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COMMERCIAL eSpeaking

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Welcome to the Winter edition of *Commercial eSpeaking*.

Enjoy reading this newsletter; we trust that the articles are both interesting and useful to you. If you would like to talk further about any of the topics covered in *Commercial eSpeaking* or any business law matter, please be in touch with us, our contact details are above.

INSIDE:

Key Considerations for Employee Share Schemes

Important to ensure you tick all the boxes for your employees

Employee share schemes can be a great way to attract, retain and incentivise staff. They haven't been widely used in New Zealand, with a big part of the problem being that the rules you need to comply with to offer one make doing so impractical and, in a lot of cases, also undesirable. In April, those rules got completely overhauled. This article looks at some key points that both employers and employees should look out for when a share scheme is offered… CONTINUE READING

Director's Drawings

Be careful as there are some pitfalls

If you are a company director it's tempting, particularly in a closely held company, to withdraw funds for expenses and to pay yourself as and when you decide that you need money – without recording the reasons for your decisions. In many situations you may think that you are doing what's best for the company, but you need to be aware that you are running the risk of being personally liable for the funds withdrawn… CONTINUE READING

Business Briefs

Business sales and earnouts: Five cautionary tips for sellers … CONTINUE READING

Supreme Court limits access to insured defence costs … CONTINUE READING

Social media in employment … CONTINUE READING

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Key Considerations for Employee Share Schemes

Important to ensure you tick all the boxes for your employees

Employee share schemes can be a great way to attract, retain and incentivise staff. They haven't been widely used in New Zealand, with a big part of the problem being that the rules you need to comply with to offer one make doing so impractical and, in a lot of cases, also undesirable. In April, those rules got completely overhauled. This article looks at some key points that both employers and employees should look out for when a share scheme is offered.

From the employer viewpoint

Under the new Securities Act 1978 exemption, before any of your employees participate in your share scheme you must give them a document that describes the plan, and its terms and conditions and contains a prescribed warning statement. They must also be given a copy of the latest annual report and financial statements (or a statement to the effect that these can be obtained from the company).

First things first though. The fundamental question you've got to ask yourself is why are you looking at offering an employee share scheme in the first place? Does it make sense for *your* company? How will the scheme complement the company's business and growth strategies? How will it impact on governance and management? What are you hoping to get out of it? That will dictate the entire structure of the scheme and guide you through the key issues, including the following:

1. You need to think about the type of plan you're going to offer, and who it will be available to. There are various possible structures, each with its own legal, accounting and tax implications.
2. How much of the company will be allocated to the scheme? Unless the scheme is intended to create a one-off benefit, you need to budget to cover all different types of events.
3. Another key issue is the vesting rules, that is, the milestones that need to be reached before any of your employees can benefit under the scheme. And, what should happen to your employee's vested and unvested entitlements if they resign or are terminated, or get sick or die?

From the employee viewpoint

If you're reading this as an employee there's plenty to think about for you too. It's essential that you understand the benefits and risks of the scheme before committing to it, especially if your participation is going to be in lieu of part of a cash salary, which is often the case.

You'll need to understand the type of scheme and its tax implications for you. Know how much you're getting, what the existing capital structure of the company is, and how and when your interest will be diluted over time. Does the vesting schedule match how long you expect to be with the company? Are there any circumstances under which you can lose your entitlement? You might not be in a position to change much or *any* of this, but you should at least understand it before getting involved. And it doesn't end there either. The value of your entitlement changes over time with the fortunes of the company and as additional capital is raised. It's important to try and stay on top of what's happening in order to be able to assess the value of your entitlement at any time.

For employers, having an employee share scheme can be a very good way to attract, incentivise and reward your staff. For employees, joining a share scheme can be a good way to be rewarded for your hard work. Before signing on the dotted line, however, we'd recommend that you make sure you get some independent legal advice. ■

Director's Drawings

Be careful as there are some pitfalls

If you are a company director it's tempting, particularly in a closely held company, to withdraw funds for expenses and to pay yourself as and when you decide that you need money – without recording the reasons for your decisions. In many situations you may think that you are doing what's best for the company, but you need to be aware that you are running the risk of being personally liable for the funds withdrawn.

Money withdrawn from the company by you as the owner or shareholder that's to be used for anything other than for the business is called 'drawings'. These drawings can generally be categorised as salary or dividend payments or advances under your shareholder current account.

What are the pitfalls of this practice?

You need to be aware that in a liquidation your wages or salary may not be treated in the same way as would another employee's wages. If you pay yourself more than a market salary or take more drawings than the actual business profit, you could be liable to repay the difference. A liquidator is required to realise the assets of the company and anything owed by you as a director is immediately payable. Any payments in excess of a reasonable and properly authorised salary are likely to be classified as advances under your shareholder current account and will be payable to the liquidator.

Be familiar with your company's constitution

If you pay yourself a salary without passing the relevant resolutions and certificates[1] you may be in breach of the company's constitution; ignorance is no excuse. Your company's constitution could be more stringent than the minimum requirements set out in the Companies Act 1993, so it pays to check.

Protection

To safeguard yourself, you should consider waiting until your company's annual accounts have been prepared before setting your salary. This allows you to record in your director's resolutions that you have assessed the company's financial status and can set a salary for the coming year that's in line with both market rates for your position and the company profits. You could then instruct your lawyer to prepare the necessary company resolutions for you to sign.[2] If the payment is to a director, the Companies Act requires you as director to sign a certificate stating that in your opinion the payment is fair to the company and the grounds for that opinion. If you don't bother, you risk becoming personally liable to repay the money that you receive to a liquidator.

The risk is even higher if you take drawings over your pre-approved salary for the year. In that instance you should reassess the company's financial standing and pass resolutions that encapsulate the special circumstances for authorising a salary increase. That way you can avoid the trap of payments above your pre-approved salary being classified as shareholder advances or as unauthorised payments.

If the company's profitability is marginal you should consult your company lawyer and accountant before going ahead with any payments to yourself.

Ambiguity – drawings or expenses?

At times company expenses may be difficult to distinguish from drawings. You should document every purchase and expense very carefully. For example, entertainment expenses may be reclassified as drawings if you have not recorded the expense properly. Ambiguity is not helpful in a liquidation setting. It can be surprisingly difficult to prove that items or costs relate to the company if you have not bothered to keep clear records. If there's any doubt a liquidator will take the view that costs are personal.

Conclusion

It's important to ensure that your shareholder current account is not overdrawn and that all salary or dividend payments have been properly authorised. Ensure at all times that you keep good records of not only transactions but also the reasons behind them. ■

1 Director's Resolutions, Shareholder's Resolutions, Director's Certificates authorising these according to the Companies Act 1993 ss107 and 161, and any further requirements of the Company's Constitution.

2 To save expense, your lawyer could prepare a precedent set of resolutions that you can easily use over and over again for other transactions.

Business Briefs

Business sales and earnouts: Five cautionary tips for sellers

So you've been negotiating the sale of your business and while you're confident that it's going to continue to grow as you're projecting, the buyer just isn't sure and you're too far apart on price to reach agreement. To break the impasse, the buyer suggests an earnout where part of the purchase price is hinged on the future performance of the business and is payable if certain financial or operational targets are met.

As a seller, under an earnout you're effectively trading the certainty of less money up front for the chance of more money over time. Before you agree to an earnout there are five critical things you need to do:

» Get the highest possible cash price up-front.

» Figure out the buyer's motivations for buying the business and what they're likely to do with it post-settlement.

» Use an objective measure, such as sales, as the target rather than something like net profit. The latter is more subject to manipulation.

» Think carefully about the key determinants of whether the target will be met and what could push the business in an unintended direction, and what you can do to influence those things.

» Get experienced accounting, tax and legal input.

Supreme Court limits access to insured defence costs

Directors of two collapsed finance companies, Bridgecorp and Feltex, have looked to their directors' and officers' insurance policy for their defence costs in responding to claims by investors and receivers, and to cover any ultimate compensation that may fall due.

Section 9 of the Law Reform Act 1936 allows a third party to claim a charge over insurance money that might become payable to an insured for losses which the third party has suffered because of the insured's actions. This would thereby ensure that insurance money intended to compensate for the loss should find its way to the suffering party.

Under the Bridgecorp/Feltex policy the directors' cover for liability to pay compensation and cover for defence costs were amalgamated into one single sum. The Supreme Court[3] has now found that the investors' s9 charge does indeed secure the full insurance sum, including the funds that could have been paid to the directors in defence costs.

The decision has significant impact on how insurance policies should be drafted in the future. In particular, cover for compensation and defence costs should now be clearly separated rather than amalgamated into a single sum.

Social media in employment

Social media is the new business lunch, promotional pamphlet, business card, word of mouth – the new 'normal'. But, who owns the Twitter followers, Facebook friends and LinkedIn connections developed by your employee when carrying out their duties for your business?

Cases overseas are beginning to emerge that deal with this issue. Without a clear determination on this issue in New Zealand, however, employers will be better placed by having a clear social media policy detailing their position with respect to these matters and/or agreeing such matters with your employees at the beginning of the employment relationship. The policy or agreement should include not only the general use of social media, but also the management and ownership of connections created and maintained via social media during your employee's employment.

Some suggested ways of managing this issue include agreeing with your employee that:

» They provide a list of their connections before they depart so you can then make necessary contact with those connections

» They delete from their account all connections made during their employment in relation to the business, or

» You are entitled to control the account for a particular period following their departure. ■

3 *BFSL 2007 Ltd v Steigrad* [2013] NZSC 156

« BACK