

The Pitfalls of "Code Company" Status and the Value of Nominee Shareholding Structures

The Takeovers Code and "Code Company" Status

The Takeovers Code (**Code**) imposes restrictions on the trading of shares in companies that are subject to it, being companies with 50 or more shareholders¹ or listed companies whose shares are quoted on the NZX or NZAX markets (**Code Companies**).

The Code is based on the principle that in widely-held, substantial companies, all shareholders should have the right to participate equally in a takeover offer (and, in particular, larger shareholders should not be offered better terms than other shareholders).

Accordingly, the "fundamental rule" in the Code is that, subject to certain exceptions:

- a person who holds less than 20% of the voting rights in a Code Company may not acquire an increased percentage of the voting rights in that company, unless after the acquisition the person (together with any of its associates) holds less than 20% of the voting rights; and
- a person who holds 20% or more of the voting rights in a Code Company may not become the holder of an increased percentage of the voting rights in the company unless it makes a takeover offer for the remaining voting rights in the company.

The main effect of this rule is that shares in Code Companies are more difficult to trade. This is of concern for both existing shareholders and potential new investors alike, since it makes exiting Code Companies by way of share sale more difficult for an individual shareholder (if they hold a shareholding of 20% or more), and can deter potential new investors or purchasers wishing to acquire a shareholding of 20% or more. Although there are exceptions to this fundamental rule, these impose a level of procedural complexity and can be onerous to comply with.

Why should I set up a nominee shareholding structure?

Unlisted companies can avoid falling within the Code and becoming Code Companies by ensuring that their shares are held by fewer than 50 persons. The simplest way of doing this is for a company's shares to be held on trust for a number of shareholders by a nominee, resulting in fewer persons being named on the company's share register.

¹ It has been proposed under the Regulatory Reform Bill (which is not likely to be passed into law until 2013) that the definition of Code Company be amended to provide that the threshold for Code Company status is 50 or more share parcels **and** 50 or more shareholders. This change would remove many unlisted companies from the ambit of the Code (as many companies have share parcels held jointly by several shareholders, for example where shares are held by trustees of trusts).

Nominee Shareholding Structures

Nominee shareholding structures need not be complex and are generally quick to set up. They should be considered by any company with a large number of shareholders, particularly if the company intends to raise capital by issuing shares to persons who are not currently shareholders (thus increasing the number of shareholders and the likelihood that the company will become a Code Company).

What is a nominee shareholding structure?

A nominee shareholding structure is an arrangement where an individual or company (**Nominee**) holds the shares of other persons (**Beneficial Owners**) on trust. This means that the Nominee has legal title to the shares (and is therefore named on the company's share register as the holder of those shares) but the Beneficial Owners retain beneficial title to the shares, meaning that the Beneficial Owners are entitled to all the rights attaching to the shares (such as voting rights and payment of dividends). Beneficial Owners generally remain liable to pay the issue price of the shares and to perform any other obligations in relation to the shares.

Who should act as Nominee?

A Nominee can be a company or an individual, but it is usually sensible to use a company specifically incorporated to act as Nominee because, unlike an individual, a company exists indefinitely (until liquidated or otherwise removed from the register of companies).

The directors and shareholders of a corporate Nominee could be people involved with the company in which the Beneficial Owners hold shares, some of the current shareholders or independent third parties.

How do I set up a nominee structure?

Setting up a nominee structure is straightforward. Generally, it involves the individual or company who is to act as Nominee and each Beneficial Owner entering into a formal document which provides that:

- the Nominee will hold the shares as trustee for the Beneficial Owner (if the Nominee is not currently the legal owner of the shares, the Beneficial Owner will transfer legal title to their shares to the Nominee);
- the Nominee will act on the instructions of the Beneficial Owner in relation to the shares, will account to the Beneficial Owner for profits and benefits deriving from the shares, and will deliver to the Beneficial Owner notices, reports etc received by the Nominee as the legal owner of the shares; and
- the Beneficial Owner will indemnify the Nominee against costs incurred by the Nominee as a result of holding the shares (unless they result from unauthorised actions by the Nominee).

Either the Nominee or the Beneficial Owner can decide to terminate the arrangement at any time, in which case legal title to the relevant shares will be transferred back to the Beneficial Owner.

As noted above, the Nominee will exercise any voting rights attached to the shares it holds as the underlying Beneficial Owner directs. In practical terms, this means that the Nominee (or if the Nominee is a company, a director of that company) will sign written resolutions and attend and vote at shareholders' meetings on behalf of the Beneficial Owners the Nominee represents. Notice of each question in respect of which the Nominee will be entitled to exercise the votes of Beneficial Owners will be given to each Beneficial Owner. Each Beneficial Owner can then direct the Nominee to vote as the Beneficial Owner desires in respect of the shares the Nominee holds for that Beneficial Owner (or sign written resolutions on its behalf, as applicable).

Nominee Shareholding Structures

Common objections to a nominee structure

There is occasionally some resistance amongst shareholders in relation to the establishment of a nominee structure, arising from concerns that the shareholders will no longer have legal title to the shares and accordingly will not be directly entitled to exercise shareholder rights (such as the right to receive information and the right to attend and vote at shareholders' meetings).

These concerns can be mitigated by including provisions in the formal document between the relevant Beneficial Owner and the Nominee under which (for example) the Nominee must ensure that all information and reports it receives as a shareholder are passed on to the Beneficial Owner. As noted above, the Nominee will be required to seek (and act upon) the Beneficial Owner's instructions in relation to the exercise of any shareholder rights.

The relevant company and the Nominee can also agree as a practical matter that the Beneficial Owners may still attend and be heard at shareholders' meetings (at which the Nominee will vote the shares it holds for Beneficial Owners as the Beneficial Owners direct).

Conclusion

A nominee shareholding structure is a relatively simple way of remaining outside the ambit of the Takeovers Code, and for the reasons discussed above, should be considered where an unlisted company has a number of shareholders approaching 50 and is therefore at risk of becoming a Code Company.

Please feel free to contact us if you would like to discuss any of the issues we have touched on above, or if you would like us to assist with putting in place a nominee structure.



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