshold of total shares in a company is proposed to be sold. These rights are negotiated for and contained in the shareholders agreement or the constitution of a company. For example, a drag along right may be triggered if shareholder(s) holding 75% or more of the total shares in a company want to sell their shares to a buyer, resulting in the selling shareholder(s) being able to 'drag-along' the shares of the rest of the non-selling shareholders in the sale. The details of 'drag-along' rights can vary as it is a negotiated right.

Q27: What is a Share Transfer Form?

A share transfer form is an instrument to document the transfer of shares from one person to another person. These are required under Companies Act 1993 for the transfer of shares and must be presented to the Company.

Q28: What is a board resolution?

A board resolution, or corporate resolution, is an action of the company approved by the directors. Board resolutions can be passed at a board meeting, or they may be passed by having the directors sign a document approving a resolution (a written board resolution) without the necessity of a meeting. Written board resolutions may, under the company's constitution and/or in the shareholders agreement, require a super-majority of directors' approval for it to be valid.

Q29: What is an ordinary resolution?

An ordinary resolution under the Companies Act 1993 is a resolution approved by a simple majority of the votes of the shareholders who can vote and are voting on a question (see S105(2) of the Companies Act 1993). Note that an ordinary resolution is an approval by shareholders, not directors.

Q30: What is a special resolution?

A special resolution under the Companies Act 1993 is a resolution approved by a majority of 75% (or higher) of the votes of the shareholders who can vote and are voting on a question (see S2 of the Companies Act 1993). If a threshold higher than 75% is required, it would need to be set out in the company's constitution.

Q31: What is equity and what is debt?

Equity and debt are the two common types of financing (or fund raising) that companies can pursue. Equity financing means selling an ownership stake to the investor. Debt financing means the company (or other entity) borrowing money from the investor. Equity investors take on more risk because they are now co-owners of the business while debt investors get a fixed return (typically interest) on their investment and do not share in the upside of the company. Debt investors also get paid out first from the company's assets should the company go insolvent.

Q32: What is a convertible note?

A convertible note is a debt that the debt holder can 'convert' into equity. This means that the debt investor has a choice of either keeping their investment as a debt (and only benefit from the loan interest) or can 'convert' their debt into shares in the company (at a pre-determined formula or price per share). A SAFE is a type of convertible note.

Q33: I would like to make sure that my company's technology is not used for certain application (e.g. military use), how can I do this?

You can put in restrictions in your shareholders agreement and/or constitution to ensure that your company will not sell its products (or licence its intellectual property) for certain applications. Please note that limiting your company's business in such a manner may result in difficulty raising funding for your business.

Q34: What is a term sheet?

A term sheet is a document that sets out the agreed high level principles between parties. For example, prior to an investor buying shares, they may negotiate for the key terms of their investment through a term sheet first. The term sheet will then form the basis for the full-form documents necessary for the investment (e.g. shareholders agreement, constitution, subscription agreement).

Q35: What is a subscription agreement?

A subscription agreement is the document that governs the mechanism of how a company will issue shares to an investor in return for the investor's funds. This is the 'money document' in that the subscription agreement sets out the process for how shares will be issued by the company and how money will be paid to the company. Key provisions within the subscription agreement are the warranties that the company will provide to the investor.

Q36: What is a representation?

A representation is a statement of fact made by one party to another. The party to whom the representation is made typically will rely on the statement, so that if the statement is proven to be false, the party making the statement will be liable for losses incurred by the false representation. See also "What is a warranty?" (Q37)

Q37: What is a warranty?

A warranty is a guarantee made by one party to another. The party who benefits from the warranty will typically rely on the warranty such that, if the warranty is breached, the party making the warranty will be liable for losses incurred by the breach. Representations and warranties are typically linked together and you will find these in subscription agreements, shareholders agreement, terms and conditions, licensing agreements, etc. It can be as simple as: "I represent and warrant to you that I am the owner of these shares."

Q38: What is liability?

Directors and shareholders have different types of liability under New Zealand law. Directors can be personally liable if they breach their legal duties under the Companies Act 1993. These duties include acting in good faith and in the best interests of the company, exercising reasonable care and skill, and avoiding conflicts of interest. If a director fails to meet these obligations, they may be held personally responsible for any resulting loss to the company.

Shareholders, on the other hand, generally have no liability except for the amount payable in acquiring their shares. They are not personally responsible for the company's debts or obligations, unless the company's constitution specifically states otherwise.

Q39: What are pre-emptive rights?

Pre-emptive rights allow shareholders to have a right of first refusal for existing shareholders where new shares are issued, or an existing shareholder wishes to sell shares. This means they have the right to subscribe to the new or existing shares before any third parties. Without modification in a company's constitution, shareholders will have pre-emptive rights for new issuances of shares under Section 45 Companies Act 1993.

Q40: What is an Option?

An Option is a contractual right to do something – typically the right to be able to purchase a share.

Q41: What is the difference between non-competition and non-solicitation?

Non-competition and non-solicitation clauses are two of the main types of restraint on trade clauses (often included in employment agreements and shareholders' agreements). Non-competition clauses are where a former employee (or shareholder) is prevented from working in a similar field or industry to the business of a prior employer or the company. A non-solicitation clause is when a former employee (or shareholder) is prevented from contacting clients and/or employees of their former employer. These clauses are often limited to a specific time period or geographic area. The purpose of including these clauses is to protect confidential information and the former employer's or the company's business interests. For these restraints to be enforced they must be reasonable and generally cannot be contrary to public policy.

Q42: What is anti-dilution?

Anti-dilution clauses are designed to protect investors from dilution in their shareholding when new shares are issued, particularly if they are issued at a lower price. The effect of dilution is the decrease of the original shareholders' ownership (so the investor now also owns a smaller "slice" of the company). If the company sells shares at a price per share that is less than the price per share sold in the earlier financing round, the value of an original investor's shares will decrease.

For example, Investor A buys 100,000 preferred shares at $1.00 per share, investing a total of $100,000. Later, the company faces challenges and raises more capital by selling new shares at $0.50 per share. Without any anti-dilution protection, Investor A's shares were purchased at $1.00, while new investor, B, gets a better deal at $0.50. Investor B can buy 200,000 shares for the same $100,000 that Investor A originally paid.

An anti-dilution clause will often be included in a shareholder agreement. In New Zealand, they often work by issuing additional shares to existing shareholders for a fixed token price to account for the dilution of additional shares at a lower subscription price.

Q43: What is a pre-money valuation?

A pre-money valuation is the estimated worth of a company before it receives any new external investment. A pre-money valuation is an estimated, subjective value. It can be based on financial statement data, the value of comparable businesses, or the potential seen in the senior management team. It is not a fixed figure, rather it changes as new investments are sought. The valuation can be used by potential investors to better understand the value of the company before they invest.

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