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Going out on your own

Company structure or sole trader for business?

You have decided to quit your job, and go out on your own to run your own business. Do you form a company or trade in your own name? We outline some of the pros and cons of these two options to help you make a decision.

Trading through a company

Brown Biscuits Limited: owner Jackie Brown

Brown Biscuits Ltd (BBL) is a separate legal entity. There are some significant advantages of trading through a limited liability company.

- **Limited liability**: The 'limited' in the name of BBL means that Jackie's obligations as a shareholder are limited to the amount of unpaid share capital. As a shareholder Jackie is not personally liable for BBL's obligations. In most commercial situations Jackie is protected from personal liability for claims against BBL, such as an employee's personal grievance claim and claims for breach of contract or negligence. If BBL fails, Jackie is not personally responsible for its debts. However, if Jackie is also a BBL director, there are some major exceptions to these rules, see page 2.

  To ensure that the situation is clear, Jackie should describe herself as 'director/Brown Biscuits Limited' on anything she signs for BBL. This makes it clear that it is BBL that is signing the document, and that Jackie is not agreeing to accept personal liability.
- **Separate entities**: BBL is a legal entity which is separate from Jackie Brown. It has its own IRD number and must pay all income tax, GST, ACC levies, wages and so on in relation to its business. BBL will continue to exist until it is wound up, even if Jackie and subsequent shareholders die or sell their shares.
- **Flexibility**: Trading as BBL gives Jackie the flexibility to have other investors (shareholders) in the business, either at the time BBL is established, or further down the track. Jackie and the shareholders can agree to own differing percentages of the shares in BBL. This means that Jackie can sell part or all of her interest in the business by selling some of her shareholding.

  Where there is more than one shareholder in BBL, it is wise to have a shareholders' agreement and a constitution. These will address matters such as restrictions on share sales to third parties, profit-sharing, dispute resolution and so on.

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Companies distribute their profits between shareholders as dividends, usually based on the shareholders' percentages of the total shares in the company.

Management and ownership are separate. Shareholders are not necessarily directors, for example, if they don't intend to be involved in running the business. Directors do not have to be shareholders. A director's remuneration (such as an annual fixed director's fee) does not need to be tied to the performance of the company.

- **Tax**: BBL may pay less tax than Jackie. The current company tax rate of 28% is lower than the current top personal tax rate. In a situation where profits are reinvested in BBL, rather than distributed to Jackie, it may be that less tax will be paid overall.

There are obligations and responsibilities on Jackie when trading as BBL, even though BBL is a 'limited liability' company Jackie is likely to be a director of BBL as well as a shareholder.

- **Complexity**: Jackie must comply with the Companies Act and other legislation such as the Minimum Wage Act, and health and safety legislation. If Jackie breaches her statutory obligations as director, there can be significant legal and tax consequences, and potential personal liability (see below).
- **Personal liability**: Jackie can be personally liable for BBL's obligations where she has not met her statutory duty as a director. One very important statutory duty is that Jackie must not allow BBL to trade while it is insolvent. If Jackie allows BBL to incur debts when it is unable to pay those debts, she may find herself personally liable for those debts.

  In the civil courts, Jackie can be personally liable for BBL's actions where she has been actively personally involved in the wrongdoing in question, such as fraud, or where she has personally assumed responsibility.

  Jackie can also be personally liable for BBL's debts where she has given a personal guarantee. Lenders, landlords, trade suppliers and other business entities will often require a personal guarantee from Jackie before they are willing to lend, rent, or extend credit to BBL. In addition to a personal guarantee, lenders may require security against Jackie's personal assets, for example, a mortgage registered against her home, before a loan and/or credit is approved.
- **Costs**: There are greater set-up costs involved in forming BBL than operating as a sole trader. Due to the legal obligations imposed on companies, there can be greater administrative, legal and accounting costs to run BBL after it has been established.
- **Tax**: The flat company tax rate of 28% could be a disadvantage if BBL is not making much profit initially, as that rate is higher than the current low-to-mid personal tax rates.

Doing business as a sole trader

Jackie Brown: trading as Brown Biscuits (BB)

Being in business as a sole trader/Brown Biscuits is more straightforward than operating as Brown Biscuits Limited.

Jackie's trading name is just a business name; there is no separate legal entity.

Some advantages of being a sole trader are:

- **Less paperwork and costs**: BB is one business entity and one taxpayer – BB *is* Jackie. Jackie does not have to get up to speed with the law and administrative detail that is necessary to run a company. That said, Jackie must still comply with the laws of being in business and employing staff.
- **Tax**: There is no separate IRD number; all Jackie's tax (personal and under her trading name of BB) will be paid under her personal name. Also, as we explain above, there may be less tax to pay on BB's profits as a sole trader rather than as a company.
- **Going solo**: As Jackie does not own the business with anyone else, there is less likelihood of friction and disputes in the running of the business.

There are some disadvantages of running the business of BB as a sole trader:

- **Unlimited liability**: Jackie's personal liability is unlimited. Her assets, including her home and other assets and bank accounts, are all vulnerable to claims arising from her business.
- **Sole responsibility**: Jackie doesn't share the responsibility with anyone else. There is no one with a stake in the business Jackie can rely on or share ideas with..

Partnership is another ownership option

Another option for shared business ownership, apart from a company, is to form a partnership. This may be with a formal partnership agreement (recommended) or by a verbal agreement with the people you are in business with. In a partnership, Jackie is personally liable (as will be the other partners) for all the partnership's obligations.

Changing your trading entity

Jackie could begin as a sole trader (BB) or in a partnership and, when the business grows, later form BBL. As BBL is a new legal entity, it must make new contracts with BB's clients, suppliers, employees and so on. BBL does not automatically take on BB's contracts and liabilities. Jackie or her other partners remain personally liable for any obligations incurred before BBL was formed.

Get advice before you start

Depending on your situation, there can be legal, financial and tax pros and cons for operating as a sole trader, establishing a company or forming a partnership. We have only scratched the surface in this article; there is more general information at **www.business.govt.nz**

You will, however, need tailor-made advice that suits your personal circumstances. Talk with us and your accountant to work out which option best suits your business and personal needs; we are happy to help ✱

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How are enforceable penalties set out in contracts?

Contracts are commonplace in business and life. A well-drafted contract can provide certainty and clarity for businesses and others by creating legal obligations for each party to do what they say they will. But what if a party to a contract doesn't do what they promised they would? Are you allowed to penalise that party for not fulfilling their obligations under the contract? We will explore the enforceability of so-called 'penalty clauses' in light of a recent decision in the Court of Appeal.[1]

What is a penalty clause?

It is common for businesses to try to reduce their risk of suffering a loss under a contract. One way businesses try to minimise their risk is by including a clause in the contract that requires money to be paid to them to compensate for loss if the other party doesn't do what they promise.

In the past, such a clause has been considered a 'penalty' clause if the amount claimed is far more than the loss that is likely to be suffered from a breach of the contract. A disproportionately large amount could be seen as a punishment for breaching the contract, rather than a deterrent.

For example, you might enter into a contract to supply 400 apples to a food truck owner by 31 October so she can sell them as candy apples at a festival. The contract includes a clause that requires you to pay the owner $20 for every apple that you do not supply. The food truck owner intends to only make $1 of profit per apple sold. The $20 per apple is far more than the foreseeable loss of $1 per apple and is likely to be considered a penalty.

In the past, the courts have only been willing to enforce such clauses if the amount claimed was a *reasonable* (our italics) estimate to compensate for any foreseeable loss when the contract was signed. If the amount claimed was far more than the foreseeable loss, then the court would view this as a punishment for breaching the contract and would not enforce it.

The Honey Bees Preschool case

The late 2019 Court of Appeal decision in *127 Hobson Street Ltd v Honey Bees Preschool Ltd* clarified the law relating to penalty clauses. The case involved the lease of the fifth floor of a central Auckland commercial building to a childcare provider, Honey Bees Preschool Ltd. The building only had one lift that serviced the whole building.

Part of the agreement between the preschool and the landlord required the landlord to install a second lift in the existing empty lift shaft. The agreement also stated that, if the lift was not installed by a certain date, the landlord would cover the remaining rent and outgoings for three years and five months, until the initial lease term ended. The lift was not installed by the due date so Honey Bees issued court proceedings.

In the Honey Bees case the court created a new approach by looking at whether there was a legitimate business interest, and whether the amount claimed was out of proportion to the protection of that legitimate business interest.

Legitimate business interest confirmed

The court stated that monetary loss was not necessarily the only legitimate business interest that could be protected – there may have been other business risks. In the Honey Bees case the preschool needed the second lift to obtain a consent to increase the number of children enrolled, otherwise their business was not viable. This was considered a legitimate business interest.

In our candy apples example, the food truck owner may not be allowed back to any future festivals if she does not have 400 apples. The court may consider this to be a legitimate business interest that may justify a greater amount of compensation than just $1 per apple.

This Court of Appeal ruling provides businesses and others with greater freedom to enter into contracts that require a larger amount of compensation for a breach than might previously have been enforced by the courts. The compensation amount under the contract, however, still needs to be proportionate to the legitimate business interest. In our candy apple example above, $20 per apple would still likely be disproportionate and not enforceable.

The Honey Bees decision has been appealed to the Supreme Court; we will report on its outcome.

If you are considering including a penalty clause in your contracts, or would like to know whether any penalty clauses in existing contracts are enforceable, do talk with us ✱

1 *127 Hobson Street Ltd v Honey Bees Preschool Ltd* [2019] NZCA 122.

Solving relationship property issues by mediation

A cost-effective alternative to court

After separating, you could find yourself at loggerheads with your former partner or spouse on exactly how all property should be divided between you. Negotiations may be bouncing between your lawyers, with no common ground achieved. Without agreement, you could file court proceedings but learn costs would increase dramatically. As well, it could be years before a judge can give a decision on how your property will be divided.

Mediation, on the other hand, could be arranged within weeks. It offers a practical alternative to reach a conclusion on how property should be divided between you and your former partner.

What is mediation?

The mediation process requires the appointment of an impartial and independent person (the mediator) whose role is to help the parties find a solution which is satisfactory to both.

The mediator does not decide an outcome. Only you and your former partner can make the final decision, but the mediator will help guide both of you towards making those decisions and resolving matters completely.

Where to start

The first step is to find a mediator. You and your former partner must appoint the mediator jointly. Your lawyers will be able to help you to get an experienced family law mediator.

You will both sign an Agreement to Mediate. This agreement will cover all the ground rules of the mediation process, your commitment to participate in good faith, costs, who is paying what and, most importantly, an agreement that the mediation is 'without prejudice'.

The concept of 'without prejudice' is key to mediation. It means that neither of you can use what you discuss at mediation against the other. It is *vital* that you and your former partner are free to fully and frankly engage and make proposals without fear of them being used against you later.

Before mediation starts, the mediator may sometimes hold a brief tele-conference with your lawyers to identify what legal issues need to be dealt with and how the mediation will run.

The mediation

What happens during a mediation will depend on several factors: the nature of the issues, your personalities and your willingness to engage. No two mediations will be the same.

Confidentiality: Similar to 'without prejudice', confidentiality is key. Everything discussed in the mediation is confidential.

You can expect breaks. Throughout the mediation you will be given the opportunity to take a break and privately discuss the issues with your lawyer.

Be prepared to listen. You might be surprised to learn something you consider minor is a major issue for your former partner. A "thank you", "I'm sorry" or "I am grateful for..." could save you thousands in legal fees.

Be prepared to engage. Remember the 'without prejudice' concept. Holding back will mean you won't have the opportunity to address what is important to you. If you want to discuss topics such as school fees, the family pet or the home being retained for the children – do so.

Think outside the box. Agreements reached in mediation are created by the parties. This means you can create solutions which may be unavailable should your dispute be taken to court.

Do I need a lawyer?

Yes, you do. For an agreement dividing relationship property to be binding, you will each need to receive independent legal advice on the effect and implications of the agreement.

The goal of mediation is to reach agreement. If the mediation is successful, you can expect to sign an agreement before leaving the mediation.

How long, how much?

The timing of mediation will vary from case to case. Some may take half a day, others two days.

There is no hard and fast rule about cost and you can expect prices to vary throughout the country. Your mediation team will be able to give you an estimate of the mediation cost. It's good to remember the costs will be shared between the two of you.

Is mediation for me?

Mediation is a tool not often considered for settling relationship property disputes. However, the reduction in costs, time and the ability to take control of the decisions that affect you means that mediation may be more appropriate than the expensive and lengthy alternatives.

If you think that mediation is appropriate for your situation, we are very happy to talk with you about this ✱

Family protection and wills

The wise and just will-maker

I need to make a will but I do not want to leave my estate to my son as I never see him. I also do not want to leave my estate to my stepchildren. What can be done?

In some parts of the world, a will-maker can leave their assets to whomever they want, whether that be their children, a distant relative or to the local cats' home. In New Zealand, however, this is currently not the case.

The Family Protection Act 1955 (FPA) states that, as a will-maker, you have a 'moral duty' to provide for the 'proper maintenance' of your family. If you leave a family member out of your will, and they feel you have not adequately provided for them, they can try and claim against your estate.

Typically, claimants are spouses or partners, children, and sometimes grandchildren. In some circumstances, stepchildren or parents who relied on, or were financially maintained, by the will-maker in some way may make a claim.

Does 'fairly' mean 'equally'?

It is not difficult to imagine the problems caused when siblings are treated differently by their parents. Making sure that someone in your family has been provided for adequately and fairly does not mean they must be treated exactly the same as other beneficiaries – understandably a common misconception. A successful challenge can result in the claimant being awarded a remedy, the size and nature of which can vary quite substantially.

Blended families can throw more complications into the pot and can prove tricky to navigate. Having said that, family protection claims are often made, not for financial gain, but because the claimant feels hurt, or inadequately acknowledged, by the will-maker.

If you plan to exclude someone or treat them differently to someone else in your will, you should reflect on the possibility of your will being challenged, and the heartache and anguish (and significant legal costs) that can cause to those you leave behind.

Setting out the reasons for your decision to make an unequal gift can sometimes be enough to fend off misunderstandings and, ultimately, claims against your estate. You can address the situation either in a separate document to your will or by talking with your beneficiaries before signing your will.

Challenging a will is a big step when family relationships are on the line. Arguments about loved ones' estates can, and sometimes do, rip even the happiest families apart, causing permanent rifts.

Forewarned is forearmed

There are ways you can help prevent future challenges against your will. When making your will we will talk with you about how you want to distribute your estate and the reasons for it. If you are considering an unequal distribution, you could gift some property before you die or transfer property into trusts. Get your will sorted while you can.

In summary, it is important you know that you do not have absolute control of your assets even after your death. Your will could be challenged so make sure you have given serious thought to what you want your will to achieve and take advice on how you can do that successfully.

Changes ahead for succession law

The government has acknowledged the difficulties of the FPA, section 8 of the Property (Relationships) Act 1976 and other statutes that govern who inherits a person's property when they die. In December 2019, the Law Commission was asked to review this country's succession law which is expected to take about two years. *

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Postscript

Government response to recommendations for changes to relationship property laws

In the Summer 2019 edition of *Fineprint*, our Postscript item noted the Law Commission's key recommendations for changes to the Property (Relationships) Act 1976 (PRA).

Soon after we published *Fineprint*, in late November the government responded to the Commission's recommendations. It acknowledged the PRA was not 'fit for purpose' for 21st century New Zealand; and it agreed with the Law Commission that the country's succession laws, where a relationship ends in separation or death, need closer examination.

The government will consider the Commission's remaining recommendations after the succession law review – for a hard copy go to www.lawcom.govt.nz and search for 'review of succession law'. The review is expected to take two years. ✱

New Privacy Act to come into force on 1 November 2020

The new Privacy Act is on its way through the House; it is expected the legislation will be passed to bring the act into force on 1 November 2020. This legislation will bring significant new obligations for most organisations that will take into account the rising tide of interest in privacy rights and protection in this country and overseas.

We plan to have an article on the new legislation in the Winter edition of *Fineprint*. In the meantime, do look out for Privacy Week that runs from 11–15 May. There's more information at www.privacy.org.nz and search 'Privacy Week'. ✱

Calling time on cheques to pay tax and ACC

If you use cheques to pay your tax and/or ACC levies, time has been called by Inland Revenue and ACC. With the decline in cheque usage (down to around 5% pa), since 1 March 2020 the IRD and ACC no longer accept cheque payments.

Cash or eftpos are still payment options, but only at Westpac branches.

If you're keen to embrace online payment methods, you can pay through internet banking or direct debit, or pay by debit or credit card online through myIR or MyACC for business ✱

Being environmentally sustainable in business

We're all keen to reduce waste and make our environment more sustainable. It's not only about reduce, reuse and recycle; there is heaps more that businesses can do to help reduce our collective carbon footprints.

Business New Zealand has some excellent content for any business to be more environmentally sustainable. It includes tips on transport and travel, water waste, energy use and power, and sustainable suppliers. There's more information on www.business.govt.nz ✱

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